1933 Act – prohibits the offer or sale of a security unless the sec has been registered with the SEC; it also requires the delivery of a prospectus to a purchaser and to other persons to whom a written offer is made.

1934 Act – Publicly held cos must enter is continuous disclosure system and file annual and quarterly reports with the SEC, and also must preclear proxy statements with the SEC before soliciting SH proxies or votes.

**Definition of Security and Exempted Security**

- first thing to always do is to look to the goals of securities laws. Then, look at substance over form.
- purpose of the sec laws are to regulate investments.
- In interpreting the term security, form should be disregarded for substance and the emphasis should be on economic reality

2(a)(1) –

- (specific test of security) includes notes, stocks, bonds, debentures
- (general catch-all phrases) includes more ambiguous catch-all phrases → evidence of indebtedness…and any instrument commonly known as security
- If it is a security, you have to register it with the SEC

**Howey test to see if it’s an investment K – limited to investment Ks, doesn’t extend to stocks**

- An investment K is any K or profit-making scheme whereby a person invests his money in a common enterprise and expects to make a profit solely form the efforts of the promoter or a third party who is responsible for management.

1) investment of money
2) in a common enterprise
   a. the fact that the return of each investor depends on their own efforts doesn’t undermine a common enterprise in this case → pyramid scheme
   b. Vertical commonality – commonality bw investor and co → may not be commonality among investors, but they are connected by their relationship to the promoter. The enterprise is the hub into which all these guys feed.
   c. Horizontal – there is a pooling of investor funds; an intention to involve multiple investors can result in horizontal commonality
3) an expectation of profit
4) solely from the efforts of a promoter or third party → keep in mind the ability or the intent of the investor
   a. solely really means “predominantly.” We use a functional approach as opposed to a literal approach – this is in response to the pyramid
approach where the investor had to put in some effort – people were trying to dodge the definition of an investment K by giving the investor a meaningless job (investor can participate on a nominal or limited basis).

5) Might want to consider whether the investors need the protection of the 1933 Act

Economic realities test: downsizing the definition of security
- something that’s called a stock isn’t necessarily a stock. Labeling isn’t dispositive. Co should bear the risk of the confusion, they could have called it something else.

Stock
- If so called “stock” possesses the characteristics normally associated with stock – it carries dividend and voting rights, it is negotiable, it can be pledged, and it can appreciate in value – then it is a security under the 1933 Act
- *United Housing Foundation v. Forman*
  o If so called stock lacks the normal indicia of stock, then the cts may look to the economic realities of the situation to determine that no securities Is involved.
  o The ct in this case refused to hold that the sale of stock in a nonprofit housing cooperative involved a security. The stock lacked the usual indicia of stock: it was not transferable, there was no right to receive dividends, etc. The purchasers essentially bought living quarters for their persona use and were not investing in stock
  o So, it’s not the end of the story that it’s called a stock.

*Landreth Timber*
- A purchaser of 100% of the stock in a corp can bring a claim under the 33 and 34 Acts, even though the transaction involved the purchase of an entire business, and even though the parties could have structured the transaction so as to avoid transferring stock
- stock is a security even though it was the purchase of a business ➔ when you buy all the shares of a co, you get all the managerial control, so you’re really in a business transaction rather than an investment one ➔ this argument is rejected
- Stocks aren’t investment Ks
- When an instrument is called a stock and bears a stock’s resemblance a purchaser justifiably may assume that the fed sec laws apply

Notes
- promise to pay somebody
- 2a1 – security includes any note
- 3a3 – arises out of a current transaction and that will mature in 9 months
- Cts generally don’t include – home mortgage, consumer installment purchase, any types of commercial financing.
**Reves v. Ernst and Young**

- To determine if a note is a note for securities purposes ct adopts the **Family Resemblance Test** – to determine whether a note is a security, cts apply the family resemblance test. The test includes a presumption and exceptions to the presumption.
  - First, any note is presumed to be a security (the def of sec includes “any note”)
  - This is a rebuttable presumption – it is not a note if it resembles one of an enumerated list of things that are not considered notes for fed sec law purposes (there is a list on p355)
  - If the note doesn’t look like one of these things we can still keep going and still say it may not be a note by creating a new category of notes to exclude.
    - Standards must be developed for determining when an item should be added to the list - 4 factors to determine the family resemblance
      - examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into the deal. If the sellers purpose is to raise money and the buyer is interested in profit, the instrument is likely to be a security
      - Plan of distribution – is there common trade for this instrument, and is there a market of people
      - What are the reasonable expectations of the investing public – did they think what they were buying would be considered a security?
      - Is there some other feature such as the existence of another regulatory scheme (like fed banking laws) that reduces the risk of the instrument thereby not needing the fed sec laws?

**Regulation of the Distribution of Securities**

- focus of the 33 Act is the preparation and filing in preparation to offering to the public. But, not all securities are offered to the public
- **Goals of the 33 Act**
  - Distribution of info to the public of new issues of securities offered for sale to the public
  - Prevent fraud
- **33 Act only applies when there is interstate commerce involved**
- There are some problems to going public. There are alternatives – PP, borrow from the bank, finance operations out of retained earnings
- All the stuff we’re going to talk about isn’t limited to IPOs
- **Sec 5 of the 33 Act:** provides rules concerning the making of offers to sell and the actual sale of securities through the facilities of interstate commerce. Divides the underwriting process into 3 time periods related to the sequence of events in the
registration process: Pre-filing period, waiting period, and post-effective period. Then, it sets forth rules regulating offers and sales of securities during each of these periods. *(Sec 5 rules for making offers and sales in the 3 periods apply only to issuers, underwriters, and dealers)*

- **IF** you’re going to offer to the public, you have to register them with the SEC, which requires making a bunch of disclosures
- The key provisions around which the 33 Act revolves
- A key part of the registration process is the delivery of the prospectus, which discloses material info; this has to be disclosed before the sale and delivery of a security. Prospectus is the means by which the disclosure is made. Look at 2a10 for def of a prospectus (broad def). Sec 10 prospectus is the one that meets the requirements of sec 5. 2a10 says all these things are considered a prospectus, but a sec 10 prospectus is a certain type of prospectus which has to be distributed to close the deal.

### Sec 5

- Sets forth registration requirements
  - **5c** – prohibits offers to sell or buy securities unless a registration statement has been filed
  - **5a** – you can’t sell if the securities are not registered (securities can’t just be filed, but has to be effective by the SEC)
  - **5b** – prospectus requirement – prohibits sale or delivery of securities if it’s not accompanied by or preceded by a prospectus as defined by sec 10.
- Face to face meetings (not interstate commerce) – short of this, you’re probably going to satisfy the jurisdictional reach of sec 5

### 3 time periods in the life of registration

**Pre-filing period (5c land)** – can’t say anything – during the period when an issuer is contemplating a public offering of its securities – but before a registration statement has been filed with the SEC – it is unlawful for issuers, underwriters and/or dealers to buy or offer to buy or to sell or offer to sell the issuer’s securities (when means of interstate commerce are used)

- **Sec 2a3** – *an offer to sell is any attempt to offer or sell a security for value.* An exemption to the definition of sale – negotiations with the underwriter → if we didn’t have this exception, there would be no way for the registrant to be able to work out the offering with the underwriting. Plus, the underwriters are a key part in the registration process.
  - The reason for this is that we don’t want investors pre-sold on the issuer’s securities by info other than that contained in a registered prospectus
- The first thing you do once you decide you want to issue a security is you have to file a registration statement. You call up an underwriter, then you assemble a big team. The job of the lawyer is to make sure the co discloses
everything they are required to disclose and to make sure it gets done and
done on time. You only have to disclose what’s material.

- **The key point is that you can’t make an offer, either oral or written, or**
  **an attempt to offer prior to the filing of a registration statement.**

- **GUN-JUMPING** – The SEC may say that if you jump the gun there needs
to be a cooling down period. This may be a big deal.
  - You can disclose purely factual information, but you can’t do
    projections, forecasts, opinions, and those sort of things. No bright
    line rule.
  - **Rule 135 checklist approach** – provides additional clarity on what
    you can say without running afoul of 5c. It generally allows the co to
    put out a notice which says that there will be an offering such as a
    tombstone ad.
    - To provide objective guidelines as to what info can be
      disseminated by issuers in news releases, the SEC has adopted a
      checklist for such releases. Some cts say that this is exclusive of
      what can be released during pre-filing

- **No conditioning of the market:** The term “offer” has been held to include
  the dissemination of any material that might condition the market prior to the
  actual offer of securities for public sale pursuant to a registration statement.

- The section 5(c) restrictions on disclosures during the pre-filing period may
  conflict with other policies of the securities law requiring that a co with
  already publicly traded securities disclose material info to the investing public
  ➔ **limited to factual reports**

**Waiting Period**

- Period bw filing and the effective date
- Securities can be marketed either through oral offers or thru certain written
  communications, but sales must not be concluded.
- Written offers are regulated:
  - Sec 5(b)(1) prohibits the use of prospectuses during this period
  - **Sec 2(10)** defines prospectus to include almost any written
    communication (plus television and radio advertisements) regarding the
    securities except the communications below.
- However, sec 5a prohibits consummation of the sale bc the registration isn’t
  yet effective ➔ can make offers, but can’t close the deal.
- Prospectus
  - 5b1 says you can’t deliver a prospectus during the waiting period unless
    it complies with sec 10
  - 5b2 – to close a deal it has to comply with sec **10a** (distinction from 10)
    – what has to be in the final prospectus
  - **10b - Red herring** – (preliminary prospectus) – the concept of a red
    herring is different from a 10a prospectus. Traditionally it pertained to
    a final registration statement that didn’t adhere to 10a.
The practical result is that you would get info out there to get interest using the red herring during the waiting period, even though it doesn’t follow 10a – still can’t consummate the sale.

10a’s aren’t effective during the waiting period bc we don’t have all the info needed to complete the 10a prospectus during the waiting period. So, when we file, it will be necessarily incomplete.

10b says that it realizes that you can’t comply with 10a in the original filing bc you don’t have all the info, so it allows a prospectus, for the purpose of 5b1 (arousing interest), that is necessarily incomplete. Allows the SEC to put out rules to allow a prospectus that is almost complete.

- So, a red herring doesn’t meet the requirement of 10a in the original filing bc you don’t have all the info, so it allows a prospectus, for the purpose of 5b1 that is necessarily incomplete.

  - So long as you comply with 430A, you can use the preliminary prospectus, and distribute it during the waiting period and be incompliance with 5b1. Once the registration statement becomes effective and a complete prospectus is available, use of the preliminary prospectus must be discontinued.
  - A sec 10b prospectus satisfies the requirements of 5b1, but does not comply with 5b2 which says you have to have a prospectus that complies with 10a
  - 10b is only good for waiting period.

W other written means by which you can arouse interest

1) tombstone ad – short announcements about a proposed offering of registered securities that typically appear in publications; can’t use during pre-filing bc it’s an offer
2) identifying statement – longer version of the tombstone ad.

Summarizing

- there are generally 4 ways under 33 Act and applicable rules to reach potential investors
  - oral offers
  - tombstone ads
  - identifying statements
  - preliminary prospectus (red herring)

Testing the Market

- underwriter wants to go out and test the market, what’s the interest in the market
- 5b1 doesn’t prohibit oral engagements, so there is a lot of talking around
- Rule 134d – can solicit indications of interest which say when you go public, I want so many shares
- Road Shows – series of meetings that the underwriter holds with potential investors where the co orally presents the co and hands out initial prospectuses. What you can’t do is distribute a writing that might constitute a prospectus that doesn’t comply with 10b. But, you can have a 10b prospectus. These are done electronically now. This is okay so long as the audience is limited to institutional investors or those who would show up at the actual meeting. We are concerned with limiting access to the electronic road show bc it starts to look like TV, which is illegal.

- So there is a lot of intense oral selling, which includes selling and solicitations of interest which will be consummated when the effective period hits.

- There is some concern that the final prospectus isn’t delivered until the investment is consummated

**Post-Effective Period** – objective of the 33 act during this period is to see that all purchasers receive a copy of the final 10a prospectus, called the statutory prospectus, which summarizes the investment information contained in the registration statement.

Once the registration statement becomes effective and a complete prospectus is available, use of the preliminary prospectus must be discontinued.

- you can close the deal

- On or before consummation, you have to deliver a final 10a

- T + 3
  - Under 5b1 certain pricing info may be excluded in the 10b prospectus
  - Rule 430A allows the same price info to be excluded from a 10a prospectus
  - We agree to do the deal 3 days later, the execution is settled
    - What has to happen before the 3 days are up is you have to give the final 10a prospectus
  - the information that is traditionally supposed to be included in the final prospectus can be delivered in a piecemeal fashion.
  - So you deliver the 10b during the waiting period, when you go effective you include the supplemental info that has been left out of the 10b – so now the requirements of the 10a prospectus has been met.
  - You have to have the term sheet out there before the confirmation

- Under certain limited circumstances, you can deliver some or all of these documents electronically, but you have to first have the buyer’s consent and you need evidence that you’ve delivered it, and simply posting the info on the website isn’t good enough, you have to actually deliver it

- EDGAR – this is how you file all SEC documents these days

The issuer should update the prospectus any time new material facts develop, since use of a prospectus which is misleading as to a material fact can result in liability.

Sec 4 exemptions break down into 2 key parts
- Sec 4(1) – exempts transactions from sec 5 other than from an issuer, underwriter or dealer → need this for the secondary market to function, so I can trade securities without having to follow sec 5
- Sec 4(2) – exempts offerings that aren’t public offerings

**Disclosure Policy and the Debate over the Efficient Market**
- **Efficient Cap Market Thesis** – generally, is used to describe the relationship between the disclosure of info and stock prices.
- Efficient if all available info is incorporated in the securities price. It doesn’t mean that everyone reaches the same opinion
- Three different forms of efficiency
  - Strong – reflect all info, pub and non-pub
  - Semi-strong – reflects all pub info → insider info helps you beat the market
  - Weak – reflects all info from historical stock price info
- The first thing we need to have to incorporate info is to get the info → disclosure
- Now info has to get to the people who can do something with it → analysts
- The problem with all of these gatekeepers, particularly the accountants, lawyers, and underwriters, is that of **conflicts of interest**. We care about the conflicts because we need to instill confidence in the market. We rely on the info of the gatekeepers. We solve the conflict in terms of the analysts and the underwriters by drawing a wedge between them in terms of compensation structure
- Is a market fundamentally efficient if it is informationally efficient? Usually not, there is a lot of noise and psychological factors
- **Mandatory disclosure**
  - Public good inefficiency
  - Promotes fairness – makes info available to everyone

**Integrated Disclosure**
- Reporting co – cos that have to report under 1934 Act
- A co is required to file (report) under the 34 Act as follows
  - 12b – if you have a class of securities that’s listed and classified on an exchange, you have to register these – co has to report
  - 12g1, in conjunction with 12g4 – if you’re an issuer with assets of 10 mil and 500 holders, you have to report whether or not you’re listed on an exchange and whether or not, you’re registered under the 33 Act.
  - 15d – if you have securities outstanding that you registered under the 1933 Act, then you have to comply with the 34 Act reporting requirements
  - 13 – tells you what you need to file (Qs and Ks)
- The goal of integrated disclosure is to simplify registration process under the 33 Act for 34 Act reporting cos, seasoned issuers. We want it easier because it’s cheaper.
- As a practical matter, it means a reporting co under the 34 Act can take advantage of their filings under the 34 act when they’re required to do a registration under the 33
Act. Specifically certain issuers, namely those who report under 34, can satisfy a chunk of their disclosure under the 33 Act by incorporating by reference to their 34 Act filings
- This assumes that everything in the registrations and in the filings have comparable quality.
  - Form S1 – permits the least amt of incorporation by reference. This form is the general form used for the registration of the securities of most companies unless another form is prescribed or authorized
    - If you’re a non-reporting co, you have to use S1 → no integration by reference. This makes sense, if they aren’t filing under the 34 Act, you can’t do it by reference.
  - Form S2 – allows those companies that qualify, to incorporate certain 34 Act filing info by reference and either to deliver their annual reports to potential purchasers or to include substantially the same info in the prospectus to investors.
  - Form S3 – requires the least amt of disclosure and incorporates by reference 34 Act reports filed by the issuer. To use form S3 in a particular transaction, the issuer must meet the registrant requirements and the transaction must meet the transaction requirements

**Shelf Registration – authorized under Rule 415**
- Many issuers are almost constantly involved in issuing new securities. It would be convenient for such issuers to simply prepare one registration statement, thereby registering all securities that they may offer at any time in the future.
- Problem – inadequate disclosure; info in the prospectus may become stale, and it may be deceiving to stretch the offering over time
  - 415a3 – you have to file post effective amendments to preserve the timeliness of the info in the prospectus
- 415a2 – the amt of securities that can be on the shelf must be limited to what the issuer can reasonably expect to sell on a continuous or delayed basis over a 2 year period.

**MD&A**
**Item 303 of Reg S-K**
- Issuers must include an MD&A section in registration statements. This section affirmatively requires a certain amt of forward looking disclosure
- Calls for a narrative description of the cos performance
- IN addition to explaining the **financials**, you have to disclose known material changes, trends and uncertainties that are likely to have an effect on the cos business prospects → forward looking statements about known trends – liquidity, cap resources, performance of divisions of the co, and changes in the co.
- Intended to give the investor an opportunity to look at the co through the eyes of management by providing both a short and long term analysis of the business of the co. It requires management to address key variables and other factors peculiar to and necessary for an understanding and evaluation of the individual co.
- SEC has made the MD&A an enforcement priority.

- **Disadvantages**
  - You have to disclose a bunch of info that you don’t want the competitor to have
  - Concern about litigation with forward looking statements be the investor relies on this, and it might not happen, and the investor with the benefit of hindsight can see you’re full of shit. The concern about using forward looking statements to mislead is a concern.

- **Safe Harbors**
  - Rule 175 under 33
  - Rule 3b6 under 34
    - These provide safe harbors for types of forward looking statements shall be deemed not to be fraudulent if there is a reasonable basis and said in good faith.
  - Sec 27a of 33
  - Sec 21e of 34
    - These encourage cos to make more voluntary forward looking statements. These provide safe harbors if the statements are accompanied by a meaningful cautionary statement.

**The Private Offering Exemptions: Sec 4(2) and 4(6)**

**sec 4(2) of 33 – exempts transactions from sec 5 by an issuer not involving a public offering**

- effectively a self executing regulation – just have to bear the burden of proof if challenged

- The registration requirements of sec 5 apply only to an offering of securities that is made to the public. Therefore, transactions by an issuer that constitute a private offering of securities are exempt from registration

- Whether an offering will be considered to be private under sec 4(2) and hence exempt from registration, is a question of fact in each case. The party claiming the exemption has the burden of proof to show that the offering is private.

- An understanding of the private offering exemption requires knowledge of both the statutory exemption under 4(2), and the rule 506 safe harbor under Reg D.

- You are still subject to the anti-fraud provisions even if you don’t have to register the securities

- We’re not worried about sec 5 registration when selling to an institutional investor be they can take care of themselves – they are sophisticated can get the data and they know how to analyze it → info, expertise, and bargaining power; therefore, no need to adhere to sec 5
- Some investors want registration rights so they can resell the stock they bought in the private offering.

- Scope of the 4(2) exemption to sec 5 registration – early SEC actions provided some initial guidance for 4(2) as far as what’s a public and what’s a private offering.
  
  - **Number of offerees** (different from number of purchasers) – generally, the more offerees, the more likely it’s public.
  
  - **Availability of info** – point of sec 5 is disclosure.
  
  - **Nature of offerees** – are they sophisticated, are they able to bear the investment risk.
  
  - **Manner of offering** – there better not be a general ad or a public announcement.
  
  - **Limitations on re-sales** – the purchase must be for investment and not with the view for resale or distribution.

  1) We care about limitations on re-sales bc we don’t want people to get around sec 5 and backdoor into a public offering.

  2) Securities that are purchased under 4(2) are not registered securities, they are often referred to as restricted securities bc there are restrictions on ability to resell. Can only resell under certain circumstances.

    - The investor registers the shares (if they get registration rights from the issuer or
      - Cos don’t want to give registration rights bc if the investor registers, it may force the co to go public.
    
    - If there is some other exemption the investor can rely on to resell the securities.

**Ralston Purina – need for protection of 33 Act**

- Ralston sold stock to all of their EEs who were of all different sophistications.

- Ct says that public doesn’t mean it has to be to the world. You can’t just define an arbitrary group → there has to be some commonality to the specific group and the reason for the issuance.

- **The test the ct sets out is that an offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering → key is whether the offerees can fend for themselves. ALL the offerees have to be able to fend for themselves, 90% isn’t good enough. Ct doesn’t adopt a bright line numerical test for the number of offerees the issuer can offer to.**

- Ct comments on access to info → certain offerings to certain true key EEs may fall under the private offering protection be they have access to the info. It’s not about title or status; it’s about the starting presumption that the offeree has access to the requisite info.

- If you can fend for yourself, private offering is available → access to info and sophistication.

**Sophistication**

- cts look at
- how much money the offeree has,
- what their experience is with investing,
- what type of formal info they have,
- what types of jobs they’ve had in the past,
- is this person in a position to bargain for himself or herself – will they know the questions to ask, have they ever bought in a private offering before,
- do they have a prior relationship with the offeror → are they knowledgeable enough to ask the right questions, demand and get the info they need to make an intelligent investment decision, appreciate and bear the risk of securities investment

**Information**
- As a check list of the type of info you want, look to a registration statement
- There is not a bright line rule – you would be safe if you gave a type of prospectus which is a disclosure doc
- Do you actually have to give it to them or just make it accessible to them? Well, just making the info accessible isn’t that helpful for those only partially sophisticated bc they might not know the questions to ask.

**Number of Offerees**
- No bright line rule – the more the offerees, the weaker your argument that this is a private offering.

**Rule 701 of 33**
- provides for non-reporting cos (non-34 Act cos) an exemption from registration for compensatory EE benefit plans
- The theory is that these plans aren’t designed to raise capital, but rather to compensate EEIs and to bind them to the co.
- Can also be used to compensate consultants and advisors

**REG D**

*Never really sure if we’re complying with 4(2) – so the uncertainty sucks. The solution is to provide Safe Harbors – REG D*

**REG D – doesn’t apply to control persons** (someone having the power to direct the management and policies of the issuer)
- if you comply with Reg D, you can be exempt from sec 5
- can’t use if you’re a reporting co under 34 Act
  - 12b – if you have a class of securities that’s listed and classified on an exchange, you have to register these – co has to report
  - 12g1, in conjunction with 12g4 – if you’re an issuer with assets of 10 mil and 500 holders, you have to report whether or not you’re listed on an exchange and whether or not, you’re registered under the 33 Act.
  - 15d – if you have securities outstanding that you registered under the 1933 Act, then you have to comply with the 34 Act reporting requirements
- If you clearly comply with 4(2) you’re good.
- **504** – cap at 1 mil, no restriction on number of purchasers, no sophistication requirement, and no disclosure requirement
  - set cap on the max aggregate offering under 502; the cap is 1 mil
  - Exemption for offers and sales not exceeding an aggregate offering price of 1 mil during any 12 month period.
  - No limitation on number of purchasers
  - Resale is restricted
  - No affirmative disclosure obligation

- **505** – cap at 5 mil, restriction on number of non-accredited purchasers, no sophistication requirements, disclosure requirement
  - Aggregate offering price in any 12 month period does not exceed 5 mil.
  - Unlimited # of accredited, only 35 non-accredited
  - There are affirmative disclosure obligations to the non accredited investors
  - Restrictions on resale

- **506** – no cap, restriction on number of non-accredited purchasers, sophistication requirements, disclosure requirement
  - If you comply with 506, you are deemed to comply with 4(2)
  - There is no limit on the aggregate offering price
  - Can have no more than 35 non-accredited investors as purchasers, but can have unlimited accredited
  - Affirmative disclosure with respect to non-accredited
  - Big difference bw 506 and 505, with 506 non accredited purchasers or their representatives must meet certain sophistication standards, or the issuer has to reasonably believe that you’re sophisticated even if it turns you that you’re not.

506 is available for any offering of any size, but it imposes the most stringent requirements; 505 is available for offerings up to 5 mil and has the disclosure requirement and limit of investors, but there are no sophistication requirements; 504 – not stringent, but can only issue 1 mil. The larger the offering, the more stringent the requirements.

**Accredited Investor**

- **only matters for 505 and 506**

- implicit in the definition is that they are assumed to be sophisticated

- If you can, you want to feed stuff into 506 so you don’t hit your cap under 504 or 505 bc in the future (within 12 months) you may want to make other offerings that can only fall under 504 or 505

- **501(a)** – any person or entity that falls within specified categories, or who the issuer reasonably believes comes within any of the following categories at the time of the sale
  - insiders of the issuer
  - natural persons with net worth exceeding mil or whose income exceeds 200K or 300K combined with spouse for past 2 years
  - Any entity in which all of the owners are accredited investors
○ Other stuff

**Sophistication requirement under 506**
- can the investor fend for themselves?
- Use a questionnaire
- Avoid sophistication requirements under 505 and 506 by getting accredited investors

**502(c) - manner of offering under Reg D** – can’t use general solicitation or general advertising
- Look for a pre-existing relationship – less likely to be considered a gen advertisement or solicitation.
- Broker/dealer should get periodic updates on the potential investors – maintains a pre-existing relationship and can also keep track if they’re sophisticated
- 135c – allows reporting cos to announce private placement, but the notice can’t be used to condition the market. It must contain limited bare bones info

**Disclosure obligation (only under 505 and 506, and only to non-accredited)**
- accrediteds are also going to want disclosure, they’re going to want everything you’re giving to the non-accrediteds
- If you’re a reporting co, the disclosure obligations can be satisfied with providing the investors with 34 act filings
- Need to give purchasers a chance to ask questions and get more info without a lot of effort on their part – Q and A sessions

**Limitations on resale**
- concern of backdoor public offering
- issuer must take certain precautions to restrict the transferability of the securities

**Bad boy disqualifier – only for 505**
- if an issuer or someone connected with the issuer has engaged in certain conduct which violates sec laws, you can’t use 505 (doesn’t apply for 504 or 506)

**Integration**
- 502(a) – if you plan to do a number or series of reg D offerings, you have to pay attention to integration – you may be integrating and therefore you may be violating a part of reg D you’re using, and blowing the requirements.
- Look at 6 months before or after that looks like its part of the same offering. Offerings that are more than 6 months apart, you have safe harbor. If the sale was within 6 months of some other offering look at
  ○ Offerings involving the same class of securities
  ○ Sales been made around the same time
  ○ Type of consideration the same
  ○ Are sales made for the same purpose
  ○ Are they part of the single plan of financing
Typically: Issuer ➔ Underwriter ➔ Dealers ➔ Retail Purchasers

Offerings by Underwriters, Affiliates and Dealers
- Sec 5 prohibits the use of interstate facilities or the mails to sell a sec unless a registration statement has become effective.
  - However, 4(1) specifically exempts from sec 5, transactions by any persons other than an issuer, underwriter or dealer
- Thus, only issuers, underwriters and dealers are subject to the registration and prospectus requirements of the 33 Act.
- Issuer (2(a)(4)) – Every person who issues or proposes to issue any security. An issuer is subject to the registration requirements of the Act whenever it makes an original distribution of its securities to the public.
- Sec 2(a)11 def of underwriter – 3 Classes of persons are considered underwriters within the meaning of the registration requirements of the 33 Act:
  1) Persons who purchase securities from the issuer with a view toward public distribution
  2) Persons who offer or sell securities for an issuer in connection with a distribution
  3) Persons who participate in a distribution
- ISSUE – When can I resell the securities I get in a private offering without having to register under sec 5?
  - Sales by issuers are primary offerings
  - Sales by everyone else are either trading transactions or secondary distributions
  - Trading transactions are exempt from sec 5, but secondary distributions are not.
  - How do we distinguish a trading transaction from a secondary distribution? In most cases whether or not an individual other than the issuer has to comply with sec 5 in order to resell will depend on whether the individual is an underwriter as defined by 2a11.

Underwriter – broad definition, to limit who can take advantage of 4(1) exemption.
4 roles that define you as an underwriter
  o Has purchased from an issuer or controlling person with a view to the distribution of a security
  o Offers or sells for an issuer in connection with a distribution
  o Participates or has a direct or indirect participation in any of the activities above
  o Participates or has a participation in the direct or indirect underwriting of anything just described.
- Definition of underwriter
  o Any purchaser who purchases securities with a view to the distribution
  o 3 parts
    1) purchase
2) with a view
- what was the investors investment intent – invest or sell?
- The longer you hold, the more likely investment intent
- Change in circumstances – liquidity issues, the co started to tank → all reasons not to hold the securities for long
  - If you’re going to make a change in circumstances argument, you’re on much better footing if you argue that there was a change in your circumstances rather than a change in the co circumstances.
- If you hold for more than 2 years, presumption in your favor; if less than 2 years, then presumption that you didn’t buy with the requisite intent

3) to the distribution
- not every resale is a distribution
- we only reach this question if we don’t show the requisite investment intent; with a view.
- There is no distribution if it would be a private offering under 4(2) and Ralston →
- Key: If the resale transaction destroys the issuers exemption, you have a distribution.

Chinese
- Transactions based approach
  - The ct explains that 4(1) intends to exempt trading transactions bw investors by securities already issued, not by issuances by issuers. This case involved an issuance by the Chinese Govt. The exemption is limited to transactions by persons other than issuers, underwriters or dealers. It does not in terms or by fair implication protect those who are engaged in steps necessary to the distribution of security issues.
  - Even if the def wasn’t itself an issuer, underwriter, or dealer it doesn’t’ matter bc the def was participating in a transaction with the issuer.
  - We focus on the transaction rather than the individual steps in the transaction
- This case falls under the second definition of underwriter – offers or sells for an issuer in connection with a distribution.
- If you take the maj’s opinion at face value it seems that anyone who has stimulated investor interest can end up finding itself being an underwriter

Functional Approach – your function in the offering. There are 4 roles that define you as an underwriter

1) Has purchased from an issuer or controlling person with a view to the distribution of a security
2) Offers or sells for an issuer in connection with a distribution
3) Participates or has a direct or indirect participation in any of the activities above
4) Participates or has a participation in the direct or indirect underwriting of anything just described.

**Issuer** shall include any person directly or indirectly controlled by issuer ➔ *every person who issues or proposes to issue any security*. An issuer is subject to the registration requirements of the Act whenever it makes an original distribution of its securities to the public

- therefore a person who resells for a control person is an underwriter bc they are selling on behalf of a control person ➔ basically you’re selling on behalf of an issuer and hence you have underwriter status
- the important point is that a control person is considered an issuer only for purposes of underwriter.

**Resales by control persons**

- Co X issues securities under a 4(2) exemption, it hasn’t come to rest in anyone’s hands
- In this case both control and non control persons are treated the same and 4(2) isn’t blown.
- Suppose the securities have come to rest
  - In terms of non-control persons, no concern bc they didn’t buy with an intent to resell. This person can take advantage of 4(1) and resell.
  - Control persons – the fact that the securities have come to rest doesn’t solve their problem. *A control person isn’t protected by his or her investment intent. The question is, is there some other entity acting as an underwriter. Don’t ask if the security has come to rest, but ask if someone is purchasing, selling, or taking part in some distribution for the control person.* IF this other entity is selling on behalf of the control person, then there is concern that there is a distribution. Then we have an underwriter and we can’t take advantage of 4(1).

**ANALYSIS**

1) Is there a control person – sec2(a)11 – any person controlling, controlled by or in common control with the issuer. If you have the ability to control in some respects then you have the requisite control aspects

2) Is there a distribution? Then the distributor could be an underwriter

3) **Investment intent doesn’t matter for the control person.**

Sales by a control person thru a broker may result in liability for both the control person and the broker, bc in such a case the broker will often be deemed to be an underwriter under sec 2(11)

- broker exemption applies only where the broker is performing no more than the usual broker’s function in this particular transaction
Receipt of more than the usual brokerage commission may take the transaction beyond the usual broker’s fx and eliminate the exemption.

Where the control person has no exemption, and the broker knows or has reasonable grounds for believing this fact, the broker may be acting as an underwriter in selling the control person’s stock.

Wolfson

- **For the purpose of determining those persons who are underwriters under the 33 Act, control persons are considered issuers. And if a public distribution actually does take place without registration, there is a violation of the registration requirements of sec 5 of the Act.**

- W and his associates sold 25% of the issuer’s shares through brokers without registration. Although not active in management, the 2 held 40% of the total stock and controlled the co behind the scenes. They were therefore held to be control persons, and the brokers were underwriters. As a result, the stock was sold in transactions by underwriters, which are not within the exemption of sec 4(1). Notice that the seller need not be an underwriter to lose the sec 4(1) exemption; it is lost even if the seller sells to an underwriter.

- The control person does have to re-register securities which he procured in a registered offering, this doesn’t only apply to unregistered shares → the co registration in the initial issuance, this covers the co’s transaction. So, when the control person wants to resell he has to register his transaction. There is no exemption available.

- There is a distribution here bc Wolfson was selling OTC and not everyone buying will be able to fend for themselves.

**Rule 144 of the 33 Act – to establish investment intent**

- Because of frequent confusion and ambiguity in determining whether an investor had investment intent (and therefore was not an underwriter, the SEC adopted rule 144 specifying an objective set of criteria that will establish investment intent. **IF these criteria are satisfied, purchasers in a private offering of securities may resell the securities (referred to in rule 144 as restricted securities) without violating the 33 Act.**
  - EX: V buys 100 shares from XYZ in a private offering by XYZ to sophisticated investors. After holding the shares for 2 years, V desires to sell but doesn’t want to violate any securities laws in doing so. If she complies with 144, her sales are not unlawful.
  - While a seller of privately purchased securities can still rely on the traditional pre-rule 144 criteria to est investment intent, the seller bears a heavy burden of proof where the facts deviate from what is required by rule 144.

- Scope of 144
o Restricted securities – applies to the sale of restricted securities, which term is defined to encompass 3 types of securities
  1) Privately offered securities acquired directly or indirectly from the issuer or a control person
  2) Securities issued pursuant to rules 505 or 506
  3) Securities sold under 144A – Private re-sales of securities to institutions
- Sales of securities by control persons – applies to the sale of securities owned by control persons, it states when and how much stock a control person may sell without becoming an issuer, and without making those that subsequently resell the stock underwriters
- If you comply with 144, there is no issuer and no underwriter, so you can resell. It’s a safe harbor.
- 144 says that if you comply with the following requirements, you are deemed not to be engaged in a distribution and therefore not an underwriter. So, since you’re not an underwriter, you can take advantage of 4(1)

Requirements
- **Holding period** – if the securities are restricted, a minimum 1 year must lapse before the securities can be sold. If you hold for more than 2 years, basically you don’t have to comply with anything else we’re going to talk about in 144. (The holding period applies only to restricted securities; thus, a control person selling non-restricted securities need not comply with this provision)
  o Ensures that the investor purchased the securities as an investment, rather than for public distribution
- **There are limitations on the amt of secs that you can resell.** Sales by control persons (or sales of restricted securities by non control persons who cannot meet the qualifications to remove the volume limitations) during the 3 month period may not exceed the greater of
  o One percent of the shares of the outstanding class of security
  o If the security is traded on an exchange, the avg weekly reported volume of trading in such securities on all exchanges
- **Manner of resale** – Have to use a broker.
- **Information** – there has to be adequate current info available regarding the securities. If you’re a 34 Act reporting co and you file Ks and Qs, then this requirement is deemed satisfied, if you’re a reporting co for at least 90 days and have complied with all the filings. If non-reporting, then have to disclose basic info (I think stuff that would show up in prospectus)
- **Have to file a notice with the SEC in reliance with 144**
- Let’s assume I’m doing a deal and obtaining restricted securities. What is the thing the co has to do that me, as the purchaser, has no control over? I’m concerned with the cos disclosure of info. So, I have covenants in the purchase docs, that the co has all its filings up to date if it’s a reporting co, or if not that it has info available.

**Rule 144A – re-sales to qualified institutional buyers of privately placed securities**
- **Policy:** The idea is that restrictions on re-sales are not needed as long as re-sales are made only to large and financially savvy institutions.

- **Implementation** – Like 144, a person complying with its requirements will be deemed not to be engaged in a distribution and therefore will not be an underwriter under 2(11)

- This generally provides a non-exclusive safe harbor exemption for re-sales of restricted securities but only when you sell to qualified institutional buyers. A transaction that complies with 144A will be deemed not to be a distribution

- Someone who acquires securities in a private offering can avail himself of 144A and resell.

- **Requirements**
  - The rule is not available to offers of sales by issuers.
  - Offers and sales are permitted under 144A only to qualified institutional buyers or persons whom the seller reasonably believes to be QIBs
    1. If you’re a QIB, you have to own or invest in 100 mil worth of other cos. There is an additional requirement for banks or S&Ls – they have to meet a holding criteria (have to have a certain amt of money)
  - **Info requirements** – A prospective purchaser as well as a holder of the securities has to have the right to obtain from the issuer certain financial info. And they have to get that info prior to the sale. If the issuer is a 34 Act reporting co, then this info requirement doesn’t apply
  - **What kind of securities covered** – the securities sold must not be of the same class as securities listed on a US stock ex or quoted on NASDAQ
  - **Holding period and volume limitations don’t apply**
  - The general practical point of 144A is that it makes raising cap much easier than using Reg D or 4(2). It gets rid of a lot of uncertainty.

- Securities sold in accordance with rule 144A are not thereby transformed into unrestricted securities.

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4(1 ½) – private sales of restricted securities by control persons in private offerings

- The discussion of re-sales so far has focused on public resale. The problem with these is that the seller (when restricted securities are sold) or the seller’s broker (when the seller is a control person selling any securities, restricted or not) are likely to be swept into the definition of underwriter. If the seller, rather than selling publicly, sells privately, this would avoid underwriter status, since an underwriter is one who is involved in a distribution.

- To determine what’s a distribution, we look to 4(2)
- only about resale by control persons

- **Control persons can’t take advantage of 4(2), the private offering exemption, bc it is only available to an issuer.**

Let’s assume we have the situation where the securities have not come to rest, in that case, it doesn’t matter whether we’re dealing with a control person or a non-control person. Will that resale run afoul of the issuer’s initial exemption? Is the resale consistent with the
original exemption? This is the question you ask whether you’re dealing with a control or a non-control person. If the buyer couldn’t have participated in the original issuance, you destroy the original exemption

Assume the securities have come to rest; this is where the control and non-control persons are treated differently. For a non-control person, they didn’t buy with a view, and they’re fine. For control persons, they don’t get the advantage of “with a view” part, the focus is whether there was a distribution. For that, we look at the standards under 4(2). And so, if you look at 4(2), you find the definition of distribution. If we say that we don’t have a distribution, then we don’t have an underwriter, therefore the resale by the control person will be exempt under 4(1).

CIVIL LIABILITY UNDER THE SEC ACT OF 33

Sec 11 – liability for misstatements or omissions in registration statement or prospectus
- imposes liability on designated persons for material false or misleading statements or omissions in an effective registration statement or prospectus
- Who can bring suit? Any person who acquires a registered security bought directly from the issuer or in the secondary market
  o The additional complexity of the secondary market is that you have to trace your shares to the faulty registration statement.
- Persons subject to liability
  o Every person who signs the registration statement. The following must sign the registration statement
    1) Issuer
    2) CEO, CFO, comptroller
    3) Maj of the BOD
  o Every director of the issuer
  o Every person named as about to become a director (has to be named in the registration statement as about to become a director of the issuer)
  o Every expert who certifies preparation of registration statements
  o Every underwriter involved in the distribution
  o Control persons – persons who control any person who is liable under sec 11 may be held jointly and severally liable with the liable persons, unless the controlling person had no knowledge of nor reasonable grounds to believe in the existence of the facts on which the liability of the controlled person is alleged to rest
- Elements of P’s cause of action
  o Material misstatements or omissions – P must prove that there has been a misstatement of, or a failure to state a material fact
• Material – those matters to which there is a substantial likelihood that a reasonable investor would attach importance in deciding whether to purchase the registered security.
  o Limited reliance requirement – P need not prove that she purchased in reliance on the misstatement to recover
  o Causation of damages – P need not prove that her loss was caused by the misrepresentation

• **Negative Causation** - Def may be able to reduce the damages by proving that all or some portion of the damages resulted from some cause other than the misrepresentation or omission of material fact in the registration statement
  o Sec 13 provides for a strict SOL for sec 11 and 12 – no action can be maintained unless brought within 1 year of the falsity or omission. And, it has to be brought within 3 years after the security was bona fide offered to the public
  o Offering price is the ceiling – In no case can the amt recovered exceed the price at which the security was offered to the public

- **Defenses**
  o The P knew of the misleading statements or omissions and invested in the securities anyway - this doesn’t usually work bc of class actions
  o If there have been 12 months of earnings statements, the purchaser can’t prove reliance on the untrue statement in the registration statement. General rule is that you don’t have to show reliance. But, there is an exception to that when the investor has 12 months of earnings statements to look at.
  o The def has 1) before the registration statement, taken steps to resign and 2) has informed the SEC and the issuer in writing
  o Def gives notice to the SEC in writing and reasonable public notice that the misleading part of the registration statement became effective without his knowledge.
  o **Due diligence defense ➔** broken down into expertized and non-expertized portions
    • Issuer can’t use this defense
    • Expertized portion – that portion that is prepared by, or on the authority of some expert
      o The expert, with respect to the expertized portions, that after reasonable investigation he had reasonable grounds to believe and did believe that the portions were correct
      o The non expert, with respect to the expertized portions, has to show that he had no reasonable ground to believe and didn’t believe that the expertized portions were false.
      o Only the experts have some burden of investigation for the expertized portions. The non experts don’t.
experts are allowed to rely on what the experts told them unless they have reason to believe otherwise

- Non Expertized portion – def are subject to a duty to investigate. Can only claim the due diligence def that after reasonable investigation they had reason to believe and did believe that the statements were true and accurate
  - Non expert with respect to non expertized – reasonable investigation and reasonable grounds to believe the statements were true
- What about the argument that I can rely on the entire registration statement bc it was prepared by atty experts? No good, bc it would apply in every case. The fact that the atty’s prepare the docs, they aren’t experts in the routine preparation of the docs.

**Escott v. BarChris**

- For their belief to be reasonable, the experts must have made a reasonable investigation into the facts supporting the statements made. Normally, this means that they must at least have performed up to the standards of their profession (accountants must make an investigation of the facts that would conform to the standars of their profession and must state the issuer’s financial results according to the GAAP)

**Outsiders v. insiders**

- Insiders are those who are also officers of the co
- Outsider directors are directors who don’t have positions as officers in the co
- Different standards? Yes. Inside directors have an affirmative obligation to investigate and it’s taken that they have knowledge that the outsiders don’t. Insiders see the red flags more easily. Inside directors with intimate knowledge of corporate affairs and of the particular transactions 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.
- It is the case that outsiders have a lower standard than the insiders.

**Causation and damages**

**Akerman v. Oryx Communications**

- **Negative Causation** – def says that they understand the price has dropped and that there was a misstatement, but it dropped for toher reasons not attributable to the misstatement.
- The prospectus contained an erroneous pro forma unaudited financial statement, no accountant has come in and said that the financial statements are in accordance with GAAP
- The price opened at 4.75 and then dropped to 3.25, and after disclosure the price jumped to 3.50. There is an argument against the materiality misstatement bc after the disclosure the price went up. So, it seems that they aren’t liable for anything bc the price went up.
- The P argue that there was insider trading and that the info leaked, so some of the drop pre-disclosure is attributable to the leaks.
- The word value is used instead of market price in the provision. If you’re a P, how might you use the term value instead of market price? The price doesn’t show the full impact of the disclosure – the market needs time to dump.

**SEC 12(1)** – liability for offers or sales in violation of sec 5
- provides that any person who offers or sells a security in violation of any of the provisions of sec 5 of the 33 Act shall be liable to the purchaser for
  o the consideration paid less the amt of any income received on the security or
  o for damages if the purchaser no longer owns the security.
- Liability is absolute for any violation of any provision of sec 5. Such violations include a sale of unregistered securities, failure to deliver the required prospectus, making an illegal offer in the pre-filing period, etc.
  o Persons who control any person liable under sec 12(1) may be held jointly and severally liable with the controlled person, unless the controlling person had no knowledge of nor reasonable grounds to believe in the existence of the facts on which the liability of the controlled person is alleged to rest.
- P has to prove that def is a seller
  o Have requirement of interstate commerce
  o Have to show that action isn’t barred by sec 13 SOL
  o Show def didn’t comply with sec 5
  o Remedies – if you still hold the sec, you have to offer it up, tender it to the issuer or if you don’t have the securities you can sue for damages
- Defenses – def wasn’t required to register
  o What if the issuer makes an illegal offer, but at the end of the day, the final sale complies with sec 5? Doesn’t matter if you do everything right after the illegal offer, it doesn’t remedy the fact that you made an illegal offer earlier.

**Pinter v. Dahl**

- Pinter sold unregistered oil and gas interests to Dahl in an attempted PP. Later, Dahl solicited some of his friends to purchase additional interests, be Dahl believed the interests were good investments. Pinter sold the interests to Dahl’s friends on the strength of Dahl’s representations that the friends qualified as PP investors. It turned out that the friends were not qualified PP investors, and when the investment became worthless, Dahl and his friends sued under 12(1). Pinter counterclaimed, alleging that Dahl was a seller under sec 12(1) and therefore that Dahl was accountable to Pinter in contribution for the amts awarded the other Ps
  o **Seller**
    ▪ Person who actually passes title to the security and
    ▪ Person who solicits the purchase from the buyer
    ▪ Does not include people whose sole motivation is to benefit the buyer

**SEC 12(2)** – general civil liability under the Act generally prohibits fraud in the interstate offer or sale of securities.

- provides that any person
  o who offers for sale a security by use of any means of interstate commerce;
  o by means of a prospectus or oral communication that contains an untrue statement or omission of material fact and
  o who cannot sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth is liable to the purchaser of the security

- **Scope**
  o Applies whether or not the securities were registered pursuant to sec 5, whether or not they were offered in writing or orally

- **Defenses**
  o Def has def of not knowing and if exercised reasonable care could not have known of the mistake or omission
  o Negative causation defense
- P is not required to show reliance, just has to show that they didn’t know
- **Damages** – mandatory right of rescission upon tender of securities, but if you already sold you securities, you can sue for damages.

**Gustafson v. Alloyd**

**Materiality** – The misrepresented or undisclosed fact must be material to the investor’s decision. A number of tests of materiality have been applied by the cts

1) **Substantial likelihood of significance**
   - **TSC Industries, v. Northway**
     - IN the context of a proxy statement, the Sup Ct has held that the test for materiality is whether there is a substantial likelihood that a reasonable SH would consider the fact of significance in determining how to vote. The Ct did not require proof of a substantial likelihood that disclosure would have caused the reasonable SH to change his vote, but only that the omitted fact would have assumed actual significance.

2) **Probability v. Magnitude**
   - **Basic v. Levinson – soft info**
     - Denial of merger talks
     - When it is uncertain whether an event will or will not occur, the question whether there is a substantial likelihood that a reasonable SH would consider the event significant is difficult to answer. The Sup Ct has adopted a test for such circumstances that balances 2 issues
       - **Probability**
         - Does the deal make sense
         - What’s the state of the negotiations
         - Boards adopted any resolutions
       - **Magnitude**
         - Size of the cos
         - What is the potential premium being paid
         - What is the effect on earnings

- **Reasons, opinions, and beliefs**
  - **Va Bankshares**
    - **Truth of the belief** – A statement that the board believes that 42 is a fair price is false if, in fact, the board does not belief that the price is fair
    - **Truth of the underlying subject matter** – A statement that the Board believes the 42 is a fair price is also an endorsement of the price, and may be taken to mean that there is sufficient extrinsic evidence to support a price of 42. thus, the statement may be false if in fact 42 is not a fair price, if there is no reasonable basis to conclude that 42 is a fair price.
    - **Lawsuit must be based on untruth of both belief and subject matter** – ct held that it is not sufficient for the P merely to prove that the belief stated was not actually held; in addition the P must show that the statement was false as to its subject matter.
  - **Forward looking statements**
• **Bespeaks Caution Doc** – judicially created doc that immunizes certain forward looking statements if it is accompanied by sufficiently cautionary statements – that what is being said is potentially wrong.
  - cautionary language, if sufficient, renders the forward looking statements immaterial as a matter of law
  - Your cautionary statements have to be specific to the forward looking statement that you’re trying to qualify

So, what would be sufficient cautionary language?
  - The bespeaks caution doc has been codified in SA 27A and SEA 21E

**SEC 10-b5 – 34 Act**
- principle anti-fraud provision
- unlawful
  o in connection with
  o the purchase or sale of any security,
  o for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national security exchange.
- When does it apply?
  o Private individuals can sue – there are implied private rights of action under 10b-5
  o Prevents fraud that is in connection with the purchase or sale of any security
    - So, we have to see if the fraud is in connection with
  o The reality is that it is a fairly loose standard – if the fraud touches the sale or purchase then falls under this standard. So, you actually have to have a purchase or sale to bring suit. Can’t sue along the following lines – “I would have bought or I would have sold” had this fraud not occurred. **Have to have actually bought or actually sold.**
- Twist on the duty to disclose – duty to update and duty to correct
  o This comes out of clause 2 of 10-b5 → prohibits the omission to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading
  o If statements have become inaccurate by some subsequent event or some statement that was made believing it was true turns out to be false – under these circumstances there is a duty to disclose if the issuer knows that persons are continuing to rely on the statement or any portion of it

*In Re Time Warner Inc. Securities Litigation*

The duty to update and the duty to correct
- 3 issues in this case
  1) Does the co have a duty to update optimistic future plans if it turns out that the plans won’t pan out
    - There is a duty to update, but not for simply expressed hopes.
  2) Does the co have the duty to disclose alternative plans if under consideration
    - Depends
    - Here, it is the case that noe disclosing these other techniques of raising cash made original statements misleading.
• So, you have to look to whether the omitted info is material

3) Is the co responsible for statements in newspapers if made by an anonymous person?

• You have to plead fraud with particularity. You can’t allege fraud when you can’t point to the person who made the statement.

**INSIDER TRADING** – possible to make money based on the semi-strong form of efficiency \( \Rightarrow \) stock prices instantaneously reflect all publicly available info relevant to the value of the traded stocks.

**Rule 10b-5** – primary regulator of insider trading

- A corp insider who has material non-public info about the enterprise is under a duty either to abstain from trading or first to disclose the non pub info.

In defining when insider trading is fraud prohibited by Rule 10b-5, the Sup Ct focused on silence by one who has such a state law duty to disclose or abstain. This liability is sometimes described as classic or traditional insider trading. This sec describes extensions of that liability beyond the classic group, first addressing those who obtain info from the classic insider and are covered by the extension of that insider’s duty. This group includes:

- those who receive info from the insider or the corp for an appropriate purpose (constructive or temporary insider) and
- those whom the insider tips for an improper purpose (tippee liability)

The second category is somewhat broader based either

- on the duty owed to a non-trading party (misappropriation)
- or one who receives info in the context of a tender offer (Rule 14e-3)

**Chiarella**

- Def’s use of info was not a fraud under 10b unless he was subject to an affirmative duty to disclose it before trading \( \Rightarrow \) without a duty to disclose, merely having the info and acting upon it doesn’t give rise to liability

- When you don’t have a duty to disclose, you can’t partake in fraud

- A duty to disclose exists when you have a relationship of trust and confidence

- 10b5-1 \( \Rightarrow \) You have to trade on the basis of the material non public info: in order to trade on the basis of the info – the person must be aware of the material non public info when they traded.

You have to trade on the basis of the material non public information. The question is then, what does this mean? Look at Rule 10b5-1 – prior to the adoption of this rule, there was a split bw what it meant to trade on the basis of the info. If you possess the info as an insider, it’s enough. Others say you actually have to use the information. On the one hand, I may be in possession, but if I don’t use it, then I shouldn’t be punished. On the other hand, it’s hard to prove if you used the info or not. Second, you may not think you used the info, but subconsciously you may have used it.

- **Affirmative defenses – clause (c)**
  1) if the person before becoming aware of the info either
  2) entered into a binding K to buy or sell or
  3) instructed another to buy or sell or
  4) had adopted a written plan to buy or sell, then you will be deemed not to have traded on the info

**Tippee liability and constructive insiders**
Tippee assumes a fiduciary duty to the SHs not to trade, only when the insider has breached his fiduciary duty to the SHs by disclosing to the tippee, and the tippee knows or should have known that there was a breach. Tippee liability is derivative of the tipper breach. We can tell if there is a tipper breach if the tipper receives some sort of benefit from the breach. The benefit can be either direct or indirect. This includes tip to a relative or friend – cts will see this as the tipper actually trading and making a gift to the relative or friend.

- **Footnote 14: Constructive insiders** – under certain circumstances, lawyers, consultants, accountants, underwriters will be treated as an insider

**Misappropriation Theory**

**O'Hagen**

- Classic insider trading – constitutes fraud or deception be the insider owes a fiduciary duty to the corp and the SHs
- O'Hagen had nothing to do with the target; he was working for the bidder, so he owes no duty to target SHs
- The misappropriation theory fills the gap – a person commits fraud in connection with a sec transaction and violated 10b and 10b-5 when he misappropriates confidential info for securities trading in breach of a duty owed to the source of the info (not to the parties on the other side of the trade).
- 2 part reasoning
  - fraud-duty discussion
    - Yes there is a fraud. Fraud is an aspect of insider trading. Fiduciaries undisclosed use of a principal’s info defrauds the principal’s use of the info
    - Is the fraud in connection with the sale or purchase of securities?
      - The in connection requirement was satisfied. The ct says that the fraud is consummated, not when the fiduciary gets the info, but when, without disclosing the info to the principal, the fiduciary uses the info to buy and sell securities.

What is the nature of the duty to the source? What is the scope of that duty?

**SCOPE OF THE DUTY**

- 10b5-2 – the requisite duty of trust and confidence exists for purposes of the misappropriation theory when
  - the person agrees to maintain the info in confidence.
  - When the person sharing the info have a history, pattern or practice of sharing confidences, such that the recipient knows or should know that there is an expectation of confidentiality

When info is shared with parent, spouse, child, or sibling, unless the recipient can show that there is no expectation of confidentiality

- discussion about Rule 14c3 – under the Williams Act (sets up a bunch of rules and provisions by which tender offers are made) – it prohibits trading on the basis of material non public info in regards to tender offers; this says nothing about a duty breach. The question is whether a rule that
doesn’t require a duty breach is beyond the SEC’s authority – if there is no duty breach, then there is no fraud, and SEC should only be prohibiting fraud and deceit. Holding – this doesn’t run afoul of the SEC’s authority, you don’t need a duty breach. The Williams act is about informed SH choice, not necessarily about fraud, and a rule that allows people to trade on insider info makes it hard for investors to trade on insider info.

Insider Trading (few words on it)
- to show the limits of the misappropriation theory
- Let’s assume that O’Hagen’s law firm gave him the information to trade with as a bonus, would that be a problem under the misappropriation theory? The firm may be liable under a tipper type of theory. Firm may be misappropriating the info from the co. But, what about O’Hagen? To have liability under the misappropriation theory, you have to have fraud. But, is there any fraud when the source of the info gives you permission to use the info? It looks like there is no breach of a duty be there is no misappropriation bc he got permission to use it.
- But, we could make the argument that the duty was owed to the co not the firm. In that case, he misappropriated it.
- What if he gets the info and he tells the co he’s going to trade it, but they say he can’t, but he does anyway? There is no misappropriation bc he disclosed it to the source. For there to be fraud under 10b-5, there has to be some non-disclosure to the source of the info.

Really, fiduciary duty is only owed to stock holders, not bond holders.

10b-5(2) – this solved the confusion over what constitutes the requisite relationship for misappropriation a duty of trust and confidence for the misappropriation theory whenever
1) a person agrees to maintain the info in confidence
2) the person sharing info (source and recipient) have a history pattern or practice of sharing confidences such that the recipient knows or should know that there is an expectation of confidence
3) when a person shares info with parent child or sibling, unless the recipient can show that there was no expectation of confidence

Non-Insider trading violations
- this is 10b-5, but not insider trading
- various elements of 10b-5, non-insider trading:
  o have to have standing ➔ have to have been a buyer or seller, and fraud has to be in connection with a transaction ➔ have to have bought or sold
  o You have to have some sort of material misstatement or omission
  o Scienter
  o Reliance
  o Causation

Scienter – another aspect of a 10b-5 claim – intent to deceive, manipulate, or defraud
Ernst and Ernst v. Hochfelder – in private transactions under 10b-5, you have to have scienter
- 10b-5 doesn’t extend to negligent behavior
- Scienter refers to a mental state embracing
  o the intent to defraud, deceive, or manipulate.
  o Also covers recklessness – recklessness is a type of intent
    • Highly unreasonable omissions or misrepresentations, which is an extreme departure from ordinary care, which is known to the def or should have known
      o Carelessness approaching indifference
Sciencter doesn’t mean that the def has an intent to deceive investors, it is enough that the def is aware of the true state of affairs and knows that there is a good chance that the investor will be mislead.

Reliance and Causation

*Basic v. Levinson*

- reliance and fraud on the market theory
- **Fraud on the market theory** – based on the hypothesis that, in an open and developed securities market, the price of a co’s stock is determined by the available material info regarding the co and its business. Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. The causal connection bw the defs’ fraud and the Ps’ purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.
  
  o **FOTMT is a rebuttable presumption**
    
    - Can rebut by showing that the market makers (guys who agree to buy and sell the securities – being the other guy to the transaction) or those who effectively set the price were privy to the truth \(\Rightarrow\) truth on the market
    - Can also rebut by showing that the P would have bought or sold regardless if they knew the truth or not \(\Rightarrow\) they weren’t relying on the integrity of the market to buy or sell.

- Reliance is an element of a 10b-5 cause of action \(\Rightarrow\) provides the requisite causal connection bw a def’s misrepresentations and a P’s injury. Be most publicly available info is reflected in market price, an investor’s reliance on any public material misrepresentation, therefore, may be presumed for purposes of a Rule 10b-5 action.

- **Causation** – the P’s economic loss was caused by the def’s wrongful conduct. If the P is able to show that the def’s wrongful conduct caused such a loss this will tend to est the in connection with requirement bw the def’s conduct and the P’s purchase or sale of securities.

The cts have established that with regard to private recovery for the violation of Rule 10b-5, a properly stated cause of action must est

- the scienter of the def
- the materiality of any misrepresentation or omission by the def
- the extent of actual reliance by the P on the def’s statements, and the justifiability of the reliance, frequently translated into a requirement of due diligence by the P.

**REG FD** – addresses selective disclosure, for reporting cos

- This is the most recent way SEC has tried to combat insider trading
- About securities analysts \(\Rightarrow\) gets info into the market that might not otherwise get there.
- Cos would selectively disclose info to their analysts – give them a heads up before anyone else would know. These guys would go and write their reports and advise their clients.
- Why weren’t they subject to liability? Well, there is no showing that there was personal benefit to the insider; therefore no breach of fiduciary duty. Arguably they weren’t getting any benefit be they were doing their job
- This is the problem that Reg FD tried to address. Even if there was no insider trading, and there were no insider trading concerns, there was this notion that selective disclosure was unfair bc there was no longer a level playing field.

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Selective disclosure results in the loss of investor confidence.

Reg FD prohibits selective disclosure to individuals who are likely to trade on the info.

BACKGROUND POLICY

- Unfair to small investors – they lose confidence in the system
- Issuers could use selective disclosure strategically. I’ll give it to you if you write up something good about the co – if you give me a buy rating. It’s easy to use this strategically.
- Selective disclosure has some benefits
  1) When we talk to the analyst we get info to the marketplace
  2) Get the info out there slowing, get the stock price moving slowly, may not want to disclose publicly bc you don’t want to get it to the competitors. So, it does encourage getting the info out there rather than not disclosing at all
  3) Notion that by selectively disclosing to those who understand and appreciate the significance of the info avoids over reactions of the marketplace → avoid the over-reaction
  4) If you don’t allow selective disclosure, some cos may not disclose anything at all – this isn’t good. So, may want selective disclosure
    - Some cos don’t want to disclose info publicly.
    - The prohibition on selective disclosure only applies to material info.
    - But, there may also be a deterrence to disclosing immaterial stuff that may be good to have in the marketplace be of the uncertainty of what is material and what is not.
  5) The disadvantages may outweigh the advantages.

unintentional disclosure – promptly disclose publicly

intentional disclosure – simultaneous disclosure

who is covered? Domestic reporting cos under the 34 act, or any person acting on behalf of a reporting co (CEO or PR guy or someone like that). Mid level EEs don’t fall within the scope of coverage. Reg FD doesn’t cover when some person in a place of confidentiality – the issuer isn’t on the hook the person who discloses is on the hook.

- disclosures of an IPO aren’t covered bc not a reporting co yet.

Same def of materiality

Mosaic theory – give little bits of immaterial info for the analyst to put together something that is material. What kind of info would be considered mosaic info? Info like a Latino person was fired. The analyst can put it together that this was the 4th Latino person fired, so maybe there will be a discrimination charge.

There are things that you have to disclose:

- Earnings, mergers, acquisitions, new products, discoveries, change of control, change of auditor, events regarding issuers stock, bankruptcy….
  (this is all listed somewhere)

Reg FD only covers disclosures to certain enumerated persons

- Sec market professionals
- Sec holders if it is reasonably likely they will trade on the info

Exemptions

- Persons in positions of confidence
Persons who agree to maintain confidence (by it’s terms Reg FD doesn’t have a carve out for private placement – so you get these guys to sign an agreement to maintain info in confidence).

Rating Agencies

Ordinary course of advertising – road shows and stuff.

Secondary Liability

Controlling Person Liability

Hollinger v. Titan Cap Corp

- Wilkowski embezzled money; investors seek to recover their losses from a brokerage firm and a financial counseling firm with which Wilkowski was associated.

- **HOLDING:** Titan is liable as a controlling person under sec 15 of the 33Act, sec 20(a) of the 34 Act and as Wilkowski’s ER under the common law theory of respondeat superior.
  - Sec 15 of the 33 – Every person who controls any person liable under sec 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable.
  - Sec 20(a) of the 34 – Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable.

ANALYSIS

- to hold control person liable under sec 20(a) P must first est that def was a controlling person within the meaning of the statute
  - P must prove that def exercised “actual power or influence” over Wilkowski’s fraudulent dealings and that def was a “culpable participant” in the alleged illegal activity in order to est that def was a “controlling person” for the purposes of sec 20(a).
    - Broker dealer is a controlling person under 20(a) with respect to its registered representatives
    - Def is still a controlling person under sec 20(a) even though Wilkowski was an independent contractor \( \Rightarrow \) the broker dealer exercises control over its registered representatives be the representatives need the broker dealer to gain access to the securities market. Broker dealer is required to supervise representatives.
  - P is not required to show culpable participation to est that a def was a controlling person under sec 20(a).
  - 20(a) provides that a controlling person is liable unless he acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
    - In an action based on 20a, the def who is a controlling person, and not the P, bears the burden of proof as to def’s good faith. Thus, a P need not make a showing as to def’s culpable participation; rather, a def has the burden of pleading and proving his good faith

**Basically, once P shows that def is a controlling person, the controlling person has the burden of showing good faith and that they did not directly or indirectly induce the violations.**

Proving good faith

- **Under sec 20a** - can est the good faith def only by proving that it maintained and enforced a reasonable and proper system of supervision and internal control. Not sufficient for a broker dealer merely to have supervisory procedures in place; the broker dealer must also prove that the supervisory system was diligently enforced.

- **Under sec 15**, only have to show ignorance, and this is a complete defense.
- My 2 cents – as far as knowledge goes, there might be a thing of imputed knowledge, like in criminal law, if you concerted try to be ignorant, then we’ll hold you knowledgeable. This will work under 20a bc it’s showing a lack of good faith, but what about under sec 15?
- Even if there is good faith shown, fed can still hold the controlling person liable under the doctrine of respondeat superior

A lot of courts have applied the following test:

- to show that the def is a controlling person must show that def
  - actively participated in the operations of the corp in general (corp being the primary violator)
  - Def possessed the power to control the specific transaction or activity upon which the primary activity was predicated, but it need not be shown that this power be exercised

Affirmative Defenses

There are affirmative defenses, but they can only be used when the violation is under their specific act (can only use sec 15 if it’s a 33 act violation)

Sec 15 of the 33 act
- if it is est that the controlling person had no knowledge or had reasonable ground to believe in the existence of the facts upon which the violation exists → knowledge standard

Sec 20a of the 34 act
- liability arises for a controlling person unless the controlling person acted in good faith and did not directly or indirectly induce the facts that caused the violation
  - once you have knowledge, you’re not acting in good faith
  - So, maybe, knowledge may be enough to knock out both affirmative defenses

Let’s say that you have no knowledge, you can take advantage of sec 15. But, if you don’t have some system in place to monitor, then you may be good under sec 15, but you didn’t act in good faith under 20a.

Aiding and Abetting

Central Bank of Denver v. First Interstate Bank of Denver
- no longer a fed right of action for aiding and abetting
- Sup ct held that aiding and abetting is no longer a basis for private action under 10b and 10b-5
- Approaches taken by the majority – interpretive methodology
  - Aiding and abetting aren’t in the statute – strict constructionist approach.
    - When you have an issue of statutory construction, you start with the statutory language
- This case has come up in the context of Enron – aiding and abetting can get all the ancillary players, but it’s hard to get them now in a private class action. We have to show that they were primary violators, which is hard bc now we have to show scienter.
  - A number of folks are now saying that this retrenchment of 10b-5 undermines the deterrent effect.
- This coupled with PSLRA really makes it hard to get secondary violators.
- We’re talking about private rights of action here, not SEC enforcement. SEC can come after you for aiding and abetting, it’s just that no private actions.
- Sec 20(e) of the 34 Act → authorizes the SEC to bring enforcement actions against any person that knowingly provides substantial assistance to another person committing an SEC violation.
- Whether or not this particular section allows SEC to bring actions for reckless aiding and abetting? So, what does knowingly mean? It is unclear.
How do we know if you’re a primary violator or an aider and abettor – Central Bank doesn’t tell us a whole lot.

As a general matter, in the post central bank world, most cts look to the degree to which the def was a substantial participant in making the misleading statement.

Ex:
- 9th circuit has held that primary participant violation was sufficiently plead when auditors had a sig role in editing and drafting financial reports and chose to withhold the truth
- Accountant created financial statements he knew were misleading and knew that they would be circulated among investors.

Sec 10A of 34 Act – provides affirmative duties on pub accountants when they become aware of illegal acts by their client

Auditor has an obligation first to see if it has an impact on the financial statements (is it material). IF it is material, the auditor has to bring this to the attention to the appropriate level of management. But, under certain circumstances, have to bring it to the attention of the board or the audit committee. If it turns out the corp does nothing to remedy, the auditor has the duty that leads to notice to the SEC. This is generally related to ancillary participants.

Auditors are in a precarious way be they will be certifying the financials. So when the auditor certifies the financials, this may be the easiest way to get them as primary violators. They knew people would be relying on the info. Damages, we have to look at what the stock price did.

PSLRA
- the most sig contribution of the PSLRA is its effect on pleading standards (specifically under 10b-5 in a private action)
- look at 20d of the 34 Act
- What this gets at is: how do you plead scienter to survive a motion to dismiss.
- The changes in this area took place in the following context:
  - Perceived explosion of law suits at the time. Want to curve the amt of suits.
  - Concern was that cos were being punished any time the stock price moved 10% there was a law suit.
  - Many cases were settled bc of the nuisance value
- Heightened pleading requirement – make it tough to plead
  - 21D(b)(2) (heightened pleading standard– requires the complaint with respect to each act or omission to violate 10b-5 have a strong inference standard.)
    - With respect to scienter, you have to plead with particularity and with a strong inference
- Discovery is stayed while the ct figures out the motion to dismiss. So, this raises a problem for the P. P can’t plead with particularity if they don’t have discovery. If you don’t plead with particularity, ct will dismiss your complaint.
- So, now it is very hard to plead with particularity.
- How do I plead with particularity enough to give rise to a strong inference? The 2nd circuit has an approach ⇒ P has to plead the following
  - Either actual factual data (co data) evidencing scienter or
  - At least strong circumstantial evidence showing conscious misbehavior or recklessness.
    OR
  - You can also show by showing a strong motive and opportunity.

In the TIME WARNER case, a pleading issue arose, and the ct found that the pleading standard was met with showing strong motive and opportunity.
The strong motive and opportunity was to get the stock price up (this is about the alternative financing).

Other factors in pleading motive and opportunity
- Raising capital
- Need to keep it quiet for merger
- Insider trading
- Individual benefit

Motive and Opportunity is important when you have no smoking gun.

**POST PSLRA**
- 2nd circuit approach, you can derive scienter from motive or opportunity, circumstantial evidence of reckless behavior – these must be proved with a strong inference of scienter and must be plead with particularity. Scienter – recklessness or intent

ON the other hand we have the 9th circuit.
- Pre-PSLRA – they had liberal pleading requirements
- Now, they have the most stringent pleading requirements.
  - Says the P must plead in great detail facts that constitute strong inference of deliberately reckless or conscious misconduct. Simply showing motive and opportunity or mere recklessness is not enough.

The 9th circuit opinion is very difficult to plead and is subject to a lot of criticism, but it is also criticized bc it changed the meaning of scienter – deliberate recklessness rather than mere recklessness.

So, just bc you can’t satisfy the pleading standards to get into fed cts, you can bring your claims to state cts. So, Congress eventually preempted state ct claims based on securities claims.

**In re Silicon Graphics**

**Lead Plaintiff**
- PSLRA made some changes to lead Ps. Concern was that whoever filed first got to be the lead P. So, there was a big rush to file. So, the PSLRA adopted a procedure to est the lead P. Choose a lead P whose interests are in line with the interest of the class – usually a big institution. Lead P is chosen by the ct. Lead P chooses its counsel and is then counsel for the class.
NEW YORK (CNNfn) - First online brokerages made it cheaper for Main Street to take on Wall Street. Now, it gets easier. With the advent of the Securities and Exchange Commission's Regulation FD, regular investors have the same earnings guidance from companies as market professionals.

But is that a good thing? The financial world is divided. Perhaps not surprisingly, Wall Streeters who once enjoyed the privilege of cozy chats with CEOs aren't happy to see them disrupted.

Other investment pros fear a "chilling effect," where companies clam up rather than get into trouble. The SEC and investment-relations professionals are still trying to sort out what's acceptable.

Not everyone agrees there was a problem in the first place. But most agree equal access will be positive in the long run.

Reg FD "certainly provides the opportunity for individuals to obtain the same information, at the same time, as professional stock analysts," James Cloonan, chairman of the American Association of Individual Investors, said when Reg FD started. Then again, "it will only help if the individual investor uses the information effectively," he said.

Companies get edgy

Regulation FD – or Fair Disclosure -- went into effect Oct. 23. But the SEC adopted the rule back in August, and many companies started adjusting how they released information for the third quarter.

Its goal is to prevent "selective disclosure," where companies convey important performance information to chosen sources. So-called "material" statements have to be made publicly if they are made at all.

It will only help if the individual investor uses the information effectively.

James Cloonan
American Association of Individual Investors

Wall Streeters say the adjustment has been a mixed bag so far. Certain companies reacted sooner, or have gone further. Some analysts say they need another six months to see how companies respond.

For the time being, Reg FD has left executives at many companies very edgy about what they can – or more importantly, can't – say.

Often they make more guidance broadly available than they have in the past. But analysts say company officials have drastically scaled back their contact with them, which often went into greater depth.

Executives also used to review analysts' earnings models. They would then "guide" the analyst as to where the model could be improved to predict the company's results. That practice -- and much one-on-one conversation -- has more or less stopped in light of FD, analysts say.

At the start of this month, the SEC's director of enforcement clarified several points in a speech to the Securities Industry Association. The SEC will only go after egregious violations, with "reckless" or "intentional" selective disclosure, Richard Walker said, or deliberate attempts to skirt the regulation.

Walker also noted that the regulation doesn't cover mid-level and junior employees and isn't a fraud law, meaning investor's can't sue under FD.

A greater number of announcements
At face value, companies are being a lot more talkative. The number of companies preannouncing earnings in the fourth quarter of 2000 was up dramatically from the same quarter in 1999. All told, 55 percent more companies guided early, close to half of them guiding investors down.

But it’s hard to tell whether the increase stems from Regulation FD. The economy is weaker. The markets have lacked direction. Both factors create uncertainty, which may prompt companies to give guidance.

"I would have expected, even without FD, to see more preannouncements this quarter," said Chuck Hill, director of research at earnings tracker First Call. "Things are worse out there."

Negative surprises grew by half, according to First Call, as the Federal Reserve's rate raises took hold. But positive surprises rose even more dramatically, doubling to 111.

More companies revealed they were on target this year than last, too. So guidance rose across the board.

More guidance, less guiding

Hill notes that Alcoa (AA: Research, Estimates) warned on its third-quarter earnings on Sept. 18. He can't remember when Alcoa ever warned before.

As a metals company, Alcoa's earnings are volatile, depending on energy costs and demand from economically sensitive sectors. But the Dow component had resisted explicit warnings in the past.

An Alcoa spokeswoman said the company acted differently because of high energy costs and softening markets like construction, not because of Reg FD. But she could not recall prior guidance from Alcoa, up or down, either.

When Nortel Networks (NT: Research, Estimates) announced its earnings Oct. 24, it also gave guidance for the following quarter and next year. A week later, on Nov. 1, it took the unusual step of reiterating that it expected to earn 16 cents a share in the fourth quarter and that revenues and earnings would grow 30 to 35 percent for 2001.

"It just seemed like there were more questions this time," spokesman John O'Connor said. "It was just simply a reinforcement of what our guidance is."

Not able to clarify a point

Companies may be reticent to attribute guidance to Reg FD because they don't want to appear to have released information selectively in the past. But Jim Parmelee, telecom-equipment analyst at CS First Boston, said Nortel is being more precise with guidance, and is not alone.

"Their view was, we have to be more explicit, not just with the coming quarter but with the quarter after that," he said. "Pretty much the entire industry is grappling with how to implement this."

He thinks Nortel decided to reiterate because it had less opportunity to interpret earnings for analysts. Nortel's third-quarter news was causing its stock to plummet, but its executives weren't able to dispel doubts about its future without another statement. Its price has been steady since.

"The flipside of FD in terms of disclosure is that it can also create more uncertainty," Parmelee said. "The companies can't respond to urgent changes and rumors."

Open analysts meetings

On Nov. 3, Sprint (FON: Research, Estimates) laid out its anticipated earnings not only for the rest of the year but also for next year. While it used to give such guidance in its annual analysts' meeting, it didn't used to publish it publicly.

Its analysts' meeting was also closed. This year, Sprint broadcast the meeting via the Web and invited 30 reporters who cover its financials, both new moves. Around 20 reporters showed up.

Sprint doesn't have a handle on how many investors listened in via the Web. But it has also started Webcasting its earnings, with its third-quarter release on Oct. 17.
Mark Bonavia, a Sprint spokesman, called the new approach "a sea change." Sprint needed to explain why its earnings on its phone side would decline, he said. It attributes the drop to capital investments it was making.

But it now has to make that information available in different ways. Webcasts and media access will be important for Sprint from here on, he said.

"You just have to consider that if there's information that needs to be told to the Street, it has to be told to others as well," Bonavia said.

**Less information leads to challenges**

Webcasts will be increasingly common, market watchers think, because they are cost effective. Smaller companies may be able to rely on phone conferencing.

But Lou Thompson, president and CEO of the National Investor Relations Institute, said smaller companies will also find it hard to guide on earnings. While they might have been able to help an analyst on one point, they may lack the ability to map their whole earnings, particularly if they are in a volatile sector like technology, he said.

But companies can't afford to stay silent, and give up marketing. Thompson said the net effect is that equal access is traded for quality information.

The Securities Industry Association also does not like the new regulation. Frank Fernandez, SIA director of research, expects analysts to be wrong more often. Companies will lack feedback from analysts on what they're doing right, he said, and not want to reveal as much information in open session.

Others agree companies will be more reticent. "Everybody is going to know the same, but it's going to be less," said Hugh Johnson, chief investment strategist at First Albany. "The disclosure of information becomes more carefully managed than the Federal Reserve manages the disclosure of information."

Like many, he thinks Reg FD will increase volatility around earnings announcements, in an already volatile year. "We'll have some bewildering rises and some bewildering, if not shocking, declines," Johnson said.

With all investors able to respond to earnings forecasts and releases at the same time, many more retail investors may be tempted to trade. But market professionals warn that uninformed investors may get caught in sudden swings, selling at inappropriate times or on information they misunderstand. Big institutions are more likely to have the resources to interpret earnings and respond rapidly, they say.

**A new kind of analysis**

But some analysts think Reg FD will have the positive effect of encouraging investors and analysts to think longer term. Without a premium on forecasting earnings, analysts will be freed -- or forced -- to mull companies' long-term picture, as well as develop industry overviews. Others suggest they will need to be better stock pickers, predicting the winners in an industry.

"It will allow you to distinguish yourself," Parmelee said. Analysts will have to know their industry and do their homework, he said.

They and investors may end up with explicit, regular information a company didn't give before, though that's debated.

Analyst Greg Smith, who covers online brokerages for Chase H&Q, notes that Ameritrade, (AMTD: Research, Estimates) has just begun releasing monthly information on its trading volumes and new accounts.

"Before, you could call and get a better idea. Now you don't get that guidance. Instead you're getting the information," he noted. So his ability to get casual guidance has been swapped for more-concrete, regular data. Greater transparency might in fact reduce volatility, he said.

He thinks private-company contacts will also become important sources. Reg FD "makes the job of an analyst more difficult," Smith said. Then again, "It was absolutely wrong for companies to tell specific information only to a few individuals."