I. SECURITIES REGULATION OVERVIEW

A. Goals of Securities Regulation: The goals of securities market focus on the issuance of securities. These laws are all about disclosure. Investors need information. They are not able to kick the tires or to squeeze the fruit to test the product. So they need to make an informed decision when buying the product – a future stream of earnings. Nearly 84 million Americans (43.6%) of the US own some sort of stock. Institutional (pension funds, mutual funds, commercial banks, insurance companies) own the rest.

1) Assuring Informed Investor Decision-Making & Consumer Protection: Investors need to trust that the company they are investing in is doing the right thing. Securities laws instill trust because the disclosure of information will mean that the investor can be confident in the company. The investor knows that that there are protective measures and legal recourse. However: this can also lead to complacency. Ex. Enron: Thus investors not confident when laws not enforced. Enron’s forms hadn’t been looked at in 3 years.

2) Allocative Efficiency: We want to ensure that stocks and other securities are priced accurately according to their true objective value. So long as the information that the regulations require is processed appropriately on the market, capital will flow to productive uses. The higher the value, the higher the price of the security and vice versa. We don’t want money being spent in places it shouldn’t be. However, corporations may restrict the outflow of information to prevent later liability actions.

3) Corporate Governance and Agency Costs: Sometimes agent/corporate interests will diverge from shareholder interest. Securities regulation mitigates these concerns, telling corporate managers don’t cook your books or stock will go down. Brandeis: “Sunlight is the best of disinfectants.”

4) Economic Growth, Innovation, Access to Capital: We want companies to be able to expand and grow. Securities regulation ensure that investors will feel confident about investing and then companies can get capital, expand, grow. A securities-centered economy like the US encourages entrepreneurial ventures. A banking-centered economy like Europe’s encourages firms dominance and corporate consolidation.

5) The Market for Lemons: Investors need to know which companies are lemons, which aren’t. Rigorous scheme of securities regulation allows the non-lemons to signal to market that they’re not lemons and thus investors won’t be afraid of investing.

B. Overview of the Financial Markets: The securities markets are a subset of the many financial markets. There are non-securities markets (bank loans, treasury bills, CDs and commercial paper) and equity markets. The decision of which market for a company to enter is based upon the cost of capital in the particular market, the time necessary to effect a transaction, and regulatory supervision. When a financial product is considered a security, the breadth of the securities laws applies.

C. The Equity Markets:

1) The Trading Markets:

   a) The Primary Market: The primary market is issuer transactions sold to investors.

   b) The Secondary Market: The secondary market are trading transactions between investors, done on NYSE, NASDAQ, Electronic Communications Markets.
D. Regulatory Framework:

1) **The SEC**: The Securities & Exchange Commission is an independent administrative body charged with the administration of the securities laws. Subject to the Administrative Procedure Act, thus there are open meetings, advance notice of regulatory changes, opportunities for interested parties to comment. Very New Dealesque. Maintains EDGAR (Electronic Data Gathering, Analysis and Retrieval).

   a) **The Composition**: One Chairman and four commissioners. Each commissioner has a five-year term, staggered, no more than three can be from the same party.

   b) **The Divisions**: The SEC is divided into 4 divisions:
      1) Corporate Finance: Oversees disclosure obligations; interprets the 33 Act.
      2) Market Regulation: Oversees secondary markets, stock exchanges.
      3) Investment Management: Oversees mutual fund, investment advisors.
      4) Enforcement: Investigates and enforces SEC regulations when there’s a public violation. No independent prosecutorial power, must work with DOJ or with U.S. Attorney’s Offices.
      5) (and) General Counsel: legal advice.

   c) **The Statutes**: Grew out of public outcry in Depression.
      i) **The Securities Act of 1933**: The 33 Act: The 33 Act handles the initial offer and sale of securities, the registration process, mandates disclosure.
      ii) **The Securities Exchange Act of 1934**: The 34 Act: Much, much broader than the 33 Act, the 34 Act requires continuous disclosure with annual and quarterly reports, handles broker-dealers, handles tender offers, insider trading.
      iii) **The Public Utility Holding Act of 1935**: (Not too effective).
      iv) **The Trust Indenture Act of 1939**: Public offerings in excess of $1M.
      v) **The Investment Company Act of 1940**: Mutual funds…
      vi) **The Investment Advisers Act of 1940**:
      vii) **The Public Company Accounting…(Sarbanes-Oxley)**:

2) **The States**: States may enforce security law through “Blue Sky Laws.”

3) **The Exchanges**: The NASD self-regulates.

II. DEFINING A SECURITY

Securities regulation goes no further than the regulation of securities, thus triggering registration, mandatory disclosure and heightened antifraud rules. Some things are definitely securities, like stocks, bonds. Others are not, such as precious metals and real estate. And some things exist in a gray area, like franchise agreements (often not because investor has much control).

**33 Act § 2(a)(1)**: Very long list, but essentially, broad and expansive. Securities pass two-part test: 1) “note”; “stock”; “bond”; or “debenture” essentially a transferable share. 2) Items with “any evidence of indebtedness,” “certificate of interest or participation in any profit-sharing agreement,” “any investment contract,” and any “instrument commonly known as a ‘security.’” Both definitions apply “unless context otherwise requires.”

**34 Act § 3(a)(10)**: (Basically repeats above).
A. Investment Contracts: Investment Ks are securities. This is a “catch-all” provision. Goal of the laws is to protect the unsophisticated investors – even if they can protect themselves

1) The Howey Test:

SEC v. W.J. Howey Co. [SCt 1946]: Howey sold parcels of citrus groves to investors. Investors took no part in cultivation but attached 10 year service Ks. Howey, however, stuck around and would then harvest oranges, pay investors according to yields of the oranges. SEC brought suit because the Ks served as “investment Ks” and Howey needed to register them.

_Held_: These are securities.
1) Investment of $: Cash or noncash, investor is not buying a consumable commodity or a service.
2) Common Enterprise: Everyone’s resources are pooled together.
3) Expected Profits/Net Proceeds: The investors weren’t buying oranges.
4) Profits Derived Solely From the Efforts of Others: Profits came on the back of Howey.

2) The Modified Howey Test: SEC v. Koscot Interplanetary [5th Cir. 1974]: Pyramid scheme in which “investors” would give money to Mary Kay-like cosmetic scheme.

_Held_: These “sales” are securities.
1) Investment of $: There must be the investment of cash, investor is not buying a consumable commodity or service (sales of make-up are not securities).
2) Common Enterprise.
   a) Horizontal Commonality: Investors are “pooled” together. Multiple investors have interrelated interest in a common scheme. There is a pro-rata distribution of profits.
   or
   b) Vertical Commonality: A single investor has an interest in the management of his/her investment.
      Broad Vertical Commonality: There is a relationship between the fortunes of investor and the fortunes of the promoter.
      Strict Vertical Commonality: There is a direct relationship between the promoter’s financial success and the investor’s, perhaps both even split the proceeds.
3) Expected Profits Derived Predominantly From the Efforts of Others: The profits no longer need to derive “solely” as was said in _Howey_. Rather, profits can derive “predominantly” from the efforts of others.

B. The “Economic Realities” Test: Restricting the Definition of Security:

United Housing Foundation, Inv. v. Forman [SCt 1975]: UHF, a cooperative housing corporation, required its residents to buy “shares” of the co-op. Money from shares was used to defray initial costs. Costs went up, however, rent went up. Tenants/Shareholders sued saying they were deceived in the purchase of these securities.

_Powell Held_: UHF wins, shareholders lose. Court looks at bottom line “economic realities.” Furthermore, (TP) this: “doesn’t look & smell like stock” – no typical indicia: shareholder rights not proportionate to number of shares, shares could not appreciate.
And applying the **Howey** Test, Court’s real focus finds “stock was not purchased in expectation of profits” but for shelter.

C. **Limited Partnerships and LLCs:**
Limited partnership: Only the general partner is on the hook. LP interests are often security.
General partnership: All of the partners are “in it together.” Basically, GP interests not security.
LLC: Law is divided, sometimes considered securities because they’re like investment Ks.

**Steinhardt Group Inc. v. Citicorp** [3rd Cir. 1997]: “Securitization transaction” conceived by Citicorp whereby Citicorp basically sold bad loans, buyers would then try to get the third party debtors to pay up. Good for seller because bad loans got ridden of, good for buyer because they can seek the $. Applying **Howey**:

*Held:*
1) Investment of $: Steinhardt did invest $42M into LP.
2) Common Enterprise: Maybe vertical commonality, but court doesn’t decide.
3) Expectation of Profits Derived Predominantly From the Efforts of Others: Court decides that limited partner had “pervasive control” of the management of the limited partnership, Steinhardt could remove the general partner and had much control of the business. This is the rare exception case where the LP is not a security. And economic realities, these are sophisticated investors.

D. **Stocks:** Laws require that “stock” be considered a security, it is not a security if “the context requires otherwise.”

1) **The Sale of Business Doctrine:** Sale of business is not stock, unless it’s the sale of stock.

**Landreth Timber Company v. Landreth** [SCt. 1985]: Father and sons (the Landreths) sold all of their “stock” in their company’s closely held corporation, a sawmill. Purchasers Dennis and Bolten then called themselves Landreth Timber Company, sued the Landreths undere securities laws when sawmill business went bad, seeking recision and damages. Landreths claimed Timber Co. couldn’t sue because they hadn’t sold stock, but had sold business.

*Powell Held:* This is definitely stock, even though business was sold. This is what is thought of when “stock” is though of – read “stock” literally. And this has all of the indicia of stock: dividend rights, liquidity, voting powers, appreciation. Sale should have been structured as an asset sale, instead. No need to look to **Howey** or to Economic Realities.

E. **Notes:** Laws require that “notes” be considered securities, not a security though if “context requires otherwise.” A note is basically issuer saying, “I promise to pay…” Laws exception, **34 Act § 3(a)(10),** though as notes that mature w/in 9 mos are not securities. Many contexts require otherwise (bank loans, school loans, etc.)

1) **The Family Resemblance Test:** Family Resemblance Test inquires if notes bear a “family resemblance” to other instruments which are securities.

**Reeves v. Ernst & Young** [SCt. 1990]: Agricultural Co-Op needed money, sold promissory notes to both members (it had 23,000 members) and to others. Co-Op filed for bankruptcy, 1,600 people holding notes sued Co-Op’s auditors.

*Marshall Held:* Any note is a security if it doesn’t mature w/in 9 months. This is a rebuttable presumption if the “context requires otherwise.”
1) Desire to Profit: Inquire if there was a desire to profit eventually, or to effect a sale. In this case, the motivation was to eventually profit.
2) Plan of Distribution: In this case there was “common trading for speculation or investment” 1600 investors is certainly a broad category.
3) Parties Expectations: The expectation was to invest. Look at Economic Realities. Was it commercial or investment-related?
4) Existence of Other Regulatory Schemes: If there are other means of investor protection, such as the collateralization of the loan, state laws, then securities law may not need to apply.

III. MANDATORY DISCLOSURE

A. Disclosure Policy: The securities laws are all premised on disclosure. With information available, the argument goes, investors will be able to protect themselves.

1) Arguments Against Mandatory Disclosure: There are many alternatives debated:

   a) Alternative: Merit Review: The government or some other body gives advice on a security. This has been fundamentally rejected because decisions or advice could be motivated by political influence instead of good faith beliefs, investors could choose to follow private investors anyway, the market takes care of itself, not ten people sitting around a conference table.

   b) Incentives Already Exist: Companies will provide info anyway so that investors will confidently invest.

   c) Information Overload: Mandatory Disclosure will incur a glut of excessive info.

2) Arguments for Mandatory Disclosure: Investor Confidence, Confidence, Confidence!

   a) Avoid Bad Faith: Companies may hold onto information for a long time so they don’t have to disclose it, they’ll reveal when they need to. Even though investors will want info to invest, companies may push the envelope.

   b) Level the Playing Field: All investors, not just a select few, will be able to participate, fairness will follow.

B. The Efficient Capital Markets Hypothesis (ECMH): The cornerstone of Disclosure Policy, the ECMH demonstrates a relationship between information and price. Thus the market accurately reflects price. There are three forms of market efficiency:

1) Weak Form Efficient: Market is efficient if past information is already reflected in the price. This info is not indicative of future results.

2) Semi-Strong Form Efficient: Market is efficient if new or just released or any public information is quickly “digested” and then immediately reflected in the price. This is more along the lines of reality, however, and bear in mind that information can be processed incorrectly.

3) Strong-Form Efficient: Market is efficient if all public and private information is immediately reflected in the price. This is not reality and explains private information and insider trading.

C. The Impossibility of Perfect Efficiency: Efficiency markets can’t be taken too seriously otherwise on one would ever make money. Other forces, for example a sunny day in NYC, may drive prices too.

1) The “Efficiency Paradox”: Analysts need to be objective, but they work in the same shop as the underwrites who want to make money!
IV. § 5 OF THE 33 ACT – REGISTRATION

There are many ways to get capital other than going public, like loans, retained earnings, private placement. The big debate for companies: debt or equity. The problems associated with going public are the expenses and many Ks, eventual demands of outside shareholders, disclosure compliance costs, and effects of the disclosure of information to competitors. Goal of laws is investor protection, however it’s important not to impede capital raising. Overall idea here is that issue is arranging with firms for the distribution with an underwriter “underwriting” the issuance. Issuer sells low to underwriter, underwriter sells a little lower (with a profit) to firm, firm then sells.

A. Statutory Framework: The basic rules of the 33 Act are 1) to disclose and thus provide investors with material financial and other information concerning the issuance of securities; 2) prohibit the fraudulent sales of securities. § 5 is based on interstate commerce, the mails, only questionable on law school exams.

§ 5: Applies to the Primary Markets (issuers and underwriters) and not to the secondary markets. This is the law of full disclosure and regulation. Applies to use of the mails and is almost always met. You must register a public offering and that means disclosure! If you do this wrongly, you’ll have to deal with § 11 and § 12.

§ 5(a): Prohibits the Sales of Securities without Effective Registration.
§ 5(b): Issuance of Prospectus must conform to § 10.
§ 5(c): Requires filing of registration statement. Reg. S-K dictates the contents of the registration statement and the requirements of the prospectus. The prospectus is the principal selling document for the offering. In turn it is required:

Reg. S-K: Requires offering price, issuer, registrants, MD & A (Rule 303), related parties, indemnification of officers and directors, co. capital structure, legal proceedings, etc.

B. The Pre-Filing Period (The Quiet Time): The company first chooses the filing date. During the pre-filing period, however, offers and sales are prohibited, otherwise the SEC may get mad, delay the effective date and then the price may have gone from $30 to $20, company hurt badly. There can be no “Gun Jumping” whereby the company conditions the market, thus lawyer must make sure CEO doesn’t go on CNBC and tell about the offer. Lawyer must also review press releases and other documents. Company cannot release predictions, forecasts. Company can, however, release factual information (amount of security to be offered, manner of offering). No Bright-Line Rule to any of this, however. Registration statement and prospectus will require S-1, S-2, S-3, info. about the company, offering and use of proceeds, a description of the registering security, the company’s undertakings. In reality, though, price will be decided by the market.

1) **No Offers:** During the “Quiet Time,” companies cannot make any effort to offer a security. The company must remain quiet.

§ 2(a)(3): (Carve Out): Defines very broadly an offer to “sell” or “sale.” However, preliminary conversations with underwriters and other necessary parties are allowed. Otherwise a complete restriction would stop the offering process. And the underwriter needs to be a part of this process.

**Rule 135:** Compliance with 135 is not an offer (some information generally about the offer is allowed to be released).

2) **No Sales Can be Consummated:** During the “Quiet Time,” as with offers, companies cannot make any sale of the security.

C. The Waiting Period: The registration statement has been filed with the SEC but it is not yet effective.

1) **Strictly Regulated Offers:** Once the company has filed their registration statement, they can begin efforts to sell the security.

§ 8(a): Registration Statement can become effective 20 days after it is filed.
§ 5(b)(1): Restricts nature of offers. Delivery of any prospectus must comply with § 10.
§ 5(b)(2): Delivery of sec.s can’t happen until prospectus complies w/§ 10(a) [The Statutory Prospectus – The Real One].
Rule 134: Registrant can solicit intent from prospective purchasers. There are thus ways to reach investors during the waiting period. In reality, these are what induce the investment decision because the official prospectus will come after the purchase:

a) Oral Offers: There can be oral offers, but not on TV, radio or phone. Only face to face. Also, preliminary prospectus is required for these meetings.

b) The Preliminary (“Red Herring”) Prospectus: There is certain information that was not in the initially filed registration statement. This prospectus includes substantially all of the information that will be in the final prospectus. It has red cover with “Subject to Completion” in red ink and thus “Red Herring.” Though this prospectus can be used in offers to sell, it does not satisfy § 10(a) and thus can’t be used in the delivery of securities. So you’ve got to use the real prospectus to seal the deal.

   Rule 430: This can be used because it complies with § 10.
   Rule 430A: Price Information can be excluded, it’s not yet available. You can also go effective without this info.

c) The Summary Prospectus: Like the Preliminary, but this also cannot be used to seal the deal.

   Rule 431: Authorizes.

d) The Tombstone Ad.: The Tombstone Ad. is a bare bones ad that announces the sale of a security, the offeror, and the underwriters. (It’s so stark…Tombstone.) Can’t be done during the Pre-Filing Period, though.

   § 2(a)(10): This is one of the “carve outs.”

e) The Identifying Statement: Like a Tombstone Ad, an Identifying Statement is an expanded Tombstone ad. And tells investors where they can get the preliminary prospectus. Can’t be done in the Pre-Filing Period.

   § 2(a)(10)(b): Allows for an expanded Tombstone ad.
   Rule 134: 14 informational requirements must be met.

f) Testing the Market: The Roadshow, etc.

2) No Sales Can be Consummated: Sales cannot be consummated until the registration statement is effective.

D. The Post-Effective Period: The SEC has then declared the registration statement effective.

1) Offers: Once effective, the prospectus can be used in an offer to sell. The Prospectus must comply with § 10.

   § 5(b)(1): Prospectus in offer must comply with § 10. Though written offers are still prohibited, they are indeed allowed in “free writing” when accompanied by a § 10(a) prospectus.

2) Sales: 

   § 5(b)(2): Delivery of securities must have a § 10(a) prospectus. SEC wants investors to have the prospectus.

   Big Q: When is delivery?: 3 Business Days following the trade date.

   Rule 434: Allows info in final prospectus to be delivered in a piecemeal fashion. Web-posting is not enough. And send with term sheet. SEC posts its docs online in EDGAR, though.

E. Integrated Disclosure & The Registration Process: The 33 Act and the 34 Act had different disclosure requirements for nearly 50 years. In 1982, however, the SEC created a unified approach to disclosure.
Today virtually all filings under either the 33 Act or the 34 Act are uniform. Goal was ease and lower compliance costs for issuance. Whole system is premised on ECMH.

34 Act: Requires registration if:

§ 12(b): Shares of either debt or equity are listed on an exchange. This is a gatekeeper requirement for securities on the market.

§ 12(g)(1) and Rule 12g-4: Company has assets over $10M and over 500 security/equity holders, whether or not company had already filed under 33 Act. Company can de-register if it falls under a threshold. Also, many companies are exempt, such as some mutual funds.

§ 15(d): Company has registered under the 33 Act.

§ 13: Required forms to file for reporting companies in periodic disclosure for “Reporting Companies” in Reg. S-K: 10-K, is an annual financial report. 10-Q is a quarterly financial report. 8-K is as special report for bankruptcy, merger, etc. The Prospectuses for these companies:

S-3: Companies widely followed by analysts. This is the shortest form. These are “seasoned companies.” This form allows offering via reference to the information already disclosed in the Qs and Ks. These companies prospectus will be stream-lined. (S-4 concerns merger and acquisition issuance, S-8 concerns EE stock purchases).

S-2: Companies subject to 34 Act for at least three years. These are “seasoned companies” or “reporting companies.” Their prospectus is streamlined, too.

S-1: Companies subject to 34 Act for less than three years. These are generally not Reporting Companies but are companies making an IPO.

G. Qualitative Disclosure: Growing concerns today about “qualitative” issues that should be disclosed, such as executive compensation, stock ownership, conflicts of interest, litigation worries.

Rule 408: “Additional Information…”

H. New Approaches to Disclosure: Soft Information: Soft information includes information such as projections, estimates or opinions. This information can be the most important and perilous to investors. Historically, the SEC was concerned with historic information and thought that forward-looking statements were misleading. Such forward-looking statements are now allowed, protected by safe-harbor provisions unless the statements were made “without reasonable belief” or were not “in good faith.”

1) Managers Discussion & Analysis (MD&A): For MD&A, there is information that companies are required to disclose and information that companies are encouraged to disclose. This is one of the most significant innovations in mandatory disclosure. However, the issuer does need safe-harbor protection.

Item 303: Liquidity and Capital Reserves.

a) Safe Harbor if Reasonable Basis/Good Faith: A company will not be subject to fraud or liability if the forward-looking statements were made based on a reasonable basis or in good faith.

Rule 3b-6: As long as there’s a reasonable belief…


I. Shelf Registration: Shelf Registration occurs when a company registers more shares than it plans to initially offer – putting some on the “shelf” until market improves. Also means company won’t have to incur time and expense of registering all over again.

Rule 415(a)(1)(x): Applies to big, seasoned companies who use S-3.

Rule 415(a)(2): The amount that can be shelved is limited to what can reasonably be sold two years from the effective date.

Rule 415(a)(3): Prospectus and information must be updated, it can’t go “stale”

Rule 176: Fraud consideration can apply.
V. § 4(2) OF THE 33 ACT – THE PRIVATE OFFERING/PLACEMENT EXEMPTION

Some issues are exempt from the rigorous registration process. These issues, however, are still liable to the fraud provisions and to Rule 10b-5.

A. The Private Placement Requirements (Generally): § 4(2) exempts transactions “by an issuer, not involving any public offering” from the requirements of the 33 Act. The purpose of this exemption is to encourage capital formation and not force the securities laws upon those who have adequate knowledge and can fend for themselves. Benefit of the exemption is saved time and resources. And § 4(6) requires that private offerings to accredited investors pass the exemption if the amount offered is below $5M.

1) Those Who Can “Fend for Themselves”: Typically, these investors are venture capital firms, family and friends, and other who can bargain.

   a) Investor Sophistication: Focus on the investor’s ability to evaluate the investment: proxies for sophistication include income, education, profession, history of investing, competence, possession of comparable securities, prior relationship with issuer.

   SEC v. Ralston Purina Co. [SCt. 1953]: Uncertainty about the scope of § 4(2) was settled. Ralston Purina sold stock to it’s “key employees” without registration. Hundreds of very unsophisticated “key employees” bought this stock, SEC sued to have future stock sales registered.

   Clark Held: The employees were unsophisticated and unable to protect themselves, the law should protect them. They couldn’t fend for themselves.

   b) Access to Information: Proxies for access to info include management team, MD&A, risk factors, compensation, auditors, forecasts.

   c) Number of Offerees: Rule 701: Allows for certain EE benefit plans.

2) Resale Restrictions: Investors resales are restricted otherwise they’re underwriters.

3) No General Solicitations: Just as offerees must be qualified, there can be no general solicitation.

VI. REG D OF THE 33 ACT – THE LIMITED OFFERING EXEMPTION

§ 4(2) is a general statutory exemption. Reg D is a combination of previous exemption rules. The SEC relied on § 4(2) and § 3(b) to promulgate these rules. They provide clarity and answers to issuers, dealers and investors unsatisfied by the Ralston Purina Test.

A. Reg D Requirements (Generally):

1) Strict Compliance: Strict Compliance is generally required (unless noncompliance did not undermine protection, or there was good faith).

2) Value: All Reg Ds (504, 505, etc) are integrated together and considered as one offering, and their respective values are aggregated (w/in past 12 mos).

   Rule 506: Five Step Test for Integration (sales 6 mos after completion are in safe harbor):
   1) Are sales part of the same single plan of financing?
   2) Are offerings the same class of security?
   3) Have sales been made around the same time?
   4) What type of consideration is received?
   5) Are sales made for the same general purpose?
3) **“Accredited Investor”**: Defined in **Rule 501** (Institutional, big organizations with more than $5M, key insiders – but title doesn’t mean everything, millionaires, wealthy people with over $200K in annual income or $300K with spouse, venture capital, sophisticated trusts, accredited-owned entities, entity where all partners are accredited). This is learned by the issuer in the investor questionnaire.

4) **General Solicitations**: Reg D does not prohibit offers to nonaccredited investors, however it does prohibit “general solicitations or general advertising.” A “preexisting relationship” would generally not be considered a “general solicitation.” Often this means issuers will rely on broker-dealers for list of potential investors. Furthermore, a coming sale can only be announced in an informative manner.

   **Rule 502(c)**: Examples of prohibited solicitations include newspapers, magazines, television or radio ads, open seminars or investment meetings.

5) **Disclosure Obligations**: Affirmative disclosure obligations are not required for **Rule 505** or **Rule 506** accredited investors, but affirmative disclosure is required to non-accredited investors in **Rule 505** or **Rule 506**. Furthermore, it generally makes sense to disclose to accrediteds, too. Disclose, disclose. If company is a reporting company, it can give its most recent filings. For non-reporting companies: $2M offering disclose financials; B/w $2M and $7.5M reg. Form and financials; $7.5M+ financials, etc.

   **Rule 502(b)(1)**: Sets forth disclosure requirements to non-accrediteds.

   **Rule 502(b)(v)**: Issuer shall also be available to answer questions, etc.

6) **Resale Restrictions**: Resales are restricted so it won’t turn into a public offering: a) investors must sign letter of intent; b) the securities restricted nature must be disclosed; c) securities must be legended as restricted.

   **Rule 502(d)**: Sets forth restrictions, securities can’t be resold without registration.

**B. The Reg D Exemptions**:

1) **Rule 504: Small “Microcap” Offerings**: Non-reporting companies can sell up to a) $1M in securities in b) any 12-month period; c) no limitation on the number of purchasers; d) no affirmative disclosure obligation; e) **Rule 144** and restricted resale rules apply (two-year restriction).

2) **Rule 505: Medium-Sized Offerings Subject to SEC Conditions**: Companies that are neither investment companies nor “Bad Guys” can sell up to a) $5M in b) any 12-month period; c) no limit on # of accredited investors and only 35 non-accredited investors (issuer must “reasonably believe” there are no more than 35 non-accredited investors); d) Non-accredited investors must receive specified written disclosure and be able to ask questions of the issuer (affirmative disclosure obligation); e) Restricted resale.

3) **Rule 506: Private Offerings Subject to Safe-Harbor Provisions**: Like Rule 505, but a) No limit on price and b) no limit on time period; c) no limit on # of accredited investors but only 35 non-accredited investors and they must be sophisticated (able to evaluate merits of the investment!); and d) affirmative disclosure to non-accredited including questions, etc; e) restricted resale. This would also pretty much mean a good § 4(2) exemption. But an offering could still be exempt under § 4(2) even if it fails Rule 506.

**VII. RULE 144 OF THE 33 ACT ET AL – SECONDARY & POSTOFFERING DISTRIBUTIONS**:

§ 4(1): The provisions of § 5 do not apply to “transactions by any person other than an issuer, underwriter, or dealer.” The focus is here is that some sales by non-issuers are within the reach of § 5.

   **A. The “Underwriter Concept”**: Sometimes sales of restricted securities (securities offered in § 4(2) or Reg D) effectively turn the seller into an underwriter. Those who buy on the NYSE, for example, would not have to worry about being an underwriter. That’s a “pure transaction” on a secondary market.
§ 2(a)(11): The term “underwriter” is defined:
1) Anyone who has purchased from an issuer [or control person] with “a view to…the distribution…”
2) Anyone who offers or sells for an issuer [or control person] in connection w/the distribution…”
3) Anyone participating in the direct or indirect underwriting…
4) Anyone who is an underwriter…

1) **Statutory/Plain Vanilla Underwriters**: These are clear underwriters.

2) **Constructive Underwriters/Agent for the Issuer**:

   *SEC v. Chinese Consolidated Benevolent Association, Inc. [2nd Cir. 1941]*: Non-profit association of Chinese Americans sought to encourage investors to buy bonds in the Republic of China. Solicitations were made in meetings, newspaper ads, and personal appeals. The Association then gave the subscriptions, without taking a fee, to the Chinese government. SEC comes after the Association because they considered Association to be underwriters, underwriters were soliciting. Bonds weren’t registered.

   **Held**: The Association served as an underwriter. Even though they weren’t “issuer, underwriter or dealer,” policy of § 2 would be thwarted if they weren’t. (This could also be used to go after newspapers, etc. who advertise).

3) **Purchaser with a “View to…the Distribution”**: Those who purchase with a “view to…the distribution are clearly considered underwriters. A re-sale will only constitute a distribution when the rationale behind exemptions is violated. This could be an investment firm or someone who purchases in a private placement of Reg D exemption (thus those companies will severely restrict their issues so they don’t unwittingly go public).

   a) **A “View”**: To determine a “view,” we need to look at intent. The longer the holding period, the more likely the intent was to make the purchase an investment. The holding period is probative of intent – though not dispositive. The security must “come to rest.” General rule: less than 6 mos has not come to rest; after 2 years is the breaking point; 2 to 3 years is presumptively an investment. Even “change in circumstance” won’t help the underwriter avoid problems.

   b) **“to the Distribution”**: In addition to a “view,” it is required that there be a distribution. The question here is whether those who bought the security from the person with the view could “fend for themselves,” as in *Ralston Purina*.

4) **Control Persons**: A control person could be an underwriter. A control person is: a) someone who “controls” the issuer or the business; b) anyone in a control relationship of the person doing the underwriter, like an intermediary. This could be a broker who assists an agent of the issuer/constructive underwriter. Thus more and more people are brought into the definition. **Rule 405** governs, policy is that those with control shouldn’t be able to take advantage of market because they have superior information. Public needs protection.

   To determine control person liability, there is a different analysis:

   a) **When Securities Have Not Yet Come to Rest**: Control Persons: Will not determine who is an underwriter.

   b) **When Securities Have Come to Rest**: Control Persons: Intent doesn’t matter; participation in distribution does matter. Non-Control Persons: They may take advantage and re-sell securities.
B. Resale Restrictions: Rule 144 concerns “persons deemed not to be engaged in a distribution and therefore not underwriters.” This rule is a saving-grace for companies that don’t want to go public. Rule 144 applies to “control securities” (held by a control person) and “restricted securities” (securities in a nonpublic offering, from the issuer or a control person in a private placement, Reg D). Public needs protection when these are sold.

1) Requirements for Resale of Restricted and Control Securities: Rule 144 sets forth the rules that need be met so there is no distribution, and thus wrong underwriting. This is a non-exclusive safe-harbor. This is how you have a secondary distribution:

a) Availability of Current Public Information: There must be adequate information about the issuer available. This req. is met if the issuer: a) already has securities registered under the 33 Act or 34 Act; b) the issuer has reported for at least 90 days prior to the sale; c) has filed 34 Act reports preceding the sale.

b) Holding Periods for Restricted Securities: A one year holding period need be met.

c) Limitations on the Amount that Can be Sold: Sales of persons acting in concert are aggregated.

d) Manner of Sale: Through a brokerage transaction or through a “market maker.”

e) Required Notices of Sale:

C. Resale Restrictions to QIBS:

1) Requirements for Resale to Qualified Institutional Buyers (QIBS): Rule 144A is an extremely important tool to raise capital. Also a non-exclusive safe-harbor provision. Securities must not be of same class as those listed on an exchange, thus these become “144A Securities.” QUIB must have $100M or more in its portfolio (much more than just “accredited”). No holding period and no volume limitations. QUIB can resell.

PART TWO: LIABILITY

VIII. CIVIL LIABILITY UNDER THE 33 ACT

A. § 11 Liability Provisions: Fraud in the Registration Statement: The idea behind § 11 is that a material misstatement or omission in an effective registration statement already filed subjects the issuer to a prima facie case by anyone who bought the security – whether in the primary market or secondary market. “Free-writing” materials are not part of this, however. There are many possible defendants: the issuer, signatories of the registration statement, directors, partners, soon-to-become partners, expert parties, and underwriters. But not lawyers (lawyers they can be taken care of in malpractice, other means).

1) Immediate Defenses:

a) Statute of limitations: § 13: Strict one year statute of limitations after plaintiff discovers or should have made discovery and action cannot be brought more than three years after security offered to public.

b) Reliance: Though reliance is not required by the plaintiff during the first year, after 12 months of earning statements, the plaintiff must show reliance on the registration statement. Idea is that new info in annual reports has come out.

c) Resignation: If defendant has resigned with a letter and informed the SEC of the misstatement then they will be off the hook.
2) **The Due Diligence Defenses**: § 11 placed the burden on the defendants to show their nonculpability regarding portions of the registration statement. § 11 divides the portions into expertised and non-expertised. Goal is to get as many on hook as possible, force compliance.

a) **Expertised Portions**: Expertised portions of the registration statement are portions prepared or certified by an expert. This can be audited financial information or legal opinions.

   **The Expert**: The Expert must show that they conducted a reasonable investigation and had reasonable grounds to believe and did believe that the expertised portions were true within their area of expertise. (same as **Non-Expert** for Non-Expertised). “I didn’t know is not sufficient.” Expert must literally kick the tires, ask the tough questions.
   
   § 11(b)(3)(B): (Sets forth).

   **The Non-Expert**: The Non-Expert must show that they had no reason to believe and did not believe that the expertised portions were false.
   
   § 11(b)(3)(C): (Sets forth)

b) **Non-Expertised Portions**: Non-Expertised portions of the registration statement not prepared by an expert. These are unreasearched statements.

   **The Expert**: No liability.

   **The Non-Expert**: The Non-Expert must show that they conducted a reasonable investigation and had reasonable grounds to believe and did believe that the expertised portions were true. (same as **Expert** for Expertised). “I didn’t know is not sufficient.”
   
   § 11(b)(3)(A): (Sets forth)

c) **Due Diligence Requirements (Generally)**:

   **Escott v. BarChris Construction Corp.** [USSD NY 1968]: Defendant BarChris company built bowling alleys, needed to raised capital, drafted registration statements to issue debentures. Reg. Statement seriously misstated company’s finances, overstated the number of bowling alleys BarChris had sold, did not disclose that BarChris would lose money on some notes, misstated backlogged orders, did not disclose that $ would go not to reconstruction but to debt financing, and that some insiders had not repaid loans. BarChris eventually filed for bankruptcy. **Held**: Everyone’s liable, should have investigated.

i) **Outside Directors**: Outside Directors due diligence can be related to their access and their position and their level of knowledge.

ii) **Inside Directors and Offices**: Inside Directors and officers are expected to make more complete investigations, because of familiarity. Presumed experts.

iii) **Underwriters**: Lead underwriter generally held to a higher standard than the syndicate underwriters.

iv) **Experts**: Only liable for information in their area of expertise.
3) **Causation and Damages**: The § 11 plaintiff does not need to prove causation, however, the defendant can advance causation as a defense to the plaintiff’s claim.

1) **The Negative Causation Defense**: Defendant can have a defense if they can show that other factors than the misinformation caused or contributed to making the price of the stock to fall. War, terrorism, loss of a CEO, etc. Defendant can write “event studies.”

*Akerman v. Oryx Communications* [2nd Cir. 1987]: Plaintiff challenged misinformation in IPO registration statement. Price went down between IPO and filing of suit. Price went up, however, between disclosure to public and the suit. *Held*: No causation.

2) **Damages**: Defendant will fight all of these with the negative causation defense, particularly the value issue.

   Formula:
   
   Cap: Damages cannot be any more than the aggregate offering price. Damages then depend on when plaintiff sold securities.

   a) **Securities Sold Before Suit**:
      
      Purchase Price
      – Sales Price
   
   b) **Securities Sold After Suit, Before Judgment**:
      
      Purchase Price
      – Sales Price
   
   c) **Securities Held at Judgment**:
      
      Purchase Price
      – Value at Time of Suit (not “Market Price”)

4) **§ 11 Plaintiffs**: All purchaser of registered securities have standing to sue. *Hertzberg v. Dignity Partners, Inc.* [9th Cir. 1999]. Securities must be traced back to offering, though.

**B. § 12 Liability Provisions**:

1) **Strict Liability for Offeror/Sellers**: § 12(a)(1) imposes strict liability against sellers of unregistered securities when no exemption applies. ICC jurisdiction. Defendant can’t say “I didn’t know I was supposed to register.” Ultimate compliance required. Plaintiff must show:

   a) **Defendant Was an Offeror or Seller**: Seller could have either transferred title, but could have participated in the solicitation. You can only go after your seller, not your seller’s seller.

   *Pinter v. Dahl* [SCt. 1988]: Pinter had an oil and gas venture. Dahl purchased shares in the venture and then recommended to his friends that they buy shares. Venture failed, investors sued Pinter for recission. Pinter tries to get Dahl on the hook, too. Question was whether Dahl himself was an offeror or just gratuitous promoter. *Blackmun Held*: Anyone who solicits for their financial interest is a seller (broker etc). Giving gratuitous advice doesn’t make one a seller.

   b) **Defendant Failed to Comply With § 5 Req.s**: Unregistered offer, no prospectus, etc.

   c) **Defendant’s Only Defense: Exemption**: Defendant does have a defense if securities would have been exempt.

   d) **Remedy**: If plaintiff still owns, gets back money and interest (no interest in § 11).
2) **Misrepresentations in Public Offerings**: § 12(a)(2) applies when there is a material misstatement or omission in the prospectus in a public offering. Somewhat of an extension of § 11, applying to prospectuses.

a) **Prospectus Must be In Registered Public Offering**: Private offerings don’t qualify, nor do purchase price agreements. Those in a private placement can already “fend for themselves.”

*Gustafson v. Alloyd Company, Inc.* [SCt. 1995]: Closely held corporation sold all of its shares to an investment corporation. Investment company sued under § 12(a)(2) for rescission. Said there were material misstatement. *Kennedy Held*: Definition of prospectus only applies to public offerings.

b) **Defendant Defenses**: Defendant can show a) reasonable care and b) negative causation.

**IX. CIVIL LIABILITY UNDER THE 34 ACT**

A. **Materiality**: A misstatement of omission must be material. The same definition of materiality applies to both Rule 14a-9 and Rule 10b-5. What’s required under Reg. S-K is definitely material. In addition:

1) **The General Standard: “Substantial Likelihood”**: The TSC general standard often applies. There is no bright-line rule otherwise the flexibility of the SEC would be greatly reduced.

*TSC Industries, Inc. v. Northway, Inc.* [SCt 1976]: *Marshall Held*: A fact is material if “there is substantial likelihood a reasonable investor would consider it important” in making a securities related decision. This was a compromise between facts an investor “might” and “would” consider. This is a content-specific standard.

a) **Quantitative & Qualitative Materiality: The “Total Mix” Test**: Quantitative information is information that could effect the stock price (less than 5% is likely not material; between 5-10% could be material; more than 10% if material). Qualitative information is information about labor problems, illegal conduct, etc. This is always material if it refers to illegal activity or conflicts of interest. If client has bad news, disclose but don’t bury.


2) **Soft Information & Forward-Looking Statements**: Soft information and forward-looking statements can also be material.

a) **Puffery**: Common law notion that puffery is not actionable. Regardless, Courts consider 1) how general the statement is; 2) whether the statement is one the company would utter regardless of the facts. Market will understand when company “puffs.”

b) **The Probability-Magnitude Test**: Another test for materiality is balancing of the probability and magnitude of the potential event. Say “no comment.” No need to voluntarily disclose. Materiality does not give rise to duty to speak. Business matters are not co-extensive with securities law obligations.

*Basic v. Levinson* [SCt 1988]: Combustion and Basic were going to merge. On three times Basic publicly denied it was going to merge. *Held*: Materiality “will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event.”
c) **The Bespeaks Caution Doctrine (Judicial):** Forward-looking statements inevitably can turn out wrong. The Bespeaks Caution Doctrine is a safe-harbor because it can immunize forward-looking statements if accompanied by cautionary documents. This entices companies to put the information out there.

d) **Meaningful Cautionary Language: Rule 175 and 3b-6 (SEC):** Benefits of safe-harbor are only for forward-looking statements. Codified in the PSLRA. Satisfying one of these by the defendant precludes action:
   i) **Defendant Did Not Have Actual Knowledge:** If the defendant did not have actual knowledge that the misstatement was wrong, then not actionable.
   ii) **Immateriality:** Material could be soft, Bespeaks Caution could also apply.
   iii) **Cautionary Statements:** Cautionary statements cannot be just boilerplates but must “convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward looking statements.”

3) **Reasons, Opinions, and Beliefs:** Reasons, opinions, and beliefs can be material.

   *Virginia Bankshares, Inc. v. Sandberg* [SCt 1991]: Minority shareholders challenged the proxy disclosure in a squeeze-out merger. VBI statement had said that merger would incur a higher value for other shareholders. Minority shareholders contended that VBI didn’t really believe that, rather board just wanted to keep their jobs. Souter Held: Statement would be material misstatement or omission if it was a misstatement about its beliefs and the factual subject matter.

B. **Rule 10b-5 & Non-Insider Trading Fraud:** The Rule applies to fraud in connection with the purchase or sale of a security. There is an implied private right of action, so private plaintiffs, and SEC can bring suit.

   1) **Standing:** The fraud or deception must be in connection with the purchase or sale of a security. Breaches of fiduciary duty, however, do not give rise to a Rule 10b-5 action. *Santa Fe.*

   2) **Materiality:** The misstatement or omission must be material (see above).

   3) **Scienter:** The mental state must “embrace intent to deceive, manipulate or defraud.” Negligence is not scienter. Recklessness (extreme departure from the standards of ordinary care) could be scienter.

   *Ernst & Ernst v. Hochfelder* [1976]: Accounting firm negligently failed to audit a company’s accounting practices, firm did not become aware that company’s president was embezzling. Held: Negligence is not scienter.

   4) **Reliance & Causation:** Reliance is an element, but standards generally relaxes requirements. Face-to-Face transactions not required. *Affiliated Ute.* Also there’s a difference between transaction causation and loss causation. Transaction: But for fraud, transaction would not have occurred. Loss causation: fraud produced the claimed fraud. Under PLSRA, plaintiffs must show loss causation in a Rule 10b-5 case (versus negative causation above).

   a) **Fraud on the Marketplace Rebuttable Presumption:** Plaintiff does not need to show that they read misstatement, etc. This is the applicability of the ECMH. Market already reflects reliance. Must be impersonal, large national market. Face to face won’t do. Rebuttable by showing that market was inefficient, plaintiff would have traded anyway, that plaintiff was sophisticated, buyer would have bought or sold regardless.

C. **Clause 2 of Rule 10b-5:** The Duty to Update & the Duty to Correct: There is a duty to update issuer statements and to correct other statements that could be attributable to the issuer. Companies cannot speak
in half-truths. This duty exists as long as the statement is “alive.” Rumors don’t give rise to the duty unless the issuer or whomever has endorsed those rumors. The issuer should know that people are relying on their statements. It is a misstatement or omission which gives rise to the duty, not the fact that information is material. This is an uncertain area of law, however.

**In re Time Warner Securities Securities Litigation** [2nd Cir. 1993]: Duty to update when company began to consider another major plan, alternative to the one announced. Alternative plan would have driven down earnings per share.

D. **Rule 10b-5 & Insider Trading**: The big focus of **Rule 10b-5** is insider trading. Insider trading is unlawful trading by any person possessing “material nonpublic information.” Policy arguments for: include fairness, get info. on the market, egalitarian, pricing efficiency, way to compensate management. Arguments against: companies will hold onto information, there are other means. There’s “good” info and “bad” info.

1) **Duty**: (Only an element in omissions): Duty arises out of a fiduciary relationship when it comes to material nonpublic information. **SEC v. Texas Gulf-Sulphur** [2nd Cir. 1968]: Anyone with material nonpublic information must abstain from trading on the information or disclose it.

**Chiarella** [SCt. 1980]: Printer employed to print T.O. documents knew of impending T.O. No duty because EE did not have a duty to abstain or disclose information.

**Held**: No duty to target corporation; duty to ER reserved; misappropriation theory reserved. Awkward and unsatisfactory rule, though. Capital information hampered and egalitarian principle not effective.

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**Dirks** [SCt 1983]: Tipper Secrist told tippee Dirks about big insurance fraud at Secrist’s old company.

**Held**: For **Tipper** Secrist to be liable: 1) tipper (Secrist) must have been violating fiduciary duty; 2) tippee (Dirks) must have known tipper was violating fiduciary duty; 3) there must be some benefit to the tipper (Secrist)]. Basically Quid Pro Quo. All this is hard to show. Analysts and whistle-blowers are immune. And tipper can be liable, if down the line sub-tipper trades even if Tipper doesn’t trade. If sub-tippees know or should know that info. came from fiduciary breach, they’re liable.

For **Tippee** to be liable: Tipper must be liable first.

**Tipper/Tippee**: (see above)

**Constructive Insiders**: FN14 [**Dirks**]: Accountants, lawyers, investment bankers as have same **Rule 10b-5** duties as corporate insiders.

**Strangers**: Strangers with no **Rule 10b-5** duty and thus no fiduciary relationship are not liable.

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**O’Hagan** [SCt 1997]: Lawyer using inside information had a fiduciary duty to the corporation from where he got the source. Lawyer made $4.3M. Requirement of IT laws is to protect integrity of securities markets from outsiders. **O’Hagan** stands for outsiders (insiders already covered). And don’t forget mail and wire fraud provisions.

**Misappropriation Theory**: Misappropriation is the “use of a deceptive device” “in connection with securities trading.”
Rule 10b5-2: Requisite fiduciary duty for misappropriation theory liability: 1) agreement to keep information in confidence; 2) history of shared confidence between the parties; 3) info. to parents, spouses, etc. unless there was no expectation of confidence.

Rule 14e-3: Prohibits trading on basis of material nonpublic information regardless of breach of fiduciary duty in a tender offer.

E. Reg FD: To get around disclosure problems of companies not knowing bad trading from good. Rules encourage release of information, stops problem analysts getting a lot of info and currying favor. Enforceable only by SEC. Ends previous problems of selective disclosure. Problems though in mosaic theory in that analysts can piece together info and conclude something material. An egregious violation would telling earnings per share to analysts but not to the public.

1) **Prohibition On**: Companies from selectively disclosing information to: a) broker-dealer; b) investment-adviser; c) investment company; d) holder of issuer’s stock.

2) **Public Disclosure**: If intentional it must be simultaneous. If unintentional, w/in 24 hours.

3) **Public Disclosure Not Required If**: a) to person with duty of trust and confidence; b) person who agrees to maintain info; 3) credit rating agency; 4) someone in connection with public offering under ’33 Act.

X. GENERAL CIVIL LIABILITY PROVISIONS

A. PSLRA: Today, if you can plead, do it in the 2nd Cir. because they have the easiest standards. If you’re the defendant, try to stay in the 9th Cir. because plaintiff will have to plead in great detail that which caused the recklessness, etc.

   Generally:
   1) In any private action the plaintiff must state exactly what was misleading and how it was misleading;
   2) In any case involving scienter, the plaintiff must show that the defendant acted with that state of mind.

B. Control Person Liability: Liability can be expanded to both deter and to compensate.

   1) Primary Violator: Person who commits the violation.
   2) Secondary Violator: Person who assists or supports the primary violator. Control persons are held liable to the same extent as the person they control. Decided by status, function.

   Affirmative Defenses:
   § 15 of the 33 Act: No knowledge of the underlying facts.
   § 20A of the 34 Act: good faith, did not induce the acts leading to the violation, no exception for independent contractors.

   **Hollinger v. Titan Capital**: Broker-dealers can be liable as control persons for their registered representatives. This induces better supervision.

C. Aiding and Abetting Liability: It’s harder to go after via aiding and abetting. Easier under control person.

   **Central Bank of Denver v. First Interstate Bank of Denver** [SCt 1994]: **Kennedy Held**: A & A just simply isn’t in the law, regardless of what the lower courts may think.