I. THE CAPITAL MARKETS: AN OVERVIEW

A. THE INSTITUTIONAL AND REGULATORY FRAMEWORK
   1. Goals of Securities Regulation
      a) Consumer protection
      b) The informational needs of investors
      c) Allocative efficiency
      d) Corporate governance and agency costs
      e) Economic growth, innovation and access to capital

B. THE FED. SEC. LAWS APPLYUNEVENLY TO THE BROADER SUBSET OF FINANCIAL MARKETS:
   1. Increasing direct competition b/n markets
   2. Option to issue in private market, bonds, notes, foreign capital
   3. Factors
      a) relative cost of capital in the different markets,
      b) the time necessary to effect a transaction in a particular market, and
      c) the degree of regulatory supervision that they subject themselves to by entering a particular market.
   4. Once a financial product is deemed to be a security, three conclusions:
      a) mandatory disclosure system applicable to sale and trading of instrument;
      b) stiff fed anti-fraud rules apply, more favorable to plaintiff than the common law’s rules on fraud; and
      c) financial intermediaries who handle transactions in the market for the financial product become subject to close, substantive regulation by the SEC.

C. TRADING MARKETS:
   1. Primary market
   2. Secondary market

D. MARKET STRUCTURE:
   1. Exchanges
      a) auction system that creates a market; to trade on any given exchange, must satisfy the exchange’s listing requirements. Auction format provides easy access to buyers, sellers.
   2. Over-the-Counter (OTC)
      a) Residual trading “market”. Call a broker-dealer who tries to locate someone who is willing to sell. Broker-dealers who buy/sell themselves, the resell or purchase again later are called market makers.
   3. NASDAQ
      a) National Association of Securities Dealers Automated Quotation System; OTC market operated by the National Association of Securities Dealers (market makers quotations of the ~500 most-actively traded securities). There is no NASDAQ trading floor like there is for the other exchanges.

E. TYPES OF SECURITIES:
   1. Publicly traded securities
   2. Private equity
      a) venture capital, LBO firms; equity offered to a very select group of investors.
      b) No secondary market for private equity, investors bound for a period of time.
      c) Investors gain share of company and share in management.
      d) Goal: go public.

   (1) Advantages of going public
      a) private deals are small, tightly regulated, limits the amount of money that can be raised;
      b) very profitable;
      c) easy to determine “value” of company.

F. FORCES SHAPING CAPITAL MARKETS:
   1. Institutional Investors
a) banks, mutual funds, insurance companies, pension funds, institutions.
   (1) Institutional Investors own well over 50% of the stock available in the market.

b) Does a securities law regime that protects unsophisticated investors, make sense?
   (1) Institutions set price and manage timing of trading.
   (2) Should securities laws be designed in a way that makes it more difficult for these institutions to exert control over the companies they own?

2. New financial products
   a) Overlap, variety put increasing pressure on the system
   b) Why is there so much financial innovation?
      (1) Preferences for risk and return
      (2) Also, ability, desire of companies to hedge certain risk varies.
      (3) Tax effects change the investing options available.
   c) Finally, regulation of the market changes the way in which people investment in order to avoid more expensive regulated alternatives.

3. Globalization
   a) Lead to an increase in the US demand for foreign securities, an increasing amount of market interconnection, and has created a “race to the bottom” problem, which is a function of competition.
   b) Theoretically, entities get money when organizations register in their jurisdictions. Entities entice investment by relaxing requirements, but soon, everyone’s regulations are so lax, they have no effect. So, what should the US do?

4. Restructuring of the Financial Industry

5. Technology
   a) What are the implications behind the disclosure of information?

G. REGULATORY FRAMEWORK:

1. Securities and Exchange Commission (SEC)
   a) SEC administers and enforces the federal securities laws.
   b) Responsibilities
      (1) ensure that the securities markets are fair and honest, and
      (2) provide investors with adequate disclosure.
   c) The 1933 Act
      (1) prohibits the offer or sale of a security unless the security has been registered with the SEC;
      (2) requires the delivery of a prospectus to a purchaser and to other persons to whom a written offer is made.
      (3) Regulates the initial offer and sale of securities in interstate commerce.
   (Primary market)
      (a) Section 5 (p. 548) – requires registration with the SEC to issue securities publicly
      (b) Section 12(a)(1) (p. 560) – imposes liability for violating section 5 (civil)
      (c) Section 12(a)(2) – imposes liability for fraudulent statements in disclosure documents
      (d) Section 17 (p. 564) – prohibits fraud in the sale and exchange of a security (criminal); some overlap with section 12.
      (e) Section 5: A key part of the registration process is the delivery of the prospectus; must be disclosed on or before the sale and delivery of the security. Section 2(a)(10) defines prospectus broadly (p. 541), and more narrowly under section 10 (p. 555) (defined under Section 2, but meets additional requirements under Section 10)
      (f) Section 5(c) says no exchanges unless a registration statement is properly filed.
      (g) Section 5(a) says no sales if the securities are not registered (filed and effective).
Section 5(b) outlines the prospectus requirement and prohibits the sale and delivery of security if it is not proceeded by or delivered with a prospectus that meets the general definition of Section 2 and the specific requirements of Section 10. Before the deal can be closed, a proper Section 10 prospectus must be delivered to the buyer.

Section 6, 7, and 8 outline the procedures from the filing to the effectiveness of registration.

Section 10 outlines the requirements for the final closing prospectus.

Section 11 covers material misstatements and omissions in the registration statement.

d) The 1934 Act
   (1) Registered companies: continuous disclosure system and file annual and quarterly reports with the SEC, preclear proxy statements with the SEC before soliciting shareholder proxies or votes.
   (2) All broker-dealers must register with the SEC.
   (3) It also regulates the credit available for securities purchases.
      (a) Section 30A incorporates the Foreign Corrupt Practices Act, which mandates that publicly held firms satisfy and maintain internal accounting controls and which prohibits bribery, both foreign and domestic.
      (b) Section 15C brings government securities brokers under the limited oversight of the SEC. The Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 established civil penalties and related sanctions for insider trading.
      (c) The Securities Law Enforcement Remedies Act of 1990 gave the Commission civil penalties, including a cease and desist power.
      (d) The Private Securities Litigation Reform Act of 1995 created a safe harbor for forward-looking information for certain corporate issuers, and heightened the pleading standards, and erected other procedural barriers that a private plaintiff must satisfy in order to state a cause of action.

   (4) Administrative Procedure
      (a) establishes the standards for judicial review of SEC administrative decisions and specifies procedures to be followed when the SEC is engaged in rulemaking.

   (5) Self-Regulatory Organizations (SROs)
      (a) include stock exchanges and NASD - must satisfy Section 6. A policy question also surrounds the desirability of allowing competitors to discipline their business rivals.

II. PART II. REGULATION OF THE DISTRIBUTION OF SECURITIES
A. DEFINITIONS OF SECURITY AND EXEMPTED SECURITIES
1. Security according to Section 2(a)(1)
   a) any note, stock, bond and debenture;
   b) catch-all: any evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, investment contract and any instrument commonly known as a security, unless the context otherwise requires a different definition.

2. SEC v. W.J. Howey Co., 1946
   a) TEST: 1) an investment of money 2) in a common enterprise 3) with an expectation of profit 4) solely (predominantly) from the efforts of a promoter or third party (requires both horizontal and vertical commonality).
   b) When property is owned by a large number of “investors” who hire someone to manage the property/business, earning profit for the investors, investment is a security.

3. SEC v. Koscot, 5th Circuit, 1974
   a) An agreement that involves an investment of money in order to join the pyramid, and the investors understood that their earnings increased with participation in the scheme by more investors, and with active involvement in the sales business, the scheme is a security.
b) MODIFIED HOWEY TEST: from SEC v. Turner Enterprises, which questioned whether “the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” Predominantly by the efforts of others. Allows for basic management.

c) POLICY
   (1) If purpose is to protect investors, then requiring them to stay in the investment with inadequate management for an indefinite period of time may not always be in the investors’ best interests. The determination of where the investor is substantially involved in management depends on the number of investors and the level of involvement, not the sophistication of the investors.

d) Franchises
   (1) Not typically considered an investment contract b/c owner of the franchise does so much work, and the success or failure of that particular business depends on the efforts of that investor, not on the franchise.

4. Vertical vs. Horizontal Commonality
   a) Vertical
      (1) common enterprise may be found when the activities of the promoter are the dominant factor in the investment’s success – even though there is no approach of funds or interests by multiple investors. Applies more restrictively and insists upon a direct relationship between the promoters’ financial successes and that of its investors (strict vertical commonality); requires that fortunes of investors be tied to the fortune of the promoter, rather than to only the efforts of the promoter. Consider broad vertical commonality, and looser requirement that the earnings go back to the promoter.

   b) Horizontal
      (1) a pooling of investor funds and a pro rata distribution of profits among the investors. An intention to involve multiple investors can result in horizontal commonality.

c) United Housing Foundation, Inc. v. Forman, 1975
   (1) Shares of stock entitling a purchaser to lease an apartment are not securities, even if called “stocks” absent showing that purchasers expected to make a profit or characteristics of stock.

   (2) POLICY:
      (a) The label “stock” created some confusion to those who purchased it, whether they believed they were covered by SEC regulations or not. Who should bear the risk for the confusion?
         (i) The issuers. SEC was created to protect investors, experienced and not. However, it creates a loophole for educated investors to act negligently, and it may not be that difficult for less experienced investors to investigate.

   (3) CONSIDER:
      (a) Whether economic value derived from housing interest should be sufficient. “What distinguishes a security transaction – and what is absent here – is a investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use.”

   (4) CONSIDER:
      (a) If we care what the investors think, why not let parties completely contract out of SEC regulations? Against protection policy. But taking the court’s comments about the importance of parties’ expectations conflicts with this. Basically, expectations are irrelevant.

5. Steinhart v. Citicorp
   a) When limited partners have the ability to propose, approve new business plans, veto other plans, remove/replace general partner and veto material actions, in highly negotiated deals, insufficient reliance on the efforts of others to earn a profit, even if did not manage day-to-day business.

a) When the entire business is purchased by asset acquisition, the third prong of the Howey test is not met, because control is essentially transferred to the purchaser. However, the purchase of stock still theoretically leaves day-to-day operations in the hands of the managers, so security.

b) Characteristics commonly associated with common stock
   (1) the right to receive dividends contingent upon an apportionment of profits;
   (2) negotiability;
   (3) the ability to be pledged or hypothecated;
   (4) the conferring of voting rights in proportion to the number of shares owned; and
   (5) the capacity to appreciate in value.

7. Reves v. Ernst & Young, 1990
   a) Promissory notes payable on demand by the holder (demand notes) issued by a cooperative can be securities.
   b) Some notes are not given for investment purposes.
   c) Is a note a security? Family Resemblance Test:
      (1) a note is presumed to be a security and that presumption may be rebutted only by showing that the note bears a strong resemblance to one of the enumerated categories of instrument.
      (a) What are the motives that would prompt a reasonable seller and buyer to enter into the transaction,
      (b) what is the plan of distribution of the instrument (is the investment traded),
      (c) what are the reasonable expectations of the investing public, and
      (d) what other factors, such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the SEC regulations unnecessary?
      (2) Courts will generally not include – home mortgage, consumer installment purchases, ordinary commercial financing deals, credit card transactions – some financing agreements as securities.

d) POLICY:
   (1) Why not exclude the notes from consideration because of the nine-month statutory limitations? As demand notes, they could be called in less or more than nine months. Because of the purposes of the laws, it is inappropriate to assume that they should be considered notes with a maturity of less than nine months.

e) CONSIDER:
   (1) Should sufficient collateralization be enough to establish a security? Well, what if you do not need to use the collateral? How stable is the collateral? What about an accelerated clause in default provisions? What about having very strong rights to information? Instead of having contractual remedies, you have strong access rights to information? The court notes that these factors are absent, which implies that they may be significant if present.

8. Exempted securities (Section 3(a)(2) and 3(a)(8))
   a) any security issued or guaranteed by any federal, state or territorial governmental entity or by a national or state bank,
   b) short term notes or bills of exchange which arise out of a current transaction,
   c) securities of nonprofit, religious, educational, fraternal or charitable institutions,
   d) securities of certain savings and loan associations and farmers’ cooperatives,
   e) interests in railroad equipment trusts,
   f) certificates of a receiver, or trustee or debtor in possession in a bankruptcy proceeding, when issued with court approval, and
   g) insurance policies or annuity contracts issued subject to the supervision of a domestic governmental authority.

B. THE BASIC STRUCTURE AND PROHIBITIONS OF THE SECURITIES ACT
1. Jurisdictional information
   a) 33 Act only applies to mails and prohibitive interstate commerce that have been used to promulgate securities violations (includes intrastate telephone calls, checks paid/received that are processed through a bank).

2. Three time periods
   a) Pre-filing period (5(c) period)
   b) Waiting period
   c) Post-filing period

   **POLICY**
   (1) The goal is to balance investors’ interests with commercial realities to make sure that the capital markets function properly. Sometimes, these two objectives are at odds. Section 2(a)(3) defines sale or sell, but creates an exclusive carve-out exception (shall not include preliminary negotiations or agreements between an issuer and any underwriter or among underwriters who are or are to be in privity of contract with an issuer. This carve-out is essential so someone can determine whether the issuance is feasible. Underwriters are a significant part of the process (concession to commercial reality).

C. GUN JUMPING
1. **POLICY**
   a) The problem is that there has to be a cooling off period to prevent inflation of the price (generally a month or so). The delay may be costly and create liquidity problems, or the market may turn against the company or against all investors.
   b) When will actions be considered gun jumping?
      (1) Prevent the risk of gun jumping by banning the company from saying anything.
      (2) Lawyers scrutinize everything that is said at press conferences, script conversations, etc.
      (3) What about companies that have already issued some securities and are disclosing as required under 1934? Still allowed to make those disclosures. Purely factual disclosures are allowed, as they are not conditioned on the market. Rule 135 – compliance will mean not sale of security (p. 588). Exclusive means available to make a pre-filing announcement.

III. THE REGISTRATION PROCESS: §§5 AND 4(3); RULES 134-135, 137, 174, 460-461

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<tr>
<th>Prefiling</th>
<th>Waiting</th>
<th>Posteffective</th>
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<tbody>
<tr>
<td>5(a)(1) no sales</td>
<td>5(a)(2) no delivery</td>
<td>5(b)(1) no prospectus, unless complies with Sect. 10</td>
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<tr>
<td>* The prohibition against offers also applies before effectiveness if the SEC issues a refusal order or commences an investigation and after effectiveness if the SEC issues a stop order</td>
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A. §5 – 3 TEMPORAL PERIODS
1. **Pre-Filing Period**
   a) Preliminary Negotiations bet. Issuer and Underwriter
(1) Pre-reg Negotiations excluded from term “sell” under §2(3). In contacting investment bankers must be careful who is contacted (e.g. not buying department).
(2) Memo of understanding or letter of intent: indicate proposed price; not binding. Oral contact and mailing underwriters agmt. allowable activities. §2(3).
(3) Restrictions on underwriters contacting dealers during pre-reg.
(4) Once registration statement filed: no offers to buy until after effective date, §5(c), 2(a)(3), Rule 134.
(5) No roadshows in pre-filing period. Not for private filing, more for going public.

b) Silent Period: No contacts w/ dealer
(1) Should not initiate publicity when in registration
(2) Should respond to legitimate inquiries for factual information about company’s financial condition and business operations.
(3) SEE CB 130-131 FOR FURTHER GUIDELINES.

c) Gun Jumping: announcements which tend to arouse interest in offering during pre-filing period
(1) Notices re: intent to register should come from issuer and be purely factual, can’t name underwriters. Rule 135.
(2) Rules 135, 137, 138, 139. see CB 132-133.

2. Waiting Period: After Reg. Statement Filed
a) Underwriters contact dealer
b) Dealers contact customers
(1) The Identifying Statement/Expanded Tombstone Ads. §2(a)(10)(b), Rule 134. Screening device to determine interest, NOT a selling tool.
(2) Testing the Market: can make offers to sell but can NOT sell, §5(a)(1), until reg. statement become effective; Roadshows: file “meaningful cautionary statement” w/ SEC to obtain safe harbor for “forward looking info.”

c) Preliminary prospectus permitted, §§5(b)(1) & 10(b), 2(a)(10) (def.)
(1) *Prospectus* §2(a)(10): include any written communication which “offers any security for sale or confirms the sale of any security.” Broad scope. Such communication can only be in form of preliminary prospectus, §10(b), during waiting period. Strictly forbidden during pre-filing. See below re: post-effective period.
(2) *Preliminary or “Red Herring” Prospectus*: can make offers to sell during waiting period. Use material info. on file w/ SEC; diff. from final prospectus (§10(a)).
(3) *Summary Prospectus/Preliminary Summary Prospectus*, §10(b), Rule 431. Authorized use by Forms S-1, S-2. Used for info. purpose only and DOES NOT satisfy prospectus requirement of §10(a)

d) Statutory Tombstones Ads, Rule 134, §2(a)(10): only during waiting and post-effective periods. Screening device to determine interest, NOT a selling tool.

3. Post Effective Period
a) Final prospectus delivered b/4 final sale, §10(a), 5(b)
(1) Cut off dates for when issuers, underwriter and dealers no longer subject to §5(b) are in §4(3). *Prospectus requirements apply to the issuer so long as it is offering any of the securities to the public.* Underwriters and dealers subject to prospectus req. so long as it is offering an unsold allotment, §4(3)(C); they must comply w/ prospectus req. during 40 day period following effective date. §4(3)(B), etc.
(2) When transaction effected by stock exchange or over-the-counter market, see §4(4). Rule 153 relaxes req. for delivery of statutory prospectus to stock exchange members where sale is made on nat’l securities exchange.
(3) Issuers permitted to use preliminary prospectus plus “term sheet” containing basic price-dependent info. deemed to constitute a statutory prospectus. Rule 434.

(4) **Free writing**: communication sent or given after the effective date (other than §10(b) prospectus) which “offers any security for sale or confirms the sale of any security.” §2(a)(10). This okay ONLY IN POST-EFFECTIVE PERIOD as long as it is preceded or is accompanied by a statutory prospectus.

4. **Shelf Registration, Rule 415**
   a) Registration statement relates to offerings to be made from time to time.
   b) Allow issuer to register security and take it off shelf at short notice for distribution at some later point.

5. **Scope of forms req’d, etc.**
   a) Can go public or do private placement: going public generates more $ but also more expensive.
   b) S-1 most used form, filing initial public offering; SB-2 for small bus. issuer (Rule 405) only, Reg. S-B; Reg. A: least popular, Form 1-A, Rules 251-63, $ limit handicap use.
   c) 3 basic reg. vehicles: Rule 506 (private placement), Form SB-2, Form S-1 (going public).
   d) Key decision w/ filing reg.: (1) who’s going to be underwriter, (2) cost of compliance, (3) hiring lawyer. #s 2&3 can be disadvantages to going public.
   e) Underwriter: key w/ helping to decide what kind of securities, how many, price, kind of underwriting (best efforts or firm commitment)

B. **CONTENTS OF REGISTRATION STATEMENT, REG. S-K DISCLOSUREReq.**
1. Start w/ good model. Follow “plain English” rules. Bed bug: use if filing is so incompetent as to be beyond repair by SEC comment letter. SEC regulation not reject offering b/c if fails satisfy some test of merit, but will bed-bug filing. State is more paternalistic and reject offering for (1) failure to disclose; (2) non-compliance w/ guidelines for industry. Good portion of SEC filing prepared by accountant. Lawyer focuses on text, risk factors, MD&A. Some allowance for forward looking statement in risk factors and/or MD&A sections.

2. **Prospectus Summary**, Item 503(a)
   a) No “puffing” allowed
   b) Give “balanced presentation”, i.e. equal prominence given to both favorable info. and unfavorable info.
   c) Not compulsory

3. **Risk Factors**, Item 503(c)
   a) Discuss principal factors that make the offering speculative or one of high risk.
   b) Should be clear, concise, understandable. Immaterial risks should NOT be included
   c) See CB 211 for common risks covered

4. **Business**, Item 101(c)
   a) SEC interested in disaggregation so investor can get clearer picture of issuer; esp. if one part of co. is failing and failure is covered up by other part.
   b) Gen’l developments in issuer’s bus. done and intended to be done by issuer, its subsidiaries, segment info., foreign operations.

5. **Management’s Discussion and Analysis**, Item 303(a)) (CB 233-239)
   a) Purpose of MD&A: prevent “ugly” surprises for investor. Give investor opportunity to look at the co. through eyes of mgmt.
   b) Prospective Information Required: legal and accounting contribute. Explanation in plain Eng. of “capital resources” (material commitments for capital expenditures, year-to-year changes in issuer’s financial statements – Item 303(a)(2)); “liquidity” (known trends or any unknown demands, commitments, events or uncertainties – Item 303(a)(1)); and “results of operations” (unusual or infrequent events or transactions, significant economic changes that materially affect income reported, etc. – Item 303(a)(3)).
   c) Private Litigation: material departures from Item 303 are not enough to support private 10b-5 anti-fraud action.
   d) SEC Enforcement: can enforce through administrative proceedings.
e) Statutory Safe Harbor for Forward-Looking Statements: PSLRA add §27A to ’33 Act and §21E to ’34 Act to encourage issuers and registrants to make forward-looking statements re: earnings, etc. Must be accompanied by “meaningful cautionary statement.”

C. INTEGRATED DISCLOSURE UNDER THE 1933 AND 1934 ACTS

1. Adoption of Integrated Disclosure System
   a) Integrate 2 systems: (1) Reg. S-K basis repository of non-financial disclosure req’s; apply to all registration forms but not all firms have to file periodic forms; and (2) Reg. S-X integrated accounting system.
   b) Those subject to periodic filings
      (1) Must be listed on non-exempt securities exchange or traded in over-the-counter market
      (2) 500+ S/Hs in stock
      (3) $10M in total assets
   c) Efficient Market Hypothesis and Reg. forms
      (1) How information reaches the market and how market responds according: that market is reflection of all publicly avail. info.

IV. THE PRIVATE OFFERING EXEMPTIONS: SECTION 4(2) AND 4(1)

A. SECTION 4(2)

1. exempts private offering transactions from the rules.
2. Scope of Section 4(2) exemption
   a) The number of offerees (different from purchasers) is generally likely to determine whether the offer is public or private (more offerees, more likely public)
   b) Availability information (more information available, more likely public)
   c) Access to information (meaningful access, more likely public)
   d) State of the relationship of the offerees to determine whether it affords them meaningful access
   e) Are the offerees sophisticated and are they able to bear the risk?
   f) The manner of the offering should not be general, implying public offering
   g) Limitations on resales imply private, not public (purchase must be for investment, not for resale or distribution)
   h) Resale considerations are significant because, by not holding these sellers responsible, they can back around Section 5 registration requirements.
   i) Securities purchased under 4(2) and Regulation D are unregistered.
      (1) They are often, always referred to as restricted securities because there are restrictions on the ability to resell.
3. Ralston-Purina
   a) TEST: 4(2) exemption: “the focus of inquiry should be on the need of the offerees for the protections afforded by registration.” An offering to individuals able to “fend for themselves” should be considered a private offering.
4. In determining whether an offering is “private”, show:
   a) Sophistication
      (1) The only party that should be considered sophisticated is one who actively participates in the market, with a “limitless” amount of money.
   b) Access to Information
      (1) POLICY:
         (a) Does registering securities solve the problem inherent in the limits of information? No.
5. Resale and exemption from Section 5 registration
   a) Sales by issuer
      (1) primary offerings
   b) Sales by anyone else
      (1) trading transactions (exempt from Section 5)
      (2) secondary distributions
depends on whether the reseller is an underwriter according to Section 2(a)(11) (page 542).

(a) Section 4(1) (central transaction exemption under the Act) exempts parties from registering under Section 5 if you are “other than issuer, underwriter or dealer”.

(b) Section 4(2) has the private offering exception.

B. SECTION 4(1) EXEMPTION: MOST PEOPLE ARE NOT ISSUERS, UNDERWRITERS OR DEALERS, AND CAN THEREFORE READILY RESELL SHARES (SECONDARY MARKET)

1. “Underwriter” depends on functional role in the offering
   a) Any person who purchases from an underwriter with a view to the distribution of a security is an underwriter.
   b) Any person who offers or sells for an issuer in connection with the distribution is an underwriter.
   c) Any person who participates or has a direct or indirect participation in any of the activities covered by 1) or 2) above, is an underwriter.
   d) Any person who participates or has a participation in the direct or indirect underwriting of any of the events above is an underwriter.
   e) The expanded definition limits the number of parties who can take advantage of the Section 4(1) exemptions.

2. SEC v. Chinese Consolidated
   a) The indirect dealer (middleman) in the deal, sells securities to the public, solicits offers to buy securities from the community, SEC said the association was the middleman to sell securities to the public, and was therefore an underwriter, and the shares sold are required to be registered under Section 5. On behalf of the issuer because, even though received no compensation, Government benefited from the earnings, and did not ask CC to stop selling.
   b) KEY: Always remember whose interests are being represented
   c) Focus on transaction, not individual steps (factors)

V. THE LIMITED OFFERING EXEMPTIONS: SECTION 3(B), REG. D AND REG. A

A. REGULATION D

1. Replacement for Rule 146
   a) Rule 146 was designed as an exemption for private offerings to increase access to capital and equity markets for small business.

2. Designed to coordinate the various limited offering exemptions contained in Rules 146, 240 and 242, to streamline the requirements applicable

3. Preempts state securities laws for the Reg’s covered securities.

4. To prove qualification under Reg D, show:
   a) A private placement master schedule, setting forth all significant events that must occur throughout the offering period to meet the conditions of the rule (now Reg D);
   b) A private placement memorandums distribution record;
   c) Potential offeree identification form;
   d) Potential offeree evaluation form;
   e) Offeree questionnaire;
   f) Offeree representative documents; and
   g) Final evaluation form.

5. Reg D Basics
   a) CONSIDER: Disclosure to unaccredited investors for 505 and 506 exemptions only; should the same disclosures be made to the accredited investors?
   b) 502(b)(2)

(1) Disclosure obligations.
(a) For 34 Act companies, the disclosure requirements can generally be satisfied with the required filings under 34 Act, for purposes of Reg. D.
(b) If you are not a reporting company, must disclose certain material, relevant information as required under the rule.
(c) Finally, any other opportunity found in the rule for investors to get more information (502(b)(v)) is in the form of a Q&A session for investors. Enables investors to ask follow-up questions and have thorough access to information.

c) 504 [from 3(b)]
   (1) $1M cap for any 12-month period offerings under 505 & 506 that would, when “integrated”, top $1M in offering price. No limitation on the number of purchasers. No affirmative disclosure obligation. Other than certain limited circumstances, resale of 504 securities are limited.

d) 505 [from 3(b)]
   (1) cap offerings up to $5M, with total from previous 12-month 504 & 505 offerings not to exceed $5M. No more than 35 purchasers, or at least the issuer must reasonably believe that there are no more than 35 purchasers. If purchaser is “accredited investor,” they are excluded from the 35 limit. Affirmative disclosure obligation with respect to non-accredited investors only. Resale of purchases in 505 offering are restricted.

e) 506 [from 4(2)]
   (1) Satisfy this, and gain benefits of 4(2) private placement exemption. No limitation on maximum aggregate offering price. No more than 35 non-accredited investors as purchasers. Affirmative disclosure obligation with respect to non-accredited investors only. Non-accredited investors or their representatives must meet certain sophistication standards. Resale of 506 securities are restricted.
   (2) Available for any offer of any size, but has most stringent disclosure requirements. Requirements for disclosure scale down as maximum amount of offering lowers to 504.
   (3) Sophistication requirement: Each person who is not an accredited investor must be savvy enough to evaluate the risks and merits of the prospective investment, or the issuer believes that the potential buyer is so savvy immediately prior to the sale.
   (4) Sophistication is not an either/or issue, and degrees of sophistication exist. The relevant inquiry should be whether the investor can understand and evaluate the nature of the risk based upon the information supplied him. The relevant inquiry should not be whether the investor is au courant in all the latest nuances and techniques of corporate finance.
      (a) Lively v. Hirshfield, Tenth Circuit
         (i) persons of exceptional business experience are sophisticated; 8th Circuit – seemingly subordinated sophistication to the access to information requirement, emphasizing the economic bargaining power of the offerees.
         (ii) Courts have placed burden on issuer of identifying and establishing the requisite qualifications of all offerees where the claim exemption is based on Section 4(2).
   (5) Avoid the sophistication requirement by using 504 or 505, given the caps.

f) Other Provisions
   (1) Courts have applied a “strict compliance” standard for Reg D, and not “due diligence.” Rule 508 makes an exception to the strict requirement standard if the failure to comply with a Reg D requirement is proven not to pertain to a requirement intended to protect a particular person, and that the failure was insignificant with respect to the offering as a whole, with certain exceptions.

g) HYPO
Assume 60 investors (30 of them are accredited investors), each offeree willing to make $100K investment. Some aren’t too sophisticated. Client asks for options to avoid registration. What do we advise?

(a) 504 – fine, except for $1M cap, so no protection
(b) 505 – Either eat the remaining $1M, or look elsewhere for investors.
(c) 506 – Make the non-accredited disclose, make sure the non-accredited are sophisticated (and if some aren’t, then get them sophisticated in a hurry), and we may be in Reg D business.

h) Accredited Investor
   (1) Banks
   (2) insiders of the issuer
   (3) mutual funds
   (4) natural persons with worth over $1M
   (5) $200K annual income over the last two years (other info for married)
   (6) Trusts
   (7) any entity where all of the general partners are accredited investors.

i) Resale under Reg D
   (1) 504 offerings incorporate limited exceptions.
   (2) 502(d) has non-exclusive list of requirements:
      (a) 1) reasonable inquiry to determine if purchase is acquiring security for self or others;
      (b) 2) written disclosure that …

6. Disclosure Obligations for nonreporting companies:

<table>
<thead>
<tr>
<th>Up to $2MM</th>
<th>Regulation A offering circular, with financials required of small business issuers (Rule 502(b)(2)(i)(A), (B)(1); Reg S-B, Item 310(a))</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2MM - $7.5MM</td>
<td>Part I of registration form for which issuer is eligible, with financials required of small business issuers (Rule 502(b)(2)(i)(A), (B)(2); Reg. S-B, Item 310(a))</td>
</tr>
<tr>
<td>Over $7.5MM</td>
<td>Part I (and financials) of the registration form for which the issuer is eligible (Rule 502(b)(2)(i)(A), (B)(3))</td>
</tr>
</tbody>
</table>

B. HOW DO YOU PROVE A PRIVATE OFFERING IS PRIVATE FOR REG D?
   1. 502(c) – Limitation on general solicitations. Look for preexisting relationship between issuer and offeree, which may indicate less likeliness of a general offer. What constitutes a preexisting relationship? Perhaps the broker/dealer aspect. If you have a relationship with a broker, chances are you’ve done some kind of scouting on them. Provide paperwork proving that (questionnaires, etc.), and you establish a preexisting relationship.
   a) What about normal informational distribution devices (e.g. quarterly updates to accredited investors) that should include upcoming offering information? Can announce a coming sale in an informative manner only, but disclosure can’t be used to condition the market – just very bare bones info.
   b) 502 disclosure obligations
      (1) only under 505 and 506, and then only to non-accredited investors. Should you disclose to accrediteds anyway? Might as well.
      502(b) sets forth disclosure obligations, which vary with size of offering and nature of issue.
      (2) General rule: if you are a reporting company required under the 34 Act, then those are adequate for disclosure obligations under Reg D.
      (3) If not a reporting company, must disclose certain info to the extent of the material, issuer, and business being offered – like a summary of written material that was provided to accredited investors.
      (4) Also need to have a Q&A session for investors to get any info they might feel missing prior to the issue. Limitation on resale in (d) to avoid back-
Integration of a series of Reg D offerings will lump systematic offerings together for purposes of analysis under the provision. Look out for the limitations (same as “entire issue” criteria, infra)!

c) 505(b)(2) “bad boy” disqualifier
   (1) If anyone involved in the issuance has violated federal securities laws, then you can’t use 505. 505(b)(2)(iii)
   (2) 505 is not available for security of issuer in 262 of Regulation A – “bad boy disqualifier” (if an issuer, predecessor of an issuer, affiliated with issuer, underwriter, 10% or greater shareholder has engaged in conduct in violation of Securities Laws, he is not protected by Section 505).

d) Integration
   (1) 502(a) says that if you plan to do a series of Reg. D offerings, must pay attention to integration. Certain offerings will be integrated and treated as if they were a single offering. Can result in running afoul of whatever Reg. D provision you thought covered you.
   (2) First, look six months before or after for another offering that might be considered part of the first offering (offerings that are more than six months apart are not a concern).
   (3) Factors:
      (a) Single plan of financing?
      (b) Involved same class of securities?
      (c) Same period of time?
      (d) Whether the consideration is the same?
      (e) Are sales made for same purpose?
      (f) Basically, are these offerings, although done at different times, the same offering?
      (g) Problematic under Reg. D with cap on permissible number of independent investors.

e) Focuses on underlying, pre-existing relationships, because offeror is in a better position to evaluate the situation, and is more aware of the offeree’s position within the transaction. 502(c) provides carve-out for companies that comply with 135.

VI. OTHER SECTION 5 EXEMPTIONS
A. REGULATION A
   1. provides for a form of mini-registration

B. REGULATION CE
   1. applies only to limited offerings in CA, but may be generalized to other states in the future

C. SECTION 3(B)
   1. Allows SEC to exempt from registration provisions other securities if it finds that registration of these securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering.
   2. Specifies the maximum aggregate offering amount as $5MM

D. RULE 701
   1. Exempts offers and sales of securities by non-reporting issuers pursuant to compensatory employee benefit plans.
   2. Addresses the issue of venture capital financing, which had made it more difficult for small employers to have ESOPs. For non-reporting companies, Rule 701 provides an exemption from registration for offers and sales pursuant to ESOPs, or included in employment contracts.
   3. THEORY
      a) These plans are not designed to raise capital, but to give incentives and to get their buy-in, and to avoid cash expenditures. They are compensatory in nature and should be encouraged. Disclosure is limited, can be used not only to offer to employees, but to certain consultants and advisors.
## VII. INTRASTATE OFFERINGS: SECTION 3(A)(11) AND RULE 147

<table>
<thead>
<tr>
<th>Scope of Offering (integration)</th>
<th>3(a)(11)</th>
<th>Rule 147</th>
</tr>
</thead>
<tbody>
<tr>
<td>All securities offered as “part of an issue” are integrated</td>
<td>Sets of sales separated by 6 months are not integrated</td>
<td></td>
</tr>
</tbody>
</table>

### In-state Issuer
- "resident and doing business” within the state
- Principal office within state and 80% of gross revenues, assets, and intended use of proceeds are within the state

### In-state Offerees
- Offerees must be domiciled within the state
- Offerees must have principal residence within the state

### Restrictions on Resales
- Securities must “come to rest” before being resold
- 9-month safe harbor holding period

### A. RULE 147 – AMPLIFIES § 3(A)(11)
1. **Integration** Safe Harbor, Rule 147(b)(2) – no sales 6 mos. b/4 and after test
   a) Rule 147, preliminary Note 3 re: determinative factors regarding integration. Also look to no action letters and case law re: interpretation.
2. Nature of the issuer, Rule 147(c)(1): resident and doing bus. in the state in which offers to sell are made
   a) 80% gross revenue, assets, net proceeds, Rule 147(c)(2)(ii)
3. Offeree and purchasers must be incorporated or organized or principal office or principal residence in the state, Rule 147(d)
4. No resales to non-residents the for 9 mos., Rule 147(e)

### VIII. OFFERINGS BY UNDERWRITERS, AFFILIATES AND DEALERS

#### A. PURCHASES FROM AN ISSUER
1. Underwriter defined as anyone who purchases a security from an issuer with a view to distribution (the intent to resell).
2. **Purchase**
   a) exchange values for interests
3. View to
   a) what was the investor’s investment intent (invest or resell)
   b) underwriter status if acquire an investment security for other than a long-term investment.
   c) Look at what they have bought in the past, and for how long they hold the security. Longer holding period indicates requisite investment intent.
   d) **POLICY**
      (1) Focusing on the holding period is flawed in some sense because it may indicate attempt to find better investment (by either selling soon, or holding until something better comes along). Is the issue that forces to sell or hold a change in the investment environment? What is enough to indicate requisite investment intent? What if the company begins to fail or succeed? The risk of success or failure is incorporated into the price of the stock and the nature of the investment. A change in personal position is a more viable argument.
   e) How long is long enough? Same situation. Look at the totality of the circumstances. Usually three (3) years is long enough, but the presumption starts to shift at two (2) years.
   f) The Changed Circumstances Doctrine (hold for less than two years)
      (1) **HYPO**
         (a) 16 months ago, bought 1,000 unregistered shares of Tyco through private placement. Then, admitted to law school, but needed some money. Sells shares. Is Section 5 violated? What presumption is there about investment intent? Presume that did not intend to invest.
(b) Rebuttal: Changed Circumstances Doctrine. But, consider when he planned to go to school in relation to when he bought the securities, and whether he planned for a circumstance in which he would have to sell his shares. But, he’s better off than if he tried to argue that he sold his stock because Tyco was having problems.

4. Distribution
   a) what constitutes a distribution (not every resale is a distribution)? Only need to show distribution if there is no requisite investment intent. Consider to distinguish between public and private offering (Rule 4(2)).
   b) What do we have to ask? Whether the investors can fend for themselves (Ralston-Purina).
   c) Similarly, if the investor’s resale violates the criteria of the underlying original exemption of the issuer, does the resale by the original investor violate the issuer’s exemption?
   d) HYPO
      (1) Investor bought shares in original offering. Two months later, sells sophisticated investor, for whom the exemption would apply. Resale would not constitute distribution. But, if sold to unsophisticated investor, and that purchaser could not have bought shares in the original offering by the company because it did not satisfy the Ralston-Purina criteria, the resale would constitute a distribution. Therefore, if the resale transaction destroys the issuer’s original exemption, there is a distribution. Could the original issuer have sold directly to the purchasers of the resale?
   e) HYPO
      (1) One year ago, bought 2,000 shares in a private placement. Annual report is released and reflects that earnings are going to increase dramatically. Needs cash for home improvements, goes to broker-dealer and talks about reselling shares (dealer is friend). Dealer solicits shares among clients. Dealer wants advice about whether the securities should be registered. What if investor had requisite investment intent? No issue. No need to register the securities. What if no requisite investment intent? Intent to distribute? Ralston-Purina test, could sell directly, no distribution, no need to register. Dealer is within the definition of the underwriter, so must register shares. * Remember to always consider the definition of underwriter and who the buyers are.

5. The definition of underwriter includes a person who resells securities for a control person.

B. RIGHT TO RESELL BY UNDERWRITERS (AND APPLICABILITY OF EXEMPTIONS)
   1. Assume issuance has not come to rest. What problems arise when someone wants to resell to a sophisticated, informed investor. None. Simple transaction that falls outside the scope of Section 5.
   2. Assume securities have come to rest. Non-control persons, there is no concern unless selling on behalf of issuer (investing intent, not intent to resell); can resell without problems. For control persons, the fact that the securities have come to rest does not solve the problem (not protected by investment intent). The question becomes whether or not some entity is acting as an underwriter. Is someone else purchasing from, selling for, or otherwise participating in the distribution on behalf of the control person. If the other entity is acting on behalf of the control person, raises concern of whether there is a distribution. If underwriting, cannot take advantage of the 4(1) exception. Must ask: 1) is there a control person; and 2) is there a distribution? Investment intent is irrelevant.
   3. How is a control person defined?
      a) Rule 405
         (1) control is the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. Old standard implied ability to gather shareholders, collect information from them, but Rule 405 lessens the constraints of the definition (p. 623)

C. US v. WOLFSON, SECOND CIRCUIT, 1969
1. Wolfson cannot take advantage of the 4(1) exception because, as a control person, he qualifies as an underwriter under Section 2(a)(11). Also, brokers were engaged in issuing the shares and underwriters were selling his stock in transactions on his behalf. Therefore, a control person cannot resell securities if it qualifies as an underwriter, regardless of whether the securities are registered or not. Section 4(3)(b). OTC sales imply public, not private, distribution.

2. The 4(4) broker exception
   a) brokers’ transactions executed upon customers’ orders on any exchange or in the over-the-counter market but not the solicitation of such orders are excepted from Section 5 (registration requirement). Broker is therefore exempt.
   b) POLICY
      (1) 4(4) was designed only to exempt the brokers’ part in security transactions. Control persons must find their own exemptions.

3. HYPOTHESIS
   a) Company trades on NASDAQ; 6 member BOD; one member owns 20% of outstanding shares, is largest shareholder. Calls broker and asks to sell into the market about one-third of the shares. 3 BOD are member’s nominees. Broker has also been asked by a director (nominee) to sell a portion of shares. Member and director were issued shares four years ago in a registered public offering.
      (1) Assuming not control persons, no problem selling shares because securities came to rest, no intent to resell.
      (2) Assuming control persons, intent is irrelevant. 1) Were they in control? Yes. 2) Did they distribute? Yes (sold to the market). Resale must be registered. Since already registered, not always need to be registered again. Just verify that shares resold are registered. Relevant statute is 4(1) because control person’s shares being sold through a broker, who is now an underwriter. Transaction not exempt. Reg. D does not apply and does not include a control person.
### D. Rule 144 (Purchases Directly from Issuer)

<table>
<thead>
<tr>
<th>Sales by noncontrol person of restricted stock</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Holding Period</strong></td>
</tr>
<tr>
<td><strong>Trickle</strong></td>
</tr>
<tr>
<td><strong>Sale Method</strong></td>
</tr>
<tr>
<td><strong>Information</strong></td>
</tr>
<tr>
<td><strong>Filing</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sales by control persons of restricted stock</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Holding Period</strong></td>
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<tr>
<td><strong>Trickle</strong></td>
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<tr>
<td><strong>Sale Method</strong></td>
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<tr>
<td><strong>Information</strong></td>
</tr>
<tr>
<td><strong>Filing</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sales by control person (through brokers) of unrestricted stock</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Holding Period</strong></td>
</tr>
<tr>
<td><strong>Trickle</strong></td>
</tr>
<tr>
<td><strong>Sale Method</strong></td>
</tr>
<tr>
<td><strong>Information</strong></td>
</tr>
<tr>
<td><strong>Filing</strong></td>
</tr>
</tbody>
</table>

* Before 1997, the Rule 144 holding period was two years. In recognition of the greater dynamism of securities markets, the SEC shortened the Rule 144 holding period to 1 year.

** All conditions are lifted if a noncontrol holder of restricted securities has held them for at least two years. That is, there are no trickle, method of sale, current public information, or filing requirements if the restricted securities have been held for two years.

*** In all the categories, the issuer must be subject to period filing under the 1934 Act, or there must otherwise be publicly available information comparable to that found in such reports.
1. Restricted securities
   a) securities that are acquired directly or indirectly from 1) the issuer, or 2) from an
      affiliate of the issuer, in a transaction or chain of transactions not involving any public
      offering, or securities acquired from the issuer that are subject to the resale limitations of
      Reg. D and are acquired in a transaction or chain of transactions not involving any public
      offering, or securities...are exempt from section 5 registration.

2. No distribution if compliance with Rule 144. No distribution, no underwriter, therefore, can
   resell (in line with restrictions discussed above).

3. Requirements
   a) The holding period
      (1) if restricted; minimum one year must lapse before securities are resold;
         does not apply to resale of non-restricted securities; two or more years, can
         resell without having to comply with remainder of Rule 144;
   b) Limitations on amount of securities that can be resold
      (1) during preceding 3 months cannot exceed the greater of 1% of class
          outstanding or average weekly volume or all such exchanges during preceding
          four weeks, if it trades on an exchange
   c) Manner of resale
      (1) must be sold in a broker transaction
   d) Information
      (1) must be adequate public information available regarding transaction;
         if 34 Act reporting company, information requirement is satisfied if subject to 34
         Act reporting requirements for 90 days and has filed all required reports in the
         prior twelve months; if non-reporting company, statute provides must disclose
         general information about business, transaction and financials
   e) Notice of Proposed Sale to SEC

4. QUESTION
   a) Assuming acquiring securities in a private placement; in contract, assure that
      company file proper reports under 34 Act or otherwise agrees to make available such
      information that is required to be available to resell under Rule 144.

5. HYPO
   a) Owner of 15,000 unregistered shares of company, bought in private offering (not
      registered). Wants to resell some shares. Will resale be covered by Rule 144? Yes,
      considered restricted securities.

6. HYPO
   a) 18 months ago, company issued 2MM shares under Rule 505; company attorney did
      not keep track of purchasers in offer, and about 40 non-accredited investors. Buyer wants
      to resell securities obtained in initial offering. Is she covered by Rule 144? Reg. D
      offerings are generally restricted securities, so not a valid Reg. D offering. If she did not
      know registration was invalid, she is okay.

7. HYPO
   a) Company is five months late with filing 34 Act documents; shareholder owns for 14
      months, wants to resell. Can she use Rule 144? No, did not keep up with filing in past
      twelve months. What if statement in most recent filings that it is current? Can she rely
      on that information? No, can only rely on statement if in most recent report required to
      be filed. Statement included in late report is not reliable. What if she held for 26
      months? Doesn’t matter because she held for more than two years.

8. HYPO
   a) Control person of company acquired shares in registered public offering; trades on
      stock exchange with average weekly trading volume of 150,000 shares, 18MM shares
      outstanding. During first quarter of the year, she sold 150,000 of shares (50,000 per
      month). How many shares can she sell in April? Greater of 180,000 or 150,000. In
      February and March she has sold 100,000 and has ability to share an addition 80,000
      shares (180,000 – 100,000). Always looking at preceding 90 days.
E. **Rule 144A**  
1. Provides non-exclusive safe harbor for resale of restricted securities but only when sold to qualified institutional buyers (QIBs).  
2. Transaction that complies with 144A will be deemed not to be a distribution. That means that someone who acquires securities in a private offering can take advantage of 144A to resell (without worrying about underwriter designation).  
3. **Requirements**  
   a) Eligible securities do not include: securities that, when they are issued, are of the same class as those listed on an exchange or NASDAQ. Purchasers cannot use 144A to resell.  
   b) Eligible purchasers are QIBs, only (must be an institution that owns and invests in $100MM in securities from outside issuers); S&L and banks must meet net worth requirement; registered broker-dealers need only have $10MM invested.  
   c) Prospective purchaser and securities holder must have right to obtain from seller basic financial information prior to the sale. If issuer is 34 Act reporting company, information requirement is satisfied through filings.  
   d) Holding period and volume limitations do not matter.  
   e) HYPO  
      (1) Company needs to raise $100MM; will issue 5-year bonds with 8% interest rate; has common shares outstanding traded over NASDAQ. CFO has excellent ties to financial institutions, calls and asks for advice on how to raise money. Why not do a registered offering? Time intensive, expensive. Is it okay to mail information to large financial institutions with portfolios over $100MM, and solicit interest. Problems? 4(2) exemption requires it be a private offering. What about Reg. D? No. What about acquiring and quickly reselling? Rule 144A applies. Different class, eligible purchasers, 34 Act filer. So, can sell.  
   f) Makes raising capital easier.
## IX. CIVIL LIABILITY UNDER THE SECURITIES ACT OF 1933

### 33 Act

<table>
<thead>
<tr>
<th>Coverage</th>
<th>Rule 10b-5</th>
<th>18(a)</th>
<th>9(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any “sale or offer” of securities</td>
<td>SEC filings</td>
<td>Trading in securities listed on stock exchange</td>
<td></td>
</tr>
<tr>
<td>Plaintiffs</td>
<td>Any purchaser or seller</td>
<td>Purchaser of seller of affected securities</td>
<td>Purchaser or seller of manipulated securities</td>
</tr>
<tr>
<td>Defendants</td>
<td>Primary violator</td>
<td>Person who makes false statement in filing</td>
<td>Willful participant in manipulative conduct</td>
</tr>
<tr>
<td>Violation</td>
<td>Material misrepresentation or omission in connection with purchase or sale of any security</td>
<td>False or misleading statement with respect to material fact in SEC filing</td>
<td>Specified manipulative practices: wash sales, matched orders, false or reckless touting, etc.</td>
</tr>
<tr>
<td>Scienter</td>
<td>Required (including recklessness)</td>
<td>Defense: good faith and no knowledge of falsity</td>
<td>Required (willful participation)</td>
</tr>
<tr>
<td>Reliance</td>
<td>Required (unless case of duty to speak or omission)</td>
<td>Required</td>
<td>N/A</td>
</tr>
<tr>
<td>Causation</td>
<td>Loss causation</td>
<td>Price affected by statement</td>
<td>Price affected by violation</td>
</tr>
<tr>
<td>Remedy</td>
<td>Varies (generally out-of-pocket damages)</td>
<td>Damages caused by reliance</td>
<td>Damages sustained as result of violation</td>
</tr>
<tr>
<td>Liability Limits</td>
<td>Proportional liability for unknowing violators</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Contribution</td>
<td>Yes</td>
<td>Yes (as in cases in contract)</td>
<td>Yes (as in cases in contract)</td>
</tr>
<tr>
<td>Limitations Period</td>
<td>1 year after discovery/three years after violation</td>
<td>1 year after discovery/three years after violation</td>
<td>1 year after actual discovery/three years after violation</td>
</tr>
</tbody>
</table>

### 34 Act

<table>
<thead>
<tr>
<th>Coverage</th>
<th>Section 11</th>
<th>Section 12(a)(1)</th>
<th>Section 12(a)(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registered offerings</td>
<td>Unregistered, nonexempt offerings</td>
<td>Public offerings</td>
<td></td>
</tr>
<tr>
<td>Plaintiffs</td>
<td>Acquiror of registered securities</td>
<td>Purchaser of unregistered securities</td>
<td>Purchaser of securities</td>
</tr>
<tr>
<td>Defendants</td>
<td>Directors, specified officers, experts, underwriters</td>
<td>Statutory seller (solicits purchasers)</td>
<td>Statutory seller (solicits purchasers)</td>
</tr>
<tr>
<td>Violation</td>
<td>Untrue statement (or misleading omission) of material fact in registration statement</td>
<td>Violation of Sect. 5: sale-offer of unregistered securities or “gun-jumping”</td>
<td>Sale-offer by means of prospectus or oral communication false or misleading statement</td>
</tr>
<tr>
<td>Scienter</td>
<td>Due diligence defenses (except for issuer)</td>
<td>N/A</td>
<td>Defense: reasonable care and no knowledge</td>
</tr>
<tr>
<td>Reliance</td>
<td>Not required (defense 12 months after offering)</td>
<td>N/A</td>
<td>Defense: purchaser not know untruth or omission</td>
</tr>
<tr>
<td>Causation</td>
<td>Defense: Negative causation</td>
<td>N/A</td>
<td>Defense: Negative causation (new)</td>
</tr>
<tr>
<td>Remedy</td>
<td>Damages formula (capped at aggregate offering price)</td>
<td>Rescission or rescissionary damages</td>
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</tr>
<tr>
<td>Liability Limits</td>
<td>Proportional liability for unknowing outside directors</td>
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<td>1 year after discovery/3 years after violation</td>
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</tr>
</tbody>
</table>
A. SECTION 11 LIABILITY

1. **material misstatement or omission in an effective registration statement** will subject the issuer, and a variety of other persons associated with the issuer and distribution, to damages incurred by any person who bought the securities covered by the registration statement. Section 11(a).

2. **PERSONS LIABLE:** the registrant, all directors of the issuer, all other persons who sign the registration statement, all underwriters of the offering, and any expert who is named as having prepared or certified any part of the registration statement are potentially liable under Section 11(a). Section 15 reaches anyone whom the plaintiff can show to be in control of any of these persons.

3. **PLAINTIFFS:** Any person who acquires a registered security, either as part of the original offering, or in the secondary market, may bring suit. The purchaser of the shares in the secondary market must be able to trace shares to applicable registration statement.

4. **POLICY**

   a) It is the case that Section 5 imposes some meaningful costs on issuers; it is also the case that Section 11 imposes a lot of potential liability on a lot of parties, so there is some disagreement as to whether the protections afforded by Section 5, bolstered by the liability provisions of Section 11 are worth the costs associated with compliance. Is that a cost or a benefit for which investors are willing to pay?

5. A plaintiff must prove (p. 557): that any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

6. The plaintiff need not prove reliance unless the plaintiff bought after the issuer had made generally available to its security holders an earnings statement covering a period of at least a year beginning after the effective date; even then reliance may be established without proof of the reading of the registration statement by such person.

7. The plaintiff need not prove causation, but damages are reduced to the extent that the defendant proves that the damages did not result from his or her misconduct.

8. Issuer’s liability is absolute with one exception: the issuer has the defense available to all defendants of showing that the plaintiff knew of the untruth or omission at the time the plaintiff acquired the security.

9. **Due Diligence Defense for Statement:**

   1) before the effective date of the part of the registration statement in question, defendant took reasonable steps to sever described connections with issuer, not responsible; 2) defendant had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that it was true and complete; 3) a non-expert defendant can state he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue.


   a) **Due Diligence Defense for reliance**

      1) Non-expert with respect to non-expertised portions must 1) conduct a reasonable investigation, and 2) have reasonable grounds to believe statement true.

      2) Experts with respect to expertised portions must 1) conduct a reasonable investigation, and 2) have reasonable grounds to believe statement/advice true

      3) Non-experts with respect to expertised portions must show 1) no reasonable grounds to believe statement untrue, and 2) no reasonable investigation required. Reasonableness is determined by what a prudent businessperson would do in the management of its own property (Section 11(c))

b) Section 11(c) regarding reasonable investigation states the standard of reasonableness shall be that required of a prudent man in the management of his own property.
POLICY

We want more people “on the hook” so more people will pay attention to what is going on (“gatekeepers”). Ignorance is no excuse for a person in his position. Might it matter if he was new to the position? What impact does the learning curve have on his liability? Since the focus is on prevention, not culpability, so how much he knew is irrelevant – take responsibility and don’t approve something you are not sure about. What facts might have helped him in proving his defense? Show that he conducted a reasonable investigation into the registration statement.

c) Underwriters are just as responsible as the company if the prospectus is false. An underwriter has not put the company’s officers into a position of trust for the express purpose of attending to details of management. In a sense, the positions of the underwriter and the company’s officers are adverse. It is not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving and unduly enthusiastic.

d) In order to make the underwriters’ participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them; may not rely solely on the company’s officers or on the company’s counsel. A prudent man in the management of his own property would not rely on them.

11. POLICY

a) Who is left off the list of potential defendants under Section 11? Explicitly, lawyers. Does that mean lawyers are off the hook? No. Indirectly, they are pulled into liability by 1) being a board member, 2) signing a document submitted in the registration statement, 3) acting in some sort of expert capacity. How else can lawyers be liable? Tort, agency.

b) Outside versus inside directors. Insiders are also officers of the company (agency, monitoring issues); outsiders are directors who do not have positions as officers in the company. Different due diligence standards apply based on knowledge base, exposure to daily operations.

B. DUE DILIGENCE DEFENSE UNDER SECTION 11(B)(3)

1. Outside directors can delegate the duty of investigation, but he or she is liable if the person to whom this duty was delegated does not perform it properly.

2. Weinberger v. Jackson held that an outside directors was not obliged to conduct an independent investigation into the accuracy of all the statements contained in the registration statement. He could rely upon the reasonable representations of management, if his own conduct and level of inquiry were reasonable under the circumstances. The outside director has no duty to make specific inquiries of management as long a the prospectus statements were consistent with the knowledge of the company which he had reasonably acquired in his position as director.

3. Inside directors with intimate knowledge of corporate affairs will be expected to make a more complete investigation and have more extensive knowledge of facts supporting or contradicting inclusions in the registration statements than outside directors.

4. There should be no doubt that the syndicate members are entitled to rely upon the underwriter’s investigation if it in fact complies with the statutory requirements. Conversely, however, it is fairly inferable from the BarChris opinion that if performance falls short, they are equally liable.

5. The defendant has 1) before the effective date of the registration statement, resigned or taken steps to resign, and 2) advised the SEC, in writing, of such intentions. Section 11(b)(1)

6. The defendant gives notice to the SEC in writing, and reasonable public notice, that the misleading part of the registration statement became effective without her knowledge. Section 11(b)(2).

7. Who is the most likely defendant?

   a) The issuer. What defenses does the issuer have available to avoid Section 11 liability? Plaintiff’s knowledge of the misstatement; otherwise, the issuer is strictly liable.

8. Policy:

   a) Why not consider attorneys experts with respect to entire document? Would always be liable. Should only be liable for scope of their opinions.
C. CAUSATION AND DAMAGES UNDER SECTION 11
1. The plaintiff does not have the affirmative burden to prove either reliance or causation in a section 11 case, but the defendant can advance causation as a defense to the plaintiff’s damages claim under the proviso in section 11(e), which states: *if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from fraudulent registration statement, such portion of or all such damages shall not be recoverable.*
   a) The misstatement was immaterial because it did not cause a stock price decline, in light of other bad news to be revealed; in fact, when the error was revealed, price went up.
   b) Difference between amount paid for security (as long as amount paid does not exceed offering price) and either the value thereof as of the time such suit was brought, OR the price at which such security shall have been disposed of in the market before suit, OR the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security and the value thereof as of the time such suit was brought.
   c) Defendants argue that price went up after disclosure, so no damages, and previous decrease is due to something other than material misstatement. Defendants will also argue that ECMT implies that information about misstatement is immediately reflected in price after disclosure; Plaintiffs argue leakage prior to disclosure were incorporated into the price, and the defendants should be liable.
3. Negative Causation
   a) Loss causation exists where the misrepresentation touches upon the reasons for the investment’s decline in value.
   a) Provided false information in registration statement in failing to disclose danger signals of which the management was aware prior to the date when the registration statement took effect.
   b) Section 11(a) requires plaintiffs to be any person acquiring such security…

D. WHO MAY RECOVER UNDER SECTION 11?
1. The plaintiff must be a purchaser of a security, and the section eliminates any requirement of privity of contract between the plaintiff and the issuer as a defendant, as contrasted with Section 12(a)(2)
2. The open market buyer must be able to trace his or her particular securities to the registration statement when it covers additional securities of an outstanding class.
3. Acquisition of assets and liabilities is distinguished from the acquisition of stock/security in Versys Inc. v. Coopers& Lybrand.
4. The plaintiff need not have actually read the registration statement with the misstatement or omission (no reliance requirement).
5. Goal is not to compensate someone who has been wronged, but to create a deterrence to this type of conduct. If the plaintiff in fact knew of the misstatement or omission, they cannot bring suit.
6. Section 13 provides for relatively strict statute of limitations under the 33 Act; no action can be maintained unless it is *brought within one year of the discovery of the misstatement or omission (when it was learned about or should have been learned about); but cannot bring suit more than three years after the statement is made, regardless of when it is discovered.*
7. Must show that the securities were purchased pursuant to the registration statement in question; essentially, even if I am not the original buyer from the issuer, no privity does not impair ability to bring suit under Section 11, but may be more difficult to prove that shares were bought pursuant to faulty registration statement. Unless can be tracked back to the IPO, may be difficult to do.

E. 4-1 ½ EXEMPTION (RESALES BY CONTROL PERSONS)
1. combination of workings of 4(1) and 4(2), actually a 4(1) exemption extension; technically, the 4-1 ½ only comes into play when talking about resales by control persons of securities that have come to rest.

2. A control person is considered an issuer for the definition of underwriter but not for other purposes; a control person cannot take advantage of the 4(2) exemption because it does not fall within the definition.

3. Does a control person, when reselling securities through an intermediary, create an underwriter that does not receive the protection of the 4(1) exemption. What is an underwriter? To avoid having status as an underwriter, must 1) make sure did not buy with a view to distribution, and 2) make sure that not offering or selling securities for an issuer in connection with the issuer’s distribution. What is a distribution? Look at 4(2), look at what is a public offering, or what is a private offering. In the context of Ralston-Purina, includes access to information and ability to “fend” for themselves. How does this relate to 4-1 1/2? Assume a situation where the securities have not come to rest. In that case, whether dealing with control person or non-control person, the question upon resale becomes will the resale transaction “blow up” the issuer’s original exemption in the private placement? Are you reselling to investors who could have participated in the original private placement and taken advantage of the exemption? If yes, no problem. If no (lack sophistication and information), the original exemption is dissolved, and must comply with registration requirements. What happens when securities have come to rest, for non-control persons, means had requisite investment intent, and are therefore not underwriters. For control persons, they do not receive the benefit of the “with a view” language; the question is whether their resale turns someone else into an underwriter (is there a distribution?). Look at 4(2)/Ralston-Purina standards. Find substantive definition of distribution; if no distribution, no underwriter. Therefore, the resale by the control person will be exempt under 4(1). Why 4-1 ½? Really a 4(1) exemption, but the substantive content of the exemption is found in 4(2).

4. HYPO:
   a) Assume control person of a company resold 1,000 shares to buyer 2 months after acquired by company in private offering. Buyer is company’s new CFO. Can she resell without having to register shares? This is not a 4-1 ½ problem because she has only held the securities for 2 months (have not come to rest). Is buyer sophisticated? How does he meet the Ralston-Purina test? If he would have been able to buy in the private placement, there is no registration requirement. As the CFO, he is presumably sophisticated (has access to adequate information). Since company could have sold to buyer, control person’s resale does not run afoul of the 4(2) exemption that applied.

5. HYPO:
   a) Assume same set of facts, except control person held securities for five years, and attorney negotiated the resale to the buyer. Does the attorney become an intermediary (underwriter) for the purposes of the 4-1 ½ exemption? Yes. Securities have come to rest. Is there a distribution involving a public offering? No. Buyer is still sophisticated and has adequate access to information. Although control person cannot take advantage of 4(2) standing requirement (no underwriter, no distribution), control person can take advantage of 4(1) and control person can resell.

6. Why worry about 4-1 ½?
   a) No need to, as long as can comply with Rule 144 (much better rule to use). If cannot comply with Rule 144, 4-1 ½ would be better.

F. SECTION 12(A)(1) (USED TO BE 12(1))

1. Any person who offers or sells a security in violation of Section 5 shall be liable to the person purchasing such security from him.

2. The plaintiff need prove:
   a) the defendant was a seller;
   b) the jurisdictional requirement of interstate commerce was satisfied;
   c) the defendant failed to comply with Section 5 registration or prospectus requirement;
   d) the action is not barred by the statute of limitations in Section 13; and
   e) adequate tender is made when the plaintiff seeks the remedy of rescission (rather than damages).
3. The only practical defense available to the defendant is to prove that the particular security or transaction was exempt from Section 5.
4. A defendant cannot claim it did not know if it was required to register; culpability is irrelevant.
5. Remedies are
   a) consideration paid (with interest) less the amount of any income received on the securities, or
   b) for damages if the purchaser no longer owns the security.
6. HYPO: a) What if offer is illegal, but at the end of the day, the registration statement complies with Section 5? Does the subsequent compliance remedy earlier illegal offer? No. Therefore, under Section 12(a)(1), still liable for making illegal OFFER.
7. Pinter v. Dahl, 1988
   a) Must one intend to confer a benefit on himself or on a third party in order to qualify as a seller within the meaning of 12(a)(1)? Yes. Even brokers and other agents, persons who are not sellers with respect to passing title, can be held liable under Section 12.
   b) Party who is representing security is not always liable if acting outside of personal interests. Includes class of persons from whom purchasers purchase… brokers and others… If only giving gratuitous advice, will not have liability imposed upon. Rather, the language and purpose of 12(a)(1) only extends to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner.
   c) HYPO: (1) Pinter had hired Dahl to round up other investors. Dahl would pay half, but needed investors for the other half. Would pay a commission to Dahl. Seller? Yes
   d) HYPO: (1) Pinter does not hire Dahl, but rather Dahl engages other investors because, without raising other half, deal will fall through. Self-interests are involved… Seller? Stronger argument, because he gets some benefit, but not as direct (i.e. commission).
   e) HYPO: (1) CEO solicits investors. Seller? Probably not. If so, every activity in the interest of the business would make him liable. How easy is it to track the benefit back to the CEO? What additional facts would make it more likely? He holds personal shares, his success is dependent on the involvement of others… Why not hold more people liable? It’s not fair to hold those without the responsibility liable. May only want to hold people liable who are mainly involved in the registration process (in control of the final product).
   f) PROBLEM: (1) Credit rating company publishes some positive comments about a corporation. Buyer learns that corporation was going to have a private placement of common stock. Buyer decides to approach CEO and asks for more information. CEO calls outside counsel and says, send some offering materials to buyer (materials are sent). $5,000 of the proceeds will be used to pay the lawyers to work on the offering. Counsel also included cover letter saying materials were being transmitted at request of corporation. Buyer buys securities, but wants to rescind because deal fell through, claiming offering did not qualify as valid private placement under 4(2) and was required to be registered. Assume buyer is correct in that offering did not meet requirements under 4(2). Does the buyer have a claim against the outside counsel? According to the Pinter test, the party must get some personal benefit from the representation. Is $5,000 of proceeds enough to consider them a seller? Maybe, must be considered in relation to the amount of the total project. Were the lawyers soliciting anyone? No. They were just doing what the corporation told them to do. No affirmative act implies they should be less liable. Is the
credit rating company a seller? Not in the traditional sense, but if there was commission tied to their positive rating, or some other financial benefit, it makes them look more like having financial motivation. The crux of the issue is whether they SOLICITED ANYONE, not necessarily only if they had a financial stake.

G. SECTION 12(A)(2)
1. creates liability where a person offers or sells a security by means of a prospectus or oral communication that includes a material misrepresentation or omission of fact. Must satisfy jurisdictional requirement of “use of any means or of instruments of transportation or communication in interstate commerce or of the mails.
2. Available defenses include “reasonable care” defense that he did not know, and in the exercise of reasonable care could not have known of a material misrepresentation or omission; and the defense that allows the defendant to reduce the amount recoverable under 12(a)(2) by proving that the depreciation in value of the security was not caused by the material misrepresentation or omission (negative causation similar to Section 11 defense).
3. Provides plaintiff a mandatory right of rescission upon tender of the subject security. Plaintiffs may also seek rescissory damages if they had sold the security and cannot tender.
4. If the ultimate seller is a dealer, Section 12(a)(2) is the only available defense
   a) Court defines “prospectus” as referring to a document that describes a public offering of securities by an issuer or controlling shareholder. The contract of sale, and its recitations, were not held out to the public and were not a prospectus (under Section 10) as the term is used in the 1933 Act. Therefore, Section 12(a)(2) does not apply to private offerings.
   b) Meaning must have same meaning under Section 10 and Section 12; therefore, if the contract is not a prospectus under Section 10, it is not a prospectus under Section 12 no liability.
   c) Dissent says true place is to look at 2(a)(10), which has Section 10 definition imbedded in it, and draws a broader distinction.
   d) 12(a)(2) does not cover resale transactions and private offerings
   e) POLICY:
      (1) What is the policy argument to limit 12(a)(2)? Broad definition goes against the intent of letting sophisticated investors fend for themselves.
      Remember the purpose of the private offering exemptions. They were in a position to contract around bad business, can’t rely on SEC regulations to fill in where you messed up.

X. SEC ACT CIVIL LIABILITY PROVISIONS
A. 14(A), 10(B), RULE 10B-5 REQUIRE A MATERIAL OMISSION.
1. Origin of materiality in Rule S-K and S-X. There is some determination that has already been made about a variety of items about what is material in these rules. SEC filings must contain such material information to make statements made not misleading (complete record). Also, general anti-fraud provisions have a materiality element.
B. TSC INDUSTRIES, INC., v. NORTHWAY, INC., 1976
1. Requires a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix (compare the basket of facts with and without the omitted materials) of information made available.
2. Only if the established omissions are so obviously important to the investor that reasonable minds cannot differ on the question of materiality is the ultimate issue of materiality appropriately resolved as a matter of law by summary judgment.
3. POLICY:
   a) Takes the middle ground between disclosure requirements, and disclosing everything, but providing consumers with enough information to make adequate
decisions; might and would were rejected as inappropriate standards (too hard to prove, too broad).

4. If the effect of the misstatement or omission has a less than 5% effect on price, earnings, etc., presumed to be immaterial; greater than 10%, presumed to be material. Battle over the mid-range. Negative causation defense applies. SEC has said there is no quantitative test by which to determine materiality. Why? Holds them to too strict a standard, other factors that affect changes in price. It binds the SEC’s hands with respect to interpreting what lead to the increase in stock price. Difficult to quantify the impact of a particular fact.


6. The Buried Facts Doctrine applies.
   a) Requires effective, not just technical, disclosure.

7. Basic Inc., v. Levinson, 1988
   a) Adopts Probability Magnitude Test: Probability of happening x expected impact; “materiality will depend at any given time upon a balancing of the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.
   b) What do you consider in determining probability prong: synergies, past similar mergers, purpose of merger, financial situation of each company, corporate culture, actions to date with respect to the merger.
   c) Magnitude: size of both sides of the company, potential premium being paid, effect on earnings of the combined companies
   d) Must disclose information in Rule S-K, MD&A, update/correct information, conflicting w/ prior statements, BUT, does not always need to disclose something simply because it’s material, unless required by other standard.
   e) Distinguish puff from factual/realistic statements. Also, if everyone is out there making puffing statements, and someone comes along with factual information, market will discount all information as puffery, results in general discounts applied to factual information. So, everyone puffs.

C. FORWARD-LOOKING INFORMATION/BELIEFS, OPINIONS (SOFT INFORMATION VS. HISTORICAL INFORMATION)

1. How do we deal with these issues in terms of materiality?
   a) SEC used to not all such information because it’s inherently uncertain. Now, MD&A (Item 303, Reg. S-K) requires management to disclose some forward-looking information, and is encouraged to disclose other types of information.
   b) POLICY:
      (1) Why care if forward-looking information is incorrect? Purpose of SEC rules is to protect the unsophisticated investor. Also, misinformation creates inefficiencies in the market. The ECMT states that market reacts immediately to information; incorrect information will still influence the market, but will create an inflation in the price. Analysts may be able to look through the information, but they also may put more weight on the information than the unsophisticated investor, leading to more severe inefficiencies.

2. Bespeaks Caution Doctrine (pp. 1032-33):
   a) As a general matter, when an offering document’s forecast, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the total mix of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law. The bespeaks caution doctrine is, as an analytical matter, equally applicable to allegations of both affirmative misrepresentations and omissions concerning soft information. Whether the plaintiffs allege a document contains an affirmative prediction/opinion that is misleading…
   b) Limited to forward-looking statements; does this make sense?

Securities Regulation 27
3. When is a forecast misleading?
   a) Should a difference between forecasted and appraised amount be sufficient for liability? Depends on what drives the difference.
   b) What is a meaningful cautionary statement? Generic blanket cautionary statement is not good enough (“everything in here may be wrong”), but where is the tipping point?
   c) Examples where courts have considered whether or not a meaningful cautionary statement:
      (1) In response to a claim that company’s earnings forecast had no reasonable basis, court dismissed suit, saying sufficient cautionary language when company warned had experienced/may continue to experience problems w/ respect to work force, production, management information systems and inventory controls.
      (2) Allegedly false prediction about ability to provide consulting; company warned limited pool of IT professionals, success depended on ability to attract other professionals; sufficient cautionary statement.
      (3) Real estate company stated project was subject to risks inherent in ownership of real estate, accompanied by information about historical fluctuations in the real estate market; insufficient cautionary statement. Therefore, very indeterminant.

4. Reasons, opinions and beliefs
   a) Virginia Bankshares, Inc. v. Sandberg, 1991
      (1) Is the information about various options on buyout prices and valuation material? Yes. Objective falseness can be the basis of liability; but subjective falseness is not the basis of liability. Requires 1) false statement, and 2) the statement must relate to something that is in fact false.
   b) Statutory safe harbor for forward-looking statements (Private Securities Reform Act of 1995) – 33 Act (Section 27A) and 34 Act (Section 21E)
      (1) Forward-looking statements that did not come true were subject to severe lawsuits, which lead to the safe harbors; 1) provides safe harbor to encourage disclosure of things there may not be a duty to disclose, and 2) prevents forward-looking statements that are not based on supporting evidence. These disclosures are generally not affirmatively required by the SEC.
      (2) Generally shields persons specified in the provision (issuer, person acting on behalf of the issuer, or an underwriter who has obtained the information from the issuer) from liability in certain private actions for forward-looking statements. Two safe harbors:
         (a) In addition to shielding immaterial forward-looking statements, the first reaches meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statement, or
         (b) The plaintiff has to prove that the forward-looking statement was made with actual knowledge that it was misleading (the burden is difficult to meet).
      (3) So, what about a knowingly false statement that is accompanied by cautionary warnings? How cautionary? Doesn’t matter. No protection? Violates the policy behind the Act. But the two safe harbors are mutually exclusive, so can take advantage of one, even though in violation of another. So the statement is protected! Safe harbor also applies to oral statements (an oral statement qualifies for the safe harbor so long as the statement identifies to the listener meaningful cautionary statements).
         (a) Not available for statements made in connection with IPOs, tender offers and going-private transactions.
         (b) Read with Bespeaks Caution Doctrine and Rule 175, MD&A and the discussion about forward-looking statements.
         (c) During the pendency of any motion to dismiss the safe harbor protection, while the battle is taking place, discovery is stayed because there may be the need for discovery to meet burden of proof under second

5. Duty to disclose forward-looking statements
   a) The mere fact that information is material does not mean that it must be disclosed; there must be an independent duty. Where does the duty come from? Regulation S-K (line-item disclosures) and Regulation S-X (more specific disclosures). While the regulations have specific disclosures, and cases have discussed which soft information must be disclosed, not all soft information must be disclosed. Relates back to the fact that disclosures cannot be materially misleading.

D. RULE 10B-5

1. Rule 10b-5 (Fraud in the purchase/sale of securities, insider trading)
   a) First question: Who has standing to sue? When does it apply?
      (1) It is now the case that there is a private right of action under Rule 10b-5.
      (2) The rule only prevents fraud that is in connection with the purchase or sale of any security. How do you define “in connection with”? As long as the fraud “touches on” the security, it is generally enough. Also, it has to be in connection with the purchase/sale of security, so the purchase/sale of a security must have taken place. Therefore, cannot sue if “would have bought/sold, or did not buy/sell, but for the fraud.”
      (3) POLICY
         (a) How do you verify what a person would have done?
   b) Duty to disclose (10b-5) → insider trading (10b5-1 and 10b5-2) → other aspects of 10b-5
      (1) arises out of clause 2 of Rule 10b-5 – prevents issuer from failing to state a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading...
      (2) SEC: If statements have become inaccurate by the introduction of some intervening information, or some statement made turns out to be false when made (statement made thinking it was true), the SEC says there is a duty to disclose/update if the issuer knows, or should know, that persons are continuing to rely on the statement or any material portion thereof.
      (3) Therefore: duty to disclose is expanded, and limits to the line item disclosures in the applicable regulations.
   c) Basis for Insider Trading Law
      (1) In Re Cadry, Roberts & Co. and SEC v. Texas Gulf Sulphur Co are the basis for most insider trading law. General principle (Disclose or Abstain Doctrine): A corporate insider, when in possession of material nonpublic information, has a duty to either: 1) abstain from trading, or 2) disclose the information.
   d) Other issues surrounding Insider Trading
      (1) What does it mean to trade “on the basis of” the information? Does the investor actually have to be investing in a certain way to use the Rule (10b5-1)? Prior to the rule, some courts said being in mere possession of information is enough to meet the requirement that traded “on the basis”; other courts said must actually use the information to trade “on the basis”. It makes sense to require actual use, but how do you prove what when into the analysis, both consciously and unconsciously? Rule 10b5-1(b) says that a person trades “on the basis of” material information if the person making the purchase or sale was “aware” of the material nonpublic information when making the purchase or sale (p. 762). Rule 10b5-1(c) contains the affirmative defenses that articulate circumstances where, although aware of the information, it is highly unlikely that it was used (p. 762).
   e) POLICY
Why have insider trading laws? Market efficiencies (avoid arbitrage), simply unfair to those who do not have access to the information (eroses investor confidence in the marketplace); insiders will withhold information so they can trade information, which would lead to delays in disclosure; subverts the duty of loyalty to the shareholders; information does not belong to the insider, it belongs to the corporation and the shareholders (property rights); its just bad not to be fair.

Why permit insider trading? Pricing efficiency (prices more accurately reflect the price of the stock – strong form market efficiency); creates a form of compensation to those who are insiders (but where is the incentive to make the company perform if there are rewards to insiders if the business tanks); encourages investors to invest because market is more efficient; if it’s so bad, why do we need to prohibit it? requiring disclosure may undermine the incentives to create the information in the first place. Subverts the duty of loyalty. Confidential info belongs to the corporation (shareholders) and have no private right to trade on such information.

Insider trading requires more than simply holding inside information; requires that there is a duty to disclose it (much more narrow definition than the original insider trading cases discussed above).

   a) There is a duty to update opinions and projections if the originals have become misleading as the result of some intervening event. But, in this case, the public statements about the negotiations lacked the definitive positive projections that would require future correction.
   b) Not disclosing these other capital-raising techniques made the information about the strategic alliances misleading because the shareholders’ understanding about how the company will eventually raise the money and meet the strategic goals will be different if they know there are other financing options available.
   c) Inadequate to allege fraud when cannot identify the source.
   d) Conclusion:
      (1) Consider continued duty to disclose/update.
      (2) If a company makes a false statement, determine when the duty to correct arises.
      (3) The issuer does not have a duty to correct a materially false statement by a third party, UNLESS the issuer somehow adopts or endorses this third party statement. In this case, the duty to correct may arise. Not necessarily a duty to correct a third party’s statement, because it is effectively that the issuer has made the statement its own.

3. Duty to Disclose/Speak
   a) Chiarella v. US, 1980
      (1) SC held that, where a trader has no duty to disclose, not liable for insider trading under 10b-5. Hard to claim engaged in fraud when there is no duty to disclose/speak. When there is a relationship of trust and confidence, a fiduciary duty to shareholders (p. 1091).

4. Affirmative defenses:
   a) A person can trade without having traded “on the basis…” if, before purchase/sale:
      (1) Entered into binding contract to purchase/sell security;
      (2) instructed another to purchase/sell on behalf;
      (3) adopted written plan for trading securities that is specific as to quantities/prices, or included formula for calculating price/quantities, or excluded any outside influence in the calculation of quantity/prices purchased/sold.

5. Tipper/Tippee Liability
   a) Dirks v. SEC, 1983
      (1) Remember to consider the duty element in Chiarella: here, the tippee who actually trades on the information owes no fiduciary duty to the
marketplace, but the breach of duty is the cornerstone of an insider trading litigation under 10b-5

(2) **Dirks Test:**

(a) The tippee assumes a fiduciary duty to the shareholders not to trade on the basis of the insider information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee, and the tippee knows or should have known of the breach. Tippee liability is ultimately a derivative of the tipper breach. Also, we tell whether or not there has been a tipper breach by considering whether or not the tipper has received some direct or indirect “personal benefit” from the breach and the tip giving. If a friend or relative is involved, still gives rise to liability, although judged under a different scale. Treated as if the insider engaged in the trading, then took the proceeds and gave those as a gift. No tipper breach, no tippee liability.

(3) Remember FN 14 under Dirks.

6. Misappropriation Theory
   a) **US v. O’Hagan, 1997**

   (1) Rule 14e-3 (p. 852) prohibits trading on the basis of information with respect to tender offers, whether or not there is a breach of fiduciary duty.

   (2) **Misappropriation theory:**

   (a) Person commits fraud in connection with a securities transaction (purchase or sale), and thereby violates Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. A fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. The misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.

   (3) **THE PROBLEM WITH THIS CASE:**

   (a) How can the court say that, although the source/principal (law firm) has been defrauded, the existence of liability for misappropriation turns on the non-existent fiduciary duty to the shareholders of the firm in which securities were bought/sold? Unless you disagree with insider trading prohibitions, the outcome is the right one.

   (b) **POLICY**

   (i) We should really say that, asymmetric information is a classic market failure that leads to allocative inefficiencies (arbitrage, fairness). So, there are two baskets of informational asymmetries – bad and good. Bad ones are where they “fall into” the information by the nature of the job (insiders), or steal the information. Good ones are where analysts have informational advantages, but they will eventually bring that information to the marketplace. They lose the incentive to gain the information if they are not allowed to have asymmetrical information. 10b-5 really creates a regime that tries to permit/encourage those informational asymmetries that have the effect of getting information to the market. On the other hand, we want to get rid of “bad asymmetries. If this is what we’re trying to do, the O’Hagan result is consistent with the policy described above.

b) Other issues with Misappropriation

   (1) A duty of trust and confidence exists for the purpose of the misappropriation theory whenever 1) a person agrees to maintain the information in confidence, 2) the persons sharing information have a history, pattern, or practice of sharing confidences such that the recipient knows or should know that there is an expectation of confidentiality, and 3) when information is shared with a parent, spouse, child or sibling, unless recipient can show there was no reasonable expectation of confidentiality.

E. NON-INSIDER TRADING VIOLATIONS UNDER 10B-5
1. Generally
   a) Material misstatements or omissions with respect to the purchase or sale of
      securities.
      (1) Elements:
         (a) Standing
         (b) buyer or seller only (not intent to buy or sell); must “touch” the
             transaction
      (2) Material misstatement/omission
         (a) in connection with the sale/purchase
      (3) Scienter
         (a) (*Ernst & Ernst*) Any state of mind (scienter) that is at least
             recklessness (where is the line between reckless and negligent?), and intent
             to deceive, is required under 10b-5. Recklessness means extreme
             departure from standards of ordinary care. Scienter does not require
             actual desire to mislead investors to further some self-serving scheme;
             rather, that defendant was aware of state of affairs and could anticipate
             the harm is sufficient. SEC was extended to SEC injunctive actions, as
             well.
   b) HYPO:
      (1) As someone at company, what role does it play in scienter if rely on the
          advice of counsel, or what role should it play? Reasonable reliance?
          Conduct reasonable grounds to believe? See section 11 and BarChris.
         (a) Reliance
            (i) *Basic Inc. v. Levinson*
               (a) can be presumed on the basis of materiality and by
               the fraud on the market theory; but is a rebuttable
               presumption based on 1) market makers have
               knowledge of false information and incorporate it; 2)
               true information dissipated the impact of the fraud; and
               3) Plaintiff acted despite actual knowledge of the fraud.
            (ii) Information need not actually be relied on; it only needs to
               be material, in the sense that it could be a factor that is
               considered in the decision-making process. The presumption of
               reliance is most often found in a case of an omission. Plaintiff
               needs to show that it is aware of the misstatement/omission.
         (b) Causation
            (i) Negative causation is allowed (Rule 10b-5) by Section
            21D(b)(4) of the 34 Act (Private Securities Litigation Reform
            Act). Difference between 10b-5 and Section 11 negative causation
            is that negative causation is a defense under Section 11, and a
            burden of proof for the plaintiff under 10b-5.
      (2) HYPO:
         (a) What if plaintiff believed the person making the statement was a
             liar? Reliance? Belief in the integrity of the market? Not likely. So fraud
             on the market theory presumption is not supported. What about a person
             who is completely unaware of how the market works, who bought for
             reasons unrelated to the market? Should this person get the presumption
             of reliance from the fraud on the market? Not likely, but should she be
             able to piggy back on the theory that everyone else who was aware set the
             price and she benefited? Maybe. Consider purpose for buying or selling.
      (3) QUESTION:
         (a) Does anyone really rely on the integrity of the marketplace?
         What does market integrity even mean? Does anyone really believe that
         stock prices reflect the value of the firm? Are we really saying that there is
         some sense that stock prices are “honest” and “fair”? Then does the
         ECMT theory really apply? What does all the “noise trading” mean with
         respect to the fraud on the market theory?

XI. REG. FD
A. CONCERNS:
   1. Selective disclosure hurts small firms
2. Selective disclosures can be used strategically by failing to disclose unless a good report is written; bargaining, reports are inflated and reflect biased opinions

3. Benefits of selective disclosure:
   a) keep the bad stuff private, incorporates more information into the market price; discourages disclosure of sensitive info to the marketplace; prevents people from overreacting to information given to the marketplace

4. On net, the advantages of selective disclosure were greater than the disadvantages because issuers will respond to a prohibition on selective disclosure by disclosing publicly; no affect on information available. How else might people respond? Not disclosing anything. What is the impact of that?? Much more severe implications for stock prices. Why would an issuer decide not to speak? Confidential information, bad information. What about the deterrence of the disclosure of immaterial information? There is some uncertainty about what is material and what is not.

B. WHAT DOES REG. FD DO?

1. Rule 100
   a) when issuer, person on its behalf (senior official), disclosed material nonpublic info, must make public disclosure of that information. If unintentionally, must be promptly (within 24 hours); if intentionally, must be made simultaneously.
   b) Disclosure with respect to IPO covered? No, not a reporting company (generally).
   c) Not responsible for mid-level executives, line employees, who do not fall within the scope of senior official
   d) If disclosure is in breach of confidence/trust, issuer is not liable, because not acting on behalf of issuer.

2. What is material nonpublic info?
   a) TSC definition of materiality applies, but the “mosaic” theory, which implies that immaterial information given to the analyst helps them piece together the full picture, is encouraged. Example of what should be disclosed (considered material): earnings info, M&A, new products, discoveries, contractual info, change in control/management, change in auditor or auditor status, issuance/management of stock and other financing, bankruptcy (see SEC release).

3. Reg. FD only covers selective disclosure to: broker/dealer, investment advisor, investment company, holder of issuer’s securities.

4. Exempt disclosures (Rule 100(b)(2)):
   a) person who owes duty of trust to issuer, protects confidentiality, protects the flow of business; person who has expressly agreed to maintain disclosed info in confidence; rating agencies; registered securities offerings; press; ordinary course of business.

5. HYPO:
   a) What if issuer discloses info to analyst today, analyst agrees to confidence, keeps private; analyst writes reports, analyses info, sets up program so can begin trading as soon as disclosure comes up. Is that okay? Yes, because no true breach of confidentiality, trading, even though it gives the analyst an advantage.

6. Reg. FD does not create a private right of action, and does not open door to Rule 10b-5 liability.

7. Reg. FD is good because it promotes fairness without any additional information. Another argument is that Reg. FD does not matter.
   a) Why? Calls are scripted, and everyone gets the same information, so Reg. FD is a non-event. But smaller companies need to get analysts and others interested in them, so it is an incentive if they can offer nuggets of info to certain parties. Not a public disclosure, but a permissible private disclosure.

C. REG FD FINAL THOUGHTS

1. SEC should provide more guidance on what is material (TSC is not a precise definition). Suggests offering real world factual scenarios to flesh out materiality.
   a) Earnings info
   b) Issues surrounding prior earnings
   c) plant/factory tours (smells like selective disclosure)
d) Why the concern about certainty in Reg FD, but not in 10b-5 or 10b? 10b-5 and 10b have disclosure requirements. Reg FD leaves open the option of not saying anything; not so under Rule 10b-5 and 10b.
e) SEC has a list of FAQs regarding how to interpret Reg FD and other statutes.

2. Make it easier to comply with Reg FD by making it more flexible with technology. Currently, posting on website is not enough, additional disclosure, conference calls is better. But, why not make postings on website sufficient? NYSE and NASD have on independent listing requirements that must be met. NYSE/NASD and Reg FD requirements should be harmonized.

3. The SEC should undertake a study to determine whether in fact disclosure has been chilled, affected, under Reg FD.

4. SEC should expand the safe harbor protection for forward-looking statements.

XII. CONTROLLING PERSON LIABILITY/AIDING AND ABETTING

A. WHO BEARS RESPONSIBILITY FOR SECURITIES LAW VIOLATIONS?

1. When we have a single buyer or seller who engages in fraud, it will be easy to find the liable party. But, most securities frauds do not take place in that setting. Complicated by 10-K, 10-Q, prospectuses, lawyers, bankers, accountants… Of all of these players, who is liable? Why should the issuer be liable when they are only entities managed by individuals? What about officers/directors who control the issuer, even if they are not involved in the fraud? Secondary liability is designed to get at these issues.

2. First, there must be a goal in mind when deciding to hold someone/some entity liable? POLICY: Are we simply looking for a deep pocket to compensate the defrauded party? Or, is it a deterrence, we want to create incentives for parties who are in a position to prevent fraud to, in fact, prevent the fraud (“gatekeeper” in Section 11). Why not just hold the primary violator responsible? Instead, are primary violators held to a high enough liability (strict liability? Negligence?)? Maybe we should make primary violators more liable. Or we should do both (primary and secondary).

3. Primary violator:

   a) the person who actually commits the act.

4. Secondary violator:

   a) anyone who assists the primary violator, or the person who is liable simply because of some relationship with the primary violator (direct or indirect).

5. Section 15 of 33 Act and Section 20A of 34 Act.

   a) Held liable to the same extent of the person they control. The definition of control is unclear. What must the control person have control over for the purposes of extending liability? Primary violators in higher business? Over the particular transactions giving rise to the violation? Control over transactions generally? All of the above? Dependent on the context? What about the scope of control required for liability (complete, supervision, minimal, ability to influence?) Who’s held liable (minority shareholders vs. majority shareholders, outside vs. inside directors?)

6. Two conceptual tests to determine control:

   a) Focus on person’s status only ➔ CEO therefore control person

   b) Focus on person’s function ➔ control or potential to control the primary violator? Exertion of control?

   c) See Case Supplement: TEST (majority of courts):

      (1) To show that the defendant is the controlling person, must show that the defendant 1) actively participated in the operations of the corporation in general, and 2) possessed the power to control the specific transaction or activity upon which the violation was predicated, but must not be shown that the power was exercised.

      d) 8th Circuit:

         (1) must show the real power based on the relationship

7. EXAMPLES:

   a) Outside directors serve on audit comm.. approve accounting practices that cause premature reporting of sales are control persons.
b) Control person when defendant signed misleading 10-K and was member of audit committee.
c) Outside directors were not control persons but the general counsel who was also outside director, drafted misleading statements, will be control person.

8. Why not just pursue control person as a primary violator under 10b-5 or 10b? Most courts want a little more involvement than merely being an executive. 10b-5 are interested in fraud on sale/purchase, not just disclosure. Scienter, reliance, causation, damages. Hard to prove scienter. Plaintiff need not prove everything to bring in other persons who are control persons, but need not prove fraud specifically with respect to these individuals.

9. What about attorneys/accountants? Are they control persons? Generally, no, as long as regular, routine advice is provided. Otherwise, every attorney would be a control person. But, if they actively participate in fraudulent creation of documents, can still be liable as a control person.

What about bank that extends 1.5B credit line, 30 page list of covenants. Would that be enough to constitute the creditor as a control person? Probably not. Again, deters creditors from loaning money, no control over what is done with the money, or how the business is otherwise operated.

10. Possible outcomes:
   a) Requirement of culpable participation (participated in the fraud, although not a primary violator) would make sense is trying to hold people liable for doing something wrong.
   b) Otherwise, impose liability on anyone who could have helped prevent the fraud, or were otherwise passive. Consider who is the least cost avoider. He who could have done something to avoid the fraud should be held liable. Which standard to adopt will determine the test the court applies. Corporate theories of liability (respondeat superior) do not go away just because of control person liability under these sections.

11. Affirmative defenses in these provision:
   a) Section 15(1) controlling person avoid liability “unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.
   b) Section 20A(1) acted in good faith, and had not directly or indirectly induced the acts giving rise to the violation.
   c) EXAMPLE:
      (1) If had knowledge, cannot take advantage of Section 15 defense, but if did not induce the acts giving rise to the violation, can take advantage of Section 20A (given the company is a 34 Act reporting company). Also requires good faith, and acting with knowledge is enough to breach good faith requirement. Moreover, under Section 20A, the notion of good faith subsumes some duty to monitor/supervise. So, assuming no knowledge, can take advantage of Section 15, but if no system in place to monitor/supervise those engaged in the fraud, notwithstanding no knowledge, that may not be enough to say no good faith, so cannot take advantage of Section 20A.
   d) Hollinger v. Titan Capital Corp.
      (1) Wilkowski embezzled money from four clients, plaintiffs sought recovery from accounting firm and brokerage firm. Wilkowski was a contractor/registered representative of Titan. No argument that Titan had actually authorized Wilkowski’s embezzlement (controlling person case). DC required Titan, as control person, exercise actual power/influence over Wilkowski, and that Titan be a culpable participant in the act. Found Wilkowski was an IC over whom Titan had no control, received no benefit, no duty to supervise unauthorized transactions. DC focused on actual culpability of alleged control person, and less on whether Titan was the least cost avoider. Court of Appeals found a brokerage firm is a control person under Section 20A. Reasoning: Broker-dealers have a duty to supervise their registered representatives. Basis for imposing broad duty was the goal of section 20A to prevent the investing public from facing the risk that representatives would be...
unsupervised. 20A is about creating the right incentives to monitor/supervise. Broker/dealers, as a matter of law, are controlling persons for 20A. No culpable action required. There is some duty to monitor/supervise, and that tried to discharge duties under the system. Finally, there is no exception for independent contractors. Is an IC no longer under the control of the controlling person? No, it does not negate the existence of the controlling person relationship for purposes of Section 20A.

B. SECONDARY PERSON LIABILITY

1. Aiding and Abetting liability for securities fraud
   a) attorneys, accountants, etc, used to be liable under Rule 10b-5, and there was a private right of action, until Central Bank.

2. Central Bank
   a) aiding and abetting is no longer a basis for private action under 10b and Rule 10b-5 (overturned every other case up to date). Their analysis was an “approach” analysis. What approach did the majority take? Strict constructionist approach to the interpretation of the statute. No discussion of aiding and abetting? No private right of action. Always start with the statutory language. But, this decision was criticized by several people.
   b) Central Bank decision in the context of Enron, makes it more difficult to get the ancillary players for liability in private action (Anderson, lawyers, etc.). Now, must get them as primary actors, and must prove scienter for each one (very difficult). Also, many folks say this retrenchment undermines the deterrent effect because it is much less likely that any one party will be found liability under securities fraud (10b-5). Too lax in the enforcement of 10b-5. Sets the stage by pulling back 10b-5 liability and not creating a disincentive to avoid fraudulent conduct. So, do we need a statutory fix to overturn Central Bank?
   c) What did the dissent say? Did not refute the statutory construction of the court head-on, but they said even though it might be the case that the majority is right, at this stage in the game (previous case law saying there is a private right of action for aiding and abetting), it is not the job of the SC to overturn the law of the land. If Congress is not pleased, it should remedy the problem by making it clear that there is no private right of action for aiding and abetting. But, is it too low a standard to say that if the trial courts like it, it must be so? Isn’t it the SC’s job to determine what the law should be? Also, the parties did not address the issue of PRA until the court asked them to brief it. They assumed that the PRA existed and was not an issue for debate. Maybe decision should just focus on the issue raised.
   d) The SEC still has a right to enforce Rule 10b-5 and Rule 10b, and has enforcement actions on aiding and abetting theories. Recognize that it was not always the case that there was any PRA under Rule 10b-5. It took the SC to find an implied PRA in a prior case, so one could see that it’s not necessarily inconsistent for the SC to say that the SEC can find aiding and abetting, but prevent private individuals from bringing suit.

C. PSLRA (PRIVATE SECURITIES LITIGATION REFORM ACT)

1. Section 20E was added to the PSLRA and authorizes the SEC to bring enforcement actions against “any person that knowingly provides substantial assistance to another person”. Does this section permit the SEC to bring an action for reckless aiding and abetting? Rule 10b-5’s scienter requirement includes recklessness, does 20E? Where is the tipping point between aider/abetter and being a primary violator? Central Bank does not address this issue. But in the post-Central Bank world, courts have focused on the degree to which the individual was a substantial participant.

2. EXAMPLES:
   a) 9th Cir – primary participant liability was sufficiently pled when allegations were such that accountants/underwriters has significant role in reviewing, drafting, editing reporting documents and deliberately chose to conceal truth. Attorney who misrepresented when speaking to investor is liable as primary participant, even when does not have full knowledge of the investment. Accountant primary participant when
knew financial statements were misleading and would be circulated among investors. 
Always need to find scienter requirement.

3. Accountants have a related duty added by the PSLRA (Section 10A of 34 Act). Imposes affirmative duties on CPAs when they become of the illegal act by their client. To whom is the illegal act disclosed? First, determine whether or not it has a material impact on the financials. Second, if material, bring to the attention of the appropriate level of management (CFO, etc.) and to the attention of the Board or Audit Committee, if executives do nothing. If the entire corporation does nothing, the auditor has a duty to give notice to the SEC.

4. In addition to participating in the preparation of financials, auditors also certify them. Perhaps the easiest basis on which to get the auditor when they certify.

5. Most important contribution of PSLRA is its effect on pleading standards, especially pleading fraud under 10b-5 in a private action (specifically class actions). See 21D of 34 Act. To date, we’ve discussed the substantive standard of scienter. But this gets at how to plead scienter so to survive a motion to dismiss.

6. The changes in this area (pleading standards) took place in the following context: At the time, both house and congress were controlled by republicans, who don’t like law suits. Also, there has been a perceived explosion of securities litigation. Led to general need to curb securities class actions. Why? 1) All these lawsuits did was help the plaintiff’s bar; 2) litigation has become an “epidemic”; 3) what was really happening was that companies were being punished every time their stock price moved significantly, whether fraud or not; and 4) many cases were settled due to the nuisance value, even if no validity. Data on both sides of the story…

7. Most important weeding-out mechanism is the heightened pleadings requirement. Before the heightened pleadings standard (especially with respect to the scienter requirement), the rule was FRCP 9b. Said that fraud had to be plead with particularity, but that the state of mind element may be averred generally. This lead to a lot of confusion about what had to be pled to satisfy the FRCP rules. Before PSLRA, a view started to emerge (remember TimeWarner case – needed to be able to attribute the fraud to someone specifically). Plaintiffs must plead enough to give rise to a strong inference of fraud under 10b-5. The strong inference standard of TimeWarner was codified in PSLRA 21D(b)(2) and 21D(b)(1). Must plead with particularity and must give rise to a strong inference of the required state of mind. Under 21D(b)(3), discovery is stayed while the court figures out the motions to dismiss. Prevents plaintiff from getting additional evidence to plead with particularity. So, must have all the information ahead of time or case gets dismissed. Difficult! The point, from a policy matter, is to keep frivolous cases out of court. So, scienter is where the big change is under the PSLRA.

8. So, how do you plead particularity enough to give rise to a strong inference? 2nd Circuit approach: (originated standard under FRCP 9b regime) – plaintiff must plead 1) actual, factual data, evidencing scienter, or 2) at least strong circumstantial evidence of conscious misbehavior or recklessness; or 3) strong motive and opportunity to commit fraud. In re Silicon Graphics. 9th Circuit disagrees with the strong inference approach of the 2nd circuit (specifically rejects it).

9. In different part of TimeWarner, pleading issue arose, court found strong inference standard of circuit was met under strong motive and opportunity prong of the test, to satisfy the pleading standard. What was the motive/opportunity? To keep the stock price up. Does the argument make any sense? Isn’t that the motivation for every firm? What does that imply about their control over the price and the ECMT? Isn’t the price supposed to reflect the value? How can stock be issued at a high price when the information about the offering is not disclosed?

10. Judge Winter is a big wig 2nd Circuit judge whose securities opinions should be paid attention to. He makes the argument that the majority’s opinion makes no sense because of the circular reasoning described above. Majority rebuts with the fact that the law of economics have not reached the reliability and veracity of the law of gravity. What about the market theory in Basic v. Levinson? In Basic, we looked to economics to find a way to presume reliance in order to preserve the lawsuit, but TimeWarner ignored economics to preserve the lawsuit. Do the ends justify the means? How much weight should we put on the argument versus the outcome.

11. Other issues to consider:
   a) Keeping stock price up?
   b) Raising capital
   c) Secrecy to facilitate merger/acquisition
d) Insider trading (holding vs. disclosing something fraudulent to take advantage of arbitrage)

e) Individual benefit

f) Motive and opportunity will be very important when there is no “smoking gun”.

12. In Re Silicon Graphics

a) Must plead with particularity and have a strong inference of scienter. According to the 2nd circuit approach, nothing about the PSLRA has an implications as to the substantive elements of scienter.

b) 9th Circuit – pre-PSLRA under 9b, had most liberal view of pleadings requirement. Now, most stringent. SC is considering taking a 9th Circuit case to resolve circuit splits about the pleading standards. Plaintiff “must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious conduct.” Also, simply showing motive and opportunity, or mere recklessness, are not enough to satisfy the deliberate recklessness adopted by the court. The case really demonstrates how hard it is to plead scienter. What may have been good enough in the 2nd circuit is not good enough in the 9th circuit. Purpose of PSLRA is to heighten the pleading standards, so cannot look to 2nd circuit – acts as a floor on the standard. 9th circuit rejects 2nd circuit approach.

c) 9th circuit has been subject to a lot of criticism because it has changed the substantive standard of scienter. Why? Now, have to plead, at a minimum, deliberate recklessness (more than mere recklessness of Ernst & Ernst). Seems that the new substantive standard of recklessness is deliberate recklessness to get into court, so the new standard for scienter is no longer mere recklessness. What does it mean? We don’t really know, but the “higher” standard helps limit class actions and other frivolous lawsuits.

13. What happened to stock prices when PSLRA was adopted, given intended to limit lawsuits, and individuals would have no recourse? In the near term, stock prices increased, because many of the suits were frivolous. Would rather trade bad suits for more certainty.

14. So, now what? Complain to the SEC and force them to bring action. Or, bring action in state court under common law fraud. In 1998, Congress adopted regulation preempting securities fraud claims brought under state law; separate fiduciary duty breaches can be brought in state court, but securities based claims cannot.

D. FINAL POINT:

1. Lead plaintiff provisions.

   a) PSLRA adopted changes with respect to lead plaintiffs to encourage more participation by institutional investors in class actions. Would rather have sophisticated clients as the lead plaintiffs that less experienced attorneys with individual investors who happen to get to the door of the court first. Procedure to establish lead plaintiff: appointed by court, chooses counsel, counsel becomes counsel for class.

XIII. PLAINTIFF’S DUE DILIGENCE (10B-5)

A. Dupuy v. Dupuy, 5th Cir. 1977 (also read notes on 1342-1344)

1. 10b-5 due diligence defense; there is considerable disagreement about whether there is a valid due diligence defense, and no consensus as to what it looks like.

2. What does it mean for the plaintiff to have failed to use due diligence? Is it enough of a defense for the plaintiff to have been negligent in not investigating the security, or must the plaintiff have been at least reckless in not conducting some sort of an investigation into the security and the particular trade.

3. Some unfriendly family relations (brother v. brother); Clarence bought stock from Milton. Claims Clarence made misstatements about the value of the stock to purchase from Milton at a discounted price. Court says Milton cannot borrow on his interest because he had no means of paying the debt. The concern was that he had no money, collateral, was not working or managing the property, so even if he borrowed against his assets, he would not be able to make the cash principle statements. Milton needs money and approaches Clarence about buying Milton’s shares.

4. Had to sole rely on Clarence to develop the business; he was not participating on his own, even though he owned 47% interest in Lori Corp.
5. Clarence says things aren’t going well, but business is actually great. All the details about the meetings on 1332 are accurate descriptions of normal negotiations.

6. Milton never knew what was going on, even though he was on the board, and should have received board resolutions. Resolutions that authorize individuals to sign contracts, avoids agency problems. But, if no resolution, no respect for corporate formalities, no validity to contract signatures.

7. Will plaintiff be denied recovery because he failed to investigate his brother’s conduct? Does the plaintiff have a due diligence obligation? What actions must the plaintiff undertake to show due diligence.

8. Court says must take some effort, a due diligence defense exists. But, what is the defense? What does the plaintiff have to do? What is the standard of care?

9. Why do we have a due diligence defense at all? Promotes equity and antifraud behavior. Holds the plaintiff responsible for protecting its own interest in equity. And investigating promotes market stability by eliminating antifraud behavior. If we put the burden on the plaintiff to take some steps, it creates an incentive to investigate, which helps prevent fraud.

10. STANDARD: Adopts recklessness (rejects negligence). The diligence of the plaintiff is to be judged subjectively, not objectively. Also, the negligence standard is rejected, and the plaintiff must have “intentionally refused to investigate in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.” Ernst & Ernst also identifies that scienter requirement (at least recklessness) applies to all of 10b-5, and should be extended to the due diligence defense. This standard is a comparative fault type standard. Scienter requirement also reigns in the scope of 10b-5. May be too narrow if defense is premised on negligence. Finally, policy of deterring intentional conduct is more important than a policy of deterring negligent conduct.

11. Conclusion: Milton was not reckless in his investigation.

12. Final thoughts:
   a) Milton had talked about Lori with Clarence, plaintiffs have never been required to investigate beyond corporate officers. Should we start to require that plaintiffs engage in a broad-based investigation? If the plaintiff is a director, owner, operator, AND the plaintiff does not trust the officer, then maybe we should require a broader investigation. What if Milton was not sick? Different standard? Probably. Then, time isn’t spent doing other things that should be business related, or should be looking for work in another business (because brother cut off funds). Again, is it reasonable to assume that the partner is being honest, or has been honest? If the test was objective, rather than subjective, would we care?
   b) Now, assume a true intent to deceive. Should there still be a standard of reckless due diligence defense? Or should there be a true intent due diligence defense (true intent to be deceived)? Not according to the court.
   c) What role for the due diligence defense in the context of market transactions? Should there be a due diligence defense that applies? What would we essentially be saying if plaintiff had to satisfy due diligence defense against a company like Enron? Plaintiff needs to engage into some independent investigation into the company (not 10-K, 10-Q, conference calls, etc.), but must investigate further. Is that reasonable? No. How would it be done, and even if it could be done, how “easy” is it to do? It’s not. So, there is no due diligence requirement in market transactions.