Chapter 1--Introduction

I. Types of Securities (See Class Handout)
   a. A security is a contract that represents a business interest in an enterprise; a bundle of rights that grants particular rights to the holder of the contract (cash flow, liquidation, voting)
   b. Common Stock
      i. Residual and discretionary dividends, residual liquidation, voting rights
   c. Preferred Stock
      i. Fixed and discretionary dividends, contingent voting rights
   d. Bonds
      i. Fixed and certain investment, high liquidation rights, no voting rights

II. The Capital Market
   a. Primary Market Transactions (Issuance transactions—sold to investors)
      i. ’33 Act and IPOs
   b. Secondary Market Transactions (Trading transactions—sold between investors)
      i. ’34 Act
      ii. NYSE, Nasdaq, etc.

III. Investment Decisions
   a. Present Discount Valuation (PDV)—What a market would pay today for a given amount of money at a given time
      i. Interest
         1. Investors must be compensated for the risk of their investment; the higher the risk, the higher the required return for investors to put their money there
      ii. Present Value
         1. Can quantify it if you have the cash flow and discount rate
         2. Cash flow/(1+discount rate)^years of discount rate
   b. Risk: the probability of a certain return coming to fruition (stocks have a lot of risk, gov’t bonds don’t)
      i. PDV doesn’t matter much if there is huge risk—your discount rate probably won’t be accurate
      ii. Risk=Inflation (discount rate) + other risk (systemic and unsystemic)
         1. Systemic: Risk that affects all companies similarly (though possibly not to the same magnitude)—Fed. Reserve Rate
         2. Unsystemic: Can be cured by diversification—it does not affect all companies in a similar manner
      iii. Inflation is only a prediction of what prices will do in the future
   c. What Risks Matter?
      i. Materiality: If information is the goal and disclosure is the means, then policing disclosure requires knowing what matters to investors
         1. You can’t require people to disclose everything. It would be too expensive and there is a lot of stuff that doesn’t matter to investors
      ii. There is no general duty to disclose all material information
      iii. Because there is an SEC rule requiring disclosure does not necessarily mean it is material

IV. Who Provides Information to Investors
   a. The Incentive to Provide Information
i. Want to be able to place a value on the security you are buying
ii. There is an information disparity between company insiders and investors
   (information=power in investing)
   1. Many people will not want to participate in an auction with a corporate
      insider who has more information than you—they will win
   2. Some say insider trading should be legal—these people know the most
      about the investment and the real value, so their investment will place price
      where it should be

b. The Argument for Mandatory Disclosure
   i. Theory: If there is no disclosure, every security will get an average price, so there
      is an incentive to disclose in order to distinguish yourself and show why they
      should be valued higher
      1. Once one discloses and others see the benefits, they will also disclose
      2. Also helps stock price more accurately reflect firm’s value
   ii. Lemon Effect Theory: In the absence of disclosure, if a buyer does not have the
       ability to differentiate bad from the good (lemons from non-lemons), buyers will
       assume everything is a lemon and will exit the market—a market must have
       disclosure to work
   iii. Coordination Problems (Informational needs of investors)
       1. If the companies do not report the same type of information, we cannot
          compare them and make intelligent investment decisions
   iv. Agency Costs: Unless required, managers will have an incentive not to disclose
       some information that would benefit shareholders
       1. Managers may not want to show salary, share ownership or trading patterns
          and if not required to do so, they wouldn’t
       2. Minimizes shareholder costs in needing to monitor managers
   v. Positive Externalities (unintended benefits to 3rd parties)
       1. More disclosures will lead to more accurate securities prices
       2. Competitors and others may benefit from the disclosed information
   vi. Promotes fairness
   vii. Duplicative Information Research
       1. Investors competing with each other have an incentive to spend a lot of
          money to obtain an informational advantage and this leads to a lot of
          overlap
       2. This discourages such a “winner take all” approach and presents everyone
          with low cost inside information
   viii. Costs of Mandatory Disclosure: Disclosure is expensive and unless required to
        make it, many companies will not want to make the necessary expenditure

c. Argument Against Mandatory Disclosure
   i. Market will take care of itself (Strong Market Incentives)—issuers will realize
      they get higher value if they make disclosure and thus will provide necessary
      information or risk losing out
   ii. “End game problem”: If you can’t afford to make disclosure, maybe you
       shouldn’t have to be as rigorous as required
   iii. Too much information: impossible to sift through it all

d. How Does Disclosure Matter?
   i. Filtering Mechanisms
      1. Investors who do not read disclosed information can still learn its contents
         and implications indirectly through brokers
ii. The Efficient Capital Market Hypothesis
   1. Describes the relation between markets and information and justifies disclosure; how strong the relationship is between information and the price
      a. Weak ECMH
         i. Reflects all past price information and knowledge, but it cannot predict future prices (“random walk”)
         ii. Likely true, but only partially because there is much more information than just about price available
      b. Semi-Strong ECMH
         i. Reflects all publicly available information and the market quickly adjusts to disclosure (price moves)—information is quickly “digested”
         ii. This is likely true and most of the story
         iii. Basis of most security regulation
      c. Strong ECMH
         i. Price reflects all information—public and private
         ii. Likely false because the market would know everything and there would be no need to regulate; plus there would be no speculation involved since price would always be accurate
      d. Implications of ECMH
         i. It cannot be strong or else we would never have bubbles, crashes or speculation—price would always be accurate
         ii. Rather, the markets react to information—it adjust quickly when new information is released
         iii. Truth is somewhere between—market isn’t rational or irrational

V. The Regulatory Apparatus
   a. Purpose of Securities Regulations
      i. Investment Protection/Level the Playing Field
         1. Mandate disclosure by requiring certain types under certain conditions
         2. Antifraud—disclosure is only as good as the accuracy of the information disclosed; investors need to trust what they are told
         3. Ex-Ante (rules about what you need to do) vs. Ex-Post (sanctions if you fail to do them)
   b. Possible Modes of Government Regulation
      i. Merit: The SEC would go in and investigate and then say whether an investment was good or bad
         1. Unfair and inefficient
      ii. Education: Government provides courses about investing and what we should look for
         1. Inefficient and would probably not accomplish much because most people wouldn’t take advantage of it—still wouldn’t have a knowledgeable public
      iii. Disclosure: Companies disclose information which helps us decide for ourselves what is good and what we want
         1. SEC regulates disclosure and this is the main mode of regulation
   c. The Federal Securities Laws
      i. Securities Exchange Act of 1934—regulates secondary markets for securities and effects everyday life significantly
         1. Mandates continuous quarterly disclosure of financial information
ii. **Securities Act of 1933**—governs primary transactions and not that significant for individuals
   1. Prohibits sales of securities w/o being SEC registered
   2. Prohibit fraudulent sales of securities
   3. Mandates disclosure of financial information to potential buyers

iii. **Sarbanes-Oxley Act of 2002**—created in response to Dot-com bubble busting and Enron

d. **The Securities and Exchange Commission**—created in §4 of ’34 Act and their power is delegated by Congress in legislation
   i. **Headed by Commission** w/ 1 Chairman, 4 commissioners
   ii. **Divisions**
      1. Corporate Finance
      2. Market Regulation
      3. Investment Management
      4. Enforcement

iii. **Offices**
   1. General Counsel
   2. Chief Accountant
   3. Economic Analysis
   4. Municipal Securities

e. **States**
f. **Self-Regulatory Organizations**
   i. NASD (National Association of Securities Dealers)
   ii. The Exchanges

**Chapter 2—Materiality**

I. **Types of Communication**
   a. Affirmative statement of historical fact (financial statements, analysis of past results)
   b. Affirmative statement of forward looking statement (prediction)
   c. Partial affirmative statement
   d. Silence; general—do you have a duty to disclose? **There is no general duty, but it is required in some circumstances**
   e. Silence; disclosure rule—if it is required then you must include it or face sanction

II. **Analysis of statements**
   a. Look at type of communication (above)
   b. What are the facts (Was it a merger? Was there a stock issuance? Etc.)
   c. What is the relevant test?

III. **Materiality** = **Substantial** likelihood that a **reasonable investor** would view it as **significantly altering the total mix of information** (*TSC Industries v. Northway*)
   a. Don’t want to require disclosure of everything
      i. You will drown investors in information (finding a needle in a haystack)
      ii. There will be huge costs to disclose everything and this will cost the investors in the end
   b. This will be used to determine if the company has made a material misstatement or omission that would have altered the behavior of an investor (basically common law fraud)
   c. You cannot necessarily use a % of revenue to define materiality (though anything more than 10% is almost surely material)

IV. **Forward Looking Information** (contingent events)
   a. *Basic v. Levinson*: “**Materiality** depends on the **significance** the **reasonable investor** would place on the withheld or misrepresented information”
i. **Probability Magnitude Test:** *Probability that an event will happen x the anticipated magnitude of the event*
   1. In judging forward looking information, look at the likelihood that it will happen and how much impact it will have if it comes to pass

ii. Puffery is not actionable

b. **Oran v. Stafford**
   i. There were liability suits and scientific evidence that the company might be in trouble, but there was no reason to give all information to investors—would have increased alarm unnecessarily
   ii. Unless info would have resolved conclusively that this drug was going to be a disaster, it is not material

iii. **Use the probability x magnitude standard**

c. **Behavioral tendencies**
   i. There is a difference between reasonable investor and most investors (not savvy)
   ii. Most people have a hindsight bias when looking at a past event (if it did happen, we assume it was more likely to happen)
      1. This is required when courts and juries do probability x magnitude equation

iii. **Should we protect the unreasonable investor?**
   1. **Hindsight bias**—people overestimate whether good or bad things will happen in the future based on past events
   2. **Overoptimism**—people are irrationally optimistic about investing
   3. **Availability bias**—people go for what is on the front page of the paper
   4. **Endowment Effects**—people will hang on to things they already have even if it is not in their best interest
   5. **Groupthink**—we subscribe to prevailing wisdom

iv. We realize people aren’t machines, should we regulate based on how they truly act?

V. **Quantitative Facts**
   a. Can we look at past fiscal results to figure out if something is material?
   b. **Ganinio v. Citizens Utilities Company**
      i. Company had increased revenue for 50+ years which they emphasized in ads, but they knew they were going to miss that in 1996. Instead they played with the books and reported it to seem their profitability increased. Then in 1997 their earnings decreased sharply and did not acknowledge that this wasn’t surprising.
      ii. The Court said there were **material misrepresentations**. They should have reported more than numerical benchmarks, but also policy decisions—qualitative assessments are important
      iii. There was an **affirmative statement** about the health of the company that was a lie (same as just making up numbers basically)
         1. You are not just worried about the company business, but also the integrity of management (did they lie about other things, can they be trusted to lead the company?)
      iv. The **value of the lie was not large** (% of revenue was only 1.7%), but **must look at other factors**—it is material if the management is a problem and employees of all levels are involved
         1. Accounting convention says 3-5% is material, but court doesn’t care here

c. **Can we quantify materiality?**
   i. Some courts says that materiality involves events or news that would affect a company’s earnings by 3-10%, is this a good standard?
      1. Probably not, it is either under or over inclusive.
2. Look more to qualitative factors (management integrity, competence)
3. Context—need to look at what the company is saying and doing

VI. The “Total Mix”
      i. Food Lion stock dropped after ABC showed they had cut sanitation corners and forced employees to work extra hours in violation of the law. The company had advertised that it was thriving because of clean stores and happy workers, which were false
      ii. The plaintiffs lose because the nature of the claims against the company were well known and the company had not made actual false statements about their situation (they weren’t going to admit guilt in a 10-Q, this was common puffery). The problems were already factored into the stock price
   b. **Who do we want to protect**—who must interpret the “total mix”?
      i. Investors who read and digest the information by themselves (presumably sophisticated)
      ii. Investors who rely on professionals (professionals might have additional information and can better interpret the information)
      iii. Investors who rely on market price and no other information
   c. **Defenses**
      i. **Truth on the Market**
         1. Everyone already knew the truth—it was in the market
         2. The market price already accounts for the information and if stock price drops when information officially announced, it was merely overpriced stock
      ii. **Bespeaks caution doctrine**
         1. Company tells investors to be cautious—some things (like future projections) are guesses and investors shouldn’t base decisions solely on that. Let them know there is risk
      iii. **Puffery**
         1. Information that everyone knows is the type of thing people discount and don’t rely on—it isn’t material because it does not change the mind of the reasonable investor

VII. Management Integrity
   a. *In The Matter of Franchard Corporation*
      i. One person was a major shareholder, president and chairman—controlled the operation and many investors only involved because of his reputation. He borrowed money from the company and did underhanded things without disclosing to the SEC
      ii. The SEC says he should have disclosed this information and about the activities of other board members—this is material information to investors who are investing based on personal reputation
         1. Highly material to his competency and reliability of his management
         2. Demonstrates several things about the company
            a. If management in a strained financial situation (possibly more willing to cheat the company)
            b. If they have integrity
            c. What the motivation is for running the company
            d. The possibility of change of control
   b. Ken Lay Loans
      i. He was getting loans using stock as collateral (>100m); the price of his investments were only as good as the value of his Enron stock; if that value went down so did his
other investments and he’d have to sell stock—started repaying loans to the company using his stock

ii. Using Franchard he failed to disclose material information
   1. You don’t want insiders able to sell stock without reporting to you (there was no report of him using stock to repay loans)
   2. Don’t want them to get personal loans using stock as collateral (not allowed under SOX

iii. Reporting this would have changed views of his integrity—material

iv. Some argue this shouldn’t be illegal because it didn’t violate the letter of the law

v. This wasn’t on the books because no on had foreseen it—now can’t make loans to executives

c. SEC v. Fehn
   i. The man who controlled the company didn’t disclose his actual position with the company for over a year and the company failed to report recent securities law violations
   ii. The company should have disclosed this information and he should admit that he did something wrong (helped securities violation) even if it means admitting he did something wrong (no 5th Amendment protection)

Chapter 3—The Definition of a Security

I. Do the Securities Laws Apply?
   a. Must ask if what you are looking at is a security
      i. Effects of being a security
         1. Disclosure obligations
         2. 10b-5 anti-fraud liability
         3. Gun jumping violation
         4. SEC jurisdiction
      ii. Defined by ’33 Act §2(a)(1); ’34 Act §3(a)(10) essentially the same
         1. Stocks, bonds, fractional interests, and catch all “investment contract”
            a. They tried to include most of the standard items in finance but the “investment contract” is meant to include things the legislature didn’t otherwise consider
            b. The catch all makes this very broad and encompasses many things
         2. ’34 Act §3(a)(10) essentially the same

II. “Investment Contract”
   a. SEC v. W.J. Howey Co.
      i. Sold interests in an orange grove and then the grove offered to sell maintenance contracts; these were securities
      ii. Look at the substance over form
      iii. Howey Test: An investment contract is a contact, transaction or scheme whereby a 1) person invests his money in a 2) common enterprise and is 3) led to expect profits 4) solely from the efforts of the promoter or third party
      iv. Worried about the offering of securities, not the purchase of them

b. “A person invests his money”
   i. Does the person choose to give up specific consideration in return for financial interest?
   ii. Teamsters v. Daniel
      1. A non-contributory, compulsory pension plan—Daniel wants to claim it is a security (investment contract) so he can claim it was fraudulent
      2. The court says this is not a security
a. The employer is paying into it and the employee is no directly; employee pays no consideration (what about labor?)

3. The type of consideration that will count
   a. **Value**: needs to be of a certain amount (but not necessarily cash)
   b. **Choice**: you need to have a say in what you are investing in
      i. Court says if it was an *optional pension* and the **people chose to put $$$ in then it would be an investment**

   c. **“In a common enterprise”** (Commonality)
      i. With whom must **investors have an interest in common**?
         1. Implies that a number of investors will stand in a similar relationship to a business in which the invest in common
      ii. **Horizontal commonality** (majority view): Involves *pooling* of assets from multiple investors so that **all share in the profits and losses**
         1. All boats rise and fall together
         2. **Ponzi and Pyramid schemes** work with this standard; both are predicated on a continuous flow of money to remain viable
      iii. **Vertical Commonality**—profit sharing (promoter and investors have different pools of assets)
         1. **Broad** (BVC): Promoter’s efforts affect all boat’s equally
            a. A wheel conspiracy—the promoter is the hub and the investors are at the ends of the spokes
            b. True in public company
         2. **Narrow** (NVC): Promoter’s boat rises and falls with investors—promoter themselves are involved in the stock

d. **“Is led to expect profits”**
   i. **Investors expect to make money**; focus on the **mental state** of the potential investor—what do they think is going on?
      1. What are the **reasonable expectations of the people who are offered the investment**?
         a. **Consumption** is not looking for profit
   ii. **Why care about expectations of profit?**
      1. SEC is wants to protect investors on the periphery in poorly understood markets—if they think they are putting money into something and hope to profit, then that should be sufficient to make it an investment contract in their mind
   iii. **United Housing Foundation v. Forman**
      1. The company sold “shares” to residents of low-income housing basically as a deposit so they would have a place to live
         a. They use the term “stock,” but you get room, not an ownership interest—don’t own it; can’t pledge it (sell it)
         b. There is **no profit motive**; just a **consumption motive**
2. Real estate deals
   a. Fee simple: If you buy land to live on, even if you hope to resell at a profit later, it is not a security
   b. Syndication (buy with others): this is a security if you are just buying to resell at a profit and not live there
   c. Time shares: Look what the investor is expecting from the transaction

iv. SEC v. Edwards
   1. Edwards would select a location, set up phone and investor would pay for the phone itself; Edwards guaranteed return of 14%--investor has title to a specific phone and can then give it back for return of $$ after 5 years (sale and leaseback)
   2. Essentially a loan with a fixed repayment from investor to company, but it is actually riskier than advertised, so investors should be protected
   3. **Fixed profits can be protected under the Howey test**
      a. Look at profits that they expected, whether or not they get them from that investment

e. “Solely from the Efforts of the Promoter of a Third Party”
   i. Don’t read it literally; it can be “predominately” from the efforts of others
      1. There are many situations in which the investor does at least a little bit of the work or has some power
   ii. We are concerned about information asymmetry—presumably the more active you are in the investment itself the more information you have and the less concern there is about you lacking equal information
      1. Worried about investors who are completely dependent on others

iii. Partnership deals
   1. Limited partner usually less active and doesn’t have control; general partner has economic and managerial control
   2. A **limited partnership interest will usually be security** unless LP has significant control; **General partnership is probably not a security**

iv. Rivanna Trawlers Unlimited v. Thompson Trawlers
   1. This is a general partnership deal and the partners can dissolve the partnership and have control over certain management decisions
   2. Court says this is not an investment because the partners have significant control within the company and are not relying on the efforts of others
   3. Only look at whether a particular partner’s contract is a security, not the entire partnership
      a. The partners here have too much control (not solely in the hands of others), so they are in charge of the company
         i. They don’t have information disparity

v. Franchise deal
   1. Franchisee is investor and franchisor is promoter
   2. Franchisor gives a lot of requirements and micromanage everything; franchisee has day to day control (they need to sell product to make money)
   3. Look whether they are able to get out of the deal (this is the type of control that means that it is not an investment)
   4. Fact specific investigation, but most are not securities (franchisees have too much control)

vi. Kinds of effort—(from most likely to be an investment contract to least likely
   1. Investor does nothing (Investment contract)
2. Investor reads a document (say a balance sheet)
3. Investor relies on managers w/o control
4. Investors rely on managers with control (hiring and firing power)
5. Investor does all (Not investment contract)

III. Stock

a. Just because it is called “stock” doesn’t mean it is a security; must look at the substance (See Forman and Landreth)

b. Landreth Timber Company v. Landreth
   i. Family owned timber company sells all stock in the company to a buyer (same as selling all property, but here it was stock)
   ii. The “sale of business doctrine”—these securities had all the attributes commonly associated with stock, regardless of the purpose of the transaction, so they were stock

   1. Investor definition is irrelevant; sniff test defines stock

c. Characteristics of stock—Don’t need all of them, but at least some of them
   i. Dividends based on profits
   ii. Negotiability
   iii. Can pledge (assign)
   iv. Vote proportionally
   v. Can appreciate in value

IV. Note

a. Promise to pay back the investment (the issuer is the borrower, not the lender)
   i. The term “note” in the statute cannot mean all notes, because some people who buy tvs on credit at Best Buy would then have to file disclosure for issuing note promising to repay note to the company

b. Reves v. Ernst & Young
   i. A co-op was giving out notes and trying to raise $10m for agriculture business—demand notes that the holder could redeem at any time, but they paid good interest so that people would hold onto them

   1. Court held these were notes because of a “family resemblance test.”
   ii. Was this a note?

      1. Family Resemblance Test: Common law test that if your facts look like the facts of previous cases, you have a security (“judicially crafted list of exemptions”)
         a. The motivation of lender and borrower (Issuer looking for cash for operations (not a specific purchase); lender looking for profit=note)
         b. Is it the subject of common trading for speculation or investment
            i. Is it offered to the general public or only specific people
         c. How the note would be perceived by reasonable members of the public
         d. Is the transaction subject to other regulatory schemes

      2. Was it not redeemable until after 9 months?
         a. It looks like a person was just borrowing (a loan) if for less than 9 months—anything shorter than 9 mos. is not a security
         b. §3(a)(3) of ’33 Act—Congress made the decision that 9 months is the cut off for loans that don’t look like investments

   iii. Notes are not consumer finance, home mortgage, short-term home lien, short term loans

      1. These things are not investment securities
c. Securitization
   i. Taking something, bundling it and then selling as a security
   ii. Ex. Home mortgages—banks bundle and sell them to 3rd party and then 3rd party sells interests in that pool
      1. If the pool is profitable investors receive share of income
      2. The underlying instrument is a note; need to do Howey test

Chapter 4—Disclosure and Accuracy
I. Mandatory Disclosure and Accuracy
   a. Rationales for mandated disclosure
      i. Value of a common standard on which we can compare two companies
      ii. Agency costs: management and investors interests might diverge and management won’t disclose certain things appropriately if not required
      iii. Wasteful duplicative research if not mandated
II. What is a “Public Company”—“Exchange Act Reporting Company”—a company required to make certain disclosures because they are regulated by the ’34 Act
   a. Public Company Status
      i. §12(a) of ’34 Act (Exchange securities)
         1. Securities traded on an exchange must meet the provisions of the ’34 Act
            a. This makes a broker-dealer a violator if they trade in unregistered security, so public companies will register or their securities won’t be sold
      ii. §12(g) of ’34 Act (Over the counter securities)
         1. Every issuer engaged in interstate commerce (that means everyone) with more than $10m in total assets and 500 shareholders will be subject to registration requirements
      iii. §15(d) of ’34 Act
         1. Every issuer who files a registration statement must also file periodic reports with SEC
   b. Escaping Public Company Status (“Going Dark”)
      i. 15(d) of ’34 Act
         1. The duty shall be suspended for a security registered pursuant to §12 if at the beginning of the fiscal year it is held by less than 300 persons (does not apply in the year you filed your registration)
            a. Must file periodic requirements for at least a year
      ii. 12(g) of ’34 Act
         1. Allowed to go dark if less than $10m and 500 shareholders for last 3 years
      iii. Why go dark?
         1. High transaction cost—very expensive to prepare forms
         2. High expectations--Must be able to say things in reports and comply with what you say—that is hard and expensive
         3. Managers don’t like scrutiny even though investors like it (agency cost)
III. When Must a Public Company Disclose and To Whom?
   a. SEC wants “integrated disclosure” which provides consistent set of disclosure requirements between the Acts
      i. Allows investors to compare companies using similar information
      ii. Allows issuers to make references to previous filings (lowers compliance cost)
   b. What must be disclosed?
      i. See Forms S-X and S-K
1. Several parts (mostly in 300 and 400) were added after SOX and include audit procedures, relationships and information about management
2. S-X is technical stuff about accounting

c. Form 8-K
   i. Companies must disclose on a “rapid and current basis”, and this is closest to a real time disclosure when something special happens at the company
      1. Entry into or conclusion of a definitive material agreement (major contract)
      2. Bankruptcy
      3. Major acquisition or sale
      4. Results of operation—if you make a significant statement about financial results, you need to file this
      5. Off-balance sheet transactions that might not be reflected in other filings
      6. Material impairments—ex. a counterparty owes a bunch of money, but is going bankrupt and will never pay it back
      7. Departure or appointment of directors
         a. Need to explain the circumstances as well; don’t include personal information, but just enough so investors know the story
         b. The company would likely argue that it is obvious why someone is leaving so they don’t need to include info (questionable)

d. Forms 10-K and 10-Q
   i. 10-K (Standard annual filing)
      1. The financial aspects in it (regulated by S-X) must be audited and the accountant must certify that it fairly presents everything (outside auditor)
      2. Includes
         a. Business, properties, legal proceedings, directors and officers, executive compensation, security ownership of beneficial owners, etc.
      3. MD&A (Item 303)—Management Discussion and Analysis of Financial Condition and Results of Operation (also required in 10-Q)
         a. This is the narrative portion—discuss what is happening in business
         b. User friendly for the average investor
         c. Management must say something about significant things coming in the future (liquidity, capital resources, etc.)
         d. Must be reasonably likely to have the stated effect
            i. There is a safe harbor for forward-looking statements
      4. CEO and CFO need to certify the 10-K and 10-Q—this won’t allow executives to escape liability for false statements in the filings
         a. SOX ratcheted up the penalties and meaning of the statement
   ii. 10-Q (Standard quarterly statement)
      1. Standard quarterly report filed 3 times a year (other quarter is 10-K)
      2. Auditor reviews financial information here so they can give certification in K, but does not need to be audited
      1. Retiring CEO had ridiculous perks and didn’t include the information on a disclosure form for lawyers, so company didn’t report them in their filings
      2. The current managers were charged with not meeting filing requirements, they failed to prevent a misstatement they should have known about
      3. The SEC realized it was probably unintentional, but it was strict liability, so the SEC gave a reprimand and there were no serious consequences

e. Other disclosure
i. Press releases, analyst conference calls, IR communications, road shows, public offering process, chit-chat, press leaks, communications with rating agencies

f. The Problem of Selective Disclosure

i. Reg FD—discusses when you are and are not allowed to selectively disclose
   1. **General Rule**: Person acting on issuer’s behalf who regularly communicates with market professionals and senior officials cannot selectively disclose
   2. This prevents insider trading, based on the idea that fairness is important in the market
      a. Worried about corruption and inequality
   3. **Probation on**: Companies from selectively disclosing to: a) broker-dealer, b) investment adviser, c) investment company, d) holder of issuer stock
   4. **Public Disclosure**: If intentional it must be simultaneous. If unintentional, must be within 24 hours
   5. **Does not apply** when a) person agrees to maintain info., b) to person with duty of trust and confidence, c) credit rating agencies and d) someone in connection with ’33 Act
   6. **No private right of action**

ii. *In the Matter of Siebel Systems, Inc.*
   1. CEO disclosed stuff accidentally on conference call and the company failed to then release information to general public
   2. Those who invested in the stock did not violate insider trading rules—relatively narrow standard
   3. They should have just used a webcast or something—protect against FD violations by making sure it is disclosed

IV. Accuracy of Disclosure

a. **Books and records** ([§13(b)(2) ’34 Act)
   i. You must have good documents (reports, proxy statements and other documents filed with SEC) that accurately and fairly reflect the financial transactions of the business
      1. This is a favorite of the SEC
      2. Very broad—a little mistake in internal documents (not even public filing) will be a violation—almost everyone would be violating if you looked deeply
   ii. **Internal accounting controls** must be sufficient to prove that reasonable recording is achieved
   iii. Only criminal if done knowingly or recklessly (SEC will not question reasonable methods)
   iv. *In the Matter of Tonka*
      1. The company allowed the CFO to invest money for the company and he invested it in a company that was not authorized that also happened to be owned by the CFO and had no assets—the CFO then took the money and kept it
         a. He lied about it and there were no accounting controls to ensure that the CFO hadn’t been doing this
         b. SEC brought charges, the company promised to implement changes; basically corporate shaming
         c. Company gets a slap on the wrist—the CFO was the criminal, so no need to punish the company and investors harshly
   b. **Gatekeepers**: Any third party without whom a transaction can’t take place
      i. **How do you create a gatekeeper**
1. **Mandate it legally**
   a. Auditing of 10-K; must have certification of auditor
   b. Must have credit rating to go on the exchange
   c. Can’t have tax shelter without opinion of a tax lawyer
2. Market forces require them if they are not mandated

ii. **Why sanction them?** Why not punish the primary party for improperly relying on the gatekeeper?
   1. Gatekeeper only valuable if they are protecting the public interest, not just the client who pays them—we want to realign their incentives to ensure fairness and exploit the value of the gatekeeper
   2. \( ES = P \times S \)
      a. Expected sanction = Probability of sanction \( \times \) Sanction
      i. Sanction may be statutory or reputation effects
      b. Expected sanction needs to exceed the benefit to get deterrence (\( ES > B \))

iii. **Problems with gatekeeper sanctions**
   1. The more work they do the higher the fees, so hard to get sanction high enough to keep gatekeeper interests aligned with the public
   2. Clients will stop asking gatekeeper for advice if they are likely to get in trouble—we need to make sure their relationship remains strong as well

c. **The Independent Auditor**
   i. A mandated gatekeeper for public companies

ii. **Tasks and duties**
   1. Required to audit financials—they engage in a process regulated by quasi-legal bodies (GAAP and GAAS—generally accepted auditing principles and standards)
   2. They ensure companies meet these standards

iii. **How did SOX change things?**
   1. There is a Public Company Accounting Oversight Board—hybrid public-private agency; gov’t appoints and their actions are under the SEC, but they are in charge of monitoring accounting industry
   2. \( \S 10A(a)(1) \)–Auditors must have procedures to find crimes and other illegal acts
   3. \( \S 10A(g) \)–restrictions on accountant ability to sell client non-audit services
   4. \( \S 10A(m) \): CEO and CFO and directors need to monitor the auditors must more closely

iv. **What are their liabilities?**
   1. **Primary violations**
      a. Sued and enforced against
   2. **Aiding and abetting** (SEC and DOJ only)
      a. Enforced against
   3. **102(e) professional discipline**
      a. Censured by the SEC
      b. You can be suspended or disbarred

v. **Why aren’t market forces sufficient?**
   1. They have an economic incentive to not hurt their reputation
      a. Not sure: they offer more services as well, so it wouldn’t hurt them completely to have bad auditing rep.
2. They really only make money if the firm likes them, so they aren’t as worried about bending rules
3. Investors don’t know much about the reputation of auditors, so they need protection
d. The **Gate keeping Role of Lawyers**
i. Lawyers should be able to check unethical behavior by managers, but only if very bad (not a day to day check like auditors)
   1. Lawyers take instruction from managers so this doesn’t always work
ii. **Required by market forces**—There isn’t mandated involvement (de facto gatekeeper) like there is for an auditor, but all companies use securities attorneys
iii. **What are their tasks?**
   1. They defend you before the SEC
   2. Their task is to prevent law breaking and are regulated themselves by professional responsibility and the SEC rules of practice
   3. Lawyer doesn’t certify the filing the way the auditor does—they don’t have to stick their neck out as far
iv. How did SOX change things?
   1. **Noisy withdrawal Provision**—attorneys must blow whistle if he knows client is doing something wrong
      a. Expected to rat on client
   2. You may reveal information without issuer consent if you think it is necessary to protect against violations or to cure violation
v. **Liabilities**
   1. Primary violations
   2. Aiding and abetting client’s primary violation (only enforcement action)
   3. 102(e) professional discipline
      a. Very rare and would probably only happen if disbarred by a state
V. **Enforcement Issues**
   a. SEC has enforcement division—report to the SEC Commission
      i. Need approval of the Commission to launch formal investigation or bring action
   ii. Investigations usually start outside the SEC
      1. Wall St. Journal Article or other press
      2. SEC reporting (regular filings)
      3. Whistleblower tips
      4. Self-Regulatory organizations (NASD, Nasdaq, NYSE)
   iii. Start with informal request for information and most companies comply—not good to say no
   iv. If the Enforcement division finds anything they go to the Commission for permission to proceed
b. **Administrative Proceedings** (Chart on Pg. 361 Gilbert)
   i. SEC powers
      1. §21(a): Allows SEC to **conduct investigations** and allows them to **publish information** about violations it uncovers w/o formal proceedings
         a. This is only a **reputational sanction**, SEC often proceeds onto formal investigation
         b. Some don’t like this because prosecutors shouldn’t punish for factual admissions, just violations of the law
      2. §15(c)(4): SEC can sanction person who does not make required filing or does so late or in incomplete way
a. **Applies to companies** subject to §12, 13, 14, or 15(d) of ’34 Act who fails to comply or causes someone to fail to comply

b. **Requests that companies comply**, but SEC must get a court order to enforce request

3. **§21C**: Allows the SEC to get a cease and desist order against persons found to be violating or about to violate the law, even if not registered with SEC (most common procedure)

   a. **Requires company to stop violating** and comply in the future
   b. **Administrative Law judge** makes determination and then you can appeal to the SEC commission

4. **§21(d)**: The SEC can sue for an injunction in federal district court (as tough as they can get)

   a. It is granted when there is “reasonable likelihood of further violations in the future”

5. **§12(j)**: SEC can revoke or suspend the registration of a security after notice and opportunity for a hearing

6. **§12(k)**: SEC can:

   a. **Suspend trading** of any security for not more than 10 days
   b. **Suspend all trading** in all securities for 90 days with approval of President
   c. In “Major Market Disturbance” it can take **whatever action respecting markets** it determines to be in the public interest

7. Pretty much anything can be appealed to the courts (D.C. Appeals is the main one)

ii. **Settlements**

1. Almost all enforcement proceedings settle?

   a. Usually include:

      i. Fine
      ii. An order: cease and desist or injunction
      iii. An agreement to neither admit nor deny

2. What purpose do they serve?

   a. **Companies**

      i. Don’t want to risk civil litigation from shareholders, so they try to settle with the SEC (collateral estoppel worries)
      ii. Companies don’t like uncertainty—want to be able to plan and limit their exposure

   b. **SEC**

      i. likes settlements because it is cheaper, takes less time and resources and most importantly it helps investors
      ii. Company is now on probation—under a microscope and if they are in big trouble if they violate anymore rules
      iii. Company and industry will be on notice not to screw up
      iv. SEC collects money, publicity and Congress and the public like it

3. **“Neither admit or deny” provision**

   a. The company pays a fine, but doesn’t admit guilt
   b. If this was not in the settlement, civil plaintiffs would take the admission and use it in court to win awards
   c. If they were required to admit, companies wouldn’t settle
c. Investigations and Strategy
   i. Cooperation from witnesses
      1. Companies do not want to appear to be obstructing investigation—gives impression that there may be greater problems
         a. Lucent Settlement
            i. The company punished harshly because they hadn’t cooperated
            ii. SEC wants cooperation because it saves resources and companies don’t want to be seen as obstructionist (they look like they have something to hide)
      2. Companies can waive attorney-client privileges at SEC request
         a. Bar doesn’t like this because confidential statements can be revealed to SEC and clients may not be as forthright with lawyers as a result
   3. Indemnification of employees: Sanctions and Costs
      a. Companies may indemnify employees for costs of SEC fines and legal fees
      b. Controversial because employees may feel more free to do illegal things knowing they’ll have free legal representation—should the SEC take this into account when punishing individuals and companies?
      c. SEC does not like companies paying for employee sanctions (just passes on the costs); might as well just fine the company

   d. Subpoenas (§21 '34 Act)
      i. Only arises in formal investigation (need Commission approval) under 21(a)
         1. Must go to court to mandate compliance if recipient refuses to comply voluntarily
      ii. Scope of power
         1. The SEC can subpoena witnesses, administer oaths and compel the production of books and records
            a. Can be denied by courts for abuse of power
         2. RNR Enterprises, Inc. v. SEC
            a. Investigation must be for legitimate purpose
               i. Investigate past or future offenses
               ii. Can investigate entire industry
            b. The information must be relevant to the issue (which can be very broad)—courts usually defer to SEC as long as not obviously wrong
            c. Must be new information—not duplicative of info. they already have
            d. Must follow proper administrative steps (go to Commission, etc.)
            e. If someone doesn’t comply, they must go to the courts, which can force compliance
      3. Why not require more? (like probable cause?)
         a. Effectiveness of investigations
         b. Competence of courts
            i. Courts aren’t in a position to decide what the SEC already knows
         c. There is a reduced expectation of privacy in corporate setting
         d. Not as powerful as grand jury subpoena
   iii. Parallel SEC/DOJ investigations
      1. Fifth Amendment Rights
a. If you assert the 5th it can’t be used in criminal trial, but an adverse inference can be drawn from the plea in civil matters
b. Do not have privilege with contents of a document, but are not required to authenticate it
c. Can’t destroy corporate documents

2. Stay of proceedings
   a. A problem when SEC and DOJ are gaming the system and acting improperly; otherwise a person could halt an investigation for one branch and prevent the gov’t from doing its job (statute of limitations, witnesses forget things, etc.)
      i. It is more efficient to have both departments working together
   b. SEC v. Dresser Industries, Inc.
      i. Court decided that Dresser must comply with subpoena for its corporate records in connection with SEC investigation, even though the DOJ was pursuing the same matter in a grand jury

e. Judicial Review of Administrative Remedies (§21C ’34 Act)
   i. KPMG, LLP v. SEC
      1. Auditors aren’t allowed to have contingency fee contracts with clients—you don’t want them to have a financial stake in how much the client is making
         a. Standard of review for cease and desist orders: Reasonable relation to prior violations (can’t simply issue very broad order, must be specific)

2. Sanctioning accountants
   a. 102(e): Need to show a lot more bad conduct because it is for serious transactions and will result in disbarment
   b. 21C: Negligence is enough, so this is more commonly used

f. Judicial Remedies
   i. Injunctions
      1. 21(d) of ’34 Act
         i. Authorizes the SEC to file an action in the appropriate court to enjoin violations of the securities laws
            1. SEC does not need to show irreparable injury or the inadequacy of other remeies
            2. Very fact specific test
      2. Aaron v. SEC
         a. “Scienter” required for 21(d)(1) injunctions
            i. Scienter is an intent on the part of the defendant to deceive, manipulate or defraud
               1. Not required of 20(b)
               ii. If scienter is a requirement for the substantive provision being violated, then it is a requirement of the injunction as well
      3. Injunctions against future violation—such an injunction is appropriate where there is proof a person is engaging or is about to engage in a substantive violation
         a. Future violations must be reasonably likely
         b. Factors to consider for likelihood of future violation:
            i. Nature of the violation
            ii. Egregiousness of the violation
            iii. Repeat offender?
iv. Degree of scienter (intent)
v. Defendant’s economic stake in the violation
vi. Likelihood the violation will occur
vii. Whether defendant recognized the wrongfulness of conduct

ii. Other Civil Remedies (Disgorgement, fines and bars)

1. **Disgorgement**: Clawing back the proceeds of an illegal action (ill gotten gains)
   a. Designed to deprive of unjust enrichment

2. **Officer and Director Bar**: injunction prohibiting someone from serving as an officer or director of another public company
   a. Must demonstrate substantial unfitness to serve as a director or officer

3. **Civil penalties**
   a. Can be up to 3x illicit profits realized

4. Factors to consider for civil penalties:
   a. Nature of the violation
   b. Egregiousness of the violation
   c. Repeat offender?
   d. Degree of scienter (intent)
   e. Defendant’s economic stake in the violation
   f. Likelihood the violation will occur

5. SOX changes
   a. **21C(c)**: New form of injunctive relief—freeze against extraordinary payments when company is in financial trouble (don’t let them pay off certain creditors and leave others in a lurch after bankruptcy)
   b. Made disbarment easier; merely “unfitness to serve as director”
   c. Disgorgement and fines go to the victims of the fraud—greater concern for victim compensation

iii. Criminal Enforcement

1. **§21(d) of ’34** authorizes the SEC to refer criminal violations of the securities to the US Attorney General for prosecution

2. Criminal sanctions backing up a civil regime makes rich companies more wary of violating the law; raise the expected cost of securities law violations 
   \[ ES = P \times S \] 
   (Expected Sanction = Probability x Sanction)
   a. Where the probability of enforcement is low, you need to increase the sanction so that ES outweighs the expected benefit
   b. If only civil suit, the defendant would likely only be paying from ill gotten gains, so they aren’t personally hurt; company may pay for them

3. **Mental State**
   a. Look for mens rea (§32(a) ’34 Act): “Any person who willfully violates the Act or rule under the Act shall be fined…”
      i. If the defendant can establish they had no knowledge (affirmative defense), then no prison
      ii. There are factors that will automatically impute knowledge
   b. **U.S. v. Dixon** (Willfully v. Knowing)
      i. Person structured loan payments to be under threshold assuming he wouldn’t have to report them, but he was wrong
1. The court said this was willful (there was intentional conduct and knowledge that it was wrongful)
   a. He knew there was a rule in existence and he was intentionally trying to avoid it
2. He didn’t have an “honest belief”
   ii. Mistake of law v. Consciousness of Wrongdoing
   1. If you knew something was wrong, but thought you could get around it, that is still wrong
   iii. Willfully can include recklessly
4. Rules v. Standards and Loopholing
   a. What is “thimblerig”
   i. Something that gets you around the letter of the law, but it ends up with the same result that the law was trying to stop
   ii. Look at substance over form
   b. The essence of accounting fraud
   i. Often argue you are complying with the form of the rules and argue technical compliance; court instead looks at the substance of the law
5. SOX added new fraud statutes
   a. It is now illegal to knowingly commit securities fraud or certify false reports
   i. Willfully doesn’t appear in statute

Chapter 5—Rule 10b-5 Antifraud
I. The Economics of Securities Fraud and Private Right of Action
   a. Why sanction fraud?
      i. Lemons problem—if you don’t have an anti-fraud regime, investors will assume everyone engages in fraud and will demand a deep discount on price of securities
         1. Companies will either need to engage in fraud or leave market because they can’t afford to provide quality information
      ii. Agency costs—managers may have incentives to commit fraud even if the corporation does not (ex. their compensation is tied to short term gains)
      iii. Sophistication of investors—investors are not sophisticated to protect themselves from fraud
   b. The Rule 10b-5 Implied Private Cause of Action
      i. Very broad delegation of police and legislative power to the SEC
         1. “Directly or indirectly”
         2. “through commerce, mail or exchange” (basically any exchange)
         3. a) employ device, scheme or artifice to defraud or b) make untrue statement of material fact or c) omit material fact necessary to make statements made not misleading or d) engage in act, practice or course of business that involves fraud or deceit
      ii. Private policing action purpose
         1. Makes it more likely that violators will be punished—SEC has limited resources to go after people, but private lawyers will help more
            a. Increases probability of sanction, adding to deterrence
         2. SEC doesn’t do little cases—they are not funded well enough to go after everyone, but private lawyers have financial incentives to do this
   c. Is 10b-5 an exclusive cause of action or can they bring other claims?
      i. §11 of ’33 Act—type of false statement which is limited to a registration statement
1. *Herman & MacLean v. Huddleston et al.*
   a. You can sue under 10b-5 and §11 because 10b-5 is a catch all and §11 is specific
      i. This allows greater protection to purchasers of registered securities
      ii. No reason to limit 10b-5 only to people who have no other remedy
      iii. 10b-5 has longer statute of limitations, allows different defendants
   ii. §9 of ’34 Act: Manipulative acts on exchanges (wash sales, etc.)—regulates purchases and sales that are designed to move the price of securities on national exchanges through artificial means
      1. Hard to prove intent, so easier for 10b-5

d. The Class Action Mechanism
   i. Each individual doesn’t have enough of an economic interest to bring suit themselves
   ii. We should worry about the net harm to society, not each individual, so you can remedy the fraud in one fell swoop

c. Sorting the Good from the Bad
   i. Frivolous lawsuits—to determine that a suit is frivolous, you need to do discovery, which is very expensive, so companies often settle rather than pursuing the case
      1. This is wasteful and people get away with bringing stupid suit
      2. They may actually decrease deterrence
         a. If you have to pay high award regardless of merits of a suit, might as well commit the fraud
      3. Trials and courts aren’t good at sorting out the good from the bad before money is spent
   ii. PSLRA (Private Securities Litigation Reform Act) (§§21D, 21E ’34 Act)
      1. Designed to fix problem of frivolous suits
         a. Lead plaintiff must be plaintiff with largest stake in the action (or most adequate plaintiff)
            i. Perhaps they are more sophisticated
            ii. Combats practice of finding a person who only has one share of stock in order to bring major suit
            iii. Person with more at stake will make more self-interested, rationale decision about the matter and will oversee the lawyer more carefully
         b. Plead with particularity—strong inference of scienter
            i. Must include facts that defendant had required state of mind
            ii. Weeds out cases that won’t survive
         c. Discovery only after motion to dismiss
            i. If they are thrown out early, not much money will be spent and less will settle out of court
         d. Safe harbor for forward-looking statements

II. Who Can Sue Under Rule 10b-5
   a. The “in connection with” Requirement
      i. *Blue Chip Stamps et al. v. Manor Drug Stores*
         1. Plaintiffs chose not to buy because the prospectus was very pessimistic; it was proven the pessimism was an intentional misstatement to prevent plaintiffs from buying shares
2. Court says they cannot sue because they did not actually purchase (requires that someone is a purchaser or seller to have standing)
   a. Cuts down on the potential plaintiffs
   b. A fair threshold to cut down on frivolous litigation that may only have a settlement value

ii. SEC v. Zandford
   1. Broker sold stocks and took money and spent it; clearly his actions were fraud, but the sales themselves were legal
   2. The misappropriation of funds from a securities account implicated 10b-5 even though it was not traceable to a specific securities sale; they were not independent events

b. The Lead Plaintiff in a Class Action
   i. PSLRA—lead plaintiff is one with the largest stake
      1. Rebuttable presumption that this person should be lead plaintiff
      2. Step 1: Identify the presumptive lead plaintiff
         a. The most adequate plaintiff is the person that
            i. Filed the complaint or motion to serve as lead plaintiff
            ii. In the determination of the court has the largest financial interest in the relief sought by the class, AND
            iii. Satisfies requirements of Civil Procedure Rules
      3. Step 2: Determine whether any member of the putative class has rebutted the presumption (shows they are the most adequate plaintiff)
         a. Say the presumed most adequate won’t fairly and adequately protect the class interests
   4. Can’t serve as lead plaintiff in more than 5 class action suits in 3 years
   5. Per-share recovery can’t be any greater than other defendants

ii. Possible changes PSLRA should consider
   1. No lead plaintiff; lead counsel only with bidding process
   2. Auction off the whole claim (Macey/Miller)
   3. Qui tam model
      a. Allow the person who brings the action to recover some portion of the damages and put the remainder in an investor fund
   4. Add-on payment for the lead plaintiff awarded by the court for the additional costs that they face
   5. PSLRA: lead plaintiff with largest stake

iii. Costs of being lead plaintiff
   1. Defendants can conduct discovery into lead plaintiff’s business practices
   2. Give up potentially stronger individual causes of action
   3. There is limited in-house personnel to act as monitors—significant out of pocket expense and hard work for in-house counsel
   4. Interference with commercial relationships

iv. Size of claims
   1. When individuals are lead plaintiff (a majority of the time), their stake is much smaller than when it is an institutional investor
      a. They don’t have as much reason to monitor what lead counsel is doing
   2. Institutional investors get involved when it is a large claim

v. Agency problem
   1. When we delegate to an individual we lose control of that task and the delegate may act in their own interests and not ours
2. Plaintiff class members are individual and institutional investors

c. Lead counsel
   i. Lead plaintiff will choose lead counsel (not absolute—subject to court approval)
      1. Auction to select counsel is not the first option
   ii. Attorney has fiduciary duty to represent the plaintiffs class, but this wasn’t always the case when lead plaintiff didn’t have large interest
      1. Worried that lawyers and client’s interests diverge—lawyers may try to settle cases too cheaply to get them done in a hurry
   iii. Now the largest shareholder will likely pay close attention
      1. Find best lawyers who will charge less (that hasn’t really happened)
   iv. Future possibilities

d. Attorney fees
   i. Court has some control over the fees, but difficult for the court to say a fee is too high
   ii. Lodestar approach: figure out how much their rate should be using hours and usual rate and then use a multiplier to account for the risk they took
   iii. Auction?—perhaps there should be an auction for the claim; attorneys will agree to pay a certain amount to make the claim their own (guarantees plaintiffs some $$ and gives attorney all risk)

e. PSLRA Effects
   i. Didn’t really impact the settlements for shareholders when individual is lead plaintiff
   ii. Did impact for institutional investors
   iii. Didn’t add much value

III. Elements of a Class Action

a. Misstatement of Material Fact; Device, Scheme or Artifice to Defraud; Fraudulent Business Act or Practice
   i. Deception—breach of duty
      1. Santa Fe Industries, Inc. v. Green et al.
         a. Directors of a company have a duty to obtain fair value for shareholders in a merger; here there was no manipulation, only negligence
         i. Breach of fiduciary duty not the kind of “fraud” covered by 10b-5
         b. Plaintiffs cannot sue under 10b-5, only state remedies; state duty to regulate corporations
   ii. The Duty to Update and Duty to Correct
      1. Gallagher v. Abbott Laboratories
         a. The company said it faced no problems in a 10-Q, but intra-quarter a problem arose, but the company didn’t disclose it until next 10-Q due
            i. The court said they didn’t have duty to update because they were correct at the time the filings were made
            ii. Duty to update only applies if they are incorrect when the filing is made (Circuits are divided about this)
         b. Duty to correct is required by all circuits (and no scienter is required)
   iii. Forward Looking Statements
      1. Safe harbor for forward looking statements—codification of common law (21E ’34 Act, 27A ’33 Act)
a. **Bespeaks Caution Doctrine**—as long as you warn investors with a “meaningful cautionary statement” that the forward looking statement may not prove correct, then they should not fully rely on it
   i. Originally judicial doctrine, not statutory (§21E ’34 Act)

b. Applies to **registration statements** and **filings**

c. Available to:
   i. ’34 Act Reporting Companies
   ii. Persons acting on behalf of such issuers
   iii. Outside reviewers hired by issuer
   iv. Issuer UW’s

d. Not available to
   i. Issues of penny stocks
      1. Small companies who are more likely to engage in fraud don’t get protection
   ii. Issuers who have been criminally convicted of securities fraud in last 3 years

e. Transactions excluded
   i. “Going private”
   ii. Tender offers
   iii. IPOs

2. Particular concerns about forward looking statements

a. **Valuable**
   i. They involve speculation, but the insiders are in the best position to say what is happening and what will likely happen
   ii. Additional information is always good for investors

b. **Danger**
   i. Company is particularly susceptible to lawsuits because of hindsight bias—people assume the forward looking statement was a lie if it doesn’t work out

c. **Fraud**
   i. Someone could easily lie about what they see happening in the future to confuse investors

3. **The cautionary statement**

a. The statement must be about “important” factors that could cause results to differ materially—must be **meaningful**

   i. The statement can’t be boilerplate
   ii. It is not required to be comprehensive

4. **Rule 175**: Management only **held liable** if their forward looking statement is **knowingly false** (reckless)

b. **Scienter**
   i. 10b-5 requires at least “reckless” and possibly “knowing” mental state

   1. **Hierarchy**
      a. **Intent**: Conscious object was to commit fraud
      b. **Knowledge**: awareness of fraud
      c. **Recklessness**: conscious disregard for ordinary care
      d. **Negligence**: Lack of due care (not really mental state at all)
      e. **Intent and knowledge** satisfy scienter requirements and most circuits allow **recklessness**
2. Prosecutor seldom knows if person actually had intent, so you need to look into psychology of it
   a. Put knowledge of the rule into violator’s head (no intent analysis necessary)
   b. Recklessness lowers the bar a little (look whether courts use “should have known” or “must have known”—“must have known” is a higher standard
3. If you had strict liability, any misstatements would bring a lawsuit and penalty—losses would be high and this would basically be an investor insurance policy, which is not the goal
   ii. *Ernst & Ernst v. Hochfelder*
      1. You need a **fault inquiry** (prove **scienter**) because the 10b statute uses classic fault terms
   iii. **PSLRA makes it harder** for plaintiffs to get past motion to dismiss
      1. Heightened pleading requirements
         a. Compliant must specify each false statement or misleading omission and explain why omission misleading
         b. Complaint must state “with particularity” facts that give rise to “strong inference” that the defendant acted with scienter
         a. Issuer is selling securities in pools of mortgages with guaranteed payments and they made money on the difference between payments in and out
            i. The plaintiffs need to show something unusual about the motive to distinguish it from other cases (no smoking gun documents saying the company is lying)
            ii. In this case there was a strange compensation package where person gets bonus for making aggressive assumptions about performance on mortgages
      3. There is no pleading rule, but some factors to consider:
         a. Insider trading: something unusual about it
         b. Internal v. external documents—stark contrasts about what they say
         c. Closeness in time between misstatement and disclosure
         d. Other fraud suit with quick settlement
         e. Disregard for current data
         f. Magnitude of accounting correction
   c. **Reliance**
      i. **Omissions**
         1. *Affiliated Ute Citizens v. U.S.*
            a. Two brokers were acting as trading agents and bought for a lower rate, sold for a higher rate in another market without telling shareholders they were doing this
            b. Court said the brokers had no right to remain silent—the facts that were held were material because a **reasonable investor** might have considered them **important in making their decision**
            c. This was a **face to face dealing** (preexisting relationship) so **reliance is presumed**
      ii. **Misrepresentations**
         1. *Basic v. Levinson*
a. The company said there were no merger talks even though there were
b. The plaintiff did not need to hear the statement themselves; they only have to rely on the effects of the statement (judged by the stock price)—this is a rebuttable presumption
c. Adopt efficient capital markets hypothesis—the price reflects the information that is in the market (weak version)
   i. Fraud on the market theory: Investors rely on the general assumption that no unsuspected manipulation has artificially inflated the price
   d. The market was not efficient when the shareholder traded (it had incorrect information), so there was a misrepresentation even though they hadn’t known specifically about the misrepresentation
2. We go with this because without it we couldn’t have a class action—each individual person would have to prove reliance factually and that would be a mess

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<td>Investor must show individual reliance</td>
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d. Loss Causation
   i. §21D(b)(4) of ‘34—plaintiff should have burden of proving that the defendant’s fraud caused the loss
   ii. Causation is not simply “but for”
   iii. Dura Pharmaceuticals v. Broudo
      1. Loss causation v. Damages
      2. Loss causation is a causal inquiry that is part of the element of the violation (a threshold inquiry) and the damages are more detailed and searching inquiry to determine what plaintiff requires
         a. The longer time between the purchase and sale, the greater likelihood that other factors affected the price adjustments

IV. Rule 10b-5 Defendants
   a. 10b-5 covers “Any person” who violates “directly or indirectly”
   b. Secondary Liability
      i. Central Bank of Denver v. First Interstate Bank of Denver
         1. There is no private cause of action against one who aids and abets
            a. Someone who renders assistance to someone else who is violating the law with the intent that the other person succeed in violating the law
            b. Reduce the number of people who can be sued
               i. This helped accountants and lawyers a lot
            c. Still punish 3rd Party if they had some control over the primary violator or had actual knowledge
   c. Who is a Primary Violator? (From strongest to weakest)
      i. Full knowledge + control
      ii. Full knowledge + veto power over one part of deal
      iii. Full knowledge + contractual relationship
      iv. Full knowledge + no contractual relationship
      v. No knowledge of fraud or risk of fraud
1. **Bright Line Test**—if you didn’t make a statement, then you aren’t responsible for it
   a. Can make recommendations, just don’t put your name on statements and filings your client is making

2. **Substantial Participation Test**—even if you did not make the statement you can be held liable for a primary violation if you had substantial aiding and abetting
   a. Auditor can’t avoid liability just by taking name off documents
   b. A factual test for the court
   vi. Corporations liable for misstatements of employees
   vii. This issue is driven by plaintiffs looking for a deep pocketed 3rd party to sue

V. **Damages**
   a. **Theory of damages**
      i. Compensation v. Deterrence
      ii. Probability x sanction $\geq$ Benefit to defendant (the legal regime can handle sanction and to some extent the probability, but not benfit)
      iii. Probability x Sanction $\geq$ Social Harm
      iv. No punitives
   b. **Open Market Damages**
      i. Difference between the value at the time of the purchase minus (price paid) or (value at time sold)
         1. Makes sense when corporation has been selling through fraud (don’t meet them in person)
      ii. §21D(e)—PSLRA damages cap
         1. Damages are limited to the difference between the **price paid or received by the plaintiff** and the **average trading price** during the 90 days after corrective information is disseminated
   c. **Face to Face Damages**
      i. In face to face transactions the court is not limited to out-of-pocket measure; they can vary based on circumstances
      ii. *Pidcock v. Sunnyland America*
         1. Guy sold piece of company based on promises that there was no 3rd party buyer by co-owners; later found out he’d been lied to
         2. The 3rd party would have bought for $6m when guy sold, but a different one bought for $7.5m shortly after he sold out
         3. Defendants should pay extra damages (disgorgement); better to give the harmed person the profit than let the fraudster retain them
      iii. **Plaintiff may not recover** any portion of the profits **attributable to the D’s special or unique efforts** other than those for which he is duly compensated
         1. There was no fraud as to the value, but he was harmed as to risk, so he deserves recisionary damages—put him in the position he would have been in if had never bought the investment
   d. **Conclusions about PSLRA (Prof. Cox)**
      i. In post-PSLRA period (1995-2002), institutional lead plaintiffs appear in 5-10% of cases but add value compared to other types of lead plaintiffs
         1. But now appearing in 30-35% of litigation $\Rightarrow$ will this still hold true?
      ii. All of types of lead plaintiff do not produce value significantly different from pre-PSLRA plaintiffs
iii. Courts should require disclosure before selecting lead plaintiff of any campaign and other contributions by plaintiffs’ law firms to decision makers at institutional investors

Chapter 7—Public Offerings
I. Economics of Public Offerings
   a. Corporate Finance
      i. Capital and the problem of timing
         1. If you are entering a business activity which will require money to expand, you need to get funds to start before earning profits
      ii. Scale problem
         1. It is very unusual for an individual to have access to enough capital to run a major business enterprise
         2. We can instead pool our resources that is more productive and efficient
   b. A Brief Description of the Public Offering Process
      i. Types of Securities
         1. Equity v. Debt
            a. Equity is a way to raise money for risky projects that banks wouldn’t be willing to finance with debt
            2. Different types of securities have different bundles of rights consisting of some combination of profits, rights upon litigation and voting rights
            3. Even after an IPO, companies continue to have public offerings—the subsequent sales have different rights
      ii. The Underwriters
         1. No law requires them; What is their purpose?
            a. They advise the company how to make itself marketable—make it appealing to the securities markets
            b. They have a reputation that calms the general public and issuer
            c. They are another gatekeeper
               i. They have an informational advantage, so they can detect problems and head them off in a way that benefits individual investors and society as a whole
                  1. Prevent fraud and valueless investments
                  2. They do diligence
            d. Problems
               i. Investors may not be able to tell how good the underwriter is based on reputation alone
               ii. When they are syndicating, the underwriters are free riding and may slack on diligence
               iii. Individual employees at banks may be willing to ignore the flaws and go forward even if it might hurt firm reputation
               iv. Corruption risk (analysts might give good recommendation if the company gives the bank business
      iii. The Underwriting Process
         1. Firm Commitment Offering
            a. The underwriter buys all the shares at a slight discount and keeps the spread
            b. It is good for the issuer because they are guaranteed to sell all their shares at a certain price (assures they are going to make their needed money)
c. It is **good for the investor** because they are reassured that the bank who bought all the shares felt it was a good value—provides a feeling of security

2. Best Efforts Offering
   a. The underwriter promises to make their best efforts to sell the shares
      i. They work on commission so they have an interest in selling them
   b. This is less helpful for investors because the downside risk for banks is minimal and they don’t guarantee that this is a good buy
   c. “All or nothing”—if the offering doesn’t sell out then the investors get their money back—might be attractive to investors

3. Direct Offering
   a. **No underwriter**—for sale by owner
   b. Very rare—the issuer won’t want to find investors and investors might worry about fraud

4. Dutch Auction
   a. Everyone bids on how much they will bid and for what price—the **clearing price** is the price at which the shares will be sold
   b. Google did this—it is becoming more popular; some companies say sales prices aren’t final until price has increased on the market

iv. Underpricing
   1. Shares are often sold for less than their value and by the end of the 1<sup>st</sup> day of trading they would be worth much more than their initial price
      a. Companies were leaving money on the table
   2. **Underwriters are risk averse**; they don’t want to pay too much and be left be holding a bunch of securities
   3. Can also have a situation in which valuations are out of whack—pricing is correct and the secondary market is irrational—still money the issuer loses

v. Capital Structure
   1. **What investors want in their public offering?**
      a. **Clarity in the capital structure** of the enterprise—don’t want it to be opaque so they don’t know what they really own in it
      b. **Reduced risk**—they want it to be low
         i. **Preexisting capital structure**—prefer enterprise in which investors and managers have already put money into it
         ii. **Corporate governance**—they like Delaware incorporation which is favorable to corporations and shareholders
      c. **Visibility with regards to price and value**—they want disclosure and want to be able to assess if something is a good value

c. Public Offering Disclosure
   i. There is a ton of extra disclosure in a public offering
      1. There is an **information asymmetry** which is heightened because insiders know more than investors; they don’t yet have a lot of information publicly available
      2. Once in the secondary market there is lots of information available—audited financial statements, analysts have looked over them, etc.
         a. You can incorporate previous disclosures so it isn’t as onerous, even for new offerings
            i. Forms S-1 and S-3 (registration statements)
1. S-1 is long form prepared before IPO—comprehensive
   ii. Reg S-K and S-X (control registration and periodic statements)
   iii. Form 10-K, 10-Q and 8K (periodic statements)

1. Since they all rely on S-K and S-X, it is easy to incorporate by reference and just refer to what’s been done before

ii. Why restrict disclosure—“gun jumping”?

1. Worried about bubbles or speculative frenzy so stock will be overvalued when it hits the market—might prevent irrational exuberance
2. Require adequate and accurate information in connection with offering, which might not be available earlier
3. Worried that there isn’t a lot of information out there to weigh the investment against (particularly with IPOs)
4. Historical purpose from the 1930s
5. We assume investors don’t know much and need projections

iii. Plain English Doctrine

1. The SEC required plain English disclosure; it is meant to help unsophisticated investors understand, but do they really read them?
   a. Short sentences, everyday language, active voice, no legal jargon, etc.
2. Experts might be more confused because they’d relied on confusing conventions before the law was passed

II. The Gun-Jumping Rules

a. Objectives
   i. Force Disclosure
      1. §5 of ’33 Act (requires full disclosure and registration)
         a. §5: Does not reach secondary market transactions—only issuers, underwriters and dealers; if you do so wrongly, you deal with §11 and §12
         b. §5(a): It is unlawful to use any means to buy or offer to buy or sell or offer to sell a security before the registration statement is filed
         c. §5(b)(2): No sale unless prospectus (Part I of the registration statement) that satisfies §10 of ’33 Act is distributed
         d. §5(c): Requires filing of registration statement
      2. § 2 ’33 Act
      3. §10 ’33 Act: “the statutory prospectus”
   ii. Control Disclosure
      1. §5 ’33 Act
         a. §5(c): unlawful to offer to sell or offer to buy any security unless registration statement has been filed; unlawful to offer through prospectus or otherwise
         b. §2 ’33 Act
            i. §2(a)(3)—the terms “offer” and “sale” should include any offer basically (very broad)
               1. The issuer may have conversations and make contracts with underwriters that will enable registration
            ii. §2(a)(10)—defines prospectus as including a list of basically any written communication (including television and radio ads) regarding the security for sale
c. §6 ’33 Act
   i. Gives information about registration statement

iii. Gun Jumping Rules
   1. Sequence
      a. Pre-filing period
         i. Quiet period, file registration statement
      b. Waiting Period
         i. Once SEC approves, the registration statement becomes effective
   c. Post-Effective Period

iv. Classes of issuers (2005 Reforms)
   1. SEC has different levels of concern about different issuers (from most to least worried)
      a. Non-Reporting Issuer (NRI)
         i. Not required to file ’34 Act reports and they are not voluntarily reporting
         ii. There is no information about them in the form of SEC filings
         iii. Won’t be able to take advantage of many safe harbors
      b. Unseasoned Issuer (UI)
         i. ’34 Act reporting companies that are not eligible for S-3; not eligible for short form
      c. Seasoned Issuer (SI)
         i. ’34 Act reporting company and eligible for S-3
      d. Well-known Seasoned Issuer (WKSI)
         i. Eligible for S-3 and meets other requirements in Rule 405
            1. Rule 405—Quantity and temporal requirements
               a. Quantity: are you big enough
                  i. Min. $700m common equity
                  ii. Issued $1bn principal in last 3 years
               b. Temporal
                  i. A certain amount of time after last S-3 (60 days)
                     ii. May not be eligible as WKSI if:
                        1. Are not current in filings
                        2. An ineligible issuer
                        3. An investment company or business development company
                  iii. They must be big companies with good history

b. Pre-Filing Period (Quiet time)
   i. §5(c) says a company can’t make an offer during the pre-filing period
   ii. What is an Offer?
      1. It is a statement “conditioning the market”; don’t want information that will raise expectations to whet the public’s appetite for the securities in order to stimulate sales; it is a factual test (Sec. Release 3844)
         a. Counsel should review all press releases, ads, etc. to make sure they don’t imply offer to sell security
      2. Some factors
         a. Motivation of communication
         b. Type of information
c. **Breadth** of distribution

d. **Description of underwriter** (they may **not** be mentioned anywhere)

iii. No hard and fast rule, so we need clarity which is provided by safe harbors

iv. **Safe Harbors**

1. Safe harbors provide some general guidance about what to do; if you have the safe harbor you’re not going to be in trouble; without it you could be

2. §2(a)(3): Allows **preliminary conversations** with **underwriters and necessary parties to an offering** (otherwise would handcuff the entire process)

3. **Rule 433(e):** hyperlinks from web pages count with offers count

4. **Rule 163A**: A **written communication** more than **30 days before** the offering that **doesn’t mention the offer** is allowed

5. **163A(d):** Pre-filing is also regulated by Reg. FD

6. **Rule 168**: You can give **factual business information** if it is a **regular release** of forward looking information or numbers; **can’t mention offer**
   a. Must be a ‘**34 Act reporting company**
   b. Includes
      i. Factual information about issuer and its business
      ii. Advertisements for issuers products and services
      iii. Periodic filings

7. **Rule 168(e):** A communication about the registered offering is excluded from the exemption

8. **Rule 169**: You are allowed to provide factual information about **non-34 Act reporting companies**, but **no forward looking statements**
   a. Can’t make it to investors, regular vendors only
   b. Dealers and UWs cannot use

9. **Rule 163**: WKSI are exempt and can make offers (they won’t be considered offers under §5) if they meet conditions of Rule 163
   a. Reg FD applies

10. **Rule 135**: You can give short, factual notice of proposed offering
    a. **Issuer, terms, timing, but cannot identify underwriter**

v. Applying the gun-jumping rules

1. Consider if it is an offer

2. Decide if there is an applicable safe harbor

c. **Waiting Period** (Registration statement filed, but not effective)

   i. Gun-jumping rules still apply, but relax them a little more so you can **“gauge the market”**—need to know if the **price is right**

   1. Allow **oral communications, statutory prospectus (SP), tombstone ads, free writing prospectus (FWP)**
   2. Still careful to make record of information available to SEC

   ii. **Statutory Framework**

   1. §5(a)—**Still prohibits all sales** of securities in the **waiting period** (except between issuer and underwriter)
   2. §5(c)—Can make offers to sell/buy once registration statement has been filed (underwriters and dealers can solicit offers to purchase)
   3. §5(b)(I)—No sales offers unless accompanied by preliminary prospectus conforming to statutory definition of prospectuses under §10; **No free writing prospectus** at this time
a. **General rule**—You can communicate with a *statutory prospectus* meeting SEC regulations, but can’t give anything else

b. **§2(a)(10)**—*prospectus=*written or broadcast communication of offer
c. **§10(b)**—*SP* can be preliminary (basically everything but a price)

4. **§5(b)(2):** Can’t deliver securities unless preceded or accompanied by a prospectus that complies with §10(a)

### iii. Gauging Market Sentiment

1. **The Preliminary Prospectus**
2. **The Road Show**
   a. You can have **in-person, private meeting** at which you make an offer for securities (**oral offers only**)
   b. Allows you to test the market

   a. A short, bare bones ad that announces the proposed offering of a registered security
      i. Must include:
         1. Issuers name
         2. Kind of security
         3. The price at which it is offered
         4. The identity of person who will be executing orders
         5. From whom the prospectus can be obtained
         6. Statement saying the ad itself is **not a solicitation** and that **no offer to purchase can be accepted during waiting period**
   b. Very specific what you are allowed to say; basically a boilerplate
   c. **§2(a)(10)(b) allows for “identifying statement”** that is an expanded tombstone ad

4. **Solicitations of interest**
   a. **Rule 134(d):** If a **Rule 134 communication** (like tombstone ad) is preceded or accompanied by §10 *statutory prospectus* (other than FWP), the communication **may solicit an offer to buy** or some other indication of interest from investors
      i. Required to have boilerplate legend advising investors that they can withdraw offer to buy prior to acceptance by underwriter—indication of interest involves no legal obligation

### iv. The Free Writing Prospectus

1. **Definition:** Any *written communication* that offers to sell or solicits an offer to buy a security that is or will be subject to a registration statement and that does not meet requirements of a §10 *statutory final* or preliminary prospectus or a §2(a)(10) for of traditional free writing (Rule 405)
   a. Must satisfy Rule 433
      i. **Two classes**
         1. **Seasoned issuers and WKSI**
            a. May use FWP at any time after filing of RS
            b. Filed RS must contain an SP that satisfies §10 (including a base prospectus)
            c. Do not have to deliver the SP to recipients of FWP
         2. **Non-reporting and Unseasoned Issuers**
a. Use of FP only after RS filed
b. FWP must be accompanied by or preceded by the most recent SP that satisfies §10 including a price range (this includes advertisements)
c. Hyperlink counts as inclusion
d. May send subsequent FWP after sending SP as long as no material changes

2. Disclosure, filing and retention requirements
   a. FWP may not contain info that is inconsistent with info in filed SP or statements incorporated by reference in RS
   b. FWP must have a legend
   c. During waiting period everyone keeps record of all information so it can be available for the SEC
   d. Filing conditions
      i. The issuer must file their own and other FWPs that include issuer info
   e. Must retain for 3 years

v. The Process of Going Effective
   1. Timing
      a. §8(a): Registration statement becomes effective **20 days after it or an amendment is filed** with the SEC
         i. You can delay going effective by filing an amendment and then request an acceleration when you’re ready
         ii. Issuers have control over effective date—it allows them time to **time the market**; 2 days after acceleration you’ll be effective
      b. You **cannot sell until registration statement is in effect**
      c. §5(a) no longer applied once registration statement is in effect

vi. Analysts
   1. People who work primarily for investments bans and make stock recommendations to others
      a. These recommendations assist investors in the secondary market, so you don’t want them to be silenced—SEC provides safe harbors so their statements are not offers
   2. The SEC has discretion to protect against analysts thinly veiled recommendations using private information

3. Safe harbors
   a. **Rule 137**: Analyst who publishes this in **regular course of business** and who is **not getting consideration from offering**—this won’t be an “offer” (for banks not involved in offering)
      i. They are not underwriter or dealer; can use §4(3) exception
   b. **Rule 138**: Allow analysts to publish even if **their company is participating** as long as it is **not about securities involved** in the offering
      i. Issuer must have filed Exchange Act reports
      ii. In equity, the research must be about debt and vice versa
   c. **Rule 139**: Analysts can write **issuer-specific report** if the issuer is a S-3 filer with at least $700m float (large company)
      i. **Industry report** allowed for any **exchange offering** report
1. Eligible to all issuers
2. BD may not devote any materially greater space or prominence to issuer compared with other securities or companies

ii. They are not considered offers to sell if rules followed

d. Post-Effective Period (The SEC has declared the registration statement effective)
i. Once effective, the prospectus can be used to offer to sell; must comply with §10

ii. Forms of the Final Prospectus
1. Adds price related information (offering price, underwriters discount, etc.) to the information contained in preliminary prospectus
2. Rule 430A: The final prospectus filed as part of the registration statement may omit price related information for all cash firm commitment offerings
   a. Also applies to RS that are immediately effective upon filing w/SEC pursuant to 462(e) and (f) (auto. shelf registration state. filed by WKSI)
   b. If they file the price information within 15 days with the SEC there is no post-effective amendment required; after 15 days it must be filed as a post-effective amendment
   c. §11 Liability
      i. Price related infor filed after effective date shall be deemed part of the RS as of effective date

iii. Prospectus Delivery Requirement
1. The Traditional Delivery Requirement
   a. §5(b)(1): People are required to send the statutory prospectus in the post-effective period either with or preceding written confirmation of their purchase
      i. §4(1): Exempts transactions not involving any “issuer, underwriter or dealer”—specifically exempts individuals selling in ordinary secondary market transactions
         1. §5 doesn’t apply in these situations
         2. Vast bulk of transactions do not require SP
   ii. §4(4): Unsolicited broker transactions are also exempted
   iii. §4(3) and Rule 174: time limits on SP requirement for dealers who are not underwriters (and underwriters not selling from their initial allotment)—don’t want them to be required to give SP indefinitely
      1. Dealers not acting as underwriter (b/c they are not participating or have sold their allotment) must deliver for the following periods:
         a. 0 days: Exchange Act reporting company prior to offering
         b. 25 days: Issuer whose security will be listed on national securities exchange
         c. 40 days: Issuer that does not fit the previous categories that is not doing an initial public offering
         d. 90 days: Issuer that does not fit previous categories and is doing IPO
Issuers and underwriters selling their initial allotment are required to deliver prospectus until their allotment is entirely sold.

2. Access Equals Delivery
   a. Rule 172(c): Access to the prospectus through filing = Delivery
      i. Issuer must file a final §10(a) SP with the SEC or “make a good faith and reasonable effort” to file
         1. The filing condition is not required for dealers to take advantage of 172 who would otherwise face deliver requirements
      ii. If 172(c) is satisfied, 172(a) exempts written confirmations of sale (broker won’t need to send final prospectus with sale confirmation)
      iii. General free writing, other than written confirmation is not covered and therefore falls under traditional requirements
   b. Rule 173 Limitations on UWs and B-D’s
      i. Requires that for transactions in which 4(3) and Rule 174 apply, UWs and B-Ds must sent to each investor who purchased from them, notice that sale took place under effective RS or final prospectus (let’s them know their rights under §§11, 12(a)(2)
      ii. Notice w/in 2 days
      iii. Purchasers may request copy of final prospectus
      iv. These notices are exempt from §5(b)(1)

iv. Updating the Prospectus and Registration Statement
   1. Updating the Prospectus
      a. §10(a)(3): If a prospectus is used more than 9 months after the effective date of the registration statement, the information in the prospectus must not be more than 16 months old
         i. The issuer should update anytime new material facts develop, so it is not misleading
         ii. Don’t worry if you are an issuer who no longer needs to deliver SP
   b. Antifraud liability: If the information is no longer accurate, the issuer and others involved are potentially liable for both §12(a)(2) and Rule 10b-5 violations
      i. There is no explicit requirement to update, but there is anti-fraud incentive to do so
      ii. SEC v. Manor Nursing: If the prospectus is “grossly misleading” then it is no longer considered a statutory prospectus, thus potentially giving rise to a §12(a)(1) cause of action
      iii. This has not been widely adopted by other circuits, but it is in the 2d Cir, where most securities litigation happens
   c. Shelf registration
      i. Issuers doing a shelf registration under Rule 415 must update the prospectus to reflect any fundamental change to the info set forth

2. Updating the Registration Statement
a. Registration statement must be **accurate as of its effective date**, because anti-fraud liability (§11 and Rule 10b-5) is measured from that date
   i. SEC may issue stop orders under §8(d) if the RS contains misrepresentations

b. There is no **general duty to update the registration statement** as long as the information was accurate at the time of filing
   i. **Rule 415**: Must update if shelf registration
      1. Allowed to incorporate by reference
   ii. **Rule 424**: If the **issuer updates the prospectus** with **substantive changes** or there is **fundamental change to info in RS** then it must be filed as an amendment to the registration statement

III. Public Offering Trading Practices
   a. **IPO Allocations**
      i. **Regulation M**: Attempts to prevent underwriters from maintaining or increasing the secondary market price of securities which cause harm to investors (allows some of them)
         1. UW cannot issue “buy” recommendations b/c does not satisfy Rules 138 and 139
         2. If hedge fund affiliated w/ UW, cannot purchase
         3. UW cannot buy in secondary market to raise price while part of allotment remains unsold
      ii. Balances three considerations
          1. Not all purchases on behalf of an underwriter are intended to manipulate the secondary market (they may be acting as market makers or brokers)
          2. Companies with a **deep secondary market** with large volumes of unrelated, independent sales, are not likely to be affected
          3. Underwriters can maintain a market price at the offering price (**regulated stabilization**) but they can’t raise the market price above its current level (**market manipulation**)
   b. **Market Manipulation**
      i. **Rules 101 and 102**: limits the types of trading during the “restricted period” which depends on the worldwide daily trading average (“ADTV”) for two month
   c. **Stabilization**
      i. **Rule 104**: Regulates efforts on the part of any person to stabilize the market price, but it is allowed to prevent or retard the drop in the secondary price of a security
   d. Laddering
      i. Inst. Investor promises to buy additional shares in secondary market in return for IPO allocations
      ii. This drives up security price

IV. **Shelf Registration**—company registers more shares than they initially intent to offer; put others on “shelf”
   a. **General Rule**: You cannot register shares not intended to be offered immediately or in the near future; registration statement applies only to **specified securities**. 6(a) ’33 Act
      i. Worried that a single registration statement might not provide adequate disclosure to investors
      ii. Prohibits issuers from registering securities not intended to be offered immediately or in the near future (probably within a month of effective date)
iii. Issuers like it because it provides flexibility to changing markets, cost savings, etc.

b. **Rule 415:** There can be practice of **shelf registration** but it is governed by this rule
   i. **Offering may be continuous** but can be delayed into the future if certain conditions are satisfied

ii. **Types of offerings**
   1. Securities offered or sold only by someone other than registrant (a)(1)(i)
   2. Securities the offering which will be commenced immediately, will be made on a continuous basis and will continue more than 30 days (a)(1)(ix)
   3. Securities registered (or qualified to be registered) on S-3 that are to be sold on an immediate, continuous or delayed basis by or on behalf of registrant and which is registrant is majority owned subsidiary (a)(1)(x)
   4. Securities offered on conversion of other outstanding securities (a)(1)(iv)

iii. **Time limits**
   1. **Rule 415(a)(2):** For non-S-3 issuers, shelf registration limited for a) business combinations and b) continuous offerings to be commenced promptly (ix) to what you can **reasonably expect to sell in 2 years**
   2. **Rule 415(a)(5):** Automatic shelf registration can only be sold for **3 years**

iv. **Updating and Undertaking**
   1. **Rule 415(a)(3): Updating requirement:** Issuer will file any prospectus required under §10(a)(3) as a post-effective amendment—make sure it doesn’t go **stale**
   2. **Rule 415(a)(6):** At end of (a)(5) period, you can renew for 3 more years
      a. Almost complete exemption from 33 Act registration regime
      b. Must be WKSI (See Rule 405)

v. **Base Prospectus**
   1. **Rule 430(b)** tells us what needs to be in shelf registration filing
      a. Prospectus may omit any information that is unknown (price) or not reasonably available

c. **Automatic Shelf Registration**
   i. **Rule 405:** WKSI can file an **automatic shelf registration** for most offerings filed on S-3
      1. They are considered filed with the SEC and in compliance until contacted by the SEC with objections **Rule 401(g)(2)**
      2. WKSI can pay filing fees as they sell securities rather than up front
   ii. **Rule 415(a)(6):** At the end of (a)(5) (3-year) period, you can file statement every 3 years to automatically renew shelf registration
      a. Nearly a complete exception from ’33 Act
   iii. **Rule 430B(a):** prospectus may omit any information that is unknown, description, securities, etc.—only the name and class must be defined

Chapter 8—Civil Liability Under the Securities Act

I. **Public Offerings, Uncertainty and Information Asymmetry**
   a. What is different from ’34 Act
      i. **Greater incentive for fraud** in offering process because profits go directly into fraudster’s pocket
      ii. Problem of **Lemon’s Market:** if all are committing fraud, all investors will get out and companies will either have to commit fraud or stop selling because they cannot afford to provide legitimate information

b. **Causes of action**
   i. §11: Fraud in **registration statement**
ii. §12(a)(1): violation of offering rules

iii. §12(a)(2): fraud in prospectus and related statements

c. **Comparison of §11 and 10b-5**

i. §11: You need to be able to trace your shares to the offering rather than anyone harmed “in connection with”

ii. §11: statutory defendants can be sued; in 10b5 any primary violator (and aiders and abettors by SEC) can be sued

iii. Easier to prove under §11—don’t need to prove reliance unless defendant releases 12 months worth of earnings in which case plaintiff needs to prove reliance

II. **Section 11 Liability—Registration statement has material misrepresentation**

a. **Standing**

i. Suit can be brought by **anyone who acquired a registered security** as long as they can prove their shares were traceable to the errant statement

   1. **No privity required**

ii. **Abbey v. Computer Memories, Inc.**

   1. A plaintiff who can only show that his shares might have been issued in the relevant offering should not be given the benefit of §11’s conclusive presumption on reliance

   2. Must be **direct tracing** and this does not include “virtual certainty”

b. **Statutory Defendants**

i. There is a definite range of potential defendants:

   1. Those who **signed the registration statement** (CEO, CFO, the issuer)
   2. **Directors**
   3. Various **experts** who prepared or certified a part of the registration statement (underwriter, lawyers, accountants, etc.)
   4. **Controlling persons**

c. **Elements of a Cause of Action**

i. Requires the showing of a **material misstatement** using the same “**total mix**” test used in ’34 Act materiality tests

   1. Determined as of **effective date**; filing of a post-effective amendment resets the **effective date**

ii. There is no further burden (scienter, causation, etc.) beyond materiality and a misstatement

iii. Must show **reliance** if issuer made public earnings statement covering a 12 month period beginning after the effective date

   1. Investors need not have read the registration statement to prove reliance; sufficient to rely on secondary sources who repeated the misstatement

d. **Defenses**

i. **P didn’t prove materiality**

ii. The alleged false statements were actually true

iii. No reliance because 12-month earnings had been published

iv. Loss causation—damages are limited because share price dropped for other reasons (see Ackerman)

v. **Blew whistle**—defense for **individual defendant**—that person had to quit and inform SEC (§11(b)(1))

vi. **P had actual knowledge** of the fraud

vii. Due Diligence Defense—§11(b)(3) (most important by far)

   1. Issuers do not have due diligence defense (all others defendants do);
2. Defendants divided into experts (who **certified** part of the statement—an “expertised section”) and non-experts to determine the duty of care
   a. **Experts:** Ex. Auditor is the expert on audited financials of the issuer
      i. They must prove they conducted a reasonable investigation and honestly believed the statements made (**performed up to the standards of their profession**)
         1. Can’t merely trust opinions and factual responses from issuers—need to look deeper
   b. **Non-Experts:** Top executive officers, underwriters, directors
      i. Held to same due diligence standard as experts
      ii. Their **reasonable investigation** is what a **prudent person would do** in the management of their own affairs (bases on their own skills, experience, etc.)
         1. Factual test
      iii. **Attorney** drafting RS
         1. If they do not certify their work is a non-expert in general, but must still conduct a reasonable investigation that goes beyond merely trusting opinions

c. **Requirements for defense:**

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<th>Non-Expertised</th>
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<tr>
<td>Expert</td>
<td>No liability--§11 (a)(4)</td>
<td>Reasonable investigation, reasonable ground to believe and did believe the truth--§11(b)(3)(B)</td>
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</table>
| Non-Expert       | Reasonable investigation, reasonable ground to believe and did believe the truth--§11(b)(3)(A) | Reasonable ground to believe and did believe of truth--§11(b)(3)(C)         

viii. **Due Diligence, Underwriters and the Form S-3 Issuer**

1. *In re WorldCom, Inc. Securities Litigation*
   a. Underwriters must exercise a **high degree of care in investigation** and independent verification of the company’s representations because they are a first line of defense for investors
      i. If they are unsatisfied with investigation, they must demand disclosure, withdraw from underwriting or bear the risk of liability
      ii. Underwriters are **nonexperts**

2. **Due diligence defense** is not friendly for defendants—they must **look behind** what is being said and **red flags don’t need to be obvious**
   a. Can’t rely on auditors unless a full blown audit (**can’t even rely on comfort letter**)

e. **Damages**
   i. **Measuring §11 Damages**
      1. The **price paid cannot exceed offering price**; ensures the plaintiff is not getting more than harm she suffers
         a. If P sold before the suit was filed= (Price paid – sale price)
         b. If P still holds at the end of the suit= (Price paid – **value** on filing date)
c. If P sold during the suit = (Price paid – sales price if greater than value at time of suit filing)

2. How to calculate “value”
   a. P theories (will want lower value, so there is a larger difference between value and market price)
      i. Information leaked early *(Ackerman)*
      ii. Unrelated positive news muted decline—the market price does not capture the full effect of the misstatement
      iii. Info filters into thin markets slowly
   b. D theories (want the value to be higher than market price)
      i. Price drop is due to panic selling (price doesn’t relate to true value; value should have something to do with fundamental economics and not investor panic)
      ii. Price drop due to litigation and management is distracted
      iii. Unrelated negative news exaggerated the decline

ii. Loss Causation Defense (“Negative causation”)
   1. §11(e): Defendants can reduce liability if they can prove depreciation of the stock value resulted from factors other than misstatement in registration statement *(See above)*
      a. *Akerman v. Oryx*: The price dropped, but the misstatement was barely material, so the depreciation was unrelated

iii. Indemnification, Contributions and Joint and Several Liability
   1. §11(a) starts with the presumption that all defendants are jointly and severally liable for damages
      a. §11(e) limits underwriter liability to “total price at which the securities underwritten and distributed to the public”
      b. §11(f)(2)(A) limits outside director liability to proportionate liability (their degree of wrongdoing relative to others)
   2. Parties may use contractual terms to seek indemnification (underwriters often require issuers to indemnify them against damages)

III. §12(a)(1)
   a. Any person who sells or offers to sells a security in violation of §5
   b. Standing
      i. Anyone who purchased security is eligible to sue
   c. Defendants
      i. Control persons: persons who control anyone else liable for §12(a)(1) may be held jointly and severally liable
      ii. Participants: sellers of the security
      iii. *Pinter v. Dahl*
         1. Defendants include 1) those who solicit purchasers and 2) those who pass the title
   d. Elements of the Cause of Action
      i. Plaintiff purchased;
      ii. Defendant offered or sold to plaintiff;
      iii. §5 violated
         1. Any violation of §5 is going to be §12(a)(1) liability *(Strict Liability)*
         2. “Crush out liability”—try to make it very easy to sue and hopefully make people very careful to obey ’33 Act
      iv. No scienter, reliance, loss causation or damages need to be proven
c. Defenses
   i. No sale of “security”
   ii. No violation of §5 (i.e. the security was exempt from registration)
   iii. No privity—there was no relationship between seller and buyer (different than §11)
   iv. Statute of limitations—3 years
f. Damages
   i. Consideration paid (plus interest) less any income from security (rescission)
      1. “Put option” for all investments in which §5 violated
   ii. Damages if the seller no longer owns security

IV. §12(a)(2) Liability
   a. The Scope of §12(a)(2)
      i. Reaches fraud committed “by means of a prospectus or oral communication”
         1. Provides private cause of action for misstatements in prospectus
      ii. What type of prospectus (§2(a)(10), §10(a))?
         1. Gustafson v. Alloyd
            a. Applies to all offerings, including those exempt from registration as private offerings
            b. Does not apply to certain gov’t and bank securities
            c. Only applies to primary offerings (from the issuer), not secondary sales
            2. Means the same things as §10 prospectus—only preliminary and statutory prospectuses count
   b. Elements of the Cause of Action
      i. P purchased
      ii. D offered or sold
      iii. By means of a prospectus or oral communication
         1. No reliance required, so P need not have read prospectus
      iv. There was a material misstatement or omission
      v. Use of instrumentality of interstate commerce
      vi. NO scienter or reliance
         1. Plaintiff need not read or rely on the prospectus
   c. Defenses (look like §11)
      i. P’s knowledge—he knew about misstatement/omission
      ii. No loss causation
         1. Drop due to factors unrelated to the fraud
      iii. Lack of knowledge: D 1) did not know and 2) couldn’t have known through reasonable care than this was a misstatement; Simple negligence
      iv. Statute of limitations—1 year from discovery, 3 years from sale
   d. Damages
      i. Rescission just like 12(a)(1) or
      ii. Damages

Chapter 9—Exempt Offerings
I. Introduction
   a. §4 tells us that in some settings, §5 will not apply
      i. §4(1) and §4(2)—transactions by issuers not involving public offering
         1. Guideposts when deciding if ’33 Act applies
      ii. §4(3)—transaction by dealers
      iii. §4(4)—unsolicited dealer transactions
iv. §4(6)—transactions not exceeding amounts in 3(b) and accredited investors

b. Reasons for regulating
   i. Information asymmetries—we want to even them out; look at them from several perspectives?
      1. Type of issuer
      2. Type of security
      3. Type of investor—do they need more or less help?
   ii. Cost-benefit analysis—if the information asymmetry sufficient to worry that we thin the cost involved with compliance is worth it?
      1. We want a well regulated market that is attractive to investors, but not one that is so burdensome for issuers that they take their business elsewhere or don’t enter market at all

c. What is at stake
   i. No §5 application
      1. No mandatory filings/updating
      2. No gun jumping violations
   ii. No ’33 Act causes of action looming over issuer
      1. §11
      2. §12(a)(1)
      3. §12(a)(2)
      4. Still liable for fraud under 10b-5

II. Section 4(2) Offerings
   a. 4(2) exempts from registration “transactions by an issuer not involving any public offering”
      i. Like this exemption because is saves money, takes less time from management, allows more accountability to investors
   b. What is a public offering? Not discussed in the Code.
      i. Factors include:
         1. The number of offerees
            a. Worry about offerees, not purchasers
         2. The relationship of the offerees to each other and to the issuer
         3. The number of units offered
         4. The size of the offering
         5. The manner of the offering
         6. A big concern is whether the investors need protection (are they sophisticated or just average people
            a. Limited to investors who could “fend for themselves”
   c. SEC v. Ralston Purina
      i. The company offered stock to “key employees” which basically meant anyone who asked about buying stock
      ii. The key question is whether they have access to information they would need to make knowledgeable investment decisions
         1. Information:
            a. Access to corporate officers, general registration information, MD&A, etc.
   d. Doran v. Petroleum Management Corp.
      i. Access = 1) Right kind of relationship to get information or 2) is there actual disclosure of relevant information?

III. Regulation D
a. §4(2) is too mushy for many issuers to take with §5 liability hanging over their head
i. As you broaden the circle of investors beyond founders, §4(2) uncertainty become acute
ii. **Strict compliance**—must abide by it exactly; though in some situations you can be excused for immaterial mistakes

b. **Aggregate Offering Price**
i. §3(b) ’33 Act—you can exempt certain classes of securities from regulation (<$5m)
   1. Rule 504
   2. Rule 505
ii. §4(2): Rule 506 safe harbor
   1. No dollar limit
iii. **Rule 502(a): Integration Rule**: Under certain situations, multiple offerings will be treated as a single offering
   1. You can’t break up transactions into a lower dollar value in order to get around dollar limits if Rule 504, 505, 506

c. **Purchasers**
i. Rules 505 and 506 limit number of investors, but that doesn’t include accredited investors (**Rule 501(e)(1)(iv)**)—can sell to unlimited accredited investors
ii. Accredited investors are supposed to be a proxy for sophistication:
   1. **Large institutions** (banks, insurance companies, trusts, partnerships, corporations)
   2. **Director, executive officers, general partner** of the issuer (501(a)(4))
   3. **Natural person w/ net worth <$1m** (501(a)(5))
   4. **Natural person w/ income <$200k** (501(a)(6))
iii. **Rule 501(e)**: Who is a purchaser
   1. **501(e)(1)(i)**: “any relative, spouse or relative of the spouse who has the same principal residence of the purchaser” is not separate
iv. Under 506, investors who are **not accredited** must be **sophisticated** (506(b)(2)(ii))
   1. **Establishing sophistication**
      a. Wealth and income (must like accredited)
      b. Experience
      c. Education
      d. Present investment status (well diversified)
      e. Performance on investment test (like driver’s license)

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<tr>
<th>504</th>
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<tr>
<td>Up to $1m (less any 3(b) or 5-violating offering in last 12 mos.)</td>
<td>Up to $5m (less any 3(b) or 5-violating offering in last 12 mos.)</td>
<td>No $ limit</td>
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<tr>
<td>No limit on # of purchasers</td>
<td>Not &gt;35 purchasers except accredited</td>
<td>Not &gt;35 purchasers (except accredited) and non-accredited must be sophisticated</td>
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<tr>
<td>No investment companies, blank check, exchange act reporting companies</td>
<td>No investments companies</td>
<td>All issuers</td>
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d. **General Solicitation**
i. **Rule 502(c): No general solicitation or advertising**: these are not meant to be offerings to the world
1. Don’t want to whip up **speculative frenzy**, so don’t want just anyone to be offered the securities (worried about **offerees, not purchasers**)

ii. Don’t want cold calling and random letters; **look at preexisting relationships**
   1. Not an exclusive test and someone can solicit small numbers w/o preexisting relationship if they can be fairly certain that they are sophisticated
   2. **Preexisting relationships can be purchased from placement agents**
      a. These people recruit sophisticated investors and can confirm their status—helps keep market operating

iii. Can only advertise to people based on **meaningful distinctions** that will limit solicitation to **sophisticated investors** capable of “fending for themselves”

c. **Disclosure**

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<td>Offerings up to $2m</td>
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<td>Offerings up to $7.5m</td>
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<td>Same as above</td>
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<tr>
<td>Offerings over $7.5m</td>
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d. **Exchange Act Reporting** issuers can provide most recent annual report, definitive proxy statement and most recent 10-K (if requested) or just the most recent 10-K
   1. Also must include a brief description of the securities being issued

e. **Non-Exchange Act Reporting** issuers must include statement similar to 1) the “same kind” of information included in Part I of registration statement
   1. As amount of offering increases, so does the level of disclosure

f. **Resale Restrictions**

i. Generally can’t be resold with the exception of Rule 504 securities (though there may not be much of a secondary market because of the small size of the offering and state law)

ii. **Rule 502(d)** explicitly restricts resales for Rule 505 and 506 offerings
   1. They **must be registered** or have a **144 exemption** if resold
   2. Issuer must **discourage resales** in situations in which **purchaser would be an underwriter** under §2(a)(11) (**contractually, legend on certificate**)
      a. This is the key concept—look at the individual transaction to determine if the investor has underwriter status (in which case §4(1) exemption is unavailable and all sales subject to §5)
      b. This hurts investor’s ability to realize capital appreciation as the stock price increased (the security will often require an illiquidity discount)
iii. Rule 504
   1. An issuer using Rule 504 can **avoid general solicitation requirements and resale requirements**

g. Integration
   i. Restrains loopholing—without this requirement, Reg D would be exploited and everyone would avoid registration
      1. Can’t divide artificially to avoid purchaser or $$ limits
   ii. Factors
      1. Whether the sales are part of a single plan of financing
      2. Whether the sales involve issuance of the same class of securities
      3. Whether they have been made at or about the same time
      4. Whether the same type of consideration is received
      5. Whether the sales are made for the same general purpose

iii. Integration safe harbor (Rule 502(a)): This rule applies 6 months before the start and 6 months after the end of the offering
   1. If they violate the 6 month window, they lose the safe harbor completely

h. Innocent and Insignificant Mistakes
   i. Under Rule 508, failure to comply with 504, 505 or 506 will not necessarily result in a loss of exemption for an offer or sale to a particular entity
      1. The issuer must commit an intentional and material violation to be prohibited from Reg D filing
      2. The investors are more sophisticated so they don’t need as much protection (and thus don’t need a strict liability anti-fraud statute like §12(a)(1))

i. Other Aspects of Regulation D
   i. Form D
      1. Issuers have until the 15th day after the start of the offering to file Form D; no immediate penalty for failing to file
      2. May not use Reg D if they are subject to order, judgment or decree enjoining it from violating Rule 503

   ii. Exchange Act Filing
      1. Exchange act reporting companies who issue an unregistered offering must submit an 8-K with the SEC, unless it is less than 1% of outstanding equity securities

j. The Private Placement Process
   i. If offering to top officers, the offering will be under 4(2) w/o much formality
   ii. If offering to outside investors the company will hire a **placement agent** (mostly like “best efforts” underwriting)
   iii. Interested investors will negotiate for specific terms with the issuer

Chapter 10—Secondary Market Transactions

I. Introduction
   a. General Rule: §5 means that **no securities transactions** after effective date of registration statement w/o complying with §5 process
   b. Minor Exceptions
      1. 4(1): No issuer, UW, dealer present—deals with transaction, not people
      2. 4(4): Brokers executing unsolicited transaction—person based
      3. 4(2): No public offering—transaction based
      4. Ackerberg fn 4: Mere presence of a broker doesn’t implicate §5
         a. If all transaction with broker were primary transactions we would never get into secondary market regime
II. Who is an Underwriter?

a. §2(a)(11)—Anyone who 1) has purchased from the issuer (controlling person); 2) offers to sell for issuer; 3) participates in the undertaking
   i. §4(1) exempts everyone from registration who isn’t issuer, dealer or underwriter
   ii. SEC v. Chinese Consolidated Benevolent Assoc.
      1. Members of the society voluntarily solicited offers to buy Chinese bonds (without a contract from issuer) and they were held to be issuers because they were “selling for” the Chinese gov’t

b. Analysis
   i. If participant = UW under 2(a)(11)
      1. UW under 2(a)(11)=
         a. Offers or sells for issuers or participates in distribution; OR
         b. Purchases with “a view to…distribution”
   ii. Then UW is present in transaction under 4(1)
   iii. So transaction is no longer exempt from §5 and must file registration statement and possible liability (§5 applies indefinitely)

c. “With a view to”
   i. Looks at intent to determine if purchase was made for an investment purpose
      1. If not, you look like an underwriter looking to distribute
      2. If you do buy for investment, you look like someone holding security for your own interest
   iii. Determine whether securities have come to rest
      a. 6 months: Security has come to rest
      b. 2 years: Presume investment purpose
      c. 3 year: conclusive presumption of investment purpose
   iv. Changed circumstances (look at the state of mind at purchase; if you had intended to keep, but chose to sell because of a change of circumstance, then you are not an underwriter)—seldom successful
      a. What kind of change required? Something significant enough to change your investment objectives that you weren’t anticipating and couldn’t have been expected
      b. Gilligan, Will & Co. v. SEC
         i. G purchased stock from issuer in private placement; converted to stock and sold it on exchange
         ii. G argued that issuer was losing money and thus there was a change of circumstance
         iii. Court held that G failed to establish an investment intent, thus was underwriter
            1. If he wasn’t almost any negative business action would be change of circumstance and this requirement would be void

d. Distribution
   i. Not all sales are distributions
   ii. Look if it is a public offering and if the purchaser could fend for themselves—they wouldn’t need as much protection

e. Examples
   i. Issuer sells to A, who sells to B
      1. A is UW (because A did not purchase from issuer for investment)
         a. The A and issuer are considered the same
b. Two transactions both collapse into primary market transaction
c. Same as issuer selling directly to B
d. Registration required

2. A is not UW (because A purchased from issuer for investment)
   a. A and the issuer are not the same
   b. Remains two transactions
   c. No registration required for A’s sale to B
   d. Unless C is between A and B; A is control person for issuer and C is UW for A

III. Control Persons’ Resales
   a. A control person is someone who controls the business or in a contractual arrangement to be
      an underwriter
   b. Additional problems arise if control person used intermediary to sell securities; the
      intermediary can be a UW because control person=issuer (§2(a)(11))
      i. If person purchases from control person with intent to distribute, they are
         underwriters if they do sell to public—control person loses exemption of §4(1)
   c. As if control person is working as UW for issuer?
      i. Under 2(a)(11) if answer is yes, then you have a problem
   d. If CP is not UW, intermediary is acting as US, there is still a problem
   e. §4(1 ½) Exemption
      i. Private sales of restricted securities by control persons
         1. From a “holder,” not an “issuer”
      ii. UW working on behalf of control person with respect to distribution
         1. Distribution=public offering under 4(2)
         iii. If the seller does not sell in public offering under 4(2), but rather a private offering,
            this is not a distribution and seller is not UW
            1. Seller must avoid sales to the public (sell only to those who could meet 4(2)
               requirements for offerees in a private placement)
            2. Seller must restrict future sales by buyer (require through contracts, legends
               on stock certificates, etc.)

IV. Rule 144
   a. Safe harbor for resales from §5 registration requirements—there is no distribution under
      Rule 144
      i. Helps determine whether investor had “investment intent” (and therefore is not
         an underwriter and not required to file registration)
      ii. If these criteria are satisfied, purchasers of private offerings may resell securities w/o
         violating §5
   b. No reselling restriction after three years (all shares presumed to be purchased for
      investment) Rule 144(k)
   c. Scope
      i. Applies to restricted securities (privately offered directly by issuer, Rule 505, 506,
         not offered to public)
         1. Non-restricted securities (registered securities) are sometime voluntarily
            registered securities and the registration statement limits resales to Rule 144
            sales
      ii. Sales by control persons: Also allows control person to sell a certain amount and
          not be considered an “issuer”
         1. For control people, both restricted and non-restricted count
Is the affiliate an UW for the issuer?
Is the non-affiliate an UW for issuer?

Is a third party an UW for the affiliate?

§4(1) generally exempts this transaction from §5 w/o Rule 144

**d. Requirements: Rule 144** works as long as the following requirements are met:

i. **Current Public Information about the Issuer**
   1. Information analogous to what is available in registration statement must be available to the public

ii. **Holding Period for Exempted Securities**
   1. Restricted securities cannot be sold until a year after the date of acquisition from issuer
      a. Ensures they purchased as investor

iii. **Limitation on Amount of Securities Sold**
   1. Sales by affiliates during a three-month period cannot exceed the greater of:
      a. 1% of the shares outstanding (aggregate)
      b. The average weekly reported volume of trading of such securities on all exchanges

iv. **Manner of Sale**
   1. The sales must be made directly to a “market maker” or in a “broker’s transaction”
      a. The person selling may not:
         i. Solicit orders
         ii. Make any payment to anyone connected with the transaction other than a broker
      b. The broker:
         i. May not do any more than execute the order to sell and cannot receive more than customary commission
         ii. May not solicit orders
         iii. May publish bid and ask quotations
         iv. Must make a reasonable inquiry to ensure person has the right to sell

v. **Notice of Proposed Sale**
   1. Anyone who intends to sell more than 500 shares or for an amount greater than $10,000, must file with the SEC