Securities Outline

Regulating the Market through Disclosure

I. Regulating Securities

a. Special Characteristics of Securities that require regulation system
   i. Information Disparity – individuals involved in the corporation are the people who need to sell the product which is hard to quantify
   ii. Intangible Product – possibly greater risk of fraud because you can’t identify, taste or quantify what you are getting
      1. Bundle of contractual rights that can be defined by the parties
   iii. Importance of investment and the capital markets – capital markets can’t exist and economy can’t grow without investment
   iv. Irrationality
   v. Collective Action Problems – small amounts invested from a large group of people mean that the incentives of any individual share holder might not be sufficient to take the kind of action necessary

b. Types of Regulation Systems – ex ante rules and ex post sanctions are possible
   i. Merit Based regulation system
      1. Determining if a product is good and then determining if people should be able to purchase
   ii. Disclosure based regulation system
      1. Disclosure of info about the underlying economics of enterprise
      2. Designed to overcome information disadvantages
   iii. Education based regulation system
      1. Courses to educate the investor before allowing them to participate
      2. Blurred with forced disclosure which should educate

c. Purposes of Securities Regulation
   i. Asymmetric information
   ii. Collective Action problems
   iii. Protection of the Unsophisticated Investor
   iv. Importance of the Capital Markets
   v. Lack of an Alternative Regulatory Scheme
   vi. Securities regulation is partly historical because systems are developed to deal with the rules and revamping the structure would be very costly
      1. We end up w/ rules upon rules, definitions, safe harbors, etc.

d. The Laws
   i. Securities Act of 1933: gate keeping process for entry into market
   ii. Securities Exchange Act of 1934: Regulates secondary market transactions
      1. Created SEC – Administrative agency in charge of enforcing and creating rules, within the scope of the delegated authority
   iii. Sarbanes-Oxley Act of 2002 – Mix of statutes that includes 6 to 8 concepts affecting securities regarding accounting, criminal liability

e. The Role of the SEC
   i. SEC is always playing catch up (See Ken Lay loan arrangements below)
      1. There was no rule against Lay’s activity because it was a novel scheme at the time, hard to predict how people get around rules

II. Information disparity and Disclosure – the underlying premise of securities is regulation to force disclosure and rectify information disparity

a. The problem with an information disparity
   i. Possibility of fraud, but motivation to commit fraud is rare enough that it should not chill market use if checked
ii. With info disadvantage many people are hesitant to participate
iii. Without people that trust money in the market we have no money

b. Economics of disclosure
   i. With no disclosure, theoretically every company would start at average price and those who disclose would have price go up while those who don’t have price go down
      1. Anti-Regulatory: Market will force disclosure based on the actions of strong companies, result would be uniform disclosure
      2. Pro-Regulatory: Lemon-Effect – for the market to function there must be a means for detecting lemons.
         a. A few bad companies without disclosure would erode market confidence and force race to the bottom
   ii. Limitations on economic incentives for disclosure
      1. If corporation is not issuing securities then it does not have incentive to disclose
      2. Agency costs: Directors may not have personal incentive
      3. Still need provisions for anti-fraud
      4. Efficiency of single standard: market might lead to over disclosure race to find advantageous information (Duplicate work)
      5. Positive externalities of mandated disclosure: learn something about other investments by comparison
   iii. The need for a government regulatory program must be weighed against the deficiencies of a regulator
      1. Cost of maintaining a central regulating body
      2. Regulator won’t choose proper disclosure amount
      3. Conflict of interest with regulator: best interests of investor?

c. The state of the market
   i. Efficient Market Hypothesis – info accurately reflected in price on market
      1. Weak form: price incorporates all past info about securities price
         a. Knowledge of past price cannot predict future price
      2. Semi-strong form: price reflects all publicly available information
         a. Likely true theoretically, forms assumptions of SECREG
         b. Demonstrated by quick reaction of market to information
      3. Strong: price perfectly incorporates all information
         a. Likely false, or no SECREG needed
   ii. Fundamental v. Informational Efficiency
      1. Fundamental efficiency concerns whether the price moved to the correct price given new information
      2. Informational efficiency concerns whether price moves quickly to a new price that people believe is correct
      3. Most believe market is info efficient, but not fund efficient
         a. Thus, ECMH is solely a starting point
   iii. Valuing investments
      1. Present Discount Value: what you would pay today for $ later
         a. Depends on both the discount rate and risk
         b. Consider decreasing marginal utility of the dollar
      2. Risk can be systematic (common to the whole market) and unsystematic (particular to an industry)
         a. Diversification eliminates unsystematic but not systematic

III. Materiality: if there is a 1) substantial likelihood that a 2) reasonable investor would view the fact as 3) significantly altering the 4) total mix of information
a. If info is goal and disclosure is means, then policing disclosures requires knowing what matters to investors
   i. There is no general duty to disclose all material information
   ii. Analyze whether requires disclosure, prohibits material misstatements, etc.
      1. Consider requirements against whether or not fact was disclosed
      2. Partial affirmative statements – consider whether disclosure was necessary to make affirmative statements not misleading
   iii. The fact that SEC requires disclosure does not automatically mean that disclosure is material for purposes of 10b-5
      1. *Oran v. Stafford* – undisclosed facts about Fen-phen not material under the total mix analysis
   iv. Change in stock price after final disclosure adds some information to whether the disclosure was material
b. Altering the total mix of information
   i. Forward Looking Statements: Consider probability of harm times magnitude of harm (Basic v. Levinson)
      1. *Basic*: Denial of merger negotiations included false affirmative historical and affirmative forward looking statement. (10b-5)
         a. Historical statement not materially fraudulent b/c no effect on stock price
      2. Full disclosure and bright line disclosure for forward-looking statements would result in more negatives than positives
      3. Large difference between ex ante analysis by corporation and ex post analysis by the court
   ii. Defenses to the affect on the total mix
      1. Truth on the Market: market already knew the truth
      2. Bespeaks caution doctrine: forward looking statements are rendered immaterial as matter of law if accompanied by a disclosure of risks that may preclude fruition of statement
      3. Puffery: People discount and don’t rely on puffery
c. Qualitative v. Quantitative Materiality: various qualitative factors may cause misstatements of quantitative
   i. *Ganino*: False actual assertion about money earned to hide failure to meet earnings target.
   ii. *Enron*: $15M sale and sell back of electricity barges
   iii. Cannot quantify materiality analysis because qualitative factors play a role, analysis is wrapped in outside context, quantitative determination would encourage pushing the limits, and there are difficult causation questions with stock prices (noisy market)
d. Reasonable Investor: total mix analysis changes based on who we protect
   i. Reasonable investor diverges from mathematical probability
      1. Hindsight bias (if something happened we think it was more likely
      2. Over-optimism
      3. Availability bias (oversubscribe to things right in front of us)
      4. Endowment effect (we hold on to things past point that it is rational to cut loses)
      5. Groupthink (believe prevailing wisdom)
   ii. With known irrationality should we base reasonable on rational decision
      1. Protect rational investor b/c this is what we can predict and there is no way to measure amounts of bias
2. But with proven irrationalities regulating on reasonable investor is regulating on falsity
   iii. Securities law based on average Joe, mom and pop investor
e. Management Integrity and Materiality
   i. Ken Lay’s line of credit arrangement and margin loans allowed him to sell stock back to company in order to keep loan collateral up
      1. Failure to disclose was material because it affected his management decisions
      2. SOX §402(a) prohibits personal loans to executives
   ii. Leveraged position of the management is cause for concern because there is too much motive on stock price rather than what is best for company
f. Disclosure and Corporate Governance
   i. No federal law requiring disclosure when corporate officer does not fulfill fiduciary duty because corporate governance is left to state law
   ii. The federal government is not in the business of deciding when fiduciary duty is breached because states determine what constitutes a well run corp.
   iii. Disclosure rules relating to corporate governance would mix merit regulation with the disclosure regime of federal securities law
IV. Definition of Securities
   a. Definition operationalizes our concept of when securities law should apply
      i. If securities regulation applies then 1) Disclosure Rules, 2) 10b-5 fraud liability, 3) Gun-jumping limitations, and 4) SEC jurisdiction
         1. Disclosure regime is costly
         2. Other protections may apply such that SECREG not needed
      ii. Defined in 33 Act §2(a)(1) and 34 Act §3(a)(10)
         1. Both definitions read to apply same analysis
         2. Laundry list of items covered, “investment contract” as catch-all
   b. Investment Contract (HOWEY TEST): A contract, transaction, or scheme where a person 1) **invests money** 2) in a **common enterprise**, 3) is led to **expect profits** 4) solely from the efforts of the promoter or third party
      i. Use the core definition of what fits under securities law to guide decision as to whether an undefined item is an investment contract
      ii. **Howey**: Strips of orange trees + optional service contract is investment K
         1. The essential ingredients of an investment contract are judged by the offering not the contact itself
         2. **Policy Behind the Case**
            a. RE contracts not investment contracts b/c purpose of legislation was stock market, not regulate all investments
               i. Land sold without service K, not regulated
            b. Howey Test based on policy of regulating “stock-like” investments
      iii. “**Invests Money**”
         1. **Teamsters v. Daniel**: Noncontributory, compulsory pension plan is not an investment contract
            a. Alternative FEDERAL regulation strongly points to an object not being a security.
               i. ERISA covers pensions
            b. Pension is different social activity than an investment
               i. EE primarily working for livelihood not investment
               ii. Contributions not tied to length of employee service
         2. **Element of Choice and Risk**
a. When a person has asset and makes a choice as to how to invest, then disclosure regime needed for informed choice
b. Profit participation units are investment if individual has choice of cash vs. percentage of profit

3. Services can count under “invests money,” but this usually only happens when services invested for a risky return

iv. “Common Enterprise”

1. Commonality: Split as to what type of commonality required
   a. Horizontal (HC): All boats rise and fall together, pooling of assets to share profits and risks of enterprise
   b. Broad Vertical (BVC): Promoter’s efforts effect all boats equally (wheel and spoke)
   c. Narrow Vertical (NVC): promoter’s boat rises and falls with investors

2. SEC v. SG Ltd: On line virtual stock exchange satisfies commonality b/c real money invested
   a. Ponzi scheme satisfies commonality requirement

v. “Led to Expected Profits”

1. Investor expects that money which could’ve been used elsewhere in capital market will produce capital appreciation or earnings
   a. Whether investor is doing something as a substitute for capital market investment
   b. Consumption decision versus investment decision

2. United Housing Formation v. Forman: stock in housing co-op allowed rental, sold back at fixed price when lease ends
   a. Not investment contract because motivated by interest in living (consumption) rather than some return
   b. Substance over Form: doesn’t matter that called stock

3. SEC v. Edwards: Lease payphones with guaranteed return
   a. No reason to distinguish between promise of fixed return and variable return for purposes of Howey test
   b. Court evaluated the risk involved and likelihood that unsophisticated investors would be attracted

vi. “Solely from the Efforts of Others”

1. The more you rely on promoter and the less on yourself provides reason to regulate – proxy for information asymmetry
2. Solely from the efforts of others not read literally
3. Rivanna Trawlers: Partnership in fishing enterprise
   a. Although general partnership is not normally a security interest, focus on power of investors
   b. Do not have to use power, must have ability to control
4. Franchises: Depends on whether the franchises efforts are “undeniably significant” in determining the success of business
   a. Normally franchises will not be security interest because bad business for corporation to micromanage that much
   b. Not security if sales are function of service in the store
5. Limited Partnerships start with the presumption of being a security
   a. If control then not a security under Howey

vii. Real Estate Deals

1. Fee Simple RE transaction: not investment K, b/c no expect profit
2. Syndication Agreement: developer raises capital for 10 condo buildings: Security under Howey Test
3. Time Shares: Buy unit and get rental proceeds when you are not there
   a. SEC Considerations (not law b/c not decided by court)
      i. Does investor expect profit from promoter effort
      ii. Is there a rental pool of money
      iii. Is there a mandatory rental period or do you choose when to rent it out
      iv. Is it mandatory that you use promoter as agent
viii. Parents give children $100K to start business w/ return in 20 yrs and low interest rate starting in 5 years (estate planning move)
   1. While not a “good investment” and not what we are trying to protect, evaluating investment is merit regulation
      a. Need limiting principle for merit regulation in the extreme
   2. May not see parents as investing, but SECREG doesn’t normally consider the state of mind of the investor
   3. Investment does take money away from capital market

c. Sale of Stock vs. Sale of Business
   i. Presumption that when stock is an investment it is a security
      1. Must consider because substance over form
      2. Inquiry not nearly as searching as investment contract inquiry
   ii. Landreth: Complete sale of all stock in corporation to sell business.
      1. Because it is sale of “stock” and investment purpose then it is subject to regulation
      2. Difference between analysis here and analysis under investment contract means name of purchase could be determinative
         a. Compare venture capital with control of company
   iii. Characteristics of Stock: Consider these characteristics in a balancing test
      1. Dividends based on profit
      2. Negotiability of Instrument
      3. Ability to pledge
      4. Voting proportionality
      5. Ability to appreciate in value

d. Notes: when is a note a security
   i. Cannot regulate all notes because this would require registration when you borrow money from any store they would have to register
      1. Landreth stock analysis will not work in this situation
   ii. 2 part test to determine if note is security (Reeves: Farmers co-op)
      1. Exceptions from Securities Regulation
         a. 9 Months §3(a)(3): if note for less than 9 months, no SECREG b/c most likely routine borrowing and unlikely to affect capital market.
         b. Note is not security if: consumer finance, home mortgage, short-term note w/ home lien, loan for current business opportunities, “character” loans
      2. Family Resemblance Test: If the facts are similar to previous case and other securities then it is a security. Four Factors
         a. Seller’s purpose and buyer’s purpose: Probably a security if
            i. Seller has a business operations motive or to finance substantial investments; AND
ii. Buyer is interested primarily in profit the note is expected to generate
b. Plan of distribution: common trading for speculation
c. Expectations of Investors: Would public expect SECREG
d. Alternative Regulatory Scheme: SECREG needed?

iii. Comparison of Reeves to the Howey test
1. Mental Inquiry: Reeves considers motivation of investor and borrower rather than just expectations of investor
2. Commonality: Common trading rather than commonality
3. Rigidity: Balancing of factors rather than must 4 meet factors
4. Predictability: More difficult because of need to consult case law

e. Securitizations:
   i. Bundling an investment and issuing a type of security (pooled mortgages)
   ii. These arrangements are almost certainly securities under Howey
   iii. Underlying interests are notes, but pool of interests is an investment contract rather than a note

V. Mandatory Disclosure: Almost entirely delegated to the SEC to promulgate rules based on big picture requirements from Congress
a. Rationales for mandating disclosure
   i. Value of a common standard on which we can compare two companies
   ii. Agency Costs: Shareholder interests vary from manager interests with regard to executive compensation disclosures
   iii. Social Waste: Duplicative efforts if race to information
b. Exchange Act Reporting Companies:
   i. Three ways to be reporting company (chart p161)
      1. §12(a) of 34 Act (H808): In order to be traded by member, broker, or dealer on a national exchange you must follow regs of 34 Act
         a. Broker, dealer is violator of statute, but causes companies to register so that they can be traded on secondary markets
      2. §15(d) of 34 Act (H846): If you file registration statement (public offering) you must comply w/ disclosure for at least 1 fiscal year, but if less than 300 investors you do not need to follow afterward
      3. §12(g) of the 34 Act (H813): Any company engaged in interstate commerce w/ more than 500 shareholders and more than $10M in assets must register with the SEC
   ii. Going Dark: Company taking itself out of 34 Act reporting requirements
      1. Terminate registration requirements under §12(g) and §15(d) if
         a. Less than 300 shareholders
         b. Less than 500 shareholders and less than $10M assets for 3 fiscal years
      2. Terminate registration requirements under §12(a) by delisting from a national exchange
      3. Reasons for going dark
         a. Reduce transaction and compliance cost of process
         b. Legal exposure to sanctioning reduced
            i. Going dark does not protect company from 10b-5
         c. Managers can avoid excessive scrutiny
   c. Integrated Disclosure: uniform system cuts down on duplicative filing with cross referencing to previous filings
      i. What must be disclosed largely contained in Reg S-K and Reg S-X:
         1. Reg. S-K: Non-financial information
2. Reg S-X: Technical information about numbers and financials
   ii. Forms for disclosure
       1. 8-K: Special filing when something happens between 10-Q’s
       2. 10-K: annual report
          a. Must be outside audited, certifying that financial statements in all material respects follow GAAP
       3. 10-Q: Quarterly report
   iii. Hewlett-Packard’s 8-K Conflict: Board conflict over poor merger gets to press, CEO investigates using pretext. Director resigned due to tactics
       1. Item 5.02(a)(1): if director resigns b/c of disagreement known to an executive officer of registrant, on any matter relating to operations, policies or practices, the 8-K must disclose a brief description of the circumstances representing disagreement
          a. No explanation of director resignation given in 8-K
       2. Item 5.02(b): Must disclose resignation of high level execs
          a. No explanation required under (b)
   iv. MD&A: Management’s narrative discussion of business
       1. Reg S-K Item 303
          a. Requirements
             i. Has to be known to the management
             ii. Has to be reasonably likely to have a material effect
          b. Subsection C is safe harbor for forward looking statements
   v. CEO/CFO Certification: Both must certify compliance of the forms
       1. Prevents officers from saying I don’t focus on details by requiring attention to what lower level employees are doing
       2. SOX added potential criminal liability to civil liability
   vi. WR Grace: former CEO retirement perks not fully disclosed
       1. SEC found violation because CEO/CFO certified assuming that material information was included. SEC did not impose sanctions
       2. Seems like strict liability, but arguably negligent omission
   vii. Other Disclosure Venues
       1. Press releases, analyst calls, Road Shows, press leaks, etc.
       2. Reg. FD (Fair Disclosure): governs selective disclosure
          a. If you intend to disclose then must disclose to everyone
          b. If you make a mistake you must cure it by disclosing it
          c. Covers broker dealers, investment advisors, companies, and holders of securities
             i. Rating Agencies not covered
          d. No private right of action
   viii. Matter of Siebel Systems: Company sanctioned for twice violating Reg FD disclosure rules, investors who used tips did nothing wrong
   ix. Book and Record Violation: Extremely broad, strict liability provision
       1. SEC fall back when they can’t find anything better
       2. Criminal liability attaches only if mistake made knowingly
       3. SEC tends to use this reasonably even though everyone is violator making this selective enforcement

SEC Enforcement Procedure
   I. Gatekeepers: Any third party w/o whom a transaction or deal cannot take place
      a. Creating and Sanctioning Gatekeepers
         i. Law requirements and market forces create gatekeepers
1. Requirements: Laws require auditors and credit rating agencies
2. Market Forces: outside audit by independent firm gives company a favorable reputation

ii. Reasons for Sanctioning Gatekeepers
1. Sanctions ensure that gatekeeper incentives aligned with public interest rather than serving interests of clients who pay them

iii. In order to properly align incentives expected sanction must outweigh the benefit of contrary action
1. The expected sanction equals the probability times the sanction
2. Easier to outweigh benefit for gatekeeper than for the company
3. \( P \times S > B \)

iv. Gatekeepers increase the probability of detection with minimal enforcement costs
1. Govt. can increase sanctions to a point where they discredit system
2. Rather than increasing sanctions, gatekeepers increase probability

v. Problems with gatekeeper sanctions
1. Even with liability, gatekeepers have benefit in aligning interests with company to further product sales
2. Hard to get gatekeeper to be both loyal and a cop
3. Can’t crack down on gatekeepers so much that companies no longer trust the gatekeeper with corporate information

b. Auditors as gatekeepers
i. Auditors are required by securities law to sign off on 10-K
   1. Certify that accounting done according to GAAP
   2. Must audit according to GAAS

ii. SOX increased gatekeeper responsibility
   1. PCAOB – quasi-public, quasi private board with power to investigate and punish accounting
      a. Takes over for self-regulating industry
   2. 34 Act, §10A: new provisions
      a. (a)(1) – accountants must have procedures to uncover illegal acts
      b. (g) – restrictions on selling client non-audit services
      c. (1) anti-revolving door provision: can’t work as auditor if previous employees are working for company as high executive
      d. (m) – audit committee of the company board have higher responsibility for supervising the audit
   3. Whistleblower requirements: 10A(b) requires reporting illegal acts to the management of client and potentially to the SEC

iii. Liabilities of the auditor
   1. Primary violations: sued/enforced when auditor commits securities fraud
   2. Aiding and abetting: SEC and DOJ can enforce
   3. §102(e): Professional discipline if practicing before the commission
      a. Censure, suspension, or debarred from practice w/ commission

iv. Market forces are not sufficient with auditors even though reputation is sold because the benefits of auditing is selling consulting services
1. Agency costs also plays a role because individual take home is greater benefit than reputational harm to the firm

c. Lawyers as Gatekeepers
i. Gatekeeper role of lawyers
   1. Lawyers who represent corporation represent the shareholders; thus, they should be a check on managers
      a. Not true in practice because lawyers represent through managers
2. Expertise and Market Knowledge: not a required gatekeeper, but value in knowledge of regulatory interpretations
3. Legal opinion is a defense to justify the actions of the board

ii. Tasks and Duties of Lawyers
   1. Advice and representation before the SEC
      a. Must follow SEC rules, prof res rules, and primary law
   2. SOX additions to duties of lawyers
      a. Noisy removal clause: Rule 3 of SEC Rules of Prof conduct
         i. If securities attorney aware of material violation, then must tell general counsel who investigates
         ii. If GC does not provide an appropriate response, lawyer must tell board and may reveal to commission
   iii. Gatekeeper liabilities
      1. Primary violations: sued/enforced when lawyer commits securities fraud
      2. Aiding and Abetting: SEC and DOJ only can enforce
      3. Rule 102(e): SEC can censure, suspend, and disbar from SEC practice
   iv. Lawyers have less defined requirements and obligations than auditors

II. SEC Enforcement Procedure
   a. SEC Enforcement Division
      i. Needs SEC Commission approval to initiate investigation, subpoena, or require testimony
         1. Informal request letters usually bring cooperation
      ii. Receives input from press, SEC reporting, Tips, SROs
   b. Options for Enforcement
      i. §21(a): Report of Investigation – public announcement of violation of securities laws without sanctions
      ii. §15(c)(4): Disclosure Violations – Enforcement proceeding in court resulting in publication of findings and injunction requiring company to comply (rare)
      iii. §21C: Cease and Desist Order (most common) – Procedure before an admin law judge that results in temporary cease and desist order from violations. Possible disgorgement and officer and director bar from public companies
         1. Adversary proceeding with right of appeal to commission, Ct. of Appeals
         2. Must show more wrong under 21C than §102(e)
         3. KPMG v. SEC: proper scope of C&D order
            a. Auditor can’t have contingency fee arrangement b/c they are supposed to be independent and should not have a financial stake
            b. Holding: Cease and Desist order must have reasonable relationship to the issue under review
      iv. §21(d): Suit for Injunction – SEC is ¶ in D.Ct. lawsuit, toughest SEC action
         1. For an injunction the mental state and standard of proof required are the same as the underlying violation
            a. Aaron v. SEC: scienter required for 17(a)(1) but not 17(a)(2), (3)
            b. Often see §17 violation included in SEC action b/c of lower standard of review than 10b (no public rights in §17)
         2. Disgorgement, Fines and Bars: Highly factual analysis
            a. Consider: egregiousness, repetition, Defendant’s financial worth, role in securities industry, likelihood of future violation, scienter
            b. Sargent – SEC disgorged consultant who shared info w/ dentist
            c. Bancorp – Sands disgorged/barred from future board positions
            d. SOX changes
i. §21C(c): SEC sue to freeze assets for extraordinary payments when company in financial difficulty

ii. §21(d)(6): SEC must only prove “unfitness” to bar from employment as executive (previously “substantial unfit”)

iii. §21(d)(4): Prohibits payment of attorney’s fees in distribution of disgorged funds

v. Criminal Referral: SEC can refer corp. to DOJ for criminal enforcement

vi. §12(j) and (k): Trading suspension – Stop trading for company, 10 days or longer

vii. Almost any commission decision can be appealed to District Court

c. Almost 99% of enforcement actions settle w/ fines, stop order, no admission or denial
   i. Neither admit or deny to avoid collateral estoppel in class action
   ii. SEC has limited resources and company under the microscope.
   iii. Cooperation: SEC condemn Lucent for non-cooperation, indicates that disclosure to investors may be incomplete
      1. Allows SEC to conserve limited resources

iv. Waiver of attorney client privilege and indemnification
   1. Waiver in SEC proceeding is waiver for criminal procedure
   2. Waiver is not required, negotiable part of the SEC procedure

d. SEC Subpoena Power (34 Act §21)
   i. Scope of Power: Theory vs. Practice
      1. SEC can investigate anything that is relevant to an investigation including investigating an entire industry (RNR Industries)
      2. Must rely on D.Ct. for approval, but requests rarely denied
         a. SEC just submits and affidavit, no evidence before investigation
      3. Low standard b/c courts have little competency, there is a reduced expectation of privacy, and it promotes effectiveness
   ii. To win enforcement of administrative subpoena SEC must show
      1. Investigation conducted pursuant to legit purpose
      2. Inquiry may be relevant to that purpose
      3. Info is not already in Commissioner’s possession
      4. Administrative steps have been followed

III. Criminal Enforcement
   a. Parallel SEC and DOJ Investigations
      i. Fifth Amendment Rights
         1. No adverse inference from 5th Amendment assertion in criminal case, but adverse inference available in civil case
         2. Company has right to fire employee if they take the 5th
      ii. Corporate documents can’t be withheld under the 5th amendment
         1. Individual cannot be compelled to authenticate the document
         2. Cannot destroy documents if you have notice or reasonably expect an SEC investigation, but you can destroy under pre-existing reasonable company policy
      iii. Nothing wrong with concurrent SEC and DOJ investigations, but if government is gaming the system the court may stay SEC proceedings (SEC v. Dresser)

   b. The Laws and Punishments
      i. Statutes
         1. §21(d) authorizes SEC to refer criminal violations to the AG
         2. §32 makes it a crime to willfully violate securities law
            a. Jail time avoided if no actual knowledge, fines still apply

      ii. Criminal Sanctions:
1. Financial sanctions are not enough because we believe retribution is needed for crimes
   a. Offensive to send thief to jail and fine white collar defendant
2. Can’t just make criminal sanctions exorbitant to outweigh benefit (Expected Sanction \[P \times S\] > B) because bankruptcy is limit
   a. Criminal punishments have greater deterrence

c. Determining which violations are worthy of criminal enforcement
   i. Mental state: Defendant must “willfully violate”
   ii. Affirmative defense: no person imprisoned if she had no “knowledge”
      1. Interpreted to require that person knew the act was wrong rather than requiring a person to know of the rule
   iii. US v. Dixon: Dixon paid loan balance at last minute to get under reporting requirement, but rule required reporting if over the limit at any time of the year
      1. Judge Friendly determines that willfulness includes consciousness of wrongdoing even though no knowledge that the rule was being broken
      2. Requiring knowledge of the law would provide mistake of law defense along with affirmative defense
   iv. SOX attempted to lower standard to “knowingly” committing securities fraud or certifying false reports for criminal proceedings
      1. Skepticism about whether this makes the issue go away

d. The Problem of Loopholing
   i. Worldcom
      1. Ebers argued that he was in compliance with GAAP so it doesn’t matter that he intended to distort accounting
      2. GAAP compliance is relevant, but not an absolute defense to accounting fraud. Jury must decide about intent to deceive
   ii. Many rules to close loopholes, but standards based schemes such as 10b-5 work to catch the newest ploy
   iii. Does our society value loopholing (taxes) or condemn the abuse?

Rule 10b-5 and Antifraud Provisions
I. Sanctioning Fraud
   a. Reasons for sanctioning fraud
      i. Lemon Effect: Fraud could lead to race to bottom, destroying market confidence
      ii. Agency Costs: Managers have incentive to commit fraud even when not in corporation’s best interest b/c of compensation tied to numbers and fear of BR which effects manager reputation or hostile takeover effects on manager’s job
      iii. Need to protect unsophisticated investors: beyond protection of diversification
      iv. We do not know what would happen without antifraud regime
         1. We can speculate from what we see in markets without regime
   b. §9 of the 34 Act: Prohibition against the MANIPULATION of SECURITY PRICES
      i. Prohibits Wash Sale: Trading with yourself or a co-conspirator to artificially drive up trade volume and price of a security
      ii. Provides a private right of action
   c. Private Policing of Securities Fraud
      i. Additional enforces drives up the probability of sanctions
         1. (expected sanctions = probability times amount of sanction)
      ii. SEC limited by budget in amount of cases and sanctions (only biggest cases)
      iii. Plaintiff’s attorneys are only limited by budget constraints of expected damages
         1. Private Right of action has existed since the beginning of 10b-5
   d. Non-exclusive Causes of Action: A party can bring both a §11 and 10b-5 cause of action
i. *Herman & MacLean*: False statement in registration, charges in §11 and 10b-5
   1. §11 claim under 33 Act restricted to purchaser in offering suing enumerated parties
   2. 10b-5 suit in any securities transaction, but requires scienter

ii. 10b-5 has larger class of defendants, longer statute of limitations, and greater damage award potential
   1. §11 strictly liable w/ due diligence defense, makes it like negligence
   2. §11 is narrower (only IPOs and has restrictions) therefore there is less concern that strict liability will create a sprawling device

II. Class Action Lawsuits in Securities Fraud
   a. The problem of class action lawsuits in securities
   i. Minimal damages to plaintiffs make it unappealing to pursue individually
   ii. Cost of a securities lawsuit is great; thus, we need class actions to efficiently pursue legal claims against a corporation
   iii. Problematic because class actions create an incentive for frivolous lawsuits

b. Frivolous lawsuits and the Private Securities Litigation Reform Act (PSLRA) of 1995
   i. The problem of frivolous lawsuits: higher probability of frivolous lawsuits in securities because there is no threshold event needed to create frivolous lawsuit
      1. Waste: Expensive to litigate to the point where you know it is frivolous and often the initial costs will exceed cost of settlement
      2. Less Deterrence: Cost of frivolous lawsuits offset the value gain of private policing
         a. Whether or not it is frivolous you have to pay certain initial costs
         b. Expected benefit of a sanction is less because normal cost higher
   3. Trials are a very ineffective and expensive way to sort cases
   ii. PSLRA restraints to the securities class action: Changes to the 34 Act §21D and E to reduce the possibility of settlement
      1. Lead Plaintiff = Plaintiff stake in the lawsuit, most likely the lead plaintiff will be an institutional investor
         a. Combats the practice of attorney finding small interest plaintiff
         b. An individual with a larger stake is more likely to make a self-interested decision about whether or not to pursue the case
            i. Plaintiff makes decisions in own interest, not lawyers
      2. Plaintiff must plead with particularity facts sufficient to establish a strong inference of scienter
         a. Required pleading creates a better chance for motion to dismiss
         b. Scienter – degree of knowledge which makes a person legally responsible for the consequences of an act or omission
            i. Consists of intent to deceive, manipulate, or defraud
      3. Discovery is delayed until after the Motion to Dismiss
      4. Safe harbor created for forward looking statements
      5. Proportionate not joint and severable liability, for defendants w/ no intent
      6. NOT Changed: Measure of damages and scope of liability
   c. Agency problems in the class action suit: Attorney has fiduciary duty to interests of class, but this representation may not be consistent across class
      i. Plaintiff Agency Problems: Division between fully divested plaintiffs who don’t care about future of corporation and those who are not fully divested (often institutional investors) who want company to survive and succeed
      ii. Kickback arrangements with lead plaintiff and counsel
1. PSLRA does not allow lead plaintiff to get more than proportional share of the settlement
2. Milberg Weiss case alleged this arrangement
   iii. Individual investors with small potential damage award may be indifferent to control of the lawsuit
d. Fee Arrangements
   i. Lodestar Approach: base attorney fee amount on number of hours and reasonable hourly rate times multiplier for risk, complexity and attorney performance
   ii. Percentage of the funds received by the class (court can control in large recovery)

III. The contours of 10b-5: Federal Law’s Most famous rule
a. Statutory Requirements of 10b-5
   i. 34 Act §10b (H795) – Unlawful to use or employ any manipulation or deceptive device against SEC rules in connection with purchase or sale of security
      1. Enormously broad grant of power to SEC under §10 of 34 Act
   ii. Rule 10b-5 (H1084) – SEC rule reaches maximum of authority granted:
      Unlawful to (1) directly or indirectly, (2) through commerce mail or exchange,
      1. (3)(a) Employ any device, scheme, or artifice to defraud
      2. (3)(b) Make any untrue statement of material fact
      3. (3)(c) Omit to state a material fact necessary to make a previous statement misleading
      4. (3)(d) Engage in act which operates or would operate as fraud or deceit
      (4) in connection with purchase or sale of ANY security
   iii. Large grant of power creates common law grant to court for development of rule
b. The elements of a 10b-5 cause of action: The standards for each of the elements have the goal of balancing deterrence against over-deterrence and frivolous lawsuits
   i. “In connection with the purchase or sale of ANY security”
      1. 10b-5 actions are not limited to exchange act reporting company, they simply have to be in connection with the transfer of a security
      2. Plaintiffs in a 10b-5 private action must be actual purchasers or sellers of securities (Birnbaum)
         a. Blue Chip Stamps: P claimed that they were deterred from buying stock b/c prospectus was fraudulently overly pessimistic
            i. Eliminates some who are actually defrauded (don’t own stock, but made decisions based on fraud), but rough cut is worthwhile to help limit frivolous lawsuits
         b. Too many people could fabricate claims w/o this limit
      3. Sale of securities must be a necessary part of the fraud, but the value of the securities does not have to be affected
         a. Zandford: Broker takes money from old man and niece by selling them a brokerage account and embezzling money
            i. Meets in connection with because embezzlement was through selling them a securities account
         b. Difficult to tell if fake broker who promises to buy and sell securities, but just steals money would meet this standard
   ii. Material Misstatement
      1. Breach of fiduciary duty by the corporation is not securities fraud
         a. Santa Fe: Corporation buys out subsidiary w/ a price that was too low for minority shareholders, but with full disclosure
            i. Supreme Court rejects 10b-5 action because securities fraud is based on full disclosure, reading of 10b-5 cannot be larger than scope of §10
Separates duties under state corporate law and SECREG

2. Duty to Correct v. Duty to Update
   a. Corporation has a duty to correct incorrect statement and no scienter is required for the incorrect statement (All circuits)
   b. *Gallagher v. Abbott Labs*: Company doesn’t disclose intraquarter problem with FDA
      i. Court refuses to adopt duty of continuous disclosure
         1. Separation of Powers: SEC/Congress established system of regular, but not continuous disclosure
         2. Duty to Correct must be based upon whether or not the statements were wrong at the time made
      ii. Circuit split - 2d Cir: Even though no general duty to update, there may be a duty to update if prior disclosure was “alive” or forward looking – mushy standard
   c. No Circuit finds that a corporation has a duty to correct 3d parties, unless corporation entangled w/ statements of 3d parties

3. Forward Looking Statements Safe Harbor
   a. §21E of 34 Act: Forward looking statements of an Exchange Act Reporting Company are protected if accompanied by “meaningful cautionary statements”
      i. Meaningful cautionary statements identify important factors that could cause results to differ materially
         1. Cautions must be tailored to risks, boilerplate is not enough
         2. Does not require accurate prediction of future
      ii. Safe harbor created by PSLRA: developed from bespeaks caution doctrine – part of materiality
      iii. §27A of 33 Act has similar safe harbor
   b. Why protect forward looking statements
      i. Valuable: Good to give info to investor, should not discourage managers from giving info
      ii. Danger: Issuers particularly susceptible to lawsuits for forward looking statements
      iii. Fraud: Particularly susceptible to fraud because statements are like crack to investors, so we don’t want to completely insulate them
   iii. Scienter: Rule 10b-5 required mental state, no strict liability
      1. Negligence is not enough: Fault level under 10b-5 is at least recklessness
         a. *Ernst & Ernst*: need mental state b/c statute uses terms like “manipulate, deceive and contrive” which indicate intent
         b. If 10b-5 was strict liability it might moot §11 of 33 Act
      2. Scienter requires a mental state greater than negligence, includes recklessness for civil cases and “willfulness” for criminal cases
         a. Intent – Knowledge – Recklessness – Negligence
         b. Recklessness (MPC description): conscious disregard in manner that is gross deviation from standard of care
      3. The use of recklessness as a standard serves as legal construct to lower the burden of proof rather than looking at subjective mental state
         a. Including should have known sounds a lot like negligence
            i. Some courts use this, but it doesn’t seem to meet 10b-5
b. Must have known or conscious disregard is only different from actual knowledge in the forgiveness on the burden of proof

4. Pleading Scienter Post-PSLRA: must raise strong inference of scienter
   a. Motive and Opportunity are not enough to establish a “strong inference of scienter” absent additional circumstantial evidence
      i. *Green Tree Fin:* Pooling of mobile home mortgages, investors claim fraudulent accounting from booking profit based on extremely low default assumptions
         1. CEO salary based on % of profit, but every CEO has this motive, would defeat PSLRA
         2. In this case CEO has special motive along with stark contradiction between assumptions and statements made and the facts available
   b. Factors to determine if motive and opportunity along with circumstantial evidence is sufficient under PSLRA
      i. Unusual insider trading: insider trading alone not enough
      ii. Contrary internal documents and external statements
      iii. Closeness in time of misstatement and disclosure
      iv. Other fraud suit with a quick settlement
      v. Disregard for current data: effort to rely on old data when new data is available
      vi. Magnitude of the accounting correction
   c. Plaintiff must have some facts to survive motion to dismiss, but cannot discover facts until after motion to dismiss
      i. Rely on inside sources, WSJ, or magnitude of misstatements

iv. Reliance: Plaintiff in 10b-5 action must prove reliance on the fraud
   1. Omission: Either no reliance required or reliance presumed
      a. *Affiliated Ute Citizens:* Market makers not conveying true value
         i. Not a very useful case b/c of unusual fact pattern
      b. Questionable standard: Presumption of reliance when disclosure duty exists or implicit reliance on the market makers
   2. Reliance on a misrepresentation
      a. Transactions on open market - rebuttable presumption of reliance
         i. *Basic v. Levinson:* (no merger talks) Individual who bought or sold stock on market does not have to show individual reliance b/c “fraud on the market” theory
         ii. Defendant can rebut presumption, but this is virtually impossible for large public company
         iii. Adoption of ECMH: price reflects information that is out on the market, whether correct or not, so plaintiff does not have to rely on misstatement
         iv. Plaintiff must show that market was efficient and that information was included in price???
      b. Face to face transactions: investor must show individual reliance
   v. Loss Causation: P has burden of proving the act violating the 34 Act caused loss
      1. PSLRA added working in §21D(b)(4), but loss causation was element before PSLRA
      2. *Dura Pharm:* Supreme Court rejected 9th Cir holding that plaintiff only need to allege that price was wrong on the date of purchase
         a. Plaintiff must allege causation of stock price change
b. Defendant can defend with other factors affecting stock price

3. Without causation SECREG would essentially provide insurance

4. Loss Causation v. Materiality:
   a. Materiality is lessor inquiry of what a reasonable investor would think, while loss causation is individual
   b. Materiality is theoretical determination by fact finder, loss causation is concrete determination supported by the market

5. Loss Causation and Damages
   a. Damages are a more searching and detailed inquiry at the end of the lawsuit while loss causation is threshold inquiry

6. Reliance and Loss Causation
   a. Investor who buys due to misrepresentation but sells at profit has reliance, but no loss causation
   b. Investor who is forced to sell (due to antitrust decree) at depressed price has no reliance, but has loss causation

vi. Damages: subsumed into loss causation for motion to dismiss determination

c. Primary vs. Secondary Violators: Rule 10b-5 defendants
   i. Central Bank: No aiding and abetting liability under the private right of action
      1. Policy: Primary violators are often defunct so court is worried about vexatious and frivolous litigation against 3rd parties with deep pockets
      2. Rationale of the court
         a. If Congress wanted to include aiding and abetting in “directly or indirectly,” would have included the words in the statute
         b. Indirectly is smaller category than aiding and abetting
            i. Court makes this assertion with little support
   3. Case occurred when most believed securities litigation was out of control
   ii. Goals: Compensation v. Deterrence
      1. For a compensation goal allowing plaintiff to sue deep pockets is good; for deterrence rationale we should only allow suit against party who committed the harmful conduct
         a. Primary goal of securities law is to protect capital markets and promote investor confidence
         b. Only sanction 3rd party if they had some impact on the harmful conduct such as knowledge or a position to stop the conduct
      2. Sliding scale to determine who is a sufficient violator to justify liability
   iii. Bright Line v. Substantial Participant Test: Circuit split as to how to determine who is a primary violator
      1. Bright Line Test (2d Cir.): Party must make the material misstatement or omission in order to be a primary violator, approval of documents without signing is not actionable
         a. Wright: Rejects plaintiff action against Ernst and Young b/c EY did not sign off on press release w/ misrepresentation
         b. Corporation is vicariously liable due to agency so you don’t need to show that the corporation is a primary violator
      2. Substantial Participant Test (9th Cir.): Party are liable for statements made by others when the party substantially participated
         a. Subjective determination of what counts as substantial
         b. One example of test: If 3d party involved in creating statement and you have scienter, then primary violator
      3. Enron case: Banks agreed to transactions made to cook the books could be primary violators under substantial participant, but not bright line
d. Damages
   i. Theory of Damages: Deterrence v. Compensation
      1. In damage calculation there seems to be an ambivalence to whether the
goal is deterrence or compensation
      2. Deterrence: Probability x Sanction must be greater than benefit
         a. The benefit to the actor cannot be measured, so the market
capitalization drop is a random number to assign as benefit
         b. Using market cap switches inquiry from benefit to social harm
            which represents a movement from deterrence to compensation
            i. Even using social harm is wrong b/c theoretically the
               loss to some is offset by the gain to others
   ii. Damage Measures

<table>
<thead>
<tr>
<th>Measure</th>
<th>Content</th>
<th>Open Market</th>
<th>Face to Face</th>
</tr>
</thead>
<tbody>
<tr>
<td>Out of Pocket</td>
<td>(Value at the time of purchase or sale) − (Price paid)</td>
<td>Yes (usual)</td>
<td>Y</td>
</tr>
<tr>
<td>Recissionary</td>
<td>Return of purchase price (buyer victim); return securities</td>
<td>N</td>
<td>Y (usually)</td>
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<td>(seller victim); or (Price of later sale by D) − (sale price)</td>
<td>Y (if fraud in the inducement)</td>
<td></td>
</tr>
<tr>
<td>Disgorgement/</td>
<td>D gives D’s profits to P</td>
<td>Y (I/T cases)</td>
<td>Y (I/T cases)</td>
</tr>
<tr>
<td>Restitution</td>
<td></td>
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<tr>
<td>Benefit of the</td>
<td>(Value promised) − (Value received)</td>
<td>N</td>
<td>Y (rare, must show certain promise)</td>
</tr>
<tr>
<td>Bargain</td>
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</tr>
</tbody>
</table>

1. Securities lawsuit at damages stage turns into a battle of experts
testifying to what the true value of stock would have been
2. PSLRA puts a time limit and price cap on the damages determination
   a. Award of damages shall not exceed the purchase price minus the
      median price for the 90 days after fraud announced
3. For face to face transactions the court is not limited to out-of-pocket
   measure. Damages vary according to the situation
   a. Pidcock: Partner tricked into selling his share of business, and
      other partners make profit on later sale to 3rd party
      i. Determine the value of the interest sold if Pidcock was
told of the upcoming buy out
      ii. Unique and special efforts by the remaining partners that
           change the value of the asset limit the plaintiffs damages
   b. Garnatz: No allegation that plaintiff paid more than value, but D
      knew P was risk averse and lied about risk in investment
4. Proportionate Liability
   a. PSLRA eliminated joint and several liability: 34 Act §21D(f)
   b. Proportionate except that
      i. Joint and severally liable for uncollectible damages if damages
greater than 10% of P’s net worth and P’s net worth is less than $200K
      ii. Co-defendant insolvency: Make up shortfalls by up to 50% of D’s share
   e. Milberg Weiss kickback scheme gave disproportionate recovery of damages to plaintiff
      in the form of “referral fees”
      i. PSLRA lead plaintiff provision seem to add value in certain types of cases
      ii. See notes for further information

Public Offerings
   I. Introduction to Public Offerings
a. Corporate Finance: The pooling of resources to engage in economic activity is the most fundamental reason for economic success and progress in our society
   i. Capital and the Problem of Timing: Need capital to build business before you can start the business activities and generate profits
      1. Problem of Scale: unusual to have individual w/ enough capital for start
   ii. Equity v. Debt: Securities can be both equity or debt in many forms
      1. Banks won’t tolerate risk involved in many business activities, but we need system to allow this type of risky behavior
      2. Individual who would like to take risk and limit liability through the corporate form can issue securities that bank would not accept
   iii. Reasons to go public
      1. Allows private enterprise to raise capital
      2. Creates secondary market though which individuals can sell interests
         a. Creators can gain millions based on ability to sell ownership
      3. Branding and publicity for the enterprise
b. The Underwriter
   i. Reasons for an underwriter: Value Added
      1. Credibility: Repeat player has the incentive to fully investigate
      2. Expertise dealing with regulatory agencies and Wall Street firms along with experience with filing and marketing
      3. Gatekeeper: 3d party in a position of informational advantage who has an incentive to detect problems and stop them
      4. Risk Spreading: Desire to make sure offering sells out creates strong incentive for accurate price
   ii. Problems with underwriters
      1. Free rider: incentive for smaller underwriters to not do due diligence
      2. Investor’s may not know who the underwriter is
      3. Competition leads to incentive to cut down on protections and increase valuation to issuer in order to get the deal
      4. Corruption: bake-offs, underwriter may guarantee that analysts will positively review the company in the future (this is prohibited)
c. Types of Offerings
   i. Firm Commitment: Underwriter buys all of offering at price below offering price (usually 7% difference) and sells it to the market (most common form)
   ii. Best Efforts: UW pledges to make best effort to sell entire stock, no guarantee
      1. Less risk to UW, but investors know UW has less confidence in offering
      2. Conditional best efforts: If not all sold then all sales rescinded
   iii. Direct Offering: Issuer sells to public w/o underwriter, very rare
   iv. Dutch Auction: Investors bid for desired number of shares at specified price and all shares are sold at the highest price that completely sells out offering (Google)
d. IPO Underpricing: Practice of underpricing so that institutional investors gain by the subsequent price jump
   i. Limit to litigation damages because inflated price due to market
   ii. Could result from irrational exuberance
   iii. Enterprise owners are leaving money on the table
   iv. Could be corruption issue with UW taking care of its institutional investor clients
II. Gun Jumping Regulations: General Information
a. Policy considerations for disclosure and offerings
   i. What do investors want in disclosures for an offering
      1. Clarity of capital structure: single tiered structure so they know where investment is going and who has a stake
2. Reduced risk:
   a. Preexisting Capital Structure: Enterprise where founders have already invested capital and have equity stake in endeavor
   b. Effective corporate governance: Generally Delaware Law
3. Visibility regarding price and value: Disclosure of finances
   ii. Extra disclosure in public offerings b/c there is heightened information asymmetry where no history of financial findings or analysis
   iii. If disclosure is of extra importance, why restrict disclosure prior to offering
      1. Historical concern from hawking investment schemes to unwary
      2. Concern that some investors could be given informational advantage
      3. Unregulated statements could make disclosure in prospectus worthless
b. Disclosure regime in general
   i. Integrated disclosure: Registration statements (S-1 and S-3-short), Periodic reports (10-K, 10-Q, 8-K), and Proxy Statements (Schedule 14A) all reference Regs S-K (narrative disclosure) and S-X (accounting and financial information)
   ii. Plain English: Use of plain English may help unsophisticated investor, but it takes away from the conventions used by those who actually read these
   iii. Objectives of disclosure regime
      1. Force disclosure (33 Act requirements)
         a. §5: Can’t sell security w/o registration statement in effect
         b. §2: Can’t sell security w/o prospectus satisfying §10
         c. §10: Statutory prospectus requirements
      2. Control disclosure: (33 Act requirements)
         a. §5: Unlawful to use commerce to offer unless reg statement filed
         b. §2(a)(3): Very broad definition of offer
         c. §2(a)(10): Definition of prospectus includes any communication
         d. §6: Information about registration statement
   iv. Sequence of Disclosure Regime: Pre-Filing ➔ Waiting Period ➔ Post-Effective Period
      1. File Registration Statement between Pre-Filing and Waiting
      2. Registration Statement becomes Effective between Waiting Period and Post-Effective Period.
c. 4 classes of Issuers (2005 reforms): Harder to qualify class = less control over offering
   i. Non-Reporting Issuers (NRI): Not required to file 34 Act reports and not filing voluntarily; there is no information available to public, greatest concern
   ii. Unseasoned Issuer (UI): 34 Act filing co. that is ineligible for S-3 short form
   iii. Seasoned Issuer (SI): 34 Act filing company that is eligible for S-3 short form
   iv. Well-Known Seasoned Issuer (WKSI): Reporting company eligible for S-3 AND
      1. As of date w/in 60 days of determination date has either
         a. $700M of common equity market value held by non-affiliates;
         b. OR Issued $1B aggregate non-convertible securities in registered offerings during the past 3 years and will only register non-convertible securities, other than common equity . . .”
      2. BUT, will lose WKSI status if not current with filings, ineligible, or an investment or business development company

III. Pre-filing period
   a. Statutory Basis
      i. §5(a) prohibits all sales until the registration statement becomes effective
      ii. §5(c) bans all offers prior to the filing of the registration statement
         1. Only applies if using a means of interstate commerce or the mails
         2. Only applies to issuer, underwriter, and dealer, not analysts
b. During the pre-filing period all offers are prohibited
i. §2(a)(3) defines offer to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value
ii. Conditioning the Market: SEC definition of offer includes all communications that may condition the market for securities (Carl M. Loeb SEC opinion)
iii. Factors that the SEC considers in determining if it is an offer
   1. Motivation of the communication
   2. Type of information – factual or speculative
   3. Breadth of distribution
   4. Form of Communication
   5. Description of the underwriter (always a red flag of market conditioning)
c. Safe Harbors provide exemptions from §5(c)’s ban on offers – not subject to uncertainty
i. Rule 163A: Communications from the issuer more than 30 days before filing are not offers if the communication does not mention the offer
   1. Pre-filing period only runs 30 days before the offering
   2. Reg FD rule that communication must be available to all still applies
ii. Rule 168: An exchange act issuer’s communication of factual business or forward looking information is not an offer if it does not mention the offer
   1. Regular release of factual business info and forward looking statements
      a. Definition of factual business info is uncertain
   2. Safe harbor applies through the pre-filing period
iii. Rule 169: Non-exchange act issuers communications of factual business info is not an offer so long as there are no forward looking statements and it is issued to non-investors
   1. Does not limit coverage to exchange act companies, but does not cover forward looking statements and cannot communicate to investors
iv. Rule 163: Any communication by a WKSI will be a Free Writing Prospectus and will be exempt from §5(c) so long as a written communication contains a LEGEND and meets FILING REQUIREMENTS
   1. Failure to meet legend and filing requirements will not be a violation of §5(c) if done in good faith and reasonable efforts made to correct
v. Rule 135: Short factual notice of the proposed offering is not an offer
   1. Notice must include a statement that it does not constitute an offer
   2. Can only include the name of the issuer, title and terms of the securities offered, amount of the offering, a brief statement of manner and purpose of the offering, and timing of the offer
   3. CANNOT identify the underwriter
vi. §2(a)(3) and §5(c): Offer to sell does not include preliminary negotiations of agreements between issuer and underwriter or among underwriters
   1. While it protects communications between underwriters considering sharing underwriting status, this exception does not protect discussions between an underwriter and i-banker regarding dealer status
d. Notes for application of the safe harbors
   i. Fallback provision that says if you are trying to evade §5 these safe harbors do not apply
   ii. Safe harbors apply to communications made by the issuer, not by UW, etc.
   iii. Rule 433 makes all hyperlinking the same as direct information in document
   iv. Penny stocks and blank check companies are excepted from safe harbors
   v. Even if safe harbors don’t apply, the communication may not be an offer it is just subject to the uncertainty of the offer determination
Safe Harbors Available By Issuers

<table>
<thead>
<tr>
<th>NRI</th>
<th>UI</th>
<th>SI</th>
<th>WKSI</th>
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<tbody>
<tr>
<td>Rule 163A</td>
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<td>Rule 169</td>
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<td>Rule 163</td>
<td>Rule 169</td>
<td>Rule 168</td>
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| Safe Harbors Available By Content |
|-------------------|----------|-----------------|-----------------|
| Rule   | Content                                                                 | F-look? | From whom? | To whom? |
| 163A   | > 30 days before filing, don’t mention offer                             | Yes     | Issuer     | Anyone   |
| 168    | “Factual business info” – don’t mention offer                            | Yes     | Exchange Act Issuer | Anyone   |
| 169    | “Factual business info”                                                  | No      | Non-Exchange Act Issuer | Non-investors |
| 163    | Oral and written communications including offers; must refer to Statutory Prospectus | N/A     | WKSI       | Investors |
| 135    | Short, factual notice of proposed offering; including issuer, terms, timing, no UW identification | N/A     | Issuer     | Investors |
| Sec. 5 | Communication with Underwriters                                          | N/A     | Issuer Underwriters | Underwriters |

IV. Waiting Period: Gun-jumping rules still apply with some exceptions to general prohibitions so that the issuer can gauge the market

   a. Statutory Framework during the waiting period: 33 Act §5
      i. §5(a): Prohibits sales because the registration is not yet “in effect”
      ii. §5(c): Allows offers because the registration statement is “filed”
      iii. §5(b)(1): Unlawful to use commerce or the mails to transmit a prospectus relating to a security with respect to which a registration statement has been filed
         1. §2(a)(10): Prospectus is anything, written or broadcast that communicates an offer, UNLESS prospectus meets requirements of §10
         2. This brings us back to prohibition of offers
      iv. §10(b): specific requirements of the statutory prospectus
         1. Rule 430: statutory prospectus can be preliminary (w/o offering price)
         v. GENERAL RULE: No offers during the waiting period unless §10 prospectus

   b. Additional Safe Harbors for the waiting period (Pre-filing safe harbors still apply because if not an offer then not a prospectus, then not prohibited)
      i. Oral Road show pitch: No specific safe harbor, but road show not covered by the prohibition because no written or broadcast communication used
         1. Would this exception apply in pre-filing period?
         2. Seems that this pitch would be an offer, but not a prospectus???
      ii. Rule 164: Free Writing Prospectus (defined in Rule 405) by issuer or any other offering participant after filing registration statement will be considered a §10 prospectus so long as conditions in Rule 433 are satisfied
         1. Rule 405: Any written communication (defined to include radio, TV, and widely distributed electronic communications) after the registration is filed that constitutes an offer to sell is a free writing prospectus
         2. Rules 433 requirements for free writing prospectus
            a. Unseasoned and non-reporting issuers must include or link to the statutory prospectus
               i. WKSI and seasoned issuers must simply have filed SP
            b. Must have a legend
            c. Must be filed with SEC if by issuer or uses issuer information
i. If FWP not by participant other than issuer and no use of issuer info then filing only necessary if sending will result in broad unrestricted dissemination
ii. Issuer must keep track of what others are saying
iii. If no substantive changes from another filed FWP then it may not need to be filed
d. Must be retained for 3 years
e. Non-reporting issuers must either file FWP for road shows or make a copy available to all people by graphic communication (Others do not need to file road show)
f. If non-compensated media sources publish or distribute FWP containing info provided by any participant, the issuer must file within four days of becoming aware of the communication

iii. Rule 134: Tombstone Ads: Communications during the waiting period that satisfy the requirements of rule 134 will not be considered prospectuses
   1. Cannot include financial information
   2. Requires legend and inclusion of SP

Application of the Free Writing Prospectus Safe Harbor in the Waiting Period

<table>
<thead>
<tr>
<th>Eligibility</th>
<th>No blank check, penny stock, other ineligible issuer, or excluded offering; only post-filing of RS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who May Use</td>
<td>Issuer and any other offering participant</td>
</tr>
<tr>
<td>Sec. 10 Stat. Prosp.</td>
<td>Non-registered or unseasoned issuers must accompany or precede (hyperlink OK)</td>
</tr>
<tr>
<td></td>
<td>Seasoned issuers and WKSI must simply have filed</td>
</tr>
<tr>
<td>Info Required</td>
<td>Nothing in conflict with RS or other incorporated filings; legend required</td>
</tr>
<tr>
<td>Filing</td>
<td>No later than first use;</td>
</tr>
<tr>
<td></td>
<td>Issuer FWP vs. issuer info;</td>
</tr>
<tr>
<td></td>
<td>Non-issuers: broad unrestricted dissemination;</td>
</tr>
<tr>
<td></td>
<td>Special rule for e-road shows</td>
</tr>
<tr>
<td>Retention</td>
<td>3 years after offering</td>
</tr>
</tbody>
</table>

c. Safe Harbors for Broker Dealer Analyst Reports:
   i. Reasoning: If the issuer is already in the secondary market, analysts are reviewing their business and we need safe harbors for their reports
   ii. Rule 137: The analyst reports of a Broker/Dealer who is not involved in the offering are exempt
      1. B/D can’t be involved or receiving payment from any participant
   iii. Rule 138: The analyst reports of participating Broker/Dealers are exempt if the report refers to other securities and relates only to other securities of participant
      1. Issuers common stock if offering involves non-convertible debt securities
      2. Issuers non-convertible debt securities if offering involves common stock
   iv. Rule 139: If the issuer is an S-3 issuer (Seasoned and WKSI), then issuer specific reports are not an offer if it meets the minimum float requirements
      1. Generally can continue to issue general reports on seasoned issuers and WKSI's and general industry reports including references to the issuer

V. Post-Effective Period
   a. Timing of the registration statement going effective: 20 days vs. delaying amendment
      i. §8(a): Registration statement (in theory) goes effective on the 20th day after filing
         1. Any change to the registration statement restarts 20 days
         2. SEC has power to accelerate the effective date of registration statement
ii. Rule 473: Delaying Amendment – issuers almost always file this amendment which delays the effective date until another amendment is filed
   1. Delaying amendment swallows the rule because any change restarts the 20 day period and issuers simply wait for the SEC to approve and then file an acceleration request
   2. Issuer and UW file and acceleration request at least 2 days prior to the desired effective date for the offering

b. Application of §5 after in post-effective period
   i. §5(a) no longer applies, sales of securities may begin
   ii. Must attach statutory prospectus
      1. §5(b)(1): w/ or proceeding written confirmation of sale b/c NO written or broadcast offers can be transmitted w/o SP
      2. §5(b)(2): no transmission of securities w/o SP
      3. Free writing after effective date is not a prospectus if accompanied by SP
   iii. 33 Act §4 Secondary market exemption: §5 requirement for SP does not apply
      1. §4(1): exempts trans by anyone other than issuer, UW, or dealer
      2. §4(4): exempts unsolicited broker transactions, order placed by customer
      3. §4(3) Underwriters and dealers do not have to attach SP after 40 days of an offering OR 90 days if it is an IPO
         a. §4(3) doesn’t apply to dealers acting as UW. If UW, SP must be attached as long as offering allotment being sold
         b. Issuers must attach SP indefinitely
   4. Rule 174: Exceptions for Dealers not acting as UW
      a. 0 days: If issuer is exchange act reporting company dealer does not have to attach the SP at all
      b. 25 days: If issuer is not and exchange act reporting company and issuer will be listed on national exchange, no SP after 25 days
      c. 40 days: Issuer not in above category, not doing an IPO
      d. 90 days: Issuer not in above category, doing an IPO
      e. For shelf registration any time measured from first registration
   5. Rule 172: Access to the SP is equivalent to delivery for confirmations of sale, allocations, and transfers of security
      a. Access is presumed if SP on file w/ SEC (swallows rule)
      b. EXCEPTION: Dealer can’t rely on this rule if they are still within 25 days AND the issuer is not an exchange act reporter
      c. Issuers can rely on Rule 172
   c. Updating the statutory prospectus:
      i. §10(a)(3): When a prospectus is used more than 9 months after the effective date of the registration statement, any info more than 16 months old must be amended
         1. If delivery of SP is no longer required then you do not need to worry about updating
      ii. Manor Nursing (2d Cir): Grossly misleading prospectus would violate prospectus deliver requirements of §5, potentially giving rise to §12(a)(1) liability
         1. Other circuits have not agreed, but b/c it is 2d Cir. must be accounted for
      iii. While there is no duty to update, the prospect of antifraud liability indirectly gives issuers incentive to update the SP
      iv. Shelf Registration: Issuers doing a shelf registration under 415 must update the SP to reflect any “fundamental” change to information set forth in Reg statement

VI. Public Offerings and Trading (Do not need to know specifics)
   a. Regulation M Anti-manipulation rules to combat price manipulation
      i. Restricted period around an offering depends on the type of issuer and offering
ii. Not allowed to bid during the restricted period except to sell the offering

b. Stabilization: Rule 104 regulates efforts to stabilize the market price
   i. Only permitted to prevent or retard a drop in secondary market price of security
   ii. Must give way to any “independent bid” at the same price regardless of the size of the independent bid at the time it is entered
   iii. Must give NOTICE to the market of stabilization efforts
   iv. Price stabilization cannot be greater than the offering price

c. Laddering: Prohibitions against agreements where initial investors agree to purchase additional shares of the offering company’s stock in secondary market trading to induce higher bidding in turn for allocations of the IPO

VII. Shelf Registration:
   a. Background information
      i. Shelf registration is the most salient example of regulating by type of company
         1. Huge carve out for WKSI – almost full exemption
      ii. 33 Act §6 General Rule: Company can only register securities if intended to be offered in the immediate or near future
         1. There is no general ability to engage in a shelf registration
         2. Registration statement effective only for securities specified therein
      iii. 33 Act §2(a)(3): When dealing with a convertible security, the conversion is not considered a separate offer of a security, but it is treated as a sale

   b. Rule 415(a)(1)(i-x1): Securities may be registered for a continuous or delayed offering if the registration statement pertains only to
      i. (i) Securities to be offered or sold solely by or on behalf of a person other than the registrant
      ii. (iv) Securities to be issued on conversion of other outstanding securities
      iii. (ix) Securities, offering of which will begin promptly, be made on a continuous basis, and continue for more than 30 days from effective date
      iv. (x) Securities registered (or qualified) on form S-3, to be offered and sold on immediate, continuous, or delayed basis by or no behalf of registrant

   c. Time Limits for Shelf Registrations
      i. Rule 415(a)(2): If securities under (a)(1)(viii) or (ix) are not registered on S-3, can only be registered in amount reasonably sold w/in 2 years of effective date
      ii. Rule 415(a)(5): Securities registered on automatic shelf registration or under (a)(1)(vi), (ix), and (x) may be offered and sold only if not more than 3 years have passed since the initial effective date, subject to automatic shelf registration

   d. Rule 415(a)(3): Undertaking and Updating
      i. Shelf registration must furnish undertakings required by Item 512(a) of Reg S-K
      ii. Undertakings include promising to reflect in prospectus any facts or events arising after the effective date which represent a fundamental change to the information set forth in the registration statement
         1. Fundamental change is higher standard than materiality

   e. Automatic Shelf Registration
      i. Rule 415(a)(6): Prior to the end of the three year time limit on continuous offerings an issuer may file a new registration statement which terminates the old registration statement and begins a new registration w/ a new effective date
      ii. Automatic Shelf Registration Statement: Registration statement for most types of offerings on Form S-3 which become effective on filing with SEC
         1. Rule 405: Only a WKSI can file automatic shelf registration statement
      iii. WKSI can add additional classes of securities to an offering w/o filing a new registration statement through a post-effective amendment
      iv. Pay as you go filing fees: WKSI pay filing fees on sale rather than at registration
v. Combination of new registration statement and automatic shelf registration statement creates almost a complete exception from the offering regime

f. Base prospectus: Minimal based prospectus filed w/ initial shelf registration
   i. Rule 430B: Required information such as unknown or not reasonably available info, plan and distribution for securities, description of securities, and identification of other issuers may be omitted from base prospectus
   ii. Base prospectus loosening requirements do not take away from responsibility to eventually give a complete prospectus, it just allows completion post-registration

33 Act Liability
I. §11 Liability
   a. Separate liability under the 33 Act
      i. Policy: Reasons for separate liability under 33 Act
         1. Greater incentive for fraud b/c profits more directly to fraudster
         2. Greater problem of lemons on the market: Sellers unwilling to engage in fraud will have more difficulty obtaining money resulting in a race to the bottom encouraging all sellers to commit fraud and collapsing market
         3. The is no mitigating argument that investors come out even on a net basis ex ante
         4. History: 33 Act proceeded 10b-5 liability
      ii. Causes of action under the 33 Act
         1. §11: Fraud in the registration statement
         2. §12(a)(1): Private cause of action for §5 gun jumping violations
         3. §12(a)(2): Private cause of action for misstatements (fraud) in the prospectus and related statements
   b. Elements of §11 Cause of Action
      i. Tracing Requirement: To have standing plaintiff must show that the stock was purchased directly through the offering and was not pre-existing on the market
         1. Stock traded on open market can satisfy the tracing requirement if it is all related to the offering giving rise to §11 action
         2. *Abbey v. Computer Mem*: Probable or % tracing not good enough, must have virtual certainty in tracing (not normally possible for traded stock)
            a. Even if pre-existing stock is only 1%, no virtual certainty
      ii. Statutory Defendants: Must be in one of the following categories
         1. §11(a)(1): All persons who sign the registration statement
         2. §11(a)(2),(3): Every director or general partner of the issuer
            a. Includes soon to be director named in registration statement
         3. §11(a)(4): Every expert “who has with his consent been named as having prepared or certified any part of the registration statement”
         4. §11(a)(5): Every underwriter of the offering
         5. §15: Every control person of a party liable under §11
      iii. Misstatement or omission:
         1. Plaintiff must show that there was a misstatement or omission as of the registration effective date
         2. Plaintiff cannot have known of the misstatement or omission
      iv. Materiality: Plaintiff must show that the misstatement was material
      v. Loss Causation is presumed, but the defendant may use it as defense
      vi. Plaintiff does not have to show reliance or scienter of defendants

Comparison of Section 11 and 10b-5
Harder to get into door under section 11, but easier to prove your case
### Elements, etc. Section 11 10b-5

<table>
<thead>
<tr>
<th>Standing</th>
<th>Strict tracing requirement</th>
<th>Anyone harmed “in connection with”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who can be sued</td>
<td>Only statutory defendants</td>
<td>Any primary violator (and aiders and abettors in SEC action)</td>
</tr>
<tr>
<td>Pleading Requirement</td>
<td>Facts according to P must state a cause of action on which relief could be granted</td>
<td>Plead with particularity to show strong inference of scienter</td>
</tr>
<tr>
<td>Misstatement or Omission</td>
<td>Yes, must prove (as of effective date)</td>
<td>Yes, must prove</td>
</tr>
<tr>
<td>Materiality</td>
<td>Yes, must prove</td>
<td>Yes, must prove</td>
</tr>
<tr>
<td>Scienter</td>
<td>Not required</td>
<td>Yes, and consider PSLRA</td>
</tr>
<tr>
<td>Reliance</td>
<td>No, except if D releases 12 months earnings (11(a))</td>
<td>Yes, but consider fraud on the market theory</td>
</tr>
<tr>
<td>Loss Causation</td>
<td>P doesn’t have to prove but it is a defense</td>
<td>Yes, must prove</td>
</tr>
</tbody>
</table>

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c. §11 Defenses  
i. §11(b)(1) and (2) Whistleblower: Must quit and report fraud to SEC  
i. Actual Knowledge: D can argue that P had actual knowledge of fraud at purchase  
  1. Almost impossible to show individually, so this argument is used following disclosure of the misstatement using ECMH theory  
  2. Encourages issuer to promptly disclose fraud to the plaintiffs who can join the §11 class  
iii. Lack of Causation: D can argue that misstatement did not cause the harm  
  1. Essentially a lack of materiality argument  
  2. Under §11(e) damages can be no more than difference between offering price and value received; thus, D can argue that decline in stock price was not a result of the misstatement  
iv. Statute of Limitations  
  1. P must file suit w/in 1yr after they learn or should have learned of fraud  
  2. No case may be filed more than 3yrs after securities offered to the public  
v. §11(b)(3) Due Diligence Defense: P simply shows material misstatement and the D has the burden to rebut fraud  
  1. Issuers are excluded from this defense  
  2. Non-issuers categorized as either experts or non-experts  
    a. Non-expert on non-expertised portion of RS: After reasonable investigation, reason to believe and did believe that there was no material misstatement or omission when that part came effective  
    b. Non-expert on expertised portion: No reasonable ground to believe and did not believe that portion was defective  
    c. Expert on non-expertised portion: Not subject to liability  
    d. Expert on expertised portion: After reasonable investigation, reason to believe and did believe that statement accurate  
  3. Reasonableness standard  
    a. §11(c): Standard of reasonableness shall be that required of a prudent man in the management of his own property  
    b. BarChris: Bowling alley construction exaggerated sales figures  
      i. Extent of investigation required for due diligence, dependent on type of person and relation w/ issuer  
      ii. Illustrates that courts not friendly to due diligence  
    c. Rule 176: Factors considered in determining whether an investigation is reasonable  
      i. Type of issuer, security, and person  
      ii. Office held and other relationships to issuer
iii. Reasonable reliance on officers and employees whose duties should have given knowledge
iv. If an UW, type of UW arrangement, role of UW, and availability of info w/ respect to registrant
v. With respect to docs included by reference, whether the individual had any responsibility for the fact or document at time of that document’s filing

4. Hostility to the due diligence defense
   a. Execs and directors either knew of misstatement or didn’t do research required by the position
      i. BarChris case exemplifies hostility
   b. Underwriters rarely have time to do necessary due diligence
      i. Courts think UW should have on-going real time due diligence so they are ready to evaluate RS
      ii. On-going due diligence limits the ability to rotate UWs and damages independence
         1. If UW creates problem, loses business
         2. If UW raises alarm, admits liability for statement already on the market
   iii. Worldcom exemplifies hostility
      1. Red flags do not have to be very red
      2. No need to do independent audit, but must do more than rely on other’s representations
   iv. Comfort letter and other informal work are not expertised; thus, cannot protect UW
      1. Incentive for UW to do thorough check
   c. Even if due diligence would not have found the information, courts likely will not protect individual that didn’t do diligence

<table>
<thead>
<tr>
<th>Due Diligence Defense</th>
<th>Non-Expertised § of Registration Statement</th>
<th>Expertised § of Registration Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expert</td>
<td>No Liability - §11(a)(4)</td>
<td>Reasonable Investigation, Reasonable Ground to Believe and Did Believe the Truth of - §11(b)(3)(B)</td>
</tr>
<tr>
<td>Non-Expert</td>
<td>Reasonable Investigation, Reasonable Ground to Believe and Did Believe the Truth of - §11(b)(3)(A)</td>
<td>Reasonable Ground to Believe and Did Believe the Truth of - §11(b)(3)(C)</td>
</tr>
</tbody>
</table>

d. §11 Damages
   i. Calculation of damages in three situations
      1. If P sold before lawsuit = (price paid [not>offer]) – (sale price)
      2. If P still holds stock = (price paid [not>offer]) – (value at date suit filed)
      3. If P sold stock during suit = (price paid [not>offer]) – (sale price [not> value at filing date])
         a. Value for calculation 2 and 3 is what the stock is worth, not necessarily what is was trading for on the date suit filed
         i. Major issue for loss causation defense
   ii. Limitations on damages
      1. §11(e): Damages can be no more than the difference between the offering price and the value received (thus limits in calcs above)
      2. §11(g): Damages can in no case be greater than the offering
         a. Gross damages cannot exceed total value of IPO
         b. Rule gives rationale for holding to the tracing requirement b/c if non-tracers received damages, tracers damages diluted under rule
iii. Value as a different measure than price
   1. If stock is not sold at the beginning of the suit, then we must calculate the
      value of the stock at the filing date
      a. Use of value shows ambivalence between compensation and
deterrence rationales
      b. Statute requires reading of value b/c it uses term price elsewhere
         i. Thus, we allow P to continue to hold rather than stick
            them to the price decision when learned of fraud
   2. Plaintiff theories for valuation
      a. Info leaked to market early this is why the price dropped before
         the information release; thus, the value was the lower price
      b. Exogenous positive news muted decline; thus, taking out this
         positive news the value at the time of the suit was lower
      c. Information filters slowly into the market; thus, later drops can
         be attributed to the misstatement
   3. Defendant theories for valuation: P has burden to prove damages, so D
      must just raise confusion and question
      a. Price drop was due to panic selling; thus, value was greater
      b. Price drop due to litigation and distracted mgmt; value greater
      c. Exogenous negative info exaggerated the decline
   4. Ackerman: When public told of misstatement, stock went up, D claimed
      no damages. P argued that price dropped when SEC told, so there was an
      info leak – P argument failed
   5. Beecher: Douglass filed materially false prospectus, but argued that
      value should be determined by considering panic selling and long-term
      outlook for company. Court agreed and pegged higher stock price.

iv. Indemnification, Contributions and Joint and Several Liability
   1. Joint and severable liability for §11 damages w/ two limitations
      a. §11(e): UW liable only to the total price that the securities
         underwritten and distributed by him were offered to public
      b. §11(f)(2)(A): Outside directors limited to proportionate liability
         based on degree of wrongdoing compared to other D [PSLRA]
   2. Contributions: If damages paid by D, can seek contribution from others
   3. Proportionate Judgment Reduction in settlements: jury assesses relative
      culpability of both settling and non-settling parties, non-settling parties
      can only pay commensurate percentage of the judgment
      a. Risk of low settlement on P, high settlement on D
      b. Jury does not know of settlement
      c. Eliminates right of non-settling party to seek contribution
   4. Indemnification
      a. Eichensholtz: invalidated indemnification clause b/c enforcing
         would undercut UW interest in doing due diligence

II. §12(a)(1) Liability
   a. Elements of a §12(a)(1) cause of action
      i. Plaintiff purchased and defendant offered or sold to the plaintiff
      ii. §5 was violated
         1. §5 violation does not have to directly affect P
            a. Example: A can sue if B doesn’t receive prospectus
         2. Violation can occur any time during offering process
            a. Pre-filing conditioning market, Waiting: Prospectus w/o
               statutory prospectus, Post-Effective: failure to deliver SP
3. No required proof of scienter, reliance, loss causation, or defenses
   
   b. Purpose of §12(a)(1) liability
      i. §12(a)(1) liability is crush out liability
      ii. Forced §5 compliance rather than optimal deterrence
      iii. Strict liability for §5 violations
   
   c. Defendants
      i. §12(a)(1): Any person who offers or sells in violation of §5 shall be liable to person purchasing security from him
      ii. Solicitation: Defendants who solicit purchases are liable, but solicitor must have a financial interest in the sale (Pinter)
         1. So long as the person who offered has a financial stake, the offeror can be a defendant
            a. Trading stock tips gains something of value = offeror
         2. Pinter: Pinter solicited Dahl to invest in oil leases and Dahl included family and friends, Pinter wants Dahl as co-defendant against his family
            a. Dahl didn’t offer securities b/c he had no financial interest in his family and friends investing
      iii. Courts have generally held that ministerial acts assisting in the offering does not bring liability (protection for attorneys, etc.)
           a. If attorneys attached name or endorsed possible liability
   
   d. Damages
      i. Rescission only = “put option” for all investments where §5 violated
      ii. If P has sold the stock he is entitled to damages for the difference between the sale price and the purchase price
   
   e. Statute of Limitations: 1yr from discovery, 3 year limit from the date of sale

III. §12(a)(2) Liability
    
    a. Elements of a §12(a)(2) cause of action
       i. Plaintiff purchased and D offered or sold
       ii. By means of a prospectus or oral communication
          1. Courts limit the causal connection by holding that the connection is established through materiality and ECMH
       iii. Material misstatement or omission
       iv. Used instrument of interstate commerce
       v. No scienter or reliance required
    
    b. Purpose:
       i. Provides private cause of action for misstatements in the prospectus
       ii. Strict liability to force compliance an crush out prospectus violations
    
    c. Prospectus under §12(a)(2)
       i. Gustafson: Sale required price adjustment based on future financials, investors wanted rescission arguing that purchase agreement was a prospectus
          1. Holding confines §12(a)(2) liability to public offerings because §12(a)(2) liability cannot attach unless there is a obligation to distribute prospectus
          2. Correct outcome, but legal reasoning suggests that prospectus cannot have different meanings – this would threaten to unwind all transactions and hamper market because of inherent uncertainty
       ii. Valence: Reconciles Gustafson to allow §12(a)(2) liability only when there is a requirement for the delivery of a §10 statutory prospectus
    
    d. Defenses to §12(a)(2) liability
       i. Statute of Limitations: 1yr from discovery, 3 year limit from the date of sale
       ii. Plaintiff knew of misstatement or omission
iii. No loss causation: provide evidence that stock price drop is due to factors unrelated to fraud
iv. Defendant did not know of misstatement/omission and could not have known through reasonable care
   1. Less demanding reasonable care standard than §11 due diligence
   2. No distinction between expertised and non-expertised statements
   3. Only requires D to show use of reasonable care
e. Damages: Rescission only as in §12(a)(1)

IV. §4 exemptions: Transactions exempted from 33 Act requirements and liability
   a. Types of exempt transactions
      i. §4(1): Transactions by person other than issuer, UW, or dealer
      ii. §4(2): Transactions by an issuer not involving any public offering
      iii. §4(3): Transactions by an issuer not involving public offerings
      iv. §4(4): Unsolicited dealer transactions
      v. §4(6): Transactions involving offers from issuer to an accredited investor less than set dollar amount
   b. Policy behind exemptions:
      i. Informational asymmetry: Regulations even out info asymmetry, but certain investors and transactions do not need this protection
      ii. Cost Benefit Analysis: Regulations designed to attract money to capital markets w/ integrity, but burdensome regulations could drive money away
      iii. Path Dependence in Regulatory Schemes: Huge cost in adopting new schemes so rules developed to build on existing machinery
   c. Benefits of exemptions
      i. No §5 applicability; thus, no mandatory filings, updating, or gun jumping
      ii. No §5 causes of action. Less liability b/c no 33 Act documents required
         1. §10b-5 liability still available
   d. 33 Act §4(2): Transactions not involving a public offering – Private placements
      i. SEC factors to determine if public offering (doesn’t provide much guidance)
         1. Number of offerees
         2. Relationship of offerees to each other and issuer
         3. Number of units and total size (gross value) of the offering
         4. Manner of the offering
      ii. Investor access to information determines whether offering is public
         1. SEC v. Purina: Purina offered treasury stock to “key employees,” who inquired about stock without any solicitation from company
            a. Court interprets §4(2) based on the overall purpose of the act
            b. Key employees needed protection of the act b/c group not confined to persons with access to info
         2. To be a public offering, the offer need not be open to the world
         3. Must ask if offeree is person who needs law to overcome info asymmetry
      iii. D can prove access to information in two ways (Duran)
         1. Right kind of relationship: either high executive position or investor with economic/relationship power to force disclosure
         2. Actual disclosure: D can show that investor actually did receive disclosure of information that would be in a registration statement
      iv. Access to all offerees considered, not just investors who bought
   V. Safe Harbors for Private Placements: Regulation D
      a. Statutory Basis
         i. 33 Act §3(b): SEC can exempt any transaction that they deem is not a threat to the policy goals of SEC REG provided it is cumulatively worth less than $5M
1. Rules 504 and 504 fall under this statutory power
   ii. 33 Act §4(2): Exemption for transaction not involving a public offering
       1. Rule 506 provides that a transaction that meets its parameters shall not be
deeemed a public offering
   iii. Safe harbor to address the unpredictability of the §4(2) exemption.
   iv. Scope: Narrower than §4(2) to ensure within regulatory power
       1. Gives issuers §4(2) arguments if they fail to comply w/ Reg D

b. Exemptions provided by Rules 504, 505, and 506

<table>
<thead>
<tr>
<th></th>
<th>Rule 504</th>
<th>Rule 505</th>
<th>Rule 506</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate Offering Price</td>
<td>Up to $1M (less any §3(b) or §5-violating offering in last 12 months)</td>
<td>Up to $5M (less any §3(b) or §5-violating offering in last 12 months)</td>
<td>No $5 limit</td>
</tr>
<tr>
<td>Number of Purchasers</td>
<td>No limit on number of purchasers</td>
<td>No more than 35 purchasers (accredited investors don’t count)</td>
<td>No more than 35 purchasers (accredited investors don’t count). Non-accredited investors must be “sophisticated”</td>
</tr>
<tr>
<td>Excluded Issuers</td>
<td>No investment, blank check, or Exchange Act reporting cos</td>
<td>No Investment companies</td>
<td>All Issuers</td>
</tr>
</tbody>
</table>

c. Definitions and Restrictions for Regulation D
   i. Accredited investors: Rule 501
      1. (a)(1),(3),(7) Entities and institutions including banks, insurance
         companies, trusts, and broker/dealers that have $5M in total assets
      2. (a)(4) Any director officer or general partner of issuer
      3. (a)(5) Any natural person (or couple) whose net worth exceeds $1M
      4. (a)(6) Any natural person whose income is greater than $200K in each of
         the two most recent years (or couple w/ joint income > $300K)
   ii. Rule 501(e): Calculation of the number of purchasers
      1. Accredited investors do not count toward the total
         a. Accredited investor can be w/ regard to purchaser representative
      2. Relatives, spouses, and relatives of spouses within the same residence
         count as the same person as the principle purchaser
      3. Trusts and corporations which are more than 50% owned by a purchaser
         and family count as the same person as the principle purchaser
      4. Corps are counted as one person unless formed for purpose of purchasing
   d. Restrictions of rules 504, 505, and 506
      i. Aggregate Offering Price: Total amount of offerings under Rules 504 and 505
         must include any Rule 504 and 505 offerings w/in the past 12 months along with
         any §5 violating offers (Does offering under 506 count against later 504/505?)
         1. Rule 504 limits aggregate offering price to $1M
         2. Rule 505 limits aggregate offering price to $5M
      ii. Number of Purchasers: Rule 505 and 506 limit total number of purchasers to 35
         1. Accredited investors do not count against this limit
      iii. Sophisticated Investors: Under rule 506 non-accredited investors must be
         sophisticated
         1. Sophisticated investors have such knowledge and experience in financial
            and business matters that they are capable of evaluating the merits and
            risks of the prospective investment
         2. Considerations: Wealth and Income, Experience, Education, Present
            investment status, Performance on an investment test
iv. **Prohibition on General Solicitation:** Rule 502(c) Neither issuer nor person on its behalf shall offer or sell securities by any form of general solicitation or ad
   1. Rule 504 exempts issuers from rule 502(c) if issuer meets state law reqs
   2. Rule 505 and 506 issuers absolutely must not use general solicitation
   3. *Kenman:* In order to not be a general solicitation an issuer must have **prior existing relationship** w/ those being solicited such that he is aware of financial circumstances or sophistication of person being solicited
      a. Prior existing relationships are not required they just help solve problems that are in the middle
      b. Venture capitalists can buy into prior existing relationship groups w/ UW or others who would find financing

v. **Disclosure Requirements:** Ask Eoghan to explain these
   1. No disclosure for rule 504 offerings, but specific disclosure required by Rule 502(b)(2) for Rule 505 and 506 offerings

vi. **Resale restrictions:** Securities sold through Reg D generally cant be freely resold
   1. Rule 502(d): resale of securities sold through 505 and 506 prohibited
   2. Rule 504 offering securities may be resold in compliance w/ state law

e. **Integration:** Multiple Reg D offerings may be characterized as one offering if the use of multiple offerings is designed to strategically evade the restrictions
   i. Factors to consider to determine whether to integrate
      1. Whether the sales are part of a single plan of financing
      2. Whether the sales involve the issuance of the same class of securities
      3. Whether the sales 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
   ii. Rule 502(a) Integration Safe Harbor: Offers or sales in a separate offering that occur either 6 months before or 6 months after the end of Reg D offering are not considered the same offering so long as no sales during the 6 month periods

f. **Innocent and Insignificant Mistakes**
   i. Rule 508: Failure to comply with a term, condition, or requirement of Rules 504, 505, or 506 will not result in loss of exemption if
      1. Issuer shows that failure to comply was insignificant to whole offering
      2. Failure to comply did not pertain to provision directly intended to protect the particular plaintiff
      3. There was a good faith and reasonable attempt to comply
   ii. Rule 508 does not apply to failures related to
      1. General solicitation prohibition
      2. Aggregate offering limitation
      3. Limit on the number of purchasers
   iii. Rule 508 only shields from private actions, not SEC actions

  g. **Rule 503:** Must file form D with the SEC for Rule 504, 505, and 506 offerings
   i. Issuer has until the 15th day after the start of offering to file form D

VI. **Separating Offerings from Secondary Market Transactions**
   a. §4(1) exempts any transaction where no issuer, UW or dealer is present
      i. 33 Act §5 General Rule: There may be no securities transactions after the effective date of the registration statement without complying with the §5 process
      ii. Ackenberg FN4: A broker’s involvement in a transaction does not preclude the §4(1) exemption, otherwise the every transaction would be subject to §5
      iii. While §4(4) protects brokers executing unsolicited transactions, and §4(2) protects private placements, these do little to protect everyday transactions if the transaction is subject to §5 when broker is present
b. Transactions with UW are subject to §5; who is an UW
   i. §2(a)(11): UW is any person who purchased from issuer with a view to . . . the distribution of any security
      1. Also includes any person who participates in such an undertaking
   ii. Whether person is UW determines if §4(1) exemption applies or the transaction must comply with §5
      1. Does corporation have any liability?

c. “With a View to . . . distribution”
   i. If purchased for investment purpose, then no view to distribution, and not an UW
      1. §4(1) exemption applies and no §5 compliance required
      2. Differentiates between those who purchase for an investment purpose and those that purchase to flip for a profit as part of offering process
      3. Mental state inquiry at the time of purchase is almost impossible
         a. Need safe harbor to relieve uncertainty
   ii. Safe harbor for securities that “have come to rest”
      1. 2 years: presume that the securities were held for investment purpose
      2. 3 years: presumption of investment purpose irrebuttable
   iii. If securities have not come to rest, change in circumstances can still prove that the securities were purchased for an investment purpose
      1. Change of circumstance must be unrelated to the investment price or all investments would have change of circumstances
      2. Change of circumstance must be unforeseeable, unrelated to investment
         a. Life event that causes need for $ immediately
   iv. If the investor did not purchase with a view toward investment, then the investor is an UW and the two transactions collapse into one primary market transaction and the investor/UW must register securities under §5

d. Distribution
   i. Distributions are defined as public offerings
   ii. If an individual does not offer the security as a public offering, then he is not an UW and §4(1) exemption applies
      1. Whether or not the transaction is the type that requires protections of the registration process determines if it is a public offering

e. Control Persons: considerations when control person sells through intermediary
   i. Definition of control person is not based on the power to force registration and can be read more broadly
   ii. §2(a)(11): An issuer for the purposes of the definition of an UW includes a person directly or indirectly controlling or controlled by the issuer
      1. If a control person sells securities, then we must consider whether the buyer becomes an UW by selling to a third party
         a. §4(4) only protects the broker
      2. If third party is an UW then §4(1) exemption does not apply and the securities must be registered under §5
      3. Policy: Control person has info advantage, need registration protections
   iii. When a control person is involved two questions must be asked
      1. Is the control person working as an UW for the issuer
         a. Consider view to distribution (4½ Exemption)
         b. If UW, then must register. If not UW, consider question 2
      2. Is the intermediary action as UW for the control person/issuer
         a. If yes, then securities must register/comply w/ §5
         b. If neither is an UW, then the transaction is exempt
iv. Methods that the control person can avoid being an UW in transactions through a broker

1. §4½ Exemption: If buyer is not someone who needs protection of 33 Act then there is no distribution
   a. The control person transferring to a person who does not need protections is just like the corporation doing the same
   b. Once the control person distributes to a person who is not in need of protections, then control person is not an UW

2. Rule 144 Safe harbor
   a. Control person is not UW regardless of investment intent if he satisfies the requirements of 144
   b. Requirements include current public info, holding period, amount limitation, manner of sale, notice of proposed sale