

**Securities Regulation
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I. INTRODUCTION

A. Main Concerns of securities regulation

1. To regulate how companies raise capital
2. To maintain honest and fair trading markets not stifled by too much regulation.
 - a. Too much de-regulation = fraud
 - b. Too much regulation = not enough risk so companies do not get enough money

B. Statutes

Security Act of 1933	Security Exchange Act of 1934
The main point is to regulate the distribution of new securities - Deals with (1) investment banking (2) IPOs	The main point is to regulate the trading of securities already issued - Establishes the SEC's oversight powers

1. Issues in the **1933 Act**
 - a. What are private companies allowed to disclose?
 - b. How are companies allowed to raise capital?
 - c. How do you file a registration statement?
 - d. What are the exemptions from registration?
 - e. The liability provisions.
2. Issues in the **1934 Exchange Act**
 - a. What are the reporting requirements?
 - b. Section 10b-5 (fraud and insider trading)
 - c. Market manipulation
 - d. Proxy solicitations
 - e. Responsibilities of securities attorneys.

C. Historical Background

1. Before 1933, the regulation of issuance and trading of securities was weak. The only federal regulation was of securities issued by railroads. States had regulations but the regulators had little funding and there was no uniform regulation between the states.
2. From 1920-1928 stock values increased 100%. From 3/28 to 9/29 stock values increased another 100%. In 1929 the stock market crashed. From 9/1/29 to 7/1/32 stock prices fell 83% and by 1933 half of all newly issued stocks were worthless. In 1932 unemployment was at 25%.
3. Congressional hearings found many problems, such as:
 - a. Market manipulation,
 - b. Borrowing on the margin,

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- c. Companies failing to disclose financial information,
 - d. Lot of discussion about sales of corporate bond issues by foreign governments.
4. Congress believed that dishonest dealings in securities was one of the main causes of stock market crash and depression. As a result, Congress enacted the 1933 Act and 1934 Exchange Act.
 5. More recently, Congress enacted the Sarbanes Oxley Act in response large scale accounting fraud scandals such as the Enron scandal.
 6. Some of the changes in Sarbanes Oxley were good, some of hurt the economy, and some are incomprehensible. Sarbanes Oxley:
 - a. Requires CEOs & CFOs to certify that the information in the company reports is accurate;
 - b. Requires the Commission to create federal rules of conduct for securities lawyers;
 - c. Greatly increases criminal penalties for violations.

D. Background/Regulatory Framework

1. Securities are the instruments through which business enterprises and governmental entities raise a substantial part of the funds with which to finance new capital construction.
2. Securities have no intrinsic value in themselves; they represent rights in something else.
3. The market price for securities depends on how much other people are willing to pay for them based on an evaluation on the company's prospects.
4. Securities have several **distinctive features**:
 - a. Securities are created, rather than produced.
 - 1) They can be issued in unlimited amounts, virtually without cost because they are nothing in and of themselves. They only represent an interest in something else.
 - 2) The important focus in securities regulation is assuring that when securities are created and offered to the public, investors have an accurate idea of what that "something else" is and how much of an interest in it the particular security represents. It is basically making sure investors are fully informed on all relevant (material) matters.
 - b. Securities are not consumed or used by their purchasers.
 - 1) They are traded in so-called "secondary markets" at fluctuating prices.

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- 2) These secondary transactions far outweigh in number and volume the offerings of newly created securities.
 - 3) Another important focus of securities regulation is to assure that there is a continuous flow of information about the corporation or other entity, which is represented by securities being actively traded in the secondary market.
- c. Since the complexity of securities invite unscrupulous people to attempt to cheat or mislead investors and traders, securities laws contain provisions prohibiting a variety of fraudulent, manipulative, or deceptive practices, such as:
- 1) Trading on inside information;
 - 2) Misleading corporate publicity; and
 - 3) Improper dealings by corporate management.
- d. Since a large industry has grown up to buy and sell securities for investors and traders, securities regulation is concerned with regulating people and firms engaged in the industry to assure that they do not take advantage of their superior experience and access to overreach their nonprofessional customers.
5. **Different Securities Markets**
- a. **Bond market** → in dollar terms, this is the largest market trading in debt instruments issued by the US government, by state and local governments, and by corporations.
 - b. **Exchange Market** → This includes markets such as the Nasdaq and the NYSE. These markets tend to regulate themselves in different manners in addition to any regulations imposed by the SEC.
 - c. **Over-the-counter-market** → traditionally this is a completely unstructured market without any physical facility. Securities sold here are not sold on the exchange markets.
6. The securities industry includes thousands of firms engaged in one or more types of securities activities, ranging from large to one person firms.
7. Securities transactions are subject to regulation under state and federal law.
- a. Federal securities laws apply to all securities involving use of the mails or facilities of interstate comers (see below for the different relevant statutes).
 - b. States have laws, called blue sky laws, that specifically regulate transactions in securities. Their purpose as the prevention of speculative schemes have no more reach than a specific amount of feet into the blue sky. These laws regulate specific securities activity only within the state.

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E. Overviews of the Acts

1. Securities Act of 1933:

- a. §§ 3 & 4 →
 - 1) deals with exemptions for registration
 - 2) registration is NOT required for transactions by
 - a) a person **other than** an
 - i. issuer,
 - ii. underwriter,
 - iii. dealer,
 - b) stock that does NOT require an IPO.
- b. § 5 → provides that new issues of securities have to be registered with SEC by filing with the SEC a registration statement and a prospectus must be delivered to purchasers.
- c. §§ 6 & 8 → spells out the procedures for filing a registration statement.
- d. §§ 7 & 10 → contains the information required in a registration statement and prospectus.
- e. §§ 11 & 12 → contains private remedies rights of action for false registration statements and prospectuses.
- f. § 13 → says that the statute of limitations is two years after you discovered or should have discovered a misstatement. But, no matter what you only have 5 years to bring a case after the security is sold to the public.
- g. § 15 → controlling person is jointly and severally liable for people they control, when they violate § 11 or 12.
- h. § 17 → general anti-fraud. It prohibits fraud by any person who offers or sells securities.

2. Securities Exchange Act of 1934: (This act is much longer than the '33 act)

a. Registration

- 1) §§ 7 & 8 → margin requirements and borrowing and lending
- 2) § 15 → Registration of brokers and dealers.
 - a) Authorizes SEC to bring administrative action against any securities firm and against any person associated with a securities firm. It gives the SEC an authority to shut down a firm and bar a person from securities industry for life.

b. Regulating Disclosures

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- 1) § 12→ registration required before transactions on a national securities exchange
 - 2) § 13→ reporting requirements
 - 3) § 14→ disclosure requirements relating to proxies and tender offers
- c. **Regulating trade of securities**
- 1) § 10(b)→ (**Rule 10b-5**)
 - a) general anti-fraud provision
 - b) deals w/ buying or selling of ANY security
 - 2) § 14→ prohibits fraud with proxy solicitations and tender offers.
 - 3) § 16(b)→
 - a) deals with trading by corporate officers, directors, and shareholders who own ten percent or more of company stock. Corporate officers and directors are regulated because they have “material non-public” information
 - b) Corporate officers and directors cannot make a profit trading their own securities. If they do, they must pay the money back.
3. **Sarbanes-Oxley**
- a. Biggest change in securities laws since 1930s
 - b. Overrides much of state law
4. **Other Securities statutes**
- a. **Public Utility Holding Act**: to prevent abuse of power in the public utility market.
 - b. **Investment Company Act of 1940**: regulates companies that hold and manage large portfolios of securities for investors (mutual funds)
 - c. **Investment Advisors Act of 1947**: regulates people who give investment advice for \$

II. **STATUTORY DEFINITION OF SECURITY**

A. Background

1. § 5 states that unless a registration statement has been filed, it shall be unlawful for any person, directly or indirectly...to sell a security.
2. **Statutory definitions**
 - a. **NOTE**: courts have held the definition of a security is the SAME for both acts!!

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- b. § 2(a)(1) in the **1933 Act** defines a security as “any note, stock, treasury stock...investment contract...put, call...option, or privilege entered into on a national securities exchange relating to foreign currency...or any interest or instrument commonly known as a security....”
 - c. § 3(a)(10) in the 1934 Act contains the same definition as in the **1933 Act § 2(a)(1)**
 - ➔ key term is **INVESTMENT CONTRACT!!**
3. Basically, the **three main categories of securities** are: (1) note (2) stock (3) investment contract (80% of the cases involve investment contracts).

B. Investment Contracts - Definition

- 1. The term investment contract has basically become a catchall. An investment contract is a way to bring a person raising money for a business into the securities laws, and for people who invest money the securities laws are the best chance they have to recover your investment.
- 2. **SEC v. Joiner** – p. 18
 - a. **Facts:** Joyner Co. owns a large tract of land. They sent letters to people, offering to sell surrounding land. Joyner claimed that the company was going to drill for oil on their land and that if oil was found the purchasers would earn a lot of money. Joyner claimed that the land was in the heart of the most oil producing land in Texas, and that all the purchasers had to do was buy the land and they would get the benefits (*passive investment*). The SEC alleged securities fraud, claiming the oil interest was a security and an investment contract. Joyner claimed he was just selling land.
 - b. The Supreme Court held that the sale was the sale of an investment contract, not land. It is a sale of land plus drilling with an expectation that the land value will increase.
 - c. **Test:** The Court looked to the following in determining whether a security existed: 1) the terms of the offer, 2) the plan of distribution, **and** 3) the economic inducements that were held out to the prospective purchaser.
 - d. The Court stated that Joyner’s promise to drill and the oil made the land valuable (these were his efforts). Without the oil, the land was worthless. There was a possibility that the landowner and Joiner would lose out (common enterprise), so it is an investment contract.
- 3. **SEC v. Howey** – p. 19
 - a. **Howey** is still the leading case on the definition of an investment contract.
 - b. **Facts:** Howey was selling orange groves to the public. They also offered to do the cultivating of the citrus groves. Possible investors were offered a land

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sales contract, a service contract, and a warranty. Howey pushed the service arrangement but did not require investors to purchase one from them. Mails were used and there was no registration statement filed. Purchasers were sophisticated investors that did not reside in Florida. The investors lacked the knowledge and skill necessary to care for and cultivate the citrus trees, but they expected profits. The SEC alleged that the sale of the grove strips plus the service contract plus the warranty was a sale of an investment contract that needed to be registered.

- c. The Supreme Court articulated a more detailed test for an investment contract. It said that state law interpreted the term “investment contract” and that Congress must have known this and intended state law to control the definition of the term. The court defined an investment contract as a flexible principle and said that an investment contract means a contract, transaction, or scheme whereby a person **invests his money** in a **common enterprise** and is led to **expect profits solely from the efforts of the promoter** or third party.
- d. Investment contract **TEST: Whether the scheme involved (1) an investment of money (2) in a common enterprise (3) with the expectation of profits (4) to come solely from the efforts of others.**
- e. **NOTE:** “The Securities Act prohibits the offer as well as the sale of unregistered, nonexempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.”

<u>Howey Investment Contract Test</u>
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- | |
|--|
| <ul style="list-style-type: none">1) investment of money2) in a common enterprise3) w/ expectation of profits4) solely from the efforts of others |
|--|

- 4. A scheme/transaction must meet **each prong of the Howey test** to be considered an investment contract and therefore a security.
- 5. **“Investment of Money” element of an Investment Contract**
 - a. Does not have to be cash - can be any exchange for value such as services or property.
 - b. **International Board of Teamsters v. Daniel** – p. 27
 - 1) **Facts:** Daniel was a truckdriver who was laid off, went back to work and then left the company and was denied his pension. To get the pension, the contract required that he work 20 continuous years, which he had not done. Daniel had been told by the teamsters that the break in his employment would not affect his pension. This was a material misstatement to Daniel. The pension plan was compulsory and noncontributory. The amount people received in pension did not

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correspond directly to the number of years a person worked. Someone who worked 20 years received the same amount as someone who worked 40.

- 2) The Supreme Court held that this was not an investment contract, and therefore not a security, because there was no specific consideration given in exchange for the plan. SC held this is not an investment contract because the employee makes no payment to the plan, the employer does. Therefore, a **non-contributory, compulsory pension is NOT an investment of money.**
 - 3) The Court said that it would look at the economic realities of the transaction when deciding whether something was a security. Because the pension plan was an insignificant part of the entire employment contract it was not an “investment of money.” The employee chose to work at the company. He was selling his labor *to obtain a livelihood*, not to make an investment in the future.
 - 4) The “through the efforts of others” prong of the test is likewise not met because the pension depended on the length of Daniel’s employments, not on the management of the company. The majority of income generated by the plan came from the employer’s contributions and so did not depend on the efforts of the fund managers.
 - 5) The Supreme Court also said that ERISA provides enough protection to employees and that there is no need to include pension plans into the securities laws.
6. **“Common Enterprise” element of an Investment Contract**
- a. There are two ways to find a common enterprise: **Horizontal Commonality** and **Vertical Commonality**.
 - b. **Horizontal Commonality** is the pooling of assets from multiple investors in such a manner that all of the investors share in the profits and risks of the enterprise. It is an investment scheme where the investors themselves are dividing up the profits and losses.
 - 1) Every circuit says that this is enough to meet the common enterprise element. Three Circuits, however, say this is the only type that is acceptable.
 - 2) **Condo Example** → 20 Condo owners join a rental pool. They share in the total rental income for that year in those rental units. It does not matter what each investor knows, you look at economic reality of the transaction – what promoter is offering. Each owner’s shares equally in the profits of the rental pool.

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- c. **Vertical Commonality** is where an investor's profits or loss is linked to the managers/promoters. The amount of each investor's profit is independent from the other, but is directly linked to the fund manager/promoter. The loss/gain corresponds to the manager/promoter, and the manager/promoter gets a piece of the profits.
- 1) Strict vertical commonality: each investor's profit or loss is linked to the promoter's profit or loss.
 - 2) Broad vertical commonality: Your profit or loss is linked to the efforts of the managers or third parties. (This is wrong in the SEC's view because the link depends on the effort of the manager, which is covered by a different element of the Howey test).
 - 3) **NOTE**: Not all courts accept vertical commonality.
- d. **Brodt v. Bache** – p. 23
- 1) **Facts**: Bache solicited appellants to open commodities trading accounts. They sold their portfolios and invested in discretionary accounts (firm could trade on the accounts without getting the customer's prior approval) with Bache. Bache said they would reap profits. They lost money and the company was insolvent. Bache received a commission from trading on the individual accounts.
 - 2) SC held that there is NOT an investment contract because there is no common enterprise. There is no link between the investors (horizontal commonality) and no vertical commonality because the firm always makes money regardless of how the investment performs. The broker gets a commission whether the client gets a profit or a loss, Bache's success did not depend clients.
 - 3) **NOTE**: commodities futures are not securities but if a trade agreement is an investment contract the agreement will be brought under the securities laws.
7. **“Expectation of Profits” element of an Investment Contract**
- a. It is not enough that the profit motive is a significant factor; it must be the primary factor in the marketing of the investment.
 - b. **Real estate interests**: The sale of condos in a resort area or other development raises questions as to the expectation of profit, the commonality of enterprise, and the efforts of the promoter. In 1973 the SEC took the position that the offering of condo units in conjunction with any of the following arrangements would be an offering:
 - 1) **One**: the condo units are offered and sold with an emphasis on the economic benefits to the purchaser to be derived from the managerial

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efforts of the promoter or a third party designated or arranged for by the promoter from the rental of the units.

- 2) **Two:** The offering of participation in a rental pool arrangement, **or**
- 3) **Three:** the offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent, or is otherwise materially restricted in his occupancy of his unit.

8. **“From the effort of Others” element of an Investment Contract**

a. **SEC v. Glenn Turner Enterprises** – p. 36

- 1) **Facts:** Glenn Turner formed an organization called Dare to be Great, which ran seminars on how to get rich. People had to pay money to attend the seminars. People running seminar show up in expensive cars acting like they are rich. It was a **pyramid scheme**, in which you could recruit others and get a percentage of their membership fee. (Doomed to collapse and a big fraud because you have to keep recruiting more people in order to make a profit).
- 2) Turner argued that it is not an investment contract because the investor has to recruit to get money, therefore it is not “from the efforts of others.” Also, you are not a passive investor, they have to do something, so the investors are different from those in Howey.
- 3) The 9th Circuit held that the plans were securities. The court is not going to read “solely from the efforts of others” literally; instead it interpreted the term “solely” broadly. The 9th circuit looked to see whether the efforts of others are the essential managerial efforts that affect the failure/success of the enterprise. It finds that while the investor has to exert some effort, the significant decisions come from others. Thus, the last prong of the Howey test is satisfied.

b. **SEC v. Aqua-Sonic Products** – p. 41

- 1) **Facts:** Aqua-Sonic would sell licensees the right to sell Steri Products. Ultrasonic Corp. was responsible for all sales of Steri for the benefit of the licensee. Licensee could cancel the contract. Ultrasonic performed all significant marketing functions. The licensees were told that if they entered the agreement, they would derive substantial tax benefits. 50 licensees entered the agreements and had no experience selling Steri Products. The venture collapsed.
- 2) **NOTE:** Courts have said that usually a franchise arrangement is not going to be an investment contract because the investor’s profits will depend on how well the investor manages the venture, not on the efforts of others.

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- 3) As in the Glen Turner case, here the defendant argues for a strict interpretation of the term “solely.” The SEC, on the other hand, argued for a totality of the circumstances approach.
 - 4) The court rejected the defendant’s argument, stating that they believed the Supreme Court would likely look to the totality of the circumstances in interpreting the term “solely.” Specifically, “the court would consider whether, under all the circumstances, the scheme was being promoted primarily as an investment or as a means whereby participants could pool their own activities, their money and the promoter’s contribution in a meaningful way.” P. 43
 - 5) The court focused on how something was promoted. The economic substance/reality is that it is pitched to people as an investment that requires minimal to no work. **If you pitch something as an investment, then you come under the securities laws.**
- c. **SEC v. SG, Ltd.** – p. 49
- 1) **FACTS:** D had a “virtual stock market” game. D set the price of the stocks and people bought it. SG said one company was great and raised the price by 215% per year. D stopped people from pulling out their money, but kept letting others in. D said not investment contract, it’s just a game.
 - 2) If you are spending money to consume something (like a game) then it is not a security. The court held that this was a **Ponzi Scheme** (people invest money, and get “return” from the new investors the schemer recruits). **Ponzi** schemes fall under the efforts of others because the managerial/promotional efforts of the “managers” determining the failure or success of the enterprise.
 - 3) It is not a game because (1) there is no term, and (2) there is no chance/risk on which companies go up or down.
- d. **SEC v. Edwards** – p. 1 in supplement
- 1) **Facts:** Edwards sold payphones which the buyers would lease back to him. Edwards promised a return of 14% and convinces more than 10,000 people to invest over \$300,000. The company goes bankrupt shortly thereafter.
 - 2) Edwards argued that because the profit was guaranteed the purchase agreement was not an investment contract. It is instead a fixed return.
 - 3) The Supreme Court rejects Edward’s argument saying that there is no bright line rule. An investment contract is defined broadly and flexibly and Edward’s interpretation would create a loophole in the definition. The

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court says that the risk being shared by the investors is the risk that the endeavor will collapse. Thus, this is a case of an investment contract.

9. Real Estate Interests

- a. The main issue here is when can a real estate transaction be classified as a security.
- b. **Hocking v. Dubois** – p. 34
 - 1) **FACTS:** A guy sells a condo and the developer manages a rental pool for the condo. The Buyer sues saying that the sale of the condo with the rental pool agreement constitutes an investment contract.
 - 2) The 9th Circuit in a 6-5 decision held that this is potentially an offer of an investment contract because the court must look at the deal from the buyer's perspective.
- c. Not all real estate scams will fall under the securities laws. If an offer is for the sale of a security that does not exist then these offers will fall under the securities laws. Courts say that if a promoter offers a security that he claims exists, then that "security" will be covered by the securities laws.

C. Stocks and Notes

1. Stocks and notes are in the statutory definition of a security.
2. **United Housing Foundation v. Forman** – p. 66
 - a. **Facts:** Co-Op. People buying apartment receive shares of stock in a corporation which gives them a right to live there. If they want to move, they can only sell the shares for what they paid – they cannot make a profit.
 - b. SC held that it was not a security. They rejected the literal approach that anything called stock was automatically a security. Supreme Court said it would not interpret "stock" literally - just because it is in the form of a stock certificate, does not mean that it's a security. You have to focus on the economic reality.
 - c. This stock did not conform to the characteristics of stock.
 - 1) They were not investing for a profit, but to acquire a place to live.
 - 2) The stock did not confer the rights that normally accompany stock. It was not transferable, could not be pledged, no voting rights, and had to be offered back to the co-op at their initial selling price
 - d. The people buying the stock are buying it so they can live in the building, not to make an investment. There was no expectation of profit. So, the people are really just buying a place to live.

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3. **Note:** United Housing Foundation has been extended to situations in which coop shares are sold at a profit, and led to the development of the **business doctrine**. The business doctrine held that if all of the stocks in a business are sold, this is just an ownership transfer akin to selling all of the assets of a business. Thus, these transactions would not fall under the securities laws. The **Supreme Court** later **reject the business doctrine** (see below).
4. **Landreth Timber Co v. Landreth** – p. 67
 - a. **Facts:** Landreth owned 100% of stock in a sawmill, which was sold through a broker Dennis. Shortly before the sale the mill was damaged by fire, but Landreth made representations about rebuilding it and about other financial results. Dennis bought the stock and assigned it to Landreth Timber. Landreth was brought on to manage the business. Rebuilding cost more than anticipated and the operation did not live up to expectations; it was sold at a loss. P sued under Rule 10b-5 and various section of the 1933 Act. Landreth moved for summary judgment based on the allegation that under the business doctrine federal securities laws did not apply, since no security was involved. The district court granted the motion. P appealed.
 - b. The Supreme Court rejected the business doctrine argument. The court held that this stock, unlike United Housing Foundation, possessed all the characteristics identified in United Housing Foundation as traditionally associated with common stock.
 - c. The Court further held that the economic reality of the transaction will only be looked at when the instruments involved are “unusual...not easily characterized as investments.” The Howey economic reality test is thus only for investment contracts and is not appropriate for other securities.
 - d. The following are **characteristics of common stock**:
 - 1) The right to receive dividends contingent upon an apportionment of profits;
 - 2) Negotiability;
 - 3) The ability to be pledged or hypothecated (i.e., to be used as collateral);
 - 4) The conferring of voting rights in proportion to the number of shares owned; and
 - 5) The capacity to appreciate in value.
 - e. The dissent said that the stocks were not securities because they were not traded on a public market. Also the investor was in a position to negotiate appropriate contractual warranties and to insist on access to inside information before consummating the transaction.

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5. Background for **Reves v. Ernst & Young**
 - a. The statute says that any note is a security. A **note means a written promise to pay a definite sum of money in the future.**
 - b. Lower courts all held that “note” could not be read literally. Congress could not possibly have intended security laws to cover every single note. Before this case, lower courts used a couple of tests. Most of courts used something called the **commercial investment test**- if the note is a commercial instrument it is not security, if the note is an investment, then it is a security.
 - c. Lower courts looked at things such as whether there is collateral, how are the notes going to be used, are they short or long term, etc. But, the second circuit used the **family resemblance test** - invented by Judge Friendly.
 - 1) **Family resemblance test**: since the statute says any note is a security, you should presume that notes are securities, recognizing that some notes are obviously not issued for investment purposes. Those notes not issued for investment purposes and any that resemble these notes are not securities.
6. **Reves v. Ernst & Young** – p. 79
 - a. **Facts**: Farmer’s coop was an agricultural co-op with 23,000 members; it sold promissory demand notes at higher than bank rates of interest in order to capitalize its operations to both members and non-members through newsletter ads. Arthur Young audited the co-op. The notes were neither insured nor guaranteed, but were advertised as safe. The co-op declared bankruptcy with investors holding 10 million in notes. Reves files a suit against Arthur Young- accounting firm on the theory that they aided and abetted securities fraud (note: a recent supreme court case held that there is no private right of action for aiding and abetting).
 - b. The Supreme Court adopted the second circuit’s **family resemblance test** for determining when something is a security.
 - c. The **general rule is that a note is presumed to be a security.** This presumption, however, is rebuttable. The Court considered the following **four factors**:
 - 1) The motivations that would prompt a reasonable seller and buyer to enter into the transaction.
 - a) If the seller’s purpose is to raise money for the general use of a business enterprise or to finance substantial investments and if the buyer is interested primarily in the profit the note is expected to generate, then it is a security.
 - b) If a note is exchanged to facilitate the purchase and sale of an asset or consumer good, to correct the seller’s cash flow difficulties, or to

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advance some other commercial or consumer purpose, then the note is not a security.

- 2) The plan of distribution of the instrument is examined to determine whether it is an instrument in which there is common trading for speculation or investment.
 - 3) The reasonable expectations of the investing public.
 - a) If the seller promotes something as an investment then it's a big factor as to whether it will be treated as an investment.
 - 4) Whether some factor exists such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary.
- d. Applying these factors, the court held that the notes were in fact notes and therefore securities subject to the securities laws.
- e. The court also stated that the following types of notes **would not** be considered securities:
- 1) Notes delivered for consumer financing;
 - 2) The note secured by a mortgage on a home;
 - 3) The short term note secured by a lien on a small business;
 - 4) Note evidencing the character of a loan;
 - 5) Notes evidencing loans by commercial banks; and
 - 6) Notes that formalize an open-account debt incurred in the ordinary course of business.
- f. **NOTE:** The statute actually contains an exception for notes that are less than 9 months. All courts, however, have held that this clause should not be read literally. The Supreme Court ducks this issue. It says that **notes payable on demand** can be viewed as short or long-term notes. So, this exception does not apply to them and they must still be examined under the family resemblance test.

III. MATERIALITY

A. Applicable Statutes and Regulations

1. **Sections 11 and 12** of 1933 Act
2. **Rule 10b-5 and 14a-9** of the 1934 Exchange Act
3. **Regulation FD** = you can NOT selectively disclose material information (ie/ not tell some investors material information and not others)

B. Why is materiality important?

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1. Materiality is important under the liability provisions of the Acts and important to what must be disclosed in registration statements, etc.
2. The principal liability provisions of the 1933 Act (Sections 11 and 12) and of the 1934 Exchange Act (Rules 10b-5 and 14a-9) impose liability where there is either:
 - a. **One:** a misstatement of a material fact, **or**
 - b. **Two:** an omission of a material fact necessary to make the other statements not misleading.

C. What is material information?

1. **Materiality is a substantial likelihood that a reasonable investor would consider it important.**
2. **Something is also material if it significantly alters the total mix of information available to the investor.**
3. This is an **objective test** – It is **not** whether a particular investor considered the information important. It is whether a **reasonable investor** would consider it important. This is a very broad standard and there is a danger of information overload.

D. Qualitative Information

1. **In the matter of Franchard Corp.** – p. 204
 - a. **Facts:** Glickman formed a real estate limited partnership as the general partner, selling limited partnership interests to the public. Franchard Corporation was formed to hold all of Glickman's general partnership interests with Glickman as president and the controlling shareholder. D registered offerings with the SEC to raise more capital. In the course of the offerings, Glickman borrowed funds from D without authorization or disclosure; he also pledged his controlling stock in D for additional personal loans. It also became apparent that Glickman was in personal financial trouble. The registration statements did not include any of this information. The SEC brought an action for a stop order to suspend the effectiveness of three of D's registration statements under which securities of D were still being offered.
 - b. This case was brought before the SEC's administrative body. They held that these things reflected the business ability, integrity, and motivation of the management. The information was highly material to the evaluation of the competence and reliability of the registrant's management. They also revealed where the control of the corporation might end up. Furthermore, the information was particularly relevant where the securities are being sold to the public largely on the reputation of the president.

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- c. Basically, an insider of a corporation that is asking the public for funds must, in return, relinquish various areas of privacy with respect to his financial affairs, which impinge significantly upon the affairs of the company.
 2. **RULE 408** says that a company must disclose any information that is material. Thus, even if not specifically asked for on the registration form, if the information is material then it must be disclosed.
- E. **SEC v. JOS. Schlitz Brewing Co.** – p. 209
1. **Facts:** Schlitz Company was bribing US and Spanish corporations to carry their product. The SEC sued saying that this information was material and should have been included in the company's registration statement.
 2. The court finds this information material because the company action/information reflects the integrity of the business and the threat of losing their liquor license.
 3. While Schlitz argued that the bribes were just a small percentage of sales. The court, however, focused more on the impact rather than the size of the payments. The court discussed the difference between quantitative and qualitative information. It stated that both types of information could be material.
- F. **Virginia Bankshares v. Sandberg** – p. 220
1. This case discusses materiality in the context of proxy solicitations.
 2. **Facts:** First American Bank of VA ("FABI") and VBI (a wholly owned subsidiary of FABI) merged. VBI then owned 85% of Bank's shares. Minority shareholders owned the other 15%. FABI decided to send out a proxy solicitation for the minority shares describing a share price of \$42 per share as a high and fair price. The proxy solicitations were subject to the proxy rules. Sandberg voted against the proposal and felt that she was cheated and the statements describing the price were misleading. Sandberg sued the FABI under § 14(a) (specifically Rule 14a-9) for making materially misleading statements in a proxy solicitation.
 3. **Blue Chip Stocks** stands for the proposition that a Plaintiff cannot bring a private cause of action under the securities laws unless she is a buyer or a seller of securities.
 4. The plaintiff's argument is that the company's directors said that the stock price was fair but they did not really believe that the statement was true.
 5. The court held that an opinion could be material. To avoid liability, you need to back up your opinion with facts. "Mere disbelief" is not enough for liability under 14(a) (misleading proxy statement) without a factual demonstration that the proxy statement was false or misleading.

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6. If a director is trying to mislead you but the price is actually fair, then that **is not** a material fact.
7. If a director is trying to mislead you and the price is not fair then that **is** a material fact; it is materially misleading.

G. Basic v. Levinson – p. 225

1. **Facts:** Combustion Engineering wants to acquire Basic and included the plan in their strategic plan. They had meetings with Basic to discuss the possibility of merger. Basic made three public statements denying that it was engaged in merger talks. Eventually, Basic took the offer. Basic shareholder sues, claiming that three public statements were misleading and a violation of 10(b) and that the denials depressed the stock price.
2. The Supreme Court stated that “Whether merger discussions are material depends on the facts.
 - a. To assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels, such as board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries;
 - b. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value.
3. The 6th circuit says you don’t have to say anything, but if you deny something is happening the denial is material.
4. This materiality test applies to any future event.

H. Wieglos v. Commonwealth Edison – p. 242

1. **Facts:** Edison wants to build a nuclear reactor. It offers stocks. The regulator initially denies the license, but then reverses the decision and approves the license. The plaintiff claims the company’s predictions as to the reactor’s cost were incorrect and misleading, and that the company should have disclosed the license application. The company, however, argued that its actions fell under the safe harbor of rule 175.
2. **Rule 175** says that if you make a prediction in a filing you cannot be liable for the prediction if you have a reasonable basis.
3. The court held that this information is not material because a reasonable investor does not need to know everything that could go wrong. The court also seemed to suggest that a company should not need to disclose information a reasonable investor should already know it.

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4. If the information is firm specific it must be disclosed. But, if the information is out in the market place then you do not need to disclose the information. Materiality depends not only on the magnitude of an effect but also on its probability.
 - I. The **bespeaks caution doctrine** is a common law doctrine to protect defendants. If you make a prediction but provide meaningful cautionary language, the prediction itself is not material.
 - J. **Kaufman v. Trumps Castle** – p. 255
 1. **Facts:** A Trump casino issues bonds to raise funds that pay 14% interest at a time when other bonds paid 9% interest. Trump issued a statement that said they believed that they could pay the bonds back from income generated from the casino. Trump defaults on the bonds and the plaintiffs sue.
 2. Trump argued that it gave predictions and provided plenty of detailed cautionary language. The court sided with Trump because Trump provided meaningful cautionary language. The court stated that a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to provide misinformation. To suffice, they must be substantive and tailored to the specific future projections, estimates, or opinions in the prospectus that the plaintiffs challenge.
 - K. **Eisenstadt Case**
 1. **Facts:** Intel made a public announcement that they were hiring investment bankers to sell the company. The stock goes up. The company enters into private negotiations for the sale. Several companies say they want to buy Intel for much less. Intel said that the auction was going smoothly. Several investors purchased stock on this statement. Intel sold for much less. The people who bought the stock sued.
 2. The court holds that the statement was not material because it is common knowledge that people puff when they are trying to sell something. A statement said as sales puffing is not a material statement.
 3. The court also stated that the truth would have been misleading because people would have overreacted.
 - L. The **Puffing** and **Bespeaks Caution** doctrines are judge made doctrines meant to limit materiality.
- IV. **SECURITIES ACT OF 1933**
- A. Quick Outline
 1. Registration
 - a. The Process of Going Public § 5
 - b. Dissemination of Information during Registration

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- c. Specific Disclosure Requirements – Registration Statement
 - d. SEC Review
2. Exemptions From Registration
- a. Non-public Offerings
 - b. Reg A
 - c. Reg D
 - d. Secondary Transactions
3. Civil Liabilities
- a. Sect. 11 – standing; damages
 - b. Sect 11 – due diligence
 - c. Sects 12(a)(1) & 12(a)(2)
- B. Public Offerings of Securities- Registration**
1. Unless there is an exemption, all securities offerings must be registered.
2. **Introduction: Initial Public Offerings**
- a. An IPO is when a private company first sells stock to the public. All public offerings have to be registered unless there is an exemption. Even companies that are already public must still register under the 1933 Act.
 - b. The IPO market is cyclical and risky.
 - c. **Why would you want to go public?**
 - 1) The main reason is to raise capital more cheaply than borrowing from a bank.
 - 2) For personal profit.
 - 3) It is easier, better, and cheaper to acquire other companies if you have stock instead of cash.
 - 4) Incentives for employees
 - 5) For the ego factor. For many people going public is the symbol of success.
 - d. **What are the disadvantages of going public?**
 - 1) It is a huge initial expense to go public.
 - 2) You have to comply with ongoing disclosure obligations of the securities laws. There are annual and quarterly reports, 10ks, and 8ks. The penalties for violating these disclosures have greatly increased, as have the criminal prosecutions. This all leads to more costs.

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- a) **Note:** many companies are going private because the cost of compliance is too great.
 - 3) There are privacy concerns with going public. Things in your private life may now be material and have to be publicly disclosed.
 - 4) You are subject to market pressure to always be showing improving results. The market focus on the quarterly reports results in you potentially making decisions that are not in the best interest for attaining your long term goals.
- e. **Underwriting Process**
- 1) The two most common types are firm commitments and best efforts.
 - 2) A **Firm Commitment Underwriting** is the most common.
 - a) This is where a company sells an entire issuance of securities to investment bankers. They buy securities at a discount then sell securities to other bankers and the public. The company gets money no matter what. Investment bankers bear the risk if the stock does not sell. The main investment bank usually establishes a syndicate to spread the risk.
 - b) The company must then file a registration statement with the Commissioner. The issuer's counsel typically drafts this statement, but the investment bank's counsel will get involved as well.
 - 3) There is a conflict here between needing to disclose information and wanting to present the company in the best possible light. The underwriter wants to sell the stock quickly. If there is a misstatement the issuer is strictly liable. The underwriter can also be liable but has a due diligence defense.
 - a) The underwriter will want to take a more conservative approach to disclosure to limit their liability even if the stock price is depressed by a couple of dollars.
 - 4) The company must also spend money to get an independent public audit for the financial statements for the registration.
 - 5) After the registration statement is filed, then there is a comment process where the registration statement must be amended as per SEC request. While the registration statement is pending, the underwriter will send out a preliminary prospectus, pitch the deal, and hold roadshows. The SEC staff then declares that the registration statement is effective.
 - 6) Underwriter can get out of the deal once it is signed if there are exceptional circumstances. ("market out" clauses in agreement)

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- a) Some examples of exceptional circumstances are: national security, war, suspension of the market, and material adverse changes.
 - b) **Walken Medical Services**: decline in stock price is not an adverse market condition that will allow underwriter out of deal.
- 7) ISSUER → UNDERWRITER → DEALER → PUBLIC
- a) An **underwriter** is defined in § 2(a)(11), which says that any person who has purchased from an issuer with a view to, or offers or sells for an issuer.
 - b) A **Dealer** is defined in § 2(a)(12) as any person who engages as agent, broker or principal in the business of offering, buying, selling or otherwise trading or dealing in securities issued by another person.
- 8) **Best efforts**: companies that are not well established are not apt to find an underwriter that will give a firm commitment and assume the risk. So, they use firms that pledge their best efforts
- a) Investment bankers, however, have a conflict of interest. They have loyalties to both their high net worth clients and to their IPO clients. These two loyalties can conflict.
- 9) There are 5 basic underwriting techniques:
- a) **Strict or “old fashioned” underwriting**: a designated “issuing house” advertises the issue and receives applications and subscriptions on the issuers behalf after an announced date. This is seldom, if ever, used.
 - b) **Firm commitment underwriting**: This was mentioned above. The issuer typically sells the entire issue outright to a group of securities firms represented by one or several “managers” or “principal underwriters” or “representatives.” They in turn sometimes sell at a price differential to a “selling group” of dealers or sell at another differential to public.
 - c) **Best efforts underwriting**: companies that are not well established are not apt to find an underwriter that will give a firm commitment and assume the risk of distribution. Of necessity, therefore, they customarily distribute their securities through firms that merely undertake to use their best efforts.
 - d) **Competitive bidding**: requires competitive bidding in the sale of issues subject to a certain statute.
 - e) **Shelf registration**: SEC Rule 415.
3. There are other ways of going public. Google, for example, went public via a modified **Dutch auction**. The premise of a **Dutch auction** is that the stock price

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is set by people bidding on the shares. The bidder gives a number of shares they want at the price they want. You sell at the highest price that will allow the company to sell all of the shares. This lets the buyers set all of the prices and allows broader participation. Google, however, reserved the right to set the price themselves. They ended up setting the price at lower than the auction price.

4. Dissemination of Information During Registration

- a. **§ 5** is the key provision of the 1933 Act.
 - 1) **§ 5** provides rules concerning the making of offers to sell and the actual sale of securities through the facilities of interstate commerce. It divides the underwriting process into three time periods related to the sequence of events in the registration process. Then, it sets forth rules regulating offers and sales of securities during each of these periods.
 - 2) There are two thrusts of **§ 5**: to prevent or restrict any public statements about the securities being offered, except those contained in the registration statement and the statutory prospectus, and to assure that the information contained in the registration statement and the statutory prospectus is made available to the investing public.
- b. **§ 5** has three important time periods:
 - 1) The **Pre-Filing Period**, which is the period before a registration statement is filed with the commission. The period starts when the issuer considers offering a security to the public.
 - 2) **Waiting Period** – the time from when you file to when the SEC declares the filing to be effective.
 - 3) **Post-Effective Period** – Period of time after the filing becomes effective.
- c. **Pre-Filing Period**
 - 1) §§ **5(c)** and **5(a)** apply to this period.
 - 2) **§ 5(c)** → prohibits any offer unless a registration statement has been filed.
 - a) Key issue- what is an offer?
 - i. Offer: defined in **§ 2(a)(3)** as “every attempt to offer to dispose of, or solicitation of an offer to buy a security...for value.”
 - ii. Prospectus: **§ 2(a)(10)**: notice, advertisement, letter, communication which offers any security for sale, except that a) a communication after the effective date shall not be deemed a prospectus if it is proved that prior to the communication, a written prospectus was sent ...and b) a notice shall not be deemed to be a prospectus if it states from whom a written prospectus may be obtained and does not more than identify the security, state the price etc.

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- b) This is a very broad provision. You cannot make an offer until you file a registration statement!! The statute has very broad language. Any use of the phone, fax, or e-mail having anything to do with an offering falls under this language.
 - c) Middle of 5(c) – prohibits any offer to sell or offer to buy through the use or medium of any prospectus or otherwise unless a registration statement has been filed.
 - d) Last part –offers are prohibited if a preceding examination has been brought by the Commission pursuant to section (a) of the statute.
 - e) § 2(3) says that preliminary negotiations between an issuer and underwriter is not an offer.
- 3) § 5(a) says that you cannot sell a security until a registration statement becomes effective.
- a. Sale: defined in § 2(a)(3) shall include every contract of sale or disposition of a security or interest in a security for value.
- 4) The main issue here is gun jumping or making an offer when prohibited, before the registration statement is filed. When do you cross the line from just providing information about the company to soliciting offer to buy and violating 5(c)?
- a) **If information is conveyed to arouse the public's interest, then that is offer prohibited by 5(c).**
- 5) **Carl M. Loeb, Rhoades & Co. – p. 127**
- a) **Facts:** Arvida published a news release with the plans of holding a public offering to fund a new development. Response to the press release was positive. Two days later the company and underwriters received specific offers to buy. After the press release, the SEC initiated an action and claimed a violation of § 5(c). The company then filed a registration statement that included information about \$30 million in mortgages and the company had been operating at a loss.
 - b) Held: publicity prior to the filing of the registration statement via public media, is presumed to set in motion or be a part of the distribution process and therefore involves an offer to sell.
 - c) **Statements by means of publicity efforts which condition the public mind or arouse public interest in the particular securities during the pre-filing period even if not couched in terms of an express offer will constitute an offer for the purposes of § 5.**

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- d) Here, the company furnished price data, named the underwriter, etc., so it is a selling effort and a violation of **5(c)**. This is a prime example of gun jumping. If the press asks you a question you can answer but you can only provide factual data.

 - 6) **Rule 135** (p. 60) is a safe harbor provision for **§ 5**. It is an exception to the definition of an offer. An issuer can announce a public offering and have it not be an offer as long as the announcement is limited to the information contained in the rule (such as the company name, number of shares, type of security, or purpose of the offering).
 - a) A company cannot announce who the underwriter is because that in itself would generate interest.

 - b) A company also cannot disclose the stock's price.

 - 7) **§ 5** reaches anyone associated with the offer, not just to the issuer.
 - a) As a result, **rules 137, 138, and 139** are safe harbor rules that allow securities firms (broker dealers) to disseminate specific information during the registration process.

 - b) **Rule 165** is a safe harbor for business corporations.

 - 8) If you say that you will give away your stock for free, that is an offer. The value of the stock does not have to be cash, it can be something abstract like hoping that a market for the stock will develop. This shows a very broad view of what an offer is.

 - 9) **NOTE:** an established company is allowed to do the following in the pre-filing period:
 - a) Continue to advertise products and services
 - b) Send out customary periodic reports
 - c) Publish proxy statements
 - d) Announcements to the press about factual business and financial developments
 - e) Answer unsolicited telephone inquiries from SH, analysts, and press about factual info
 - f) "Open door" policy on answering unsolicited inquiries concerning factual matters
 - g) Hold scheduled shareholder meetings

 - 10) Basically **any statement that conditions the market is an offer.**
- d. **Waiting Period**
- 1) **§§ 5(a) and 5(b)(1)** apply to this period.

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- 2) **§ 5(b)(1)** says that it is unlawful to transmit any prospectus, relating to any security with respect to which a registration statement has been filed unless such prospectus meets the requirements of **§ 10**.
 - a) **Prospectus: § 2(10)**: notice, advertisement, letter, communication which offers any security for sale, except that a) a communication after the effective date shall not be deemed a prospectus if it is proved that prior to the communication, a written prospectus was sent ...and b) a notice shall not be deemed to be a prospectus if it states from whom a written prospectus may be obtained and does not more than identify the security, state the price etc.
 - b) **§ 5(b)(1) does not** prohibit oral offers because the definition of prospectus does not include oral offers. You cannot have a binding contract (**§ 5(a)** says that you cannot sell a security until the registration statement becomes effective) but you can give oral offers.
 - i. Limited oral communications over the internet (roadshows) to a narrowly defined group of people are ok.
 - ii. Also you can send emails even though they are written if the email looks like a phone call. If the email looks like a written offer then it is not ok.
 - iii. This section is also referred to as a prohibition against free writing. “free writing” = ads, brochures, etc...
- 3) **Rule 134** (p. 56) allows tombstone ads.
 - a) This says that a written communication is not a prospectus if it states where you can get a prospectus and only limited information.
 - b) This can include the company name, the underwriter (where they can get a prospectus), the # of shares, the share price, etc.
- 4) Offerees should receive a preliminary prospectus 48 hours before the effective date.
- 5) **§ 10 of the 1933 Act: Information Required in a Prospectus**
 - a) **§ 10(a)** says what should go into the prospectus; the information that is required.
 - b) **§ 10(b)** creates exceptions to Section 10. **10(b)** says that the Commission can make rules that permit a prospectus that omits in part, or summarizes information that otherwise would be required in Section 10.
 - c) Under this authority, Commission adopted **Rule 430**.

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- i. **Rule 430** allows an issuer to send out a preliminary prospectus during the waiting period (aka **Red Herring Prospectus**).
 - ii. The preliminary prospectus must contain substantially the same information as the final prospectus, but certain information can be omitted if it is not available yet such as the stock price.
- d) **NOTE:** A written interview that does not meet the requirements of § **10** is prohibited.
- 6) There is no statutory requirement that a company must send a prospective investor a preliminary prospectus or anything else. But, the SEC's view is that investors should view a Red Herring before the registration becomes effective. The Commission has an Exchange Act rule that basically requires the distribution of a Red Herring Prospectus.
- e. **Post-Effective Period**
- 1) §§ **5(b)(1)** and **5(b)(2)** apply to this period.
 - 2) § **5(b)(2)** says that a prospectus must accompany or precede a sale of a security. It shall be unlawful to carry or transmit any security for sale unless accompanied or preceded by a prospectus that meets requirements of § **10(a)**.
 - 3) § **2(a)(10)** says that a communication sent post-effective date is not a prospectus if prior to or concurrently a § **10(a)** prospectus was sent to the recipient of the communication. Thus, once you send a red herring you are allowed to send anything else as well post-effective date.
 - 4) **Rule 434** says that after a registration is effective if an offeree has already been sent a red herring, all you have to do is send supplemental information. If a preliminary prospectus was already sent, you can just send a term sheet with the price and whatever was omitted in the preliminary prospectus.
 - 5) "free writing": sending an advertisement/written materials IS allowed. But, you need to be sure they have a prospectus FIRST.
5. **When creating a Registration Statement ask 2 basic questions**
- a. What form do you use?
 - and**
 - b. What information is required to be included?
6. **What form do you use?**
- a. There are three types of forms:
 - 1) S-1

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- 2) S-2
 - 3) S-3
- b. The forms provide the eligibility requirements and state which company can use which form.
- c. **Form S-3** - p. 222
- 1) Most desirable for companies' perspective (takes less time) – allows for incorporation by reference, but it's the hardest to qualify for.
 - 2) Again, this form requires the least work, mandates the least disclosure, but there is a significant restriction on who can use it.
 - 3) This form covers:
 - a) An offering of senior securities, secondary offerings, certain special kinds of offerings, and
 - b) New offerings of equity securities if the market value of the issuers publicly held voting stock is at least 150 million.
 - 4) Two requirements: issuer requirements and transaction requirements.
 - a) **Issuer requirements**- have to be a US company. Have to have filed reports under exchange act for at least the past year.
 - b) **Transactions requirements** – if it's a cash offering and persons who are not affiliated with the issuer hold stock with the issuer worth at least 75 million dollars, then ok. Key is affiliate- any person that controls or is controlled by the company (Rule 405) - they want a company that's established and has a wide market following.
- d. **Form S-1** – p. 206
- 1) This form is for issuers who can't qualify for S3, S2, or anything else.
 - 2) This is the form all IPOs **must** file this form.
 - 3) There is no incorporation by reference
- e. Also forms **S(b), S(b)(1), and S(b)(2)** – cover small businesses with revenue of less than \$25 million dollars in a year.
- f. There are different forms for offerings by foreign issuers, forms **F1, F2, and F3**. There's one key difference. On F1, F2, and F3, relaxes rules for financial statements- that have to conform for US accounting standards. They have to conform with the accounting standards of the foreign country. This is always problematic issue. US standards are always viewed as the most strict.

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7. **What information is required to be included?**
- a. **§ 7(a) 1933 Act:** the registration statement shall contain information required by Schedule A.
 - 1) Describes what must be included in the registration statement, and points you to Schedule A.
 - 2) Section 7(a) of the statute also says that the commission may require that any information need not be included.
 - b. There are two parts to a registration statement
 - 1) **Part I:** contains the information *required* in the prospectus. Part I is the prospectus. It refers to **Regulation S-K** (p. 342).
 - a) **Regulation S-K** is the elaborate precisely spelled out mandatory disclosure requirements.
 - i. **Item 10** says that the regulation applies not only to registration statements, but to many other forms filed under the '34 Act
 - ii. **Item 10(b)** contains the Commission's policy on projections. It encourages projections on future economic performance, as long as the projections have a reasonable basis.* With materiality, rule 175. If there is a reasonable basis, the issuer cannot be subject to liability. The Commission used to prohibit any projection of future performance.
 - iii. **Item 103** says that the issuer must disclose **material** pending legal proceedings against it.
 - **Materiality is still an issue!**
 - iv. **Item 303** says that the registration form must contain an **MD&A (Management Discussion and Analysis)**. This must include known trends or known uncertainties that could affect future operations. It is supposed to give investors an opportunity to look at the company through the eyes of management by providing both a short and long term analysis of the company's business. The Commission gives a few examples of what should always be included- material changes in advertising, purchase, or sale of major assets.
 - **NOTE:** if this report is too optimistic or too pessimistic, management could be liable.
 - v. **Item 304** says that if the issuer fires their accountant and hires a new one to prepare the financial statements (accountant shopping), the issuer must disclose this. This is a HUGE red flag to a [potential] investor.

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- vi. **Item 503** contains the requirements for the prospectus summary and the risk factors. This section must describe the risk that relates to the issuer and to the security, but there is no need to disclose the risk as to any issuer. The risk section is usually pessimistic.
- b) **Rule 408** (p. 126) says that the registration statement must include any additional information or material statement that may be necessary to make the required disclosures not misleading.
 - i. There is no bright line test here.
- 2) **Part II**: contains the items not required in the prospectus but that are available for public inspection in the SEC files. This is mainly information such as the company's financial statements.
- 3) **Rule 421** (p. 137) says that the prospectus should be intelligible to people that are not professionals. In other words it must be written in plain English; no legalese allowed.
 - a) In other words, certain parts of the prospectus have to substantially comply with the following plain English principle: short sentences, active voice, and no legal jargon.
 - b) **NOTE**: the criticism to this rule is that oversimplification can be misleading in and of itself.
- 8. **Who has to sign the registration statement?**
 - a. **§ 6** states that the following individuals must sign the registration statement: the issuer, company officers, financial officer, accounting officer, and a majority of the company's board or directors.
 - 1) This is important because under **§ 11**, whoever signs the registration statement is liable.
- 9. **Process of SEC Review**
 - a. **§ 8** gives the SEC the authority to review the registration statement.
 - 1) **Subsection (a)** says that the registration statement becomes effective 20 days from filing it. Any time the statement is amended the 20-day wait period starts over.
 - 2) **Subsection (b)** says that prior to the effective date, the SEC can issue a **refusal order** if registration statement appears incomplete and inaccurate.
 - 3) **Subsection (d)** says that at any time, the SEC can issue a **stop order**.
 - 4) Section 8 gives SEC authority to shorten 20-day period amendment. This is done through **Rule 473**. Registration can become effective on such earlier date determined. The Commission can **accelerate** effectiveness.

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b. Rule 473

- 1) Includes language-delaying amendment. Don't have to file an amendment every 20 days to keep the process going. Solves problem about automatic effectiveness in 20 days. This process is called **acceleration** because the Commission can **accelerate** the registration statement's effectiveness.
 - a) **Acceleration** allows an issuer to add a delaying statement to the registration statement to keep the statement pending. In this way, the issuer and the staff can choose the registration statement's effective date.
- c. If a registration statement or prospectus filed with the SEC does not adequately comply with the requirements set forth in the 1933 act, the SEC can take the following action:
 - 1) The SEC can refuse to let a statement become effective by issuing a refusal order **§ 8(b)**; **or**
 - 2) The SEC can stop an effective registration by issuing a stop order **§ 8(d)**.
 - 3) **NOTE:** the SEC can also institute administrative proceedings or civil court actions. It can also refer criminal cases to the Justice Department.
- d. **NOTE:** Not all filings are reviewed by the SEC. Sarbanes Oxley says that the SEC staff must review a company's filings every three years.

10. Shelf Registration

- a. A corporation can register securities now to be issued in the future (up to 2 years) so that they can wait for more favorable market conditions.
- b. The main push for this type of registration came from companies that wanted to sell debt.
- c. **Rule 415** (p. 128) lists of who can use shelf registration. Any company that can use a **Form S-3** can use shelf registration.
- d. Must comply with **Rule 512(a)** of Reg S-K.
 - 1) You must file a post-effective amendment at the time you actually sell the securities in order to keep the statement up to date.
 - 2) If you filed a Form S-3, you may not need to do this because you would already have had to file the amendment under the S-3 rules.

C. Exemptions From Registration

1. Introduction

- a. Exempt transactions are found in **§ 4(2)**, **§ 3(b)**, and **§ 3(a)(11)**.

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- b. Exempt transactions are different from exempt securities. If a security is exempt it is always exempt from registration. If a transaction is exempt then only that transaction is exempt.
 - c. Exempt securities are listed in **§ 3(a)(2) - § 3(a)(8)**
 - d. The exemption is an exemption from the registration requirements in **§ 5**. You do not have to file a registration statement and you do not have to worry about gun jumping. However, the anti-fraud provisions of the '33 Act and the '34 Act still apply.
 - e. You must fit the entire transaction within one of the exemptions. You cannot split the transaction into different exemptions.
2. **Private Offering Exemption**
- a. This can be used by a private company or by an established public company. The party claiming an exemption has the burden of proof that the offering is private.
 - b. There are two ways to do a private offering:
 - 1) Comply with **§ 4(2)** and the cases that interpret **§ 4(2)**, or
 - 2) Comply with the safe harbor provisions in **Rule 506** of Regulation D.
 - a) This safe harbor provision is independent of the statute.
 - b) The point of this safe harbor is to create objective bright line rules.
 - c. **SEC v. Ralston Purina Co.** – p. 436
 - 1) **Facts:** Between 1947 and 1951, Ralston Purina sold nearly 2 million of its stock to employees from all levels of the company without registration and, in doing so, made use of the mails. In each of these years, a corporate resolution authorized the sale of common stock to employees who, without solicitation by the corporation, inquired as to the manner in which common stock could be purchased from D. Sales in each year were to approximately 400 employees. The company claimed that only key employees bought the stock and that the employees initiates the sale, so the transaction should fall under **§ 4(2)**.
 - 2) The court said that to determine whether an offering was public or private “it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction.”
 - 3) Application of **§ 4(2)** should turn on whether the class of persons affected are sophisticated investors and thus don't need protection of the Act or

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not. Basically, **an offering to those who are shown to be able to fend for themselves is a transaction “not involving any public offering.”**

- 4) **TEST:** Do the **offerees** need the protection of the securities laws?
 - 5) Court basically looks at (in interpreting § 4(2)):
 - a) **The availability of information,**
 - b) **Sophistication of the investors, and**
 - c) **Number of offerees**
 - 6) The court said that the focus should be on the need of the **offerees** for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with § 5.
- d. **NOTE:** The § 4(2) exemption applies only to issuers.
- e. **Rules after Ralston:**
- 1) Availability of information:
 - a) People need access to the same information that would have been disclosed in a registration statement. This means access to all of the information that is material to the investment decision.
 - b) Is there a relationship that affords the investors access to or disclosure of the information about the issuer that registration would reveal? For example, did the offerees have a close relationship to the issuer and its management such that they would have had access to any relevant and material information?
 - i. If the people involved seem to have equal bargaining power then the transaction is a private offering.
 - c) The issuer can also show that it actually distributed to its offerees the same type of material information as would be contained in a formal registration statement, and provided access to any additional information requested.
 - 2) Investor sophistication:
 - a) Do they have knowledge, experience, on financial matter to accurately assess the risks?
 - b) What is the wealth of the investor?
 - c) You can have **representatives** who are sophisticated when you are not

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- 3) Number of investors & size of investment:
 - a) No bright line rule
 - b) Fewer looks private, while more looks public
 - c) If the amount of money being raised is small and a direct offering, then probably private.
 - d) Technically, the rule applies to any size, but smaller offerings are more likely to be exempt.
 - 4) Absence of resales: resales of securities originally sold pursuant to the private placement exemption can destroy the exemption because the reseller thereby may become an underwriter. Resales are discussed later.
- f. **SEC v. Murphy** – p. 446
- 1) Murphy formed Intertie and was Chairman of the Board. Intertie promoted 30 limited partnerships. Murphy would buy a cable TV company, finance it, and then sell it to one of the partnerships. Intertie engaged a securities brokerage firm to find investors who wanted to buy interests in the cable companies. These securities were not registered, and Murphy claimed they were exempt under 4(2). Murphy did not assure that the securities were offered to only a small number of sophisticated investors. He was heavily involved in the offerings.
 - 2) The person or party claiming the exemption has the burden of proof. If the issuer cannot keep track of who the offerees were, then the issuer will pretty much lose because the test turns on the identities of the offerees.
 - 3) An issuer means every person who issues or proposes to issue a security. Thus, when a person organizes or sponsors the organization of limited partnerships and is primarily responsible for the success and failure of the venture for which the partnership is formed, he will be considered an issuer for purposes of determining the availability of the private offering exemption.
 - 4) In construing the securities laws, the courts will look to the substance over the form of the transaction, to its economic realities.
3. **Integration of Offerings**
- a. There is a general rule that an issuer cannot just break up an offering into different parts for the purpose of making the pieces fall under different exemptions.
 - b. The SEC uses the following **Test** for determining whether to integrate separate offerings:

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- 1) Whether the offerings are part of a single plan of financing;
 - 2) Whether the offerings involve issuance of the same class of securities;
 - 3) Whether the offerings are made at or about the same time;
 - 4) Whether the same kind of consideration is to be received; and
 - 5) Whether the offerings are made for the same general purpose.
- c. Example: an issuer does a private offering followed by a registered offering. If these are integrated then the issuer loses the private offering exemption because the issuer filed a registration statement, and the issuer loses the public offering because the private offering is considered gun jumping. As a result the SEC has a 6-month safe harbor provision in the Rules.
- 1) **Rule 155** provides a safe harbor if a party starts to do a private offering and then changes her mind. For the purposes of integration this abandoned offering will not be combined with a later public offering.
4. **Integration v. Aggregation**
- a. **Integration** will combine several offerings into one if money is raised for the same purpose close in time. See the 5 Factor test above. If your offerings are integrated then you will almost always lose all of the exemptions you thought you could take advantage of. If the Reg. A or Reg. D offerings are separated by 6 months or more there is no integration.
 - b. **Aggregation** is when you are counting the total amount of money raised in a one-year period time for the purposes of the safe harbor provisions in Reg. D.
5. **Limited Offerings – Section 3 (b); Regulations A and D**
- a. Regulations A and D exist to make it easier for small businesses to make offerings while at the same time providing investor protection.
 - 1) **Note:** A majority of the securities fraud cases involve small business.
 - b. **§ 3(b)** says that the commission can create exemptions from registration for offerings of less than \$5,000,000.
 - c. **Regulation A – Conditional small issues exemption – p. 104 (Rules 251 to 263)**
 - 1) **Issuer Requirements:**
 - a) **Rule 251(a)** - tells you who is eligible. Only US or Canadian companies are eligible. You also cannot be a company that is required to file Exchange Act reports.

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- b) If the assets of a company exceed \$10 million dollars and stock is held by more than 500 persons you cannot use Regulation A to do an IPO. You need to register the offering.
 - c) **Rule 251(b)** – sets out the \$5 million limit. In the case of any 12-month period, you cannot use regulation A to raise more than \$5 million (designed for small businesses).
 - d) **Rule 251(c)** – This is the integration from safe harbor. A Regulation A offering will not be integrated with any prior offering or with any offering done more than 6 months after a regulation A offering. This attempts to create bright line rules and remove the expense of not knowing if you will be sued.
 - e) **Rule 251(d)** – puts conditions on what you can do with a Regulation A offering. Creates offering that's similar to a short form registration. You must file a form called **form 1-A**. The Commission must approve this form. It is basically a much simpler and cheaper § 5 registration statement with streamlined SEC review.
 - f) **Rule 254** - allows you to make offers prior to any filing with commission. This is the “Test the Waters” provision in sharp contrast to Section 5. This is the main advantage of Regulation A; the part people like best.
- 2) Regulation A forms do not require audited financial statements.
- 3) **Rule 260** protects issuers who substantially and in good faith comply with the requirements of Regulation A against the loss of the exemption. There is no loss of the exemption if:
- a) The requirement was not directly intended to protect that investor;
 - b) The failure to comply was insignificant to the offering as a whole; **and**
 - c) The issuer made a good faith and reasonable attempt to comply with and of the requirements of Regulation A.
- 4) **Rule 262** says that Regulation A filings shall not be available if the issuer or any of its directors, officers, promoters, or other affiliated persons are subject to proceedings orders or judgments related to violations of the federal securities laws.
- 5) **A company cannot raise more than \$5 million under Regulation A.**
- d. **Regulation D – Limited offerings** – p. 169 (**Rules 501 to 508**)

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- 1) This more complicated than Regulation A. It has different requirements depending on the size of the offering and who you are selling it to.
- 2) **Rule 501** contains definitions and terms. **Subsection (e)** says that an accredited investor is not a **purchaser** and **Subsection (a)** defines the term “**Accredited Investor**” as any person who comes within any of the following categories, or who the issuer believes comes within any of the following categories, at the time of the sale of the securities to that person:
 - a) Any bank; broker or dealer; insurance company; investment company or a business development company; Small Business Investment Company, ect.;
 - b) Any private business development company;
 - c) Any 501(c)(3) organization, not formed with the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
 - d) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of that issuer;
 - e) **Any natural person whose individual net worth or joint net worth with that person’s spouse at the time of his purchase exceeds \$1,000,000;**
 - f) **Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;**
 - g) Any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person;
 - h) Any entity in which all of the equity owners are accredited investors.
- 3) **Rule 504** covers offerings that do not exceed \$1 million in any 12 month period.
 - a) Any issuer required to file forms under the exchange act, any investment company, and any blank check companies **are not** allowed to use Regulation D.
 - i. A blank check company is a company that seeks to raise money but does not tell anyone what it plans to do with the money.

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- b) There is **no limit on number of investors**, but the issuer must comply with **Rules 502(a), (c) and (d)**.
 - c) **502(a)** – integration rule of Regulation D. There is no integration of a Regulation D offering with another offering as long as they are more than 6 months apart.
 - d) **502(c)** - limitations on manner of offering –no general solicitations or general advertising by issuer or any person acting on behalf the issuer. But, is the issuer can show a pre-existing relationship with the offeree then it is not a general solicitation.
 - e) **502(d)** – limits on resale. The issuer must exercise reasonable care to assure that the securities purchasers are not underwriters within the meaning of § 2(a)(11).
 - i. An underwriter is anyone who buys securities with a **view or intent towards distribution**, contrasted to someone who buys the securities with a view towards investment.
 - ii. **Reasonable care** can be shown by putting legends on the stock restricting transferability and by getting the purchaser to sign a document of understanding.
 - f) Advantages- no disclosure requirements and no limit on purchasers. Disadvantages –only 1 million dollars a year.
- 4) **Rule 505** - covers offerings that do not exceed \$5 million in any 12-month period.
- a) These offers must also comply with **§ 502(a), (c) and (d)**.
 - b) There is a limit on the number of purchasers. The offering can have no more than **35 purchasers**. But, you can have an unlimited number of accredited investors.
 - i. The issuer has a defense here. As long as the issuer **reasonably believes** that the buyer is an accredited investor, then the issuer is safe.
 - c) **Note:** there are disclosure requirements in **§ 502(b)** that says that the issuer must give purchasers certain information regarding the issuer and allow the purchaser to ask questions about the issuer. These requirements do not apply to accredited investors.
 - d) Investment companies cannot use this exemption.
- 5) **Rule 506** is an exemption for limited **offers without regard to dollar amount of offer**.

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- a) These offers must also comply with § 502(a), (c) and (d).
 - b) The issuer can sell to an **unlimited number of accredited investors** and to **no more than 35 non-accredited investors**.
 - i. But, **every purchaser who is not an accredited investor must** have knowledge and experience in financial and business matters that makes him capable of evaluating the risks of the investment. Good faith defense when issuer reasonably believes that person has enough knowledge and experience.
 - c) The non-accredited investors must also have access to the information authorized by § 502(b).
- 6) **Rule 508** says that the failure to comply with Rules 504-506 requirements will not result in the loss of the exemption if the person relying on the exemption shows a good faith and reasonable attempt to comply.
- 7) **Rule 503** - an issuer must file a notice of the sale - Form D - within 15 days of the offering. Nothing in rules 504-506 require you to file a form D. So, if don't file, then don't lose the exemption. But, you could be prohibited from using Reg. D in the future.
- 8) **There is no SEC pre-approval under the safe harbor provisions of Reg. D.** You just have to comply with the rules. After the deal is complete, you simply have to file papers saying what you have done.
- e. **NO Action Letters**
- 1) There are very few cases dealing with Reg. A and D. In order to get guidance, can send the SEC staff a no action letter. Send this letter to SEC if you are concerned about setting up exempt offerings, but you must explain exactly what you plan to do in great detail. The Staff gets that letter, and replies – says whether or not it would recommend an enforcement action against you if the matter were brought to their attention.
 - 2) No-action letters are letters sent to the SEC to see if the SEC will bring an action against the company after the company does what they propose to do. These are not binding and hold no precedential value, but they are good for support purposes.
6. **Intrastate Offerings**
- a. **Section 3(a)(11)** - exempted securities. Refers to any security that is part of an issue offered or sold to anyone resident in a single state or territory, and the issuer must be a person/corporation living/incorporated and doing business in the state.

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- 1) **Note:** The issuer must still comply with the state's laws and registration requirements.
 - 2) **Rule 147 – safe harbor provision for Intrastate Offerings**
 - a) Provides rules for intrastate offerings, to know when it applies.
 - b) Defines residence: state where business has principal office and where person has principle residence
 - c) Defines "doing business": 80% TEST
 - i. 80% of revenue is earned from property or services in state – and-
 - ii. 80% of corporation's assets are in state –and-
 - iii. 80% of proceeds from the offering are used in state for operation of the business
 - d) Integration applies
 - b. Two rationales for this exemption:
 - 1) Investor is in the same state as the issuer
 - 2) State regulator will have the power over business in their states.
 - c. Advantages of interstate- no dollar limit. Unlike Rule 505-506- no disclosure requirements. No requirements about accredited investors.
 - d. Disadvantages- one offer or purchase can disqualify with whole offering. Have to worry about reselling out of state. Have to worry about test for doing business within the state.
 - e. In general the issue is whether it really makes sense given the artificiality of state boundaries. Have a law enforcement problem. Rational in terms of people being familiar with the company might make more sense.
 - f. **Early Release 4434** says that the entire issue of stock must be offered and sold to residents of the state. If any buyer is a nonresident, there is no exemption. Therefore, just one sale outside the state screws up everything.
7. **Regulation S – Rules governing offers and sales made outside the United States without registration under the securities act of 1933 – p. 188 (Rules 901 to 905)**
- a. § 5 says that Registration must occur if the transaction involves interstate commerce, which includes transactions between a foreign country and US state.
 - 1) § 7 defines interstate commerce to include trade or commerce b/w any foreign country and any state.

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- b. So, this exempts sales of securities outside the United States and says that § 5 registration requirements will not apply if offerings are made in an offshore transaction and there are NO “directed selling efforts” in the U.S.
 - c. The SEC says that the purpose of the registration requirements is to protect investors in the US markets. So, it is ok to make an offering an outside the US without registration as long as the offering is not designed to redistribute the securities back into the US.
 - d. **Note:** while these transactions are exempt from registration, the anti-fraud provisions of the Acts may apply because we do not want the United States to be a launching pad for fraud even if the fraud takes place overseas.
 - e. **The Key Requirement** is that the issuer must sell the securities in an off-shore transaction and cannot have any directed selling efforts in the US.
 - f. An **off-shore transaction** means that the buyer must be outside the US or the transaction takes place on an off-shore securities exchange, and you cannot offer or sell the security to a person in the US.
 - g. **Directed selling efforts** includes anything that would condition the market in the United States. This is prohibited.
8. **Secondary Transactions**
- a. Secondary transactions are sales of securities not done by the issuer. These are resales of securities.
 - b. **Trading Exemptions**
 - 1) Most of these are under § 4 which exempts the following:
 - a) Subsection (1) Any transactions by any person other than an issuer, underwriter or dealer.
 - b) Subsection (3) Transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transactions) except...(in certain circumstances)
 - c) Subsection (4) Broker’s transactions executed upon customers’ orders on any exchange or in the over-the-counter market but not the solicitation of such orders.
 - c. The main issue in § 4(1) is who is an underwriter for purposes of the ‘33 Act.
 - 1) § 2(a)(11) defines **underwriter** as any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security or any person who buys securities with a **view or intent towards distribution**, contrasted to someone who buys the securities with a view towards investment.

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- 2) A **Typical Underwriter** is any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security. This is usually an investment banker or someone like that.
 - 3) **Statutory underwriter** is someone buys securities with a view or intent towards direct or indirect distribution. This is an involuntary underwriter
 - 4) Anyone of three things can make someone a statutory underwriter:
 - a) Directly or indirectly participating in a distribution;
 - b) Purchasing securities from an issuer or control person (someone who controls the issuer) with a view toward distribution; or
 - c) Selling securities for an issuer or control person in connection with a distribution.
 - 5) **Rule 144** –This rule provides a statutory safe harbor.
- d. **SEC v. Chinese Consolidated Benevolent Assoc.** – p. 484
- 1) **Facts:** Chinese government issues bonds to sell in US. D is a nonprofit organization that advertised the offering of the bond, collected money from people, and transmitted the money to China. D receives no compensation for the service.
 - 2) Court held that D was an underwriter. Court says: they were an **essential cog in the public offering (underwriters are like conduits)**. D participated in the distribution and there is no intent requirement to be underwriter
- e. **US v. Sherwood** – p. 485
- 1) **Facts:** Sherwood (D) purchased shares from the issuer and from another shareholder of the issuer. He owned 8% of the outstanding stock, but was not an officer or director; furthermore, he had had a falling out with Doyle, the president. D has the stock for more than two years. He had also consented to an SEC decree that he would not sell the stock without registration, if a registration statement were needed. D sold 12,000 shares over various exchanges in daily transactions. US brings a criminal contempt action, alleging that D is a control person who has made an unlawful public distribution and/or that he is an underwriter since he bought the securities from the issuer with a view to a public distribution.
 - 2) Court held that the determination of who is a control person is a factual based inquiry. That a person purchases stock from a control person does not automatically make the buyer a control person.

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- 3) Here, D bought the stock from a control person, but he is not a control person. He could not get a place on the Board and he had a falling out with Doyle, who controlled the management decisions. He **also** held onto the stock for two years, so there is no intent to distribute. Thus, there is no proof that D had a view to distribute the stock at the time of the purchase. Thus, D need not register the shares he sold on this basis.
 - 4) **Note:** the court created a safe harbor. If a buyer holds stock for two years and then sells it, the buyer will not be found to have had a view to distribute the stock at the time of the purchase and therefore will not be an underwriter.
- f. **Ira Haupt & Co.** – p. 488
- 1) **Facts:** Schulte owned 22% of Park & Tilford stock; a trust run by his son owned 67%; a corporation he controlled owned 2%; and the public owned 9%. The stock was selling at about \$57 per share. The Price Administration controlled the retail price of liquor, but the demand for it was so high (during the war) that it could be resold at a higher price. Schulte called in Haupt, a broker-dealer, and indicated that Park & Tilford was going to declare a dividend of its liquor inventory to its shareholders and that in connection therewith it wanted to sell some of its stock moved up in price. D was authorized to sell 73,000 shares for the trust at \$80 or better and 200 shares on each quarter point the stock moved up for Schulte personally. None of the sales were registered.
 - 2) D claims that he is exempt under § 4(3) and § 4(4).
 - 3) The key **issue** is whether the sale was a distribution.
 - 4) The court defined a distribution as “the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hand of the investing public.” p. 492
 - 5) D is an underwriter because Schulte was a control person and D effected a distribution in a control person’s stock. A distribution is the entire process by which a block of securities is dispersed to the public. It makes no difference that when the distribution began D might not have known the exact number of shares that were to be distributed, nor that there were certain conditions (such as price) attached to the sale. On the facts, D knew that a large number of shares were to be sold. D knew of the dividend plan and that the stock would go up. Thus, D has the necessary intent to make a distribution for a control person (for the purposes of the liability section being applies here-1934 act) and thus he is not exempt under § 4(3).

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- 6) The court then finds that § 4(4) exemption is not available to the broker because the securities laws differentiate between trading and distribution. The idea of the § 4(4) exemption is to facilitate trading. This exemption allows the broker to help/participate/facilitate the trading activity.
- g. **US v. Wolfson** – p. 501
- 1) **Facts:** Wolfson controlled Continental Enterprises, and with his family and close associates owned 40% of its stock. Over a period of 18 months, D's sold 55% of their own holdings (25% of the corporation's outstanding shares) without registering the sales. The US brought criminal charges of conspiracy to sell unregistered stock and an action for selling unregistered stock. Ds were convicted and appeal their conviction.
 - 2) **Issue:** Are transactions between control persons and brokers exempt from registration when the brokers are considered underwriters under section 2(11) of the 33 Act (which makes control persons issuers)?
 - 3) The court held no. § 4(4) is unavailable because it is designed only to exempt the broker's part in securities transactions, not a control person's exemption. The seller has to have its own exemption and cannot rely on the broker's exemption. Also, the volume of sales by Ds indicated a distribution rather than an ordinary brokerage transaction, so the broker here may not have an exemption.
- h. **Rule 144:** Persons Deemed Not to be Engaged in the Distribution and therefore Not Underwriters.
- 1) This rule provides a statutory safe harbor for the resale of restricted securities by persons other than the issuer. It deals with restricted securities and securities held by an affiliate of an issuer.
 - a) Restricted Securities are any securities acquired from an issuer or affiliate of an issuer in any non-public offering. It also includes securities that are restricted under certain Reg. A, D, & S offerings.
 - b) Affiliate means control person (any person who controls or is controlled by an issuer).
 - 2) To take advantage of 144, there must be adequate current public information about the issuer. This is accomplished if the company has been filing regular reports under the exchange act or if the company voluntarily discloses information to the public.
 - 3) **Holding Period. You can resell restricted securities if you hold them for 1 year.** But, if the holding period is less than 2 years there's a limit on volume. In any 3-month period you can sell no more than 1% of issuers total outstanding shares or the average weekly trading volume of the past 4 weeks (which ever is larger is the limit of what you can sell).

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- 4) If you hold for 2 years then the volume limit and the public disclosure restrictions do not apply. **But**, you cannot have been an affiliate for 3 months prior to the sale.
 - 5) The securities must also be sold in ordinary brokerage transactions, or transactions directly with a market maker not involving any special remuneration or solicitation.
 - 6) You have to file a notice of the sale with the SEC on form 144.
- i. **Section 4(1½) – exemption for private resale of securities by purchasers**
- 1) Deals with affiliates and nonaffiliates who want to sell securities in a routine private transaction after a short holding period. Allows affiliates to sell if some of **4(1)** and **4(2)** requirements are met.
 - 2) To come under **4(1½)** –look to section **4(2)** to determine whether the resale would qualify as a private offer. If resale is private offering, then there is no distribution under **§ 4(1)**. If there is no distribution, then you are not an underwriter.
 - a) Distribution is the equivalent of a public offering, so if there is no public offering there is no distribution. So, you make it a private offering (sophisticated, small number, access to info, only sell to those who do not need protection of the acts). Then, you are not distributing and do not need to register it.
 - 3) **Elements:**
 - a) **First:** the purchasers must have access to current information about the issuer similar to the types of information that would be made available through a registration statement.
 - b) **Second:** The offering must be a private offering under **§ 4(2)**.
 - c) **Third:** If too many **§ 4(1½)** sales take place within a given time there is a possibility that a distribution will be found to exist.
9. **State registration**
- a. In 1996 Congress preempted most state registration requirements.
 - b. If a security is traded on an exchange, then it does not need to be registered with the state. Private offerings are also preempted.
 - c. Regs A & D **do not** preempt state regulation requirements.
 - d. **NOTE:** Even if a state's registration is preempted, you usually must still pay the state a fee.

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D. Civil Liabilities

1. Introduction

a. Purpose: to create incentives for the people who have control over the registration statement to make it accurate so that investors can make informed investment decisions based on disclosure of information about the issuer.

2. **§ 11** creates an express private right of action and civil liability for material misstatements or omissions in a registration statement.

a. If any part of the registration statement contained an untrue statement of material fact *or* omitted a material fact required to make statements not misleading, **any person acquiring such security may sue**.

1) Requirements of § 11:

a) **Privity, scienter, and reliance are NOT necessary**.

b) **NO showing of causation**

c) **Statute of limitations: 1 – 3 years**

d) Must show materiality

b. A plaintiff **does not have to show reliance** (that she actually read the registration statement), *unless* there has been an earning statement filed in the last 12 months in which the plaintiff has to prove that they relied on the untrue statement or did not know of the omission.

1) For reliance, the plaintiff does not need to prove they read the registration statement.

c. The defendants are anyone who signs the registration statement, every director, accountant, underwriters, or engineers (i.e. anyone that prepares a report in the registration statement). Also control persons- this comes from Section 15- anyone who controls any person is liable to the same extent as controlled person. Person includes corporation. Parent company will be liable if a subsidiary violates these provisions. Basically anyone involved in the offering faces potential § 11 liability.

d. **§ 11(b)** sets out the **due diligence** defense.

1) This defense is not available to issuers. An issuer is strictly liable for material misrepresentations or omissions in registration statements.

2) The defendant's have the burden of proof. Under **§ 11(b)(3)** a defendant must show that he made a reasonable investigation and reasonably believed at the time that the registration became effective there were no misstatements of omissions.

3) Three Key Provisions (11(b)(3)(A)-(C)):

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- a) (A) for any part of the registration statement **not made on the authority of an expert**, at the time of the filing of the registration statement you have to **make a reasonable investigation** and have a *reasonable grounds to believe that statements were true* and there was no omission of material fact.
 - b) (B) part of registration made by an **expert**, after reasonable investigation, **expert** he *had reasonable ground to believe it was true*.
 - c) (C) if you are **not an expert, as to the parts prepared by the expert**, **there is no requirement that you do an investigation**, you just have to *have a reasonable ground to believe that the statements are not false*.
- 4) Therefore, if you are not an expert, you **will be** held liable if you know that there are false statements.
- 5) Divide the registration up to the expertised parts and the non-expert parts
- a) Expert parts
 - i. experts: reasonable investigation and reasonable belief.
 - ii. everyone else: no investigation requirement, they just have to show that they had a reasonable belief that the statements weren't false or misleading.
 - b) Non expert parts
 - i. experts: no responsibility.
 - ii. everyone else: reasonable investigation and reasonable belief.
- e. § 11(c) says that in determining... what constitutes a **reasonable investigation** and reasonable ground for belief, the standard of reasonableness shall be that required of a **prudent man** in the management of his own property.
- 1) This is not a very clear definition of reasonable investigation and reasonable ground for belief.
 - 2) **Inside vs. Outside Directors**
 - a) **Inside Directors** → held to a strict standard of due diligence.
 - i. Inside Directors are liable for a failure to investigate. Reasonable investigation and reasonable ground to believe will vary with the degree of involvement of the individual, his access to information, and his expertise.
 - b) **Outside directors** must make some independent verification of the information.
- f. § 11 (g) caps the total damages. Damages shall not exceed the offering price.

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- g. **Escott v. Barchris Construction Corp.** – p. 327 (leading case on due diligence)
- 1) **Facts:** Plaintiff brings suit against BarChris under § 11 for material misrepresentations in the registration statement. BarChris was inadequately financed and defaulted on the payment of the interest on the debentures. Plaintiff claims inadequacies and omissions in the prospectus.
 - 2) Non-experts, with respect to parts of the registration statement not prepared by experts, must after a reasonable investigation, have reasonable grounds to believe and actually that the statements made were true and that there were no omissions of a material back. A reasonable investigation is one that a prudent person on the management of his own property would conduct.
 - 3) With respect to statements made by experts, non-experts must show that they had no reasonable ground to believe and did not believe that the statements made were untrue or that there was a material omission.
 - a) The only expert part of the registration statement is the certified financial statements, not statements in the body of the registration statement that purport to be based on the financial statements.
- h. Courts have held that **if something is verifiable you must check it** or you will not be deemed to have conducted a reasonable investigation.
- i. **Rule 176** lists the factors that are relevant to whether there has been a reasonable investigation. Not at all helpful. It pretty much states the obvious and is not a safe-harbor.
- j. **Feit v. Leasco Data Processing Equipment Corp.** – p. 346
- 1) **Facts:** A surplus surplus statement was omitted from the registration statement because the directors assumed that the company manager would not give them the information to calculate the surplus surplus. The directors never asked the manager for the information.
 - 2) Held: What constitutes “reasonable investigation” and a “reasonable ground to believe” will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data.
 - 3) **Director-defendants** failed to fulfill their duty of reasonable investigation and that they had no reasonable ground to believe that an omission of an estimate of surplus surplus was not materially misleading. The directors should have asked the manager for the information, especially because they later made piece with the manager.

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- a) Surplus surplus is an amount beyond what an insurance company is required to keep in its surplus.
 - 4) **Underwriters-defendants.** The court seems to imply that the underwriters should be held to a higher standard. Tacit reliance on management is unacceptable but you can reasonably rely on them. Here they escape because they independently examined the audit report and the report of an actuary on the company, made searching inquiries of D's bank, and made study of corporate minutes and major agreements.
3. **§ 12**
- a. **§ 12(a)**
 - 1) **§ 12(a)(1)** says that any person who **offers or sells** a security in violation of **section 5** is civilly liable to the person purchasing from him.
 - a) This is strict liability for all. There is no due diligence defense.
 - b) The remedy is a rescission or damages. If you still own the security you can get your money back. If you already sold the security you can get damages. Damages is interpreted to mean the difference between the purchase price and the sale price
 - c) The issue is typically who is a seller.
 - b. **Pinter v. Dahl** – p. 366
 - 1) **Facts:** Pinter sells unregistered securities (oil and gas interests) to Dahl. Other people invested when Dahl did. Dahl helped them, but got no commission from Pinter. The venture proved to be worthless. Dahl and the other buyers sought rescission under § 12(1), for the sale of unregistered securities. Pinter sues Dahl for contribution.
 - 2) The Supreme Court says that liability under **§ 12** extends only to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner.
 - 3) The Supreme Court says that because **§ 2(3)** includes solicitation in the definition of the terms “sale or sell” solicitation is included in **§ 12**. The “purchase from” requirement of **§ 12** focuses on the defendant’s relationship with the plaintiff-purchaser.
 - 4) **TEST:** Liability extends only to the person who actually sells and who **successfully** solicits the purchase, motivated, at least in part, by a desire to service his own financial interests or those of a securities owner. If person has such a motivation, it is fair to say the buyer purchased the security from him to align him with the owner in a rescission action.

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- 5) **Rule** → liability extends to only those who successfully solicit the purchase, motivated at least in part by a desire to serve his own financial interests or those of a security owner.
- c. **§ 12(a)(2)** creates liability for offering or selling a security by means of a prospectus or oral communication that includes an untrue statement of material fact or omission.
- 1) Applies whether or not securities are exempt under Section 3.
 - 2) Applies only in public offerings.
 - 3) The Pinter test is also used for determining who the seller is.
- d. **Defenses to § 12 liability**
- 1) If you can show the plaintiff knew about the misstatement or omission at the time of the transaction, then that is a defense.
 - 2) **Reasonable care** → In the exercise of reasonable care you could not have known about the misstatement or omission.
 - a) **Note:** Courts have suggested that reasonable care is an easier standard to meet than reasonable investigation.
 - 3) **Negative causation defense** → The defendant can reduce the amount of damages if the defendant shows that all or some of the reduction of a security's value is caused by something other than the misstatement or omission.
- e. **Gustafson v. Alloyd Company** - p. 374
- 1) **Facts:** P purchased all of corporate stock from D sellers. He brings suit under **§ 12(a)(2)** of the 1933 Act, claiming that sale agreement was "prospectus" under the Act and that it contained material misstatements sufficient to support an action for rescission under **§ 12(a)(2)**.
 - 2) This is a private offering so **§ 5** and **§ 12(a)(1)** are not relevant. This is an exempt private transaction.
 - 3) The court looks to **§§ 2(10), 10, and 12(a)(2)** to find what a prospectus is.
 - 4) The court held that whatever else "prospectus" may mean, under **§ 12(a)(2)**, the term is confined to a document that, absent an overriding exemption, must include the "information contained in the registration statement." 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 its controlling shareholder.
 - 5) The court says that it is not plausible that Congress created **§ 12(b)(2)** liability for "every casual communication between a buyer and seller in the secondary market."

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- 6) Thomas' Dissent-
 - a) Should start with 12(a)(2)- that's how statutory interpretation works
 - b) The majority opinion violates every rule of statutory construction.
 - c) According to Quinn the dissent is right on target – this is contrary to long line of case law.
- f. §§ 12(a)(1) and 12(a)(2) liability is limited to sellers.

4. The SEC cannot bring a suit under Sections 11 or 12.

5. § 12(a)(2) v. § 11

- a. Defendants are different.
 - 1) In 11 → anyone who signed RS
 - a) Broker is not liable under 11 because they did not sign the RS.
 - b) Reasonable investigation is DEF
 - 2) In 12(a)(2) → sellers only (narrower class of defendants).
 - a) Underwriters are not necessarily in the reach of “seller”
 - b) Reasonable care standard (lower than standard for 11).
- b. Sales CAN be different
 - 1) § 12(a)(2) is limited to sales from a public offering.
 - 2) § 11 = can get after-market seller
- c. Duties
 - 1) Sect 12 = reasonable care
 - 2) Sect 11 = reasonable investigation (higher standard)
- d. § 11 gives strict liability to an issuer. An issuer is not necessarily a seller under § 12, so if an investor wants to sue an issuer you sue under § 11.

E. Other Liability Provisions

- 1. § 17(a) → the general anti-fraud provision that applies to sales.
 - a. There is no private right of action under this provision.
- 2. § 13 → contains a statute of limitations that apply to § 11 and § 12 cases.
 - a. You have two years after you have or should have discovered a misstatement.

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- b. But, no matter what you only have 5 years to bring a case after the security is sold to the public.
- 3. § 14 → The anti-waiver provision (there is a similar provision in the exchange act).
 - a. A buyer of securities cannot waive compliance with any provision of the '33 Act or with any of the Commission's rules and regulations.

V. SECURITIES EXCHANGE ACT OF 1934

A. Introduction

- 1. The main point is to regulate the trading of securities that have already been issued (trading in the secondary market).
- 2. The trade volume in the secondary market is much greater than the initial distribution market.
- 3. The act covers the following:
 - a. It regulates the securities business itself.
 - 1) §§ 5 & 15(a) require trade associations to register with the SEC. This includes the stock exchanges and the Nasdaq.
 - 2) §§ 15 & 19 give the SEC the administrative authority to bring actions against securities firms and against any person associated with a securities firm. They give the SEC an authority to shut down a firm and bar a person from securities industry for life.
 - a) Stock exchanges and the NASD can bring actions against their members. The SEC has the authority over this and over rules promulgated by the NASD or the stock exchanges.
 - b) The SEC can impose rules on the NASD or the stock exchanges.
 - c) This is the source of the SEC authority over the securities industry.
 - b. It deals with corporate disclosures on an on-going basis.
 - 1) §§ 12 & 13 require companies to register securities and file reports with the SEC.
 - 2) § 14 contains disclosure requirements relating to proxies and tender offers.
 - c. It regulates trading
 - 1) § 10(b) contains the general anti-fraud provision.
 - 2) § 14 also has specific anti-fraud provisions directed at proxies and tender offers.

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- 3) § 16 deals with officers, directors, etc. Any profit they make trading their own securities they must pay back.
4. Securities Market
 - a. The two most important securities markets are the Nasdaq and the NYSE (New York Stock Exchange).
 - b. NYSE (New York Stock Exchange)
 - 1) This is basically an auction market.
 - 2) All orders go to the trading floor.
 - 3) Every security that trades has a **specialist** on the floor that conducts the auction.
 - a) The specialist has a duty to maintain “a fair and orderly market as far as is practicable and to take steps reasonably necessary to maintain an orderly market.”
 - b) If there is an imbalance in the buy and sell the specialist must trade on her own account. The specialist is supposed to trade when there is no interest on the other side.
 - c. Nasdaq
 - 1) This is screen based trading.
 - 2) Quotations are entered into the computer and firms get access to the computer. Firms must have a subscription. These firms are the market makers
 - 3) **Market makers** enter quotes. If a firm puts out a quote it must honor that commitment. There is more than one market maker for the security that is traded on the Nasdaq; the theory being that this is where you get liquidity and competition on price.
 - a) Make money from difference between buy and sell price.
 - 4) Most securities have more than one market maker, so that sets the price as they compete.
 - d. Electronic Communications Networks (ECNs) also known as Automatic Trading System (ATS):
 - 1) The ECNs match buy and sell orders between members, so you can limit transaction costs. The transactions are automatically executed when the buyer puts their request to buy in the system.
 - 2) ECNs have taken a lot of volume away from Nasdaq partly because it is cheaper, and partly because it can be done anonymously.

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5. Reporting Requirements
 - a. **Who must file reports?**
 - 1) If a company trades on any exchange, **or**
 - 2) If a company has assets of \$10 million or 500 shares, **or**
 - 3) If a company has registered any securities under the '33 Act.
 - b. **What must you file?**
 - 1) Yearly (10k) and quarterly (10Q) reports
 - 2) MD&A reports
 - 3) 8K report of material developments or other events.
 - 4) Companies must put all of their filings on their web site if they have a web site.
 - c. **NOTE:** On every company report, the CEOs and CFOs must certify that the company is not lying.
 - d. Foreign companies whose shares trade in the US are exempt from filings as long as the company is located outside the United States and primarily owned by non-US investors. They do have to file whatever reports their country makes them file.
6. **Regulation FD**
 - a. This is a disclosure rule under the exchange act.
 - b. It says that companies cannot selectively disclose material non-public information.
 - c. This was meant to deal with the situation where companies would release important non-public information to research analysts or institutional investors. This is using a disclosure rule to regulate conduct.
 - d. If a company intentionally discloses information to a limited group of people, they must at the same time disclose the information to the public.
 - e. If the disclosure is unintended, then the company must disclose the information to the public within 24 hours.
 - f. This regulation does not apply to communications to the press or to ordinary business communications with customers and suppliers. It also does not apply to any registered offering.

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B. Securities Fraud Litigation Under Rule 10b-5

1. **§10(b)** → it shall be unlawful for any person ... to use or employ, *in connection with the purchase OR sale* of any security registered on a national securities exchange or any security not so registered...any *manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the Commission may prescribe...
 - a. § 17 of the 1933 Act prohibited fraud in the in the sale of securities, but NOT in the purchase of securities.
 - b. By itself, 10(b) would have no force.
 - 1) 10(b) by its terms does not make anything unlawful unless the Commission has adopted a rule prohibit it.
 - 2) **Rule 10(b)-5** was adopted because of a loophole that existed.
 - 3) § 17 of '33 Act prohibits fraud when it dealt with a sale.
 - a) Someone took advantage of this while "buying."
 - b) 10(b)-5 was created to fix this.
2. **Rule 10b-5** → "It shall be unlawful for any person...to employ any device, scheme or artifice to defraud, *to make any untrue statement of material fact* or to omit to state a material fact necessary to make the statements not misleading, or to engage in any act, practice or course of business which would operate as a *fraud or deceit* on any person *in connection with the purchase OR sale of any security*.
 - a. This rule applies whether the transaction originates from the issuer or from a secondary transaction and regardless of whether the security if exempt from registration.
 - b. The following are types of **Rule 10b-5** cases:
 - 1) The publishing of misleading press releases;
 - 2) The filing of false or misleading documents;
 - 3) The manipulation of securities.
3. **Elements of the Violation:**
 - a. In a private 10b-5 case, the **plaintiff has to be purchaser or seller** of securities. (This does not apply to cases where the SEC is the plaintiff.)
 - b. The defendant is anyone whose fraud is **in connection with** the purchase or sale (the defendant does not need to be a purchaser or seller).
 - c. There must be a **deception**. A misleading statement or silence when there is some duty to disclose. If you make a full disclosure, even if you breach a duty, there is no deception.

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- d. The deception must be **material**.
 - e. There must be **scienter** (mental state). There must be an intent to manipulate, deceive, or defraud. Negligence is not enough.
4. The following **limits** are **imposed on private plaintiffs by the courts**:
- a. The private plaintiff must show **reasonable reliance on the deception**.
 - b. The **defendant's misstatement or omission must have caused** the private plaintiff's **damages**.
 - 1) The private plaintiff must show **transaction causation** (but for D's deception I would not have bought or sold the security).
 - 2) The private plaintiff must show **loss causation** (that the defendant's deception caused the loss).
5. **Scienter**
- a. **Ernst & Ernst v. Hochfelder** – p. 528
 - 1) **Facts:** Ernst & Ernst was retained by First Securities. E&E prepared statements to the SEC and Midwest stock exchange. Respondents gave money to First Securities' president who was supposed to invest them in escrow accounts. There were no escrow accounts and he used them for his own personal investment. There was no record of them on the firm financials. The President committed suicide and left a note saying the escrows were fake. The President had a "mail rule" that he could only open the mail addressed to him, to cover the fraud.
 - 2) Plaintiff sued the accounting firm, claiming that if they had not been negligent in their audit, they would have found the irregularity in the firm's financial documents. The mail rule was an irregular procedure that should have been reported to the SEC, thus the firm was negligent.
 - 3) **RULE:** An intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b-5.
 - 4) Dissent: says that if negligence is a factor when the SEC sues under Rule 10b-5, then it must be a violation factor when a private party sues.
 - a) **Note:** A future Supreme Court case imposed the same scienter standard on the SEC. Thus negligence is not enough under either scenario.
 - b. The Supreme Court has never decided whether reckless conduct is enough under the statute.
 - 1) **Note:** While all circuits have held that reckless conduct is enough to impose liability, there is no uniform definition/formulation of reckless

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conduct. Most courts have followed the language used in Sundstrand to define recklessness. See Note 2 page 534.

6. The fraud must be “**in connection with**” the purchase or sale of securities.
 - a. **Texas Gulf Sulpher** – p. 541 note 4
 - 1) **Facts:** Company discovers minerals but they want to buy land at a cheap price so that they issue a statement saying discovery is not a big deal. When it comes out that the discovery was huge the stock price increases. The SEC sues.
 - 2) D argued that they just wanted cheap land; they had no intention to defraud investors. The court says that public statements that are reasonably likely to influence investors are “in connection with” the purchase or sale of securities.
 - b. **Superintendent of Insurance v. Bankers Life & Casualty** – p. 539
 - 1) **Facts:** Banker’s Life agreed to sell all of Manhattan’s stock to Begole for 5 million. Begole conspired with others to pay for the stock with Manhattan’s assets. They arranged to obtain a check from Irving Trust for 5 million, but they had no funds there. They purchased stock from Manhattan. Then Manhattan sold treasury bonds for \$5 million and the president uses this money to cover the check from Irving Trust. Begole had effectively bought all of Manhattan’s stock using its own assets.
 - 2) There is no misrepresentation about what the security is worth. Nevertheless, there was a fraud and a sale of a security. The company was tricked with regards to proceeds of the sale so that satisfies the “in connection with” standard.
 - 3) **Fraud is “in connection with” if an injury as a result of deceptive practices touches the sale of a security** as an investor.
 - c. **SEC v Zanford**
 - 1) **Facts:** Zanford convinces investors to invest in an account and says that he will invest the money conservatively. He raises about \$500,000. Zanford buys and sells the securities as he said he would, but keeps the money for himself.
 - 2) The Supreme Court said that a misrepresentation is not limited to the value of securities. The **fraud is “in connection with”** a purchase or sale of securities **if the fraud and the securities trading coincide.**
7. **Statute of limitations**
 - a. Before Sarbanes Oxley, the statute of limitation in 10b-5 cases was 1 year from the date of discovery, but no more than 3 years after the date of the

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violation. Recently, Sarbanes Oxley changed this to 2 years after discovery, but no more than 5 years after the violation.

1) The **key issue** is still what does discovery mean?

b. **Dodds v. Cigna** – p. 569

1) **Facts:** Dodds' husband dies and she wanted to invest that money. She met with Palumbos. He left her securities materials. She never read the prospectus [claimed she didn't understand it], but decided to go with his investment strategy. Her accountant later said that her investments were too risky. She filed suit against Cigna within one year from the date her accountant told her that the investments were bad, more than one year after the date on which she made the investment in which she suffered losses.

2) **Rule:** a plaintiff in a federal securities case will be deemed to have discovered fraud for the purposes of triggering the statute of limitations when reasonable investor of ordinary intelligence would have discovered the existence of the fraud.

3) The court rejected the widow's argument that the time should have started when she had actual notice of the fraud. Instead, **the court held** that because the widow had **constructive notice** of the fraud (the information contained in the different prospectuses she was given) the time began to toll when she purchased the investments. Her action was thus time barred.

c. **NOTE:** *Statutes of limitations* do not apply to the government in general and the SEC.

1) If the SEC wants to bring a fraud case, it can when it learns of it.

2) Even though there is not an absolute bar, the court might say no because the action is too far removed.

8. **Standing to Sue**

a. **Blue Chips Stamps v. Manor Drug Stores** – p. 573

1) **Facts:** Under a consent decree in an antitrust case, Blue Chip was required to offer a substantial number of shares to retailers that used its stamp service. They were registered and sold. Two years later, 1 purchaser sued under 10b-5, alleging that the prospectus was overly negative, so P did not purchase the shares. Defendant offered the shares to the public at a higher price.

2) **Issue:** Can P sue, even though he did not purchase or sell the security?

3) The Court concludes that Congress did not intend a private cause of action for money damages to the non-purchasing offeree of a stock offering

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registered under the 33 Act or loss of the opportunity to purchase due to an overly pessimistic prospectus.

- 4) **Rule:** A plaintiff must actually purchase or sell stock in order to bring a private cause of action for money damages under § 10(b) and Rule 10b-5.
- 5) Allowing a suit to be brought by a non-purchaser would lead to an unlimited number of potential plaintiffs, because they can claim that they read a company statement in prospectus or newspaper that caused them not to purchase the stock when they would have.

b. **Wharf Holdings Limited v. United International Holdings** – p. 580

- 1) **Facts:** US firm helps Hong King co. get cable TV license, and has an oral agreement to buy 10% of stock in Hong Kong firm if it gets the license.
- 2) The court differentiates between the speculative question of how many shares you would have bought if there wasn't a misstatement (Blue Chips) and an oral agreement.
- 3) Supreme Court says that *Blue Chip* only applies w/ potential buyers, but here they were actual buyers, *even though* it was an oral K to buy securities
- 4) Supreme Court holds that an **oral agreement can be enforced**. It doesn't raise the speculative concerns that were found in Blue Chip.

9. **Secondary Liability**

a. **History**

- 1) Until 1994 all of the courts of appeals had held that 10b-5 applied to secondary violators (aiders and abettors).
- 2) Typical Aiders and Abettors were small purchasers, lawyer (general counsel or firm) who drafted the deal, outside Lawyer who changed the language, and accounting firms.
- 3) For liability under this theory a P had to show that there was a primary violation, and that the aider and abettor knew of primary violation & gave substantial assistance to violators.
- 4) All of this changed with the Supreme Court's holding in Central Bank.

b. **Central Bank v. First Interstate Bank** – p. 583

- 1) **Facts:** Central Bank is a trustee for two municipal bond offerings. Requirement that bonds have an appraised value of at least 160% of bond's obligations. There is an initial offering. Before the second offering, the real estate market declined and the bank knew that the

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appraisal was wrong. They did not do a new appraisal until after the second offering. It argues that if the bank had done another appraisal before the second offering, then the second offering would not have occurred. They argue that the bank allowed the issuer to sell when they knew it should not have, therefore they aided and abetted the violation of 10(b).

- 2) **Rule: no liability for aiding and abetting in a private cause of action**
 - a) The plain language of the statute does not include liability for aiding and abetting and so it will not be included.
 - b) The statutory language “directly or indirectly” does not include aiding and abetting.
 - c) Congress enacted criminal aiding and abetting liability, but not civil aiding and abetting liability. Specifically, Congress has not enacted civil aiding and abetting liability in the securities laws.
- 3) The court says that policy concerns, that aider and abettor liability deters secondary actors from contributing to fraud and ensures that defrauded plaintiffs are made whole, cannot override the language and structure of the Act.
- 4) The court again argues that expansive litigation may lead to the failure of new and smaller business due to the large cost of defending aider and abettor cases.
- 5) The dissent says that the majority decision goes against a well of established lower court precedent. It also identifies a workable 3 part test for aider and abettor liability, thereby negating the majority’s allegations of confusion and high litigation costs.

10. Primary v. Secondary Liability

- a. There is disagreement in the Circuits on what is primary and what is secondary liability.
 - 1) **Second Circuit:** There is no primary liability unless there is a misrepresentation attributed to a specific actor at the time of the public dissemination.
 - a) This means that if a lawyer drafts a misleading statement without signing it, and the statement gets passed to the public, then the **lawyer is not** civilly liable. **Note:** The government could still go after the lawyer criminally.
 - 2) **Ninth Circuit:** If you substantially participate in preparing fraudulent statements, then you can be primarily liable.

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- 3) **SEC view:** A primary violator is someone who creates a misrepresentation or scheme to defraud.
 - a) This means that if a lawyer drafts a misleading statement without signing it, and the statement gets passed to the public, then the **lawyer is civilly liable.**
11. **Presumption of reliance (fraud on the market)**
- a. A plaintiff must show that she reasonably relied on the misstatement.
 - b. **NOTE:** The reliance standard does not apply to the SEC. The SEC does not have to show that it or an injured party relied on a misstatement.
 - c. **Basic v. Levinson** – p. 735
 - 1) **Facts:** Combustion Engineering wants to acquire Basic and included the plan in their strategic plan. They had meetings with Basic to discuss the possibility of merger. Basic made three public statements denying that it was engaged in merger talks. Eventually, Basic took the offer.
 - 2) **Issue:** Whether a person, who traded a company's shares on an exchange, after material misstatements were made, may invoke a rebuttable presumption that in trading, he relied on the integrity of the price set by the market?
 - 3) The Supreme Court held that there is a rebuttable presumption that misleading statements to the market artificially depress the market price of the shares. It accepts the **fraud on the market theory.**
 - a) "Where materially misleading statements have been disseminated into an impersonal, well developed market for securities, the reliance of the individual plaintiffs on the integrity of the market price may be presumed."
 - 4) This presumed reliance, however, is rebuttable. The **defendant has the burden of proof.**
 - a) Any showing that **severs the link between the alleged misrepresentations and either the price received** by the plaintiff **or his decision to trade** will be sufficient to rebut the presumption of reliance
 - 5) The dissent says that the fraud on the market theory is too new to be made into law. Also, people who buy stocks do not necessarily believe that the market price is the true value of the stock. People disagree over the value of a security; otherwise there would be no trading.
 - d. **Note:** 10b-5 has a market reliance element. Basic says that you just have to show:

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- 1) That there is false information (a material misstatement or omission);
 - 2) The shares were traded on an efficient market (you need to make sure the market reflects all of the publicly available information); **and**
 - a) Courts look at the following factors when determining if there is an efficient market for the security:
 - i. Trading volume
 - ii. Market figures
 - iii. Number of analysts following the company
 - iv. How the price responds to press releases
 - 3) That the plaintiff traded the stock after the material misstatement or omission occurred and before the statement was corrected.
 - a) This could encompass a large number of plaintiffs, which could lead to large damage awards.
- e. This rule is, however, rebuttable. The defendant's failure to disclose material information may be excused where that information has been made credibly available to the market by OTHER sources.
- 1) **In Re Apple Computer** – p. 743
 - a) **Facts:** Plaintiff alleges that Apple Computers misled the market about the capabilities and prospects of a novel office computer and disk drive. They claim they purchased the stock in reliance on the artificially high stock price and then suffered damages.
 - b) The Supreme Court held that “the defendant’s failure to disclose material information may be excused where that information has been made credibly available to the market by other sources.”
 - c) There were press releases in the public that the computer was risky, so the defendant is not liable. **When deficiencies are corrected with lots of media coverage, reliance using fraud on the market will be rebutted.**
 - d) BUT, this is a limited holding. The information must be transmitted to the public with a *degree of intensity and credibility sufficient to effectively counterbalance* any misleading impression created by the insider’s one-sided representations.
12. **Fraud or Deception/Scienter**
- a. **Santa Fe Industries v. Green** – p. 782
 - 1) **Facts:** Company bought 60% of the shares of another company. They then purchased up to 95% of the shares. Company does a short-form merger in accordance with Delaware law and buys out the remaining 5% of minority stock. The appraisal set the share price at \$25 per share so the company offered the minority shareholder \$150 per share. The company

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informs the minority shareholders that they can challenge the share price in a DE chancery court. The minority shareholders sue the company in federal court seeking to set aside the merger saying that the share price was really \$772 per share.

- 2) The Supreme Court held that negligence is not enough to show scienter under Rule 10b-5.
- 3) The Court also held that breach of fiduciary duty is something ordinarily left to the states and that federal law should not impose a stricter standard of fiduciary duty than that required by the laws of a state. State law will generally govern the internal affairs of a corporation and states should remain free to regulate corporate conduct except where federal law **expressly** requires certain responsibilities of directors with respect to shareholders.

13. Extraterritorial jurisdiction

- a. The issue is how far does **rule 10b-5** liability extend to securities fraud that involves offshore transactions?
- b. There are two situations where US courts will extend the reach of **rule 10b-5**:
 - 1) **Conduct Test:** Where investors outside the US claim that they were defrauded by a fraudulent scheme created in the US.
 - 2) **Effects Test:** Where there is fraudulent conduct outside the US that effects an investor in the US or a foreign company whose shares trade in the US.
- c. **Zoelsch v. Arthur Andersen** – p. 603
 - 1) **Facts:** Plaintiffs are West German citizens; the defendant is the US branch of Arthur Andersen. P invested on a tax shelter plan via a German limited partnership that invested in property in the US. German Arthur Andersen audited the partnership. P claims that the US Arthur Andersen branch provided misleading information to the German Arthur Andersen branch knowing that the information would be included in an audit report. The Audit report is prepared in Germany and all of the transactions take place in Germany.
 - 2) The Court dismisses the case for lack of subject matter jurisdiction.
 - 3) **Test:** Jurisdiction is appropriate when the fraudulent statements or misrepresentations originate in the US, are made with scienter and in connection with the purchase or sale of securities, and “directly cause” the harm to those who claim to be defrauded even if the reliance and damages occur elsewhere.

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14. Insider Trading

- a. 10b-5 does not explicitly address insider trading, but one of the most important applications of 10b5 is a sanction against insider trading.
 - 1) **Insider trading** is trading securities in breach of a duty based on **material, non-public information**.
 - 2) Liability is not limited to people traditionally thought of as corporate insiders. Also includes people such as lawyers, investment bankers, people who are tipped by insiders, and people who get nonpublic information by breaching a duty to someone other than a corporate insider.
- b. **Two Theories** for Insider Trading Liability:
 - 1) **Classical Theory**: where company's officers or directors trade shares of their own company based on material, non-public information, thereby breaching their duty to the company's shareholders.
 - 2) **Misappropriation Theory**: where a person uses information that was obtained by breaching a duty to the source of the information.
- c. **Cady, Roberts Co.** – p. 632 (SEC Opinion)
 - 1) **Facts**: Broker got information that the Board was going to cut a dividend, so he placed an order to sell Curtis-Wright stock for his customers before the news of the dividend was disseminated to the public.
 - 2) The SEC says that if you have special access to material non-public information you must either disclose the information to the public or abstain from trading.
 - 3) A broker who receives inside information from the corporation and uses it to assist his customers in making sales before public disclosure of a material fact is liable.
 - 4) The obligation rests on the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.
- d. **SEC v. Texas Gulf Sulpher** – p. 657 (5th Circuit)
 - 1) **Facts**: Plaintiff claimed officers of TGS bought stock or calls using material nonpublic information about a drilling site in Canada. Two of the officers had given information to others for use and recommended purchase while the information was undisclosed to others.
 - 2) Court holds that **ANYONE in possession of material inside information must either DISCLOSE** it to the investing public, **or** if he is disabled

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from disclosing it in order to protect corporate confidence, must **ABSTAIN from trading in or RECOMMENDING** the securities concerned while such information remains undisclosed.

- 3) Tippers inside the corporation who pass along information to relatives, friends, and business associates outside the corporation are insiders. These tippers were held liable for the profits made by the tippees.
 - 4) **All were in violation.** The drill results were material. The insiders were not trading on an equal footing with the outside investors. They had access to the information about the probability of the finding ore on the land, while the public was unaware of the favorable probabilities or unproductive exploration.
- e. **Chiarella v. US** – p. 672 (Supreme Court Case)
- 1) **Facts:** An employee of a financial printing firm, who was working on documents related to a contemplated tender offer, ascertained the identities of the companies which were the targets of those offers, purchased stock in those companies, and sold stock at a profit after the tender offers were announced. Employee returned the money as part of a settlement with the SEC in a civil case. The US then instituted a criminal proceeding against him.
 - 2) **Rule:** One who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.
 - a) “The duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other similar relationship of trust and confidence between them.”
 - 3) “A purchaser of stock who has no duty **to a prospective seller** because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts.”
 - 4) Burger Dissent: said that liability should be established when an informational advantage is obtained not by superior experience, foresight, or industry, but by unlawful means. He introduces the misappropriation theory.
- f. NOTE: There is a line between deception and stealing. For example, if you break into a company's office and steal a memo, that is theft and not fraud. But, if you pretend to be someone else to get information then this is fraud. These are treated differently by the court. 10b-5 works for fraud but not for theft.
- g. **US v. Newman** – p. 678

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- 1) **Facts:** Bankers hired by bidder in a takeover. The bankers use inside information to trade stocks.
 - 2) The second circuit held that the bankers had criminally violated Rule 10b-5, based on the misappropriation theory because they breached a duty to the **source of the information**.
- h. **US v. Carpenter** – p. 678
- 1) **Facts:** Wall Street Journal (“WSJ”) writer traded on inside information that he later published in his column. The column affected the company’s stock price. The writer breached a duty to the WSJ. Writer had told D the info and D also traded on the stock prior to the publication of the column.
 - 2) **Issue:** Is D liable for insider trading?
 - 3) 2d Cir: upholds conviction under the misappropriation theory. The Supreme Court has a 4-4 split which means that the 2nd Circuit opinion is still good law.
- i. **United States v. O’Hagan** – p. 679
- 1) **Facts:** O’Hagan was a crooked lawyer before engaging in insider trading. He was a securities partner who was embezzling funds. O’Hagan had previously embezzled money, and decided to use inside information regarding the hostile take-over as a means of recouping the client funds that he had embezzled
 - 2) The Supreme Court accepts the misappropriation theory. The **misappropriation theory** holds that a person commits fraud in connection with a securities transaction and thereby violates § 10 and Rule 10b5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed not to trading party but to the source of the information.
 - 3) **RULE:** A person who trades in securities for personal profit, using confidential **information misappropriated in breach of a fiduciary duty to the source of the information**, is guilty of violating Rule 10b-5.
 - a) “Misappropriators...deal in deception. A fiduciary who pretends loyalty to the principal while secretly converting the principal’s information for personal gain, dupes or defrauds the principal.”
 - 4) The court finds the “in connection with: requirement satisfied because the Defendant’s fraud is consummated when, without disclosure to the source, the defendant uses the information to purchase or sell securities.
- j. **Family Relationships**

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- 1) There are a number of insider trading cases dealing with family relationships – when one spouse tells one spouse something important – parents/child, siblings. The reason why these are securities fraud cases is because if there is material non-public information and you are using it then you can be liable. **What are the duties dealing with family members?**

- 2) **Chestman Case** – p. 690
 - a) **Facts:** This is a criminal case. Ira was chairman of Waldbaum's stores – A&P is going buy Walbaums.' Ira tells his sister that this is going to happen and says that she has to keep the information confidential. Ira's sister tells her daughter and says that this is confidential information. The daughter tells her husband, the guy named Lowe, and tells him to keep the information confidential. Lowe buys Walbums stock and tips his stockbroker, Chestman. Chestman then buys the stock.

 - b) The key in this whole chain of transactions is that you have to show that Lowe owed a duty to his wife. Because if there was no duty, then there was no breach of duty. This case turns on relationships between husbands and wives.

 - c) The court said, a fiduciary duty does not automatically exist between spouses or family members. The duty is determined on case by case basis.

 - d) There are several ways you can show this fiduciary duty:
 - i. You can show that someone expressly agrees to accept a duty, **or**
 - ii. You can imply a fiduciary duty based on prior dealings or a past practice of keeping confidential information.

 - e) The court says that there was no duty here. Lowe never expressly agreed to keep the information confidential and there was not enough evidence to imply a duty based on a prior sharing of confidential information.

 - f) Critics of this case says that this is stupid because you have securities fraud that is turning on the relationship between family members

- k. **Dirks v. SEC** – p. 683 (**tippee liability**)
 - 1) **Facts:** Dirks gets information from a former officer of a corporation, stating that the company was full of crooks and the stock would plummet when fraud was uncovered. The officer wanted Dirks to verify the fraud and disclose it. Dirks tried to inform SEC and the WSJ of the fraud but no

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one listened. Dirks traded the company's stock based on the information he discovered. Dirks was not an insider and had no duty to shareholders.

- 2) **Test** for whether a tippee is liable: A tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.
 - a) **Test** for whether the insider breached a duty: The test is whether the insider personally will benefit, directly or indirectly, such as a pecuniary gain or a reputational benefit that will translate into future earnings (basically was there a gift or a quid pro quo arrangement?).
- 3) Tippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information.
- 4) **RULE:**
 - a) There is no tippee liability, unless the tipper breaches a duty.
 - b) The tipper breaches a duty only if the information is improperly disclosed. Tipper must have a fiduciary duty, then seek to breach that duty under circumstances where:
 - i. The **tippee knew or should have known that the tipper was breaching a duty**; and
 - ii. The **tipper received a personal benefit** from disclosing the information to the tippee (The benefit does not necessarily have to be financial in nature).
- 5) In Dirks, the tippers received no monetary or personal benefit for revealing secrets. They were motivated to uncover the fraud. Therefore, he was not held liable.
- 6) Dissent- have this policy response to majority's construction. Common law framework- unless insider doing something improperly, then there is no breach of duty.
- l. Dirks seemed to condone the selective disclosure by insiders of material non-public information to securities analysts. As a result, the Commission came up with **Regulation F-D**.
 - 1) **Regulation F-D** states that if a regulated person discloses material non-public information to another regulated person, the issuer must simultaneously or promptly thereafter make the information public.

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- 2) **Regulation F-D** applies to 1934 act reporting companies. This is a reporting provision not an anti-fraud provision
 - 3) **The following individuals are subject to the regulation:**
 - a) Broker dealers,
 - b) Investment Advisers
 - c) Investment Companies
 - d) A person associated with any of the above; **and**
 - e) Holder of issuer securities if it is reasonably foreseeable that the holders will buy or sell issuer securities on the basis of the information
 - 4) **The following individuals are excluded from the regulation:**
 - a) Rating Agencies;
 - b) Persons subject to a duty of confidentiality; **and**
 - c) Persons who agree to keep the information confidential.
- m. **US v. Kim** – p. 693
- 1) **Facts:** Company CEO disclosed confidential information to the members of a group called Young Presidents Organization (“YPO”). YPO members sign a confidentiality commitment by which they agree to keep all things disclosed by other members strictly confidential. Kim traded on the info the CEO disclosed. Kim also passed the information along to other close friends and family members.
 - 2) **Issue:** Is Kim liable for insider trading?
 - 3) The court says that there could be a fiduciary duty in a non-fiduciary situation, if a similar relationship of trust and confidence exists. You have a similar relationship if you have dominance, superiority, and control.
 - 4) **Held:** Liability depends on whether you are under a duty to keep the information confidential. An express agreement to keep the information confidential can provide the basis for misappropriation liability only if the express agreement sets forth a relationship with the hallmarks of a fiduciary relationship.
 - 5) **NOTE:** In view of the US government the Kim case was wrong. The SEC now has a rule where the duty is presumed in certain situations. The conduct in Kim predated this rule, the rule does cover the conduct here and Kim would be held liable.
- n. **Switzer Case**
- 1) **Facts:** Switzer, football coach, overhears a CEO tell his wife that he is going to be traveling for a major deal.

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- 2) The CEO did not tip Switzer because he did not know that Switzer was there and listening. Thus, the CEO (Tipper) did not breach a duty so Switzer was free and clear.
 - 3) The tippee inherits the tipper's duty. If the tipper did not breach a duty then there is no liability to the tippee.
- o. **NOTE:** Tender offers do not require breach of duty for insider trading liability under **Rule 14e-3**.
- p. **Martha Stewart Case**
- 1) **Facts:** Implone has a new cancer drug they want to sell pending FDA approval. Waxol (President) learns that the FDA will delay approval. Waxol's broker is also Martha's broker. Waxol tell his broker to sell all of his and his daughter's stock. Broker has assistant tell Martha about Waxol's sale of stock. Martha promptly sells all her stock.
 - 2) Broker clearly breached a duty to Waxol so the issue is did Martha know or should she have known that broker breached his duty? Also Was the information that the CEO was selling all his stock material?
 - 3) **Note:** Martha worked as a broker in the past so it'll be hard for her to say she did not know broker breached his duty.

C. Market Manipulation

1. **§ 9** specifically targets manipulation in connection with securities traded on an exchange.
 - a. It prohibits:
 - 1) Wash sales (stock traded between parties who are related and there is no actual change in beneficial ownership as result of sales),
 - 2) Any simultaneous transaction whose purpose is to make it appear as though there is active trading, **and**
 - 3) Transactions that create actual or apparent trading for the purpose of inducing others to trade.
 - b. **§ 9(a)(1)**- prohibits wash sales, and match sales.
 - c. **§ 9(a)(2)** – unlawful to effect transactions that effect actual or apparent trading, or that raise or depress prices for the purpose of inducing sale of securities by others. Key-purpose requirement.
 - d. **§ 9(e)** - Any person who **willfully participates** in any transaction in violation of a, shall be liable to any person who shall purchase or sell any security at a price that was affected by the conduct.

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2. **Rule 10b-5** is the catchall.
 - a. Courts have incorporated this section to include all of the prohibited activities in § 9.
 - b. Courts have expanded liability under this section to include transactions and statements made with the intent to affect prices. Thus, in some circumstances an act can be manipulative without showing purpose of inducing others to trade.
3. **Rule:** The Supreme Court **defines manipulation as** conduct that is designed to deceive or defraud investors by controlling or artificially affecting the price of securities. Manipulation is also conduct that interferes with the free forces of supply and demand.
4. **United States v. Mulheren** – p. 897
 - a. **Facts:** Boesky wanted to gain control of G&W and met with Davis. Davis was not interested. Boesky offered to sell his shares back to the company at 45\$/share. Davis said he would only buy back if it were the last sale. Boesky called Mulheren. Mulheren was chief trader at and general partner of Jamie Securities, a registered broker dealer. Mulheren asked if Boesky liked the stock. He said yes, and “it would be great if it traded at \$45.” U.S. claimed that M purchased 75,000 shares of G&W common stock with the intent to drive the price to \$45/share, as a favor to Boesky.
 - b. Manipulation is a violation that turns on the motivation of the people trading. **When an investor, who is neither a fiduciary nor an insider, engages in securities transactions in the open market with the sole intent to affect the price of the security, the transaction is manipulative and violates Rule 10b-5.**
 - c. The Court held that there must be substantial evidence in the record to show that there was evidence beyond a reasonable doubt that D intended to manipulate the market.
 - d. The government’s theory is questionable, that it is illegally manipulative for an investor who is neither a fiduciary nor an insider to engage in securities transactions in the open market and with the sole intent to affect the price of a security.
 - e. It was not proved beyond a reasonable doubt that D even knew that Boesky had a stock position in G&W. Boesky never testified he told D; D testified that he had not read the speculation in the press; and in the meeting of D with Davis, D said he did not think Boesky had a position. Further, the government did not prove beyond a reasonable doubt that D purchased the 75,000 shares for the purpose of manipulating the price of G&W stock

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5. **Markowski v. SEC** – p. 907

- a. **Facts:** Markowski, CEO, & Riccio, Trader, manipulated the stock price of the company they underwrote called Mountaintop. When the company could no longer continue to actively trade Mountaintop's stock, the company went bankrupt. Mountaintop stock dropped about 75%.
- b. Court held Markowski & Riccio liable. It said that they manipulated the stock because the company had an interest in keeping customer interest.
- c. **Rule:** The legality of a transaction depends entirely on whether the investor's intent was "an investment purpose" or "solely to affect the price of a security."

6. **Internet Cases**

- a. **Lebed** - in this case, he was the youngest person charged by the SEC (he was 15 at the time). He was buying shares of thinly traded companies. He then posted hundreds of messages under false names in chat rooms saying that the prices of the stock were going to go up. The kid made \$800,000.
- b. **Hoke** - Involved a computer company called pairgame. Hoke posted a message that falsely reported that pairgame was going to be bought out by foreign company. Had a link to another webpage that looked like Bloomberg webpage. This created a lot of trading, and price crashed.

D. **Takeovers and Tender Offers**

1. Tender offers are subject to both state and federal regulation.
2. In 1968 Congress passed the **Williams Act**, which added several provisions to sections **13** and **14** of the exchange act.
 - a. **§ 13(d)** –is a general disclosure provision. It says that any group or person that acquires ownership of 5% or more of a company's stock must disclose certain information.
 - 1) Have to file or make disclosure within 10 days and send to the issuer a statement containing the background, identity, residence and citizenship of the owner, the source of the funds, the purpose of the purchases, and number of shares.
 - 2) This applies regardless of whether or not there is a tender offer.
 - b. **§ 13(e)** governs issuer tender offers (when the issuer repurchases their own stock).
 - c. **§ 14(d)** contains disclosure requirements and substantive regulations for takeovers

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- 1) It is unlawful to make a tender offer if afterwards the person would be the beneficial owner of 5% of the class, UNLESS a 13(d) statement has been filed.
- 2) Includes specific rules that must be followed for tender offers.
 - a) The offer must be open for 20 days.
 - b) The target can withdraw at any time.
 - c) Purchaser has to purchase the shares pro rata.
 - i. If buyer makes a Tender Offer for 75% of shares, each shareholder will only sell 75% of their shares. This means that if a bidder needs 75% and 90% of the shareholders say that they will sell their shares, then all of those shareholders are entitled to sell some shares.
 - ii. It is not first come first served. You can't consume until you get to 75% and then stop. You must wait the twenty days and then, after that break down the 75% that you need among the 90% of shareholders that are willing to sell.
 - d) If the bidder increases the offer, everyone gets the higher price
- d. **§14(e)** is the general anti-fraud provision in connection with tender offers.
 - 1) It shall be unlawful to make any untrue statement of a material fact...in connection with any tender offer.
 - 2) This section gives The Commission power to enact rules reasonably designed to prevent fraud relating to tender offers.
- e. **Rule 14e-3** under **§ 14(e)**
 - 1) If anyone has taken a substantial step to commence a tender offer then it is unlawful to trade in the target company's securities if you know or have reason to know that you are in possession of material non public information obtained directly or indirectly from the bidder or from the target.
 - 2) Note there is a "should have known" standard. This is much broader than Rule 10b-5. You do not have to be tipped. If you overhear a conversation about a tender offer this is enough to bring you under the rule!
 - 3) There is **NO requirement to show a breach of duty**
 - a) This makes it easier to prosecute under 14e-3 than 10b-5 but remember that 14e-3 only comes into play when there is a tender offer
- f. **SEC v. Carter Hawley Hale** – p. 824

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- 1) **Facts:** Limited wanted to take over Carter. When Limited made the offer, Carter's management did not think it would be in the shareholder's best interest, so they instituted a repurchase plan. They bought back stocks.
- 2) Court used the **Eight Factor Wellman test** to determine that the company's repurchase was not a tender offer:
 - a) Active or widespread solicitation of public shareholders for the shares of the issuer
 - i. Court said there was no direct solicitation of shareholders- no active and widespread solicitation occurred.
 - b) Solicitation made for a substantial percentage of the issuer's stock
 - i. Court said the company did accumulate a large percentage of stock
 - c) Offer to purchase made at a premium over the prevailing price
 - i. Court said the premium was determined not by reference to pretender offer price, but rather by reference to market price
 - d) Terms of the offer are firm, rather than negotiable
 - i. Court said the company engaged in a number of transactions at many different market prices
 - e) Offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be repurchased
 - i. Court said the company's purchases were not contingent on the tender of a fixed number of shares
 - f) Offer only open for a limited period of time
 - i. Court said the company's offer not only open for a limited period of time, but open during the pendency of the tender offer of the Limited.
 - g) Offeree subjected to pressure to sell his stock
 - i. Court said the company did not pressure any offeree to sell his/her stock.
 - h) Public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of a large amount of target company's securities.
- 3) Court said that not all factors need be present, and some may outweigh others. But, the court did not specify which factors were more important.

g. **Hanson Trust v. SCM** – p. 829

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- 1) **Facts:** Hanson [English Company] made a cash tender offer to purchase SCM's shares (more than 5%). The tender offer was to last for 10 days; at \$60/share. SCM advised its shareholders not to do it. Then SCM made a deal with Merrill to create a new entity with the purpose of making a tender offer for \$70 to buy out SCM. Hanson then offered \$72. SCM/Merrill offered \$74. Hanson withdrew their tender offer. Hanson thought they could acquire slightly less than 1/3 of the shares (on the open market) and this would thus block the buyout. SCM sued for a preliminary injunction after Hanson acquired about 25% of SCM shares.
- 2) **Issue:** What is a tender offer?
- 3) The court held that privately negotiated security transactions are not tender offers for the purpose of the act.

E. Proxy Regulation

1. Companies hold shareholder meetings once a year to elect directors. State law sets basic requirements for shareholder meetings. Shareholders can vote in person or by proxy. Federal law regulates the solicitation of proxies by all public companies. Reason is that Congress felt this was an issue of national importance.
2. **§ 14(a):** any person soliciting proxies with respect to any security registered under the exchange act MUST comply with rules and regulations adopted by the SEC.
3. **Rule 14a-3** – mandatory disclosure requirements - sets forth type of information that has to be given to shareholders in connection with any proxy solicitation.
 - a. Annual reports have to accompany proxy statements.
4. **Rule 14a-6** – companies have to file preliminary copies of copy materials with the SEC.
 - a. Exceptions include situations when matters to be voted on include election of directors, approval of auditors, or proposal of shareholders.
 - b. Companies are required to file copies, staff selectively reviews them, and gives comments. If staff calls and says that a particular filing is misleading – the company will likely change the proxy.
 - c. Just because SEC review proxy statement, does not preclude shareholder from suing.
5. **Rule 14a-7** – deals with providing shareholder lists- corporation must comply with a request for a shareholder list.
 - a. If a shareholder wants to fight a proxy, they need a list.
6. **Rule 14a-8** - deals with shareholder proposals.
 - a. These cover a wide range of topics and often involve political or social issues.

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- b. **Rule:** if a shareholder meets the requirements, then the **shareholder can have their proposal, along with a brief statement explaining it, included in the proxy materials.**
 - 1) Shareholder must own 1/10 of the securities, or \$2000 worth of securities.
 - 2) Proposals cannot exceed 500 words.
 - c. Rule sets when company can omit shareholder proposal.
 - 1) Proposals that relate to “ordinary business operations of the issuer” can be omitted.
 - 2) No bright line rule as to what falls under “ordinary business operations.”
7. **Rule 14a-9** - antifraud – it is unlawful to make any material misstatement or omission in connection with proxy solicitation.
- a. In Borak the Supreme Court held that there was an implied private right of action in **Rule 14a-9** for violations. The Court, however, limited this right by imposing a causation requirement on plaintiffs. The **rule 14a-9** violation must have caused the Plaintiffs damages.
 - b. This could include negligence → **no scienter requirement.**
 - 1) Unlike 10b-5, most lower courts say scienter is not required and that negligence is enough to establish a violation under Rule 14a-9.
 - 2) Section 14(a), unlike Section 10, does not contain words like ‘manipulative’ or ‘deceptive device’ that Supreme Court said required scienter for violation of Rule 10b-5. But, the Supreme Court has not addressed this issue under Rule 14a-9.
8. **Mills v. Electric Auto-Lite Co.** – p. 759
- a. **Facts:** A merger proposal required the approval of 2/3 of the shareholders. Mills alleged that Board lied in the proxy statement and that it was misleading in violation of Section 14-a.
 - b. The Supreme Court held that if a Plaintiff can prove that 1) there is a material misrepresentation in the proxy solicitation **and** 2) that the solicitation is an essential link in the transaction, then causation has been established/shown.
9. **Virginia Bankshares v. Sandberg** – p. 765
- a. **Facts:** VA law only required that a merger proposal be submitted at the shareholder meeting. But, Virginia Bankshares (“Bank”) solicited proxies on the merger from the shareholders. Bank did not need any of the minority votes to approve the merger. Bank already had enough votes for approval.

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- b. Plaintiff alleged that minority shareholder votes were an essential link because of public relations purposes and because minority approval would satisfy a state law regarding the potential conflict of interest of one of the inside directors.
 - c. Court holds that respondents have failed to demonstrate the equitable basis required to extend the 14(a) private action to such shareholders when any indication of congressional intent to do so is lacking
 - 1) Public relations are too speculative a reason and a state law remedy is still available to the shareholder.
 - d. This case left open the question of what if a minority shareholder loses their rights under state law.
10. **Wilson v. Great American** – p. 769
- a. This case answered the question left open in VA Bankshares.
 - b. Addressed issue left open by Virginia Bankshares: even if minority votes not needed, what if misleading proxy statement and shareholder votes yes and shareholder loses possible remedy under state law.
 - c. **Rule:** A minority shareholder who has lost the right to a state appraisal because of a materially deceptive proxy may make a sufficient showing of causal relationship between the violation and the injury for which he seeks redress.

F. Responsibilities of Attorneys

- 1. **Two Types of cases:**
 - a. Securities lawyers who participate or assist in a securities law violation, **or**
 - b. Securities lawyer who represents a company and has a strong suspicion that the client is violating the securities laws.
- 2. **In re Keating, Muething, and Klekamp** – p. 405
 - a. **Facts:** Law Firm represented a business for filings with the SEC. One lawyer in the firm was on the board of the bank; another lawyer was on the board of the business' subsidiary. Both the business and the subsidiary lied or omitted facts about the loan transactions. 50-80% of the Firm's annual revenues came from the business.
 - b. The case was brought under **Rule 2(e)** (now **Rule 102e**), which gives the SEC authority over lawyers and accountants who appear or practice before the Commission.
 - 1) If a lawyer or accountant engages in unethical or improper professional conduct, then the Commission can suspend or bar the individual from practicing before the Commission.

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- c. The SEC brought an injunctive action against the Firm. The SEC alleged that because of the Firm's involvement with the business and subsidiary the firm knew or should have known of the material misstatements and omissions in the business' filings with the Commission. **NOTE:** This case involved a settlement agreement.
 - d. **Rule:** A law firm has a duty to make sure that the disclosure documents filed with the Commission include all of the material facts about a client that the firm has knowledge of as a result of its legal representation of that client.
3. **Ziemba v. Cascade International Inc.** – p. 425
- a. **Facts:** Shareholder sues a firm for material misstatements and omissions in the company's filings. Specifically, the company omitted bad/negative news from the filings. The shareholder alleged that the firm did not make sure that the information that the Company disseminated to the public was correct. It also failed to verify as accurate information that the firm helped draft. The firm approved and reviewed a press release that the firm knew was not true. Basically, the shareholder argued that the firm was a primary violator because it failed to act.
 - b. The Court found that a defendant's omission to state a material fact is proscribed only when the defendant has a duty to disclose.
 - c. The Court basically agrees with the idea that a primary violator is a person **known** to have made the misleading statement.
 - d. Furthermore, unless the Firm had a duty to the public or Plaintiffs then it does not have a duty to disclose. The Court articulated several factors used to determine if a duty to disclose exists, such as:
 - 1) The relationship between the plaintiff and defendant;
 - 2) The parties' relative access to the information to be disclosed;
 - 3) The benefit derived by the defendant from the purchase or sale;
 - 4) The defendant's awareness of the plaintiff's reliance on the defendant in making its investment decision, **and**
 - 5) The defendant's role in initiating the purchase or sale.
 - e. The court held that there was no attorney-client relationship between the shareholder and the firm (they had no duty to disclose), the attorney-client relationship between the business and the firm forbid the Firm from discussing the information with the public, and the firm did not give any statements to the plaintiff (plaintiff did not rely on the firm).

Securities Regulation
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4. Sarbanes Oxley

- a. **§ 307** required the Commission to set forth minimum standard of professional conduct for attorneys.
 - 1) The Commission rule has to require that the attorney report evidence of securities law violations to the CEO or CLO. If the CEO or CLO does not respond appropriately, then the attorney must report the violations up to the board of directors or a committee of the board of directors.
 - 2) The Commission also allows any lawyer to reveal confidential information without the company's consent in order to prevent a crime that would result in a substantial financial loss.
- b. SEC Proposed Rule is a "Noisy Withdrawal" or "Reporting Out" requirement
 1. Under the proposal, a lawyer can reveal confidential info, without the company's consent if the violation is "likely" to cause a significant financial hardship to the company or investors.
 2. If company does not do anything, then a lawyer must withdraw and tell the SEC she is withdrawing without saying why they are withdrawing.