Securities Act of 1933 (Purpose: to provide full and fair disclosure of the character of the securities sold in interstate commerce and through the mails, and to prevent fraud in the sale thereof...)

I. Is This a Security?

Section 2(a)(1) def. includes “any note,” “stock,” “investment contracts”

A. “Investment Contracts”

1. SEC v. W.J. Howey Co. (1946)

Howey test applied to real estate co-op (UHF), limited partnership (Steinhardt), pyramid scheme (Koscot). Investment contract is a security w/in the scope of §2(a)(1) when it involves:

a) Investment of money

b) In a common enterprise

   (1) Vertical vs. horizontal commonality

      (a) Vertical: no pooling of funds or interests by multiple investors; horizontal: pooling of funds, investors (Howey). Majority follows horizontal commonality.

      (b) Even w/ one investor can find horizontal common. if there is intention to involve multiple investors (Wals v. Fox Hills Dev. Corp., 7th Cir. 1994)

      (c) Koscot: Fortunes of all investors inextricably tied to efficacy of Koscot meetings and guidelines on recruiting prospects and consummating a sale; apparent vertical comm. b/c of pyramid structure of investment but they were all in it together, thus horizontal comm.

   (2) Steinhardt (3d Cir. 1997) pooling of mortgage loans; no rule on whether vertical comm. is suff.

   c) With an expectation of profits

      (1) United Housing Foundation – “investors” purchase stock but must resell it back to foundation at no gain, just a place to live; purchaser motivation: personal consumption or hope of receiving profits from efforts of others?

      (2) Grenader v. Spitz (2d Cir. 1976): where profit motive “purely incidental” NOT security.

      (3) Howey: investors attracted solely by prospect of return on their investment; provide capital and share in earnings and profits

      (4) Economic Realities Test: substance over form! (vs. formalism in Landreth). Must examine economic substance rather than names that may be employed by parties (UHF; Steinhardt)

   d) Soley from the efforts of others

      (1) Koscot (313-17): interpret “solely” as predominantly. Promoter designed scheme, wrote scripts, organized “opportunity meetings.” Cite Turner.
(2) **Knowledge and role of investors** will have bearing on their control: Koscot investors role “little more than perfunctory” vs. Steinhardt (ltd p’ship): **no investor passivity**, provisions of partnership agmt. show Steinhardt not passive investor b/c had “pervasive control over mgmt of the Partnership”, i.e. had [controlling] legal rights and powers assigned to investor re: p’ship. NOTE: ct. finds this prong dispositive.

(3) SEC v. Glenn W. Turner Enterp. (9th Cir. 1973) “efforts made by those of other than investor are undeniably significant ones, ... managerial efforts which affect failure or success of enterprise...”

**B. “Stock”**

1. **United Housing Foundation**
   a) **Substance over Form**, look to economic reality of transaction.

2. **Landreth v. Landreth** (1985) – sale of bus. = sale of security?
   a) Sale of Bus. Doctrine Dead, i.e. sale of 100% of bus. is NOT stock. Here D sell all stock in closely held co. and retain control = security.
   b) “Stock” listed in def. of security
      (1) **“Stock” is quintessential security.** When used “stock” as intended by Congress, then NOT need UHF economic realities test.
      (2) Only use econ. realities test if have unusual instrument, i.e. UHF is exception to rule.
   c) Has characteristics associated w/ stock: FORM over substance!
      (1) Right to receive dividends; (2) negotiability; (3) may be pledged or hypothecated (?); (4) confer voting rights; (5) capacity to appreciate in value

**C. “Note”**

Most indeterminate area. **SEPARATE ANALYSIS FROM HOWEY**

1. **Reeves v. Ernst & Young** (1990) – §2(a)(1) “any note” = security?
   a) Investment (securities) vs. commercial (not security) (e.g. CB 355)
   b) **Family Resemblance Test** (2d Cir.): begin w/ presumption that “any note” w/ term of more than 9 mos. is “security.” Test permits issue to rebut presumption that note is a security if can show that note in question “bears a strong family resemblance” to an item on the judicially crafted list of exceptions or convinces ct. to add new instrument to list.
   c) **Four Parts “Standards”** for S. Ct. version of resemblance test (355-56).
      (1) Motivations of reasonable seller and buyer: if to raise money for bus./investments w/ interest primarily in profit then = security (356)
(2) **Plan of distribution:** to determine whether there is “common trading for speculation or investment”, **pivotal factor**, i.e. offered and sold to broad segment of public

(3) Reas. expectation of investing public: does public view it as investment in which $ will be made?

(4) Existence of other regulatory scheme significantly reducing risk of instrument, rendering application of Securities Acts unnecessary?

d) Debt securities vs. equity securities. Latter more likely to be held security but allow exemption b/c more fraud likely to occur w/ equity security. See §3(a)(3) of ’33 Act and §3(a)(10) of ’34 Act re: commercial paper note.

II. Is It Exempt from the Securities Act?

NOTE: even if exempt transaction and don’t have to register, still subject to fraud provisions. Three vehicles for exemption: §3(a)(11) (intrastate exemption); §4(2) (private placement); and case law.

**A. Private Placements §§ 4(2) and Reg. D– MOST COMMON**

2 ways to file private placement: (1) case law (Ralston Purina) or Reg. D.

1. **SEC v. Ralston Purina Co.** (1953)

   Purina sell unregistered securities to “key EEs”.

   a) Court distinguish bet. **private vs. public offering** by examining certain factors:

      (1) **Access to information:** access to same kind of info. that Act would make available in form of reg. statement? E.g. corp. officers [but what about doctors, lawyers?]; Purina **ct. found** EEs did not have access to kind of info. which reg. would disclose.

      (2) **Nature of offeree:** Sophistication or knowledge of offerree – “accredited investor”

      (3) **Needs Test:** Does investor need protection? Can investor fend for herself? If yes, then is a trans. “not involving any public offering.”

      (4) Number of people to whom offering is made: NOT a fact

2. **Regulation D (Rule 501-508)**

   a) **Rule 501(a)** – “Accredited Investor”

      (1) Institutional, Rule 501(a)(1)

      (2) **Natural person** whose pers. net worth or joint net worth w/ spouse exceeds $1M at time of purchase, Rule 501(a)(5)

   b) **Rule 504** – Below $1 M

      (1) Must sell to accredited investor, Rule 501

      (2) Not subject to §13 or 15(d) (periodic reporting requirements) of ’34 Act.
(3) Integration Rule 502(a) (includes 6 mos. safe harbor)
(4) No disclosure req’d under Rule 502(b)
(5) Per exception in 504(b), normally NOT subject Rule 502(c)
(limit. on manner of offer, ads) or Rule 502(d) (limit. on resale)
(6) Filing of notice of sale, Rule 503

c) **Rule 505** – Up to $5M (least popular options)
   (1) Unlimited accredited, up to 35 non-accredited investors, Rule
       505(b)(2)(ii), Rule 501(e).
   (2) Info – if non-accredited, Rule 502(b)
   (3) No public ads, Rule 502(c)
   (4) Limitation on resale, Rule 502(d)
   (5) **Bad Boy disqualifications**, Rule 505(b)(2)(iii) pursuant to Rule
       262(a)(3) felony or misdemeanor convictions in last 5 yrs in
       connection w/ purchase or sale of security...
   (6) Filing of notice of sale, Rule 503

d) **Rule 506** – Above $5M, no cap (most popular)
   (1) Unlimited accredited, up to 35 non-accredited investors, Rule
       506(b)(2), Rule 501(e).
   (2) Info – if non-accredited, Rule 502(b)
   (3) **Purchasers Representative**, Rule 501(h)
   (4) No public ads, Rule 502(c)
   (5) Limitation on resale, Rule 502(d)
   (6) Filing of notice of sale, Rule 503

e) Other Limited Offering Exemptions: §3(b) (exempt securities) and
   Reg. A (Conditional Small Issues Exemptions (Rule 251-263))

3. §2(a)(4) def of “issuer”

**B. Intrastate Offerings: §3(a)(11); Rule 147**

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

d) No resales to non-residents the for 9 mos., Rule 147(e)

C. Can Exempt Securities Be Resold?

1. Exempt Securities vs. Exempt Transactions

<table>
<thead>
<tr>
<th>Exempt Securities §§3(a)(2)–3(a)(8)</th>
<th>Exempt Transactions §§3(a)(9)–3(a)(11), 4(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Always exempt, whether in an initial sale or in any subsequent sale.</td>
<td>Only exempt [from §5 registration requirements] in a specific transaction. To resell a security exempted in an intrastate or Regulation D offering requires a new exemption.</td>
</tr>
</tbody>
</table>

2. Statutory Restrictions on Distributions of Securities by “Controlling Persons” or “Affiliates”

Reg. C, Rule 405 (def. of “control”)

a) Matter of Ira Haupt & Co. (SEC 1946) Haupt, a broker-dealer, charged w/ distribution of unregistered securities. Attempt to fit under §4(4), broker transaction executed upon customers’ orders but NOT solicitation. However, client is “controlling person” (Rule 405) and per §2(a)(11) such controlling person b/comes an issuer, making Haupt an underwriter and NOT qualify for §4(1) exemption. Case=broker engaged in sale of shares for controlling person can trigger “distribution” and b/come an underwriter. Not much guidance on how many shares trigger “distribution” in a sale. Haupt says 37%=distribution.

3. Rule 144 – Persons deemed not engaged in distribution and not underwriters (cf. §4(1))

a) Factors to consider:

(1) Sales by Controlling Persons: hard to sell w/o triggering “distribution.”

(2) Investment Intent: individual investor purchasing securities in nonpublic offering pursuant §4(2) exemption must purchase w/ investment intent and NOT w/ view to distribution of securities, otherwise will be deemed “underwriter” per §2(a)(11). Sign “investment intent” letter.

(3) “Change of Circumstances” Doctrine: Investor must demonstrate that resale of exempt securities was made solely as result of “change in circumstances” bet. original purchase and resale. Gilligan, Will & Co. v. SEC court found “change of circumstance” insufficient to keep investor from being “underwriter” where there were 10 mos. bet. purchase and resale.

(4) The Fungibility Concept: if purchase over the counter stock then later purchase private placement stock, mixing of exempt stock and nonexempt put hold on reselling all stock.

b) Affiliates, Rule 144(a)(2)
c) Applicable to **Restricted security**, Rule 144(a)(3)

d) **Current info. available**, Rule 144(c): availability of the rule is conditioned on the existence of adequate current public info.

e) **Holding Period**: Shares held min. of 1 yr., Rule 144(d)

f) **Limits on shares sold** b/c of concern of impact transaction has on trading markets. Person reselling securities under §4(1) must sell in such ltd quantities and in such manner as to not disrupt the trading markets. Rule 144(e)(1, 2)

   (1) **Affiliate**: 3 mos. period, may not exceed greater of

   (a) 1% of stock outstanding; or

   (b) average weekly volumes; or

   (c) 1% of reported trades

   (2) **Non-affiliates**: no limits after 2 yrs, Rule 144(k)

g) **Sales in brokerage transactions**, Rule 144(g)

h) **Notice Requirement**, Rule 144(h)

4. **Rule 144A** – Private Resales of Securities to Institutions

   a) Limited to sales to Qualified Institutional Buyers (QIBs), def. Rule 144A(a)(1): No natural person, higher $ value, no add’l limits, use PORTAL for trading.

   b) Usually no resale restrictions

   c) Really rule giving issuer and QIBs §4(1) exemption (i.e, exempt transactions by any person other than issuer, underwriter, or dealer)

III. **Registration under 1933 Act, §5**

   §§5 and 4(3); Rules 134-135, 137, 174, 460-461

   **A. §5 – 3 Temporal Periods**

   1. **Pre-Filing Period**

       a) **Preliminary Negotiations** bet. Issuer and Underwriter

           (1) Pre-reg Negotiations excluded from term “sell” under §2(3). In contacting investment bankers must be careful who is contacted (e.g. not buying department).

           (2) Memo of understanding or letter of intent: indicate proposed price; not binding. Oral contact and mailing underwriters agmt. allowable activities. §2(3).

           (3) Restrictions on underwriters contacting dealers during pre-reg.

           (4) Once registration statement filed: **no offers to buy** until after effective date, §5(c), 2(a)(3), Rule 134.
(5) No roadshows in pre-filing period. Not for private filing, more for going public.

b) **Silent Period**: No contacts w/ dealer

   (1) Should not initiate publicity when in registration
   
   (2) Should respond to legitimate inquiries for factual information about company’s financial condition and business operations.
   
   (3) SEE CB 130-131 FOR FURTHER GUIDELINES.

c) **Gun Jumping**: announcements which tend to arouse interest in offering during pre-filing period

   (1) Notices re: intent to register should come from issuer and be purely factual, can’t name underwriters. Rule 135.
   
   (2) Rules 135, 137, 138, 139. see CB 132-133.

2. **Waiting Period**: After Reg. Statement Filed

   a) Underwriters contact dealer
   
   b) Dealers contact customers

      (1) The Identifying Statement/Expanded Tombstone Ads, §2(a)(10)(b), Rule 134. Screening device to determine interest, NOT a selling tool.

      (2) **Testing the Market**: can make offers to sell but can NOT sell, §5(a)(1), until reg. statement become effective; **Roadshows**: file “meaningful cautionary statement” w/ SEC to obtain safe harbor for “forward looking info.”

   c) Preliminary prospectus permitted, §§5(b)(1) & 10(b), 2(a)(10) (def.)

      (1) **Prospectus** §2(a)(10): include any written communication which “offers any security for sale or confirms the sale of any security.” Broad scope. Such communication can only be inform of preliminary prospectus, §10(b), during waiting period. Strictly forbidden during pre-filing. See below re: post-effective period.

      (2) **Preliminary or “Red Herring” Prospectus**: can make offers to sell during waiting period. Use material info. on file w/ SEC; diff. from final prospectus (§10(a)).

      (3) **Summary Prospectus/Preliminary Summary Prospectus**, §10(b), Rule 431. Authorized use by Forms S-1, S-2. Used for info. purpose only and DOES NOT satisfy prospectus requirement of §10(a)

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

3. **Post Effective Period**
a) Final prospectus delivered b/4 final sale, §10(a), 5(b)

(1) Cut off dates for when issuers, underwriter and dealers no longer subject to §5(b) are in §4(3). Prospectus requirements apply to the issuer so long as it is offering any of the securities to the public. Underwriters and dealers subject to prospectus req. so long as it is offering an unsold allotment, §4(3)(C); they must comply w/ prospectus req. during 40 day period following effective date. §4(3)(B), etc.

(2) When transaction effected by stock exchange or over-the-counter market, see §4(4). Rule 153 relaxes req. for delivery of statutory prospectus to stock exchange members where sale is made on nat’l securities exchange.

(3) Issuers permitted to use preliminary prospectus plus “term sheet” containing basic price-dependent info. deemed to constitute a statutory prospectus. Rule 434.

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

4. Shelf Registration, Rule 415

a) Registration statement relates to offerings to be made from time to time.

b) Allow issuer to register security and take it off shelf at short notice for distribution at some later point.

5. Scope of forms req’d, etc.

a) Can go public or do private placement: going public generates more $ but also more expensive.

b) S-1 most used form, filing initial public offering; SB-2 for small bus. issuer (Rule 405) only, Reg. S-B; Reg. A: least popular, Form 1-A, Rules 251-63, $ limit handicap use.

c) 3 basic reg. vehicles: Rule 506 (private placement), Form SB-2, Form S-1 (going public).

d) Key decision w/ filing reg.: (1) who’s going to be underwriter, (2) cost of compliance, (3) hiring lawyer. #s 2&3 can be disadvantages to going public.

e) Underwriter: key w/ helping to decide what kind of securities, how many, price, kind of underwriting (best efforts or firm commitment)

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

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

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

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

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

C. **Integrated Disclosure under the 1933 and 1934 Acts**
   1. Adoption of Integrated Disclosure System
a) Integrate 2 systems: (1) Reg. S-K basis repository of non-financial disclosure req’s; apply to all registration forms but not all firms have to file periodic forms; and (2) Reg. S-X integrated accounting system.

b) Those subject to periodic filings
   (1) Must be listed on non-exempt securities exchange or traded in over-the-counter market
   (2) 500+ S/Hs in stock
   (3) $10M in total assets

c) Efficient Market Hypothesis and Reg. forms
   (1) How information reaches the market and how market responds according: that market is reflection of all publicly avail. info.

IV. Civil Liability Under the Securities Act

Several potential for liability for fraud in registration statement: §11, §12(a)(2), and §17 (no private cause of action) of ’33 Act; Rule 10b-5 of ’34 Act; §410 of Uniform Securities Act or other Blue Sky Provisions; Common law fraud or deceit

A. Section 11 – Civil liabilities on account of false reg. statement

Duty to correct but NO duty to update. Only liable for documents at time they were put out. NOTE: §11 cases usually solved on basis of documents. Need documents to prove due diligence. ONLY USE §11 W/ REGISTERED OFFERING.

1. A material misrepresentation or material omission
2. In any part of a registration statement
3. Any purchaser may sue

Hertzberg: (1) “any person” can sue, no need for privity, under ECMH market takes into account and reflects falsehoods in its pricing of security, thus extent of injury goes beyond privity; and (2) no requirement of express reliance on registration statement. Can make claim until period of corrective statement. NOTE: Tracing: must show that purchase is traced back to the original registration statement and falsehood.

a) Issuer

b) Signer, §6(a): includes principal executive officers, principal financial officer, comptroller or principal accounting officer, majority of board directors

c) Director: or partner in the issuer at time of filing of registration statement and every person who consents to be named or about to become director or partner (see Escot); along w/ issuer, signer & underwriter, can be held liable for both expertised and non-expertised portion.

d) Expert (e.g., accountant, engineer, appraiser): w/ consent, who certifies any part of a registration statement; accountant only liable for expertised portion

e) Underwriter
f) **LAWYER (NO):** can be NOT be sued under § 11 (rather, under principles of respondeat superior, conspiracy, agency theory, aiding & abetting – see Rule 10b-5, Rule 102(e)); as long as role in limited to non-expertised section, lawyer cannot be sued under §11.

4. **Defenses**

- Several: (1) purchaser knew of untruth or omission at time of acquisition (§11(a)); (2) after 12 mos. of earnings statement, the purchaser cannot prove reliance upon the untrue statement in the reg. statement (§11(a)); (3) D has (a) resigned or taken appropriate steps to resign relevant position and (b) advised the SEC (§11(b)(1)); (4) D gives notice that part of the reg. statement b/came effective w/o his knowledge (§11(b)(2)); (5) due diligence

  **a) Due Diligence (§11(b)(3))**

  **DOCUMENTATION IS IMPORTANT TO SHOW PROOF OF DUE DILIGENCE.**

  (1) *Escott v. BarChris Construction Corp.* (D. NY 1968)

     (a) No due diligence defense for Issuer (strict liability)

     (b) Only accountant’s part of registration statement expertised

- Kircher (CFO) should have spoken up and corrected Peat Marwick’s audit. Knew info. was incorrect and did not have defense of reas. belief that it was correct.

  (c) Expert only liable w/ respect to those portions of statement which are expressly stated to be made on his/her authority as an expert.

  (d) Due diligence not satisfied if no reasonable investigation

     (i) Applies to new directors

- Auslander only on board for 1 mo. b/4 final filing w/ SEC, held liable.

     (ii) Greater burden for outside counsel, underwriters, etc.

- Auslander, **outside director**, not liable for expertised part b/c had no reason to believe Peat Marwick report was untrue. However, liable for non-expertised portion b/c had opp ty to read prospectus b/4 signing it and he only glanced at it. Prudent man in his position would have read it.

- Grant, **atty**. for BarChris and director. Greater due diligence burden than Auslander b/c he was partner of law firm that prepared reg. statement. Court refused argument that lawyer should be able to rely on clients’ statements b/c Grant had several opp tys to verify info., check original written record (minutes, legder, etc.) but did not – rather he relied on oral info.

- Ct. felt investigation by attys for **underwriters** was not thorough enough. Should have reviewed material contracts, insisted on executive comm. minutes, verify management’s representations, make reasonable attempt to verify data submitted to them. Court insist on holding underwriters liable to effectuate Act’s purpose of protecting investors.

- Due diligence review must be completed to date reg. becomes effective.

- **Accountants**, Peat Marwick, **should have conducted further research once red flag raised** (2 names for one bowling alley), found more accounting records which would have clarified issue. However, NOTE, investigation re: leased vs. sold bowling alley, reviewing contract, was reasonable. **NOT reas. to require accountants to examine all of client’s correspondence when**
there was no reason to suspect irregularity. Failed to meet standards of his profession. There were enough “danger signals in materials” to require further investigation which he did not do.

- Monroe v. Hughes, accountants good faith compliance w/ GAAP and GAAS discharges accountant’s professional obligation to act w/ reas. care. HOWEVER, compliance w/ GAAP and AAS do NOT immunize accountant who consciously chooses not to disclose on reg. statement a known material fact.

(2) In re Software Toolworks Inc. (9th Cir. 1994)

(a) Reasonable investigation under §11 similar to reasonable care under §12(a)(2), i.e. “reasonableness req’d of prudent man in the mgmt of his own property.”

(i) Ct. say due diligence standard is negligence standard, cite Ernst & Ernst v. Hochfelder

(b) Due diligence can be determined by summary judgment

(c) Underwriter need not conduct due diligence into expertised part of prospectus if underwriter had no reasonable grounds to believe the expertised statements were misleading.

(d) Underwriter burden greater when underwriter helped write part of a registration statement and had red flags (Barron’s article)

(i) Hold underwriters to almost high a standard as “inside” def’s b/c public looks to them for independent, disinterested investigation of bus., and for advice re: the issue.

(ii) Members of underwriting syndicate should be able to rely on investigation of “lead” underwriter, but if his performance falls short they are all equally liable

(3) Hertzberg v. Dignity Partners, Inc. (9th Cir. 1999)

(a) Represent majority opinion

(b) §11 applies to after market trades that can be traced to registered offering. See above re: privity.

b) 3 Basic Types of Due Diligence Defense

§11(c) defines standard of reasonableness for “reasonable investigation” and “reasonable grounds for belief” as that “required of a prudent [person] in the management of his/her own property.”

(1) Non-expertised Parts

(a) “Reasonable investigation”

(b) “Reasonable grounds to believe” statements true

(2) Expertised Parts – Expert Defense (accountants, etc.)

(a) Reasonable investigation
(b) Reasonable grounds to believe statements true

(3) Expertised Parts – Non-expert defense (directors, officers, etc.)

(a) No reasonable ground to believe untrue

c) Rule 176, Circumstances affecting determination of what constitutes “reas. investigation” and “reas. grounds for belief” under §11

(1) See 176(h) and role it has in determining underwriter liability vis-a-vis annual report and other docs. they do prepare.

(2) Intended to relax §11 liability for underwriters, but to date has had little impact on §11 litigation.

(3) **Compare w/ Item 11 of Form S-3** which requires update of material changes since the end of latest fiscal year. Raise sufficient “red flags” for underwriter to investigate.

5. **Damages**

a) §11(e) allows for damages for depreciation in value, i.e. diff. bet. amt. paid for security and

(1) value of security as of time suit is brought; OR

(2) price at which security was sold b/4 suit; OR

(3) price at which security is sold AFTER suit but B/4 judgment if such damages shall be LESS THAN damages under #1 above

b) §11(e) also creates a **“negative causation” that def.** can advance as defense:

(1) Can prove loss NOT due to false statements

(2) **Akerman v. Oryx Communications, Inc.** (2d Cir. 1987)

(a) **Decline b/c of overall or sectoral decline:** Look to aggregate of market, industry index, collateral events in industry, general economy, gov’t regulation, etc.

(b) **Net of the market:** value of stock when bought-value of stock after the market has absorbed corrective disclosure.

(i) Evidence showing net of the market admissible under §11(e) theory b/c def. should be liable for loss caused by their misconduct or negligence.

**B. Section 12 – Civil liabilities arising in connection w/ prospectus & communications**

1. §12(a)(1) imposes absolute or virtually absolute liability for a sale in violation of §5. Includes sale of unregistered securities, “gunjumping” or failure to deliver prospectuses.

   a) Only defense is that transaction was exempt from §5

2. §12(a)(2) reaches:
a) any person

b) who offers or sells a security (including exempt securities under §3, other than §3(a)(2)

c) by means of a prospectus or oral communication

d) which includes a material misrepresentation or omission

e) unless the def. can sustain the burden of proof that he/she did not know or in the exercise of reas. care could not have known of the material misrep. or omission

f) to person purchasing such security from him/her

3. Who is a seller?

a) **Pinter v. Dahl (1988)**

Dahl, investor, approached friends, family and bus. assoc. and told them about investment oppty., rec’d no $ or financial benefit for what he did; got documentation prepared by Pinter, a registered securities dealer.

   (1) Privity; OR

   (2) Seller: motivated by financial interests, e.g. lawyers, if get special or add’l compensation

   (a) Collateral participants not statutory sellers for purposes of §12(a)(1); although finders fee may be construed as financial benefit sufficient to trigger §12(a)(2)

   (b) Must have (1) sale and (2) benefit to seller for liability under §12(a)(1).

b) Lawyer who can get in trouble: (1) accompany offering circular w/ letter might =solicitation; and (2) gets financial benefit. Open question.

4. Material Misrepresentation or Omission of Fact. §12(a)(2)


Secondary trading involving purchase of stock of financial consulting firm. Purchaser, after deal is closed, discover co.’s earnings sig. lower than figures used to calculate purchase price. Sought to have transaction rescinded under §12(a)(2). S. Ct. “prospectus” have same meaning in §10 as in §12

   (1) Hold: Limited to sales by means of a prospectus, NOT secondary trading (as does §17(a)). Narrow coverage in §12(a)(2) vs. broad reach of liability in §17.

   (2) Unaddressed issue is whether §12(a)(2) applies to private placement. Lower courts divided. Some feel since private placement should be registered in first place then should apply. Other say private placement memo. N\not “prospectus” for purpose of §12(a)(2).

5. Reasonable Care Defense §12(a)(2)

a) Seller not subject to strict liability (vs. §12(a)(1))
b) John Nuveen, 7th Cir. found no diff. in reas. investigation required by §11 and §12(a)(2) reas. care.

(1) Justice Powell’s dissent urge that analysis is diff. and that the standard is higher under §11 w/ underwriters have stronger connection to registration statement than sellers do to prospectuses.

c) Software Toolworks: analysis of two sections is same even if there are diff. standards (suggests law remains unsettled whether §11 standard is identical to §12(a)(2) standard).

d) Most courts see no practical diff. bet. §11 (reas. investigation) and §12(a)(2) (reas. care). §12(b) harmonized w/ §11(e), gets to same place, i.e. actual damages.

V. Securities Exchange Act 1934

A. History

1. §10(b) and Rule 10b-5 deal w/ (1) false annual report or press release; (2) insider trading cases. A 10b-5 claim must allege scienter.

2. Private cause of action implied under §10b and Rule 10b-5. Can reach “any person.”

3. Katy Roberts, 1961 held insider trading cases not limited to having def’s in privity w/ plaint

4. Basic Inc. v. Levinson, can base class actions on proof of “fraud on the market doctrine” NOT need to show actual reliance by ea. Plain.

5. Blue Chip, standing limited to actual purchasers


B. Pleading Standards - Private Securities Litigation Reform Act (PSLRA)

1. Pre-PSLRA

   a) Litigation held up by pre-trial motions. Act lengthen time needed to get judgment on merits. Goal: limit non-meritorious suits; better pleadings.

2. W/ advent of PSLRA, issue as to whether it altered existing standards

   a) Greebel v. FTP Software, Inc. (1st Cir. 1999)

   (1) Open question whether PSLRA:

      (a) Altered standards for pleading fraud w/ particularity

      (b) Restricted the characteristic pattern of facts that may be pleaded in order to establish “strong inference” of scienter

      (c) Altered the scienter req. for actions under §10(b) and Rule 10b-5. Specifically, whether recklessness will suffice.
3. **PSLRA Pleading standard for culpability/fraud**

Arguable if PSLRA standard, based on 2d Cir. standard, raised bar above 2d Cir. As seen in *Silicon Graphics*, below, the 9th Cir. believe it did. The 2d Cir. continues to follow it’s standard.

a) If allegation of fraud is made on info. or belief, plaint. must state w/ **particularity** all facts on which belief is formed, §21D(b)(1)

(1) *Silicon Graphics*, 9th Cir.: must name individual sources for claim to stand. Believe Congress intended to raise standard above 2d Cir.

(2) Novacks, 2d Cir.: don’t have to name individual sources. Congress merely adopted 2d Cir. standard and add gloss to it. [majority view]

b) To plead fraud must state w/ particularity of facts giving rise to a "**strong inference**", §21D(b)(2)


   (a) def. had both motive (personal benefit to def.) and opportunity to commit fraud; or

   (b) by alleging facts that constitute strong “**circumstantial evidence of conscious misbehavior**” or recklessness, i.e., deliberate blindness to facts should have been aware of

4. **Lead Plaintiffs provision** – § 21D(a)(3), when plaint. files suit to bring action, must also file notice of it so that others can attempt to become lead plaint. in your stead. Courts take more aggressive role in who attys are that plaints can hire (deter frivolous suits).

C. **§10(b) and Rule 10b-5**

1. **§10(b) states:**

   a) unlawful for **any person**

   b) directly or indirectly

   c) to use or employ

   d) **in connection w/ purchase or sale of**

   e) **any security** registered on nat’l securities exchange or any security not so registered

   f) **any manipulative or deceptive device**

   g) in contravention of such rules and regulations (Rule 10b-5)

2. **Culpability**

   a) Re: **Historical Data** - Ernst & Ernst v. Hochfelder (1976)
Nay, officer of co. sell false securities. Plaints charge E&E w/ aiding & abetting (note: can no longer plead aiding & abetting under 10b-5 cause of action post-Central Bank of Denver) alleging if had “mail rule” in place would have caught the problem. Issue: whether action for civil damages may lie under §10(b) and Rule 10b-5 in absence of allegation of intent to deceive, manipulate, or defraud.

(1) Intent to deceive, manipulate or defraud (sciente) [actual knowledge] is standard

(2) Negligence not enough

(3) Reserved question: FN 12: will recklessness suffice?
   (a) [Most] lower courts allow recklessness. See e.g., Novak v. Kasaks (2d Cir. 2000)

b) Re: Forward Looking Data - §21E(c)(1)(B)(i)
   (1) Actual knowledge

3. Fraud Requirement

10b-5 applied to 3 types of fraud: (1) material misrepresentations or omissions in corp. statements; (2) duty to update or correct; and (3) trading while in possession of material nonpublic info. (“insider trading”)

a) Material misrepresentations or omissions
   (1) Santa Fe v. Green (1977)

Santa Fe attempt to acquire 100% control of Kirby Lumber. Executed a short-form merger transaction under DE law and bought out minority S/Hs. Those bought out, while they had option to obtain appraisal of shares under DE law, pursued action in fed. ct. alleging (1) fed law violated b/c merger lacked justifiable bus. purpose & was under taken w/o prior notice to minority S/Hs; (2) low valuation of shares was fraud actionable under 10b-5.

   (a) Normally breaches of fiduciary duty (duty of loyalty & care) NOT =fraud

   (b) Plain lang. of statute req. “manipulative or deceptive device or contrivance”, not present here

   (i) Ct. also believe (1) should not imply private cause of action where unnec. and (2) congress not intend to preempt state law where it is traditionally applied

   (c) Harmonize w/ Ernst & Ernst req. for intent to deceive or defraud

b) Duty to Update or Duty to Correct

   (1) Duty to Correct: Made false statement, while statement still alive b/come aware that it is false (as in reg. statement)

   (a) Duty persists as long as prior statement remains “alive.” Time may render statements immaterial and end duty to correct or revise them.

   (b) Duty exists as long as investor could reasonably rely on statement
Only have duty if statement came from co. or co. was original source of info. No duty re: rumors if not the source. No duty to warn analysts re: analysts’ optimistic view of co.

(2) Duty to Update: True statement originally which subsequent events make false.

(3) Rule 10b-5(2): all agree that there is duty to correct based on Rule 10b-5(2); split on whether there is duty to update.

(4) Time Warner Inc. Sec. Lit. (2d Cir. 1993)
Time bought Warner. To finance deal they formed 2 strategic partnerships to raise $. They had hoped to get cash infusion but got smaller amt than expected. Issued new stock offering that diluted substantially the rights of existing S/Hs. Made 2 proposals of variable price offering to SEC but SEC approved 2d. During this period price fell from $117 to $94 to $89.75.

(a) Duty to update opinions and “definitive positive projections” if original opinions have become misleading as a result of intervening events. NOTE: can’t base suit on puffery.

(b) §21E(c)(2)’s safe harbor allows issuer to make forward looking statements and provides investor w/ cautionary statements allowing him/her to proceed knowledgeably. Not negate duty to update in right situation.

(c) Rule 10b-5 omission is actionable only when a corp. has a duty to disclose material facts.

(i) Duty arises when undisclosed info. completely negates public statement; also

(ii) When “secret info.” renders public info. materially misleading

(5) Regulation FD: limitations on selective disclosure. If disclose non-public info. to designated person (analyst, etc. - see provision) then corp. have duty to disclose to public.

c) Insider Trading

NO flat prohibition on insider trading b/c not want to discourage investor investigation in the market (allocatively efficient market)

(1) Classical insiders – Chiarella v. US (1980) (holding that plaint. must prove that the def. violated a duty to NOT disclose material info. by insider trading)

(2) Tipper/Tippees – Dirks v. SEC (1983)

(a) FN 14: specified outsiders such as underwriter, accountant, lawyer or consultant, would have same type of fiduciary duty as a classical insider when such persons:

(i) acquired nonpublic material info.
(ii) entered into special confidential relationship in conduct of the enterprise and is given access to info. solely for corp. purposes; and

(iii) the corp. expects the outsider to keep the info. confidential and the relationship at least implies such a duty [of trust].

(b) Tippees who knowingly receive info. in violation of tipper’s duty also can be held liable. But the insider/tipper must breach a duty and the tippee must know or be reckless in not knowing of the fiduciary duty breach.

(c) Tippee’s liability is derivative of the tipper. If the tipper did NOT violate a duty, the tippee is OKAY (can trade to his or her heart’s delight). Problem: finding evidence to prove.


Atty., who works for law firm involved in tender offer, buys shares in Pillsbury knowing they were going to receive tender offer. He was not an “insider” b/c he was not an EE of the company whose stock was traded (Pillsbury). To reach O’Hagan, outsider, apply insider trading law to “outsider.”

(a) Outsiders can be reached by the misappropriation theory when there is deception on the source in connection w/ a purchase or sale of a security

(i) O’Hagan satisfy “deception” of Rule 10b-5 b/c deceive the source (his firm). If O’Hagan had told his law firm of his intent to purchase stock would NOT have been deception on the source (“serendipi-tipee,” Barbara Aldire: fortuitous gain of info.)

(4) Possession/Use Test – SEC v. Adler (11th Cir. 1998)

If showing trading “while in possession” of material non-public info., only need show that the material non-public info. was rec’d by the relevant def.

(a) Inference based on possession: When one has possession of material nonpublic info. the court will infer that the investor traded on the basis of it. Use test for proof of insider trading upheld.

(b) SEC Response: Rule 10b5-1 which includes a “knowing possession” test and give list of affirmative defense.

(5) Rule 14e-3

(a) Alternative to violation of disclosure duty under §10(b) -- Rule 14e-3(a) covers duties in tender offers ONLY and “any person”. See O’Hagan. Hard for private litigant to bring 10(b) or 14e case against someone under
misappropriation theory b/c it is based on duty to the source. Usually enforced by SEC or DOJ.

(b) Does NOT require proof of a duty

4. **Materiality** of fraud

a) **TSC Indus., Inc. v. Northway, Inc.** (1976)

(1) An omitted fact is **material** if there is a substantial likelihood that a **reasonable shareholder (S/H) would consider it important** in deciding how to vote.

b) **Quantitative Materiality** – SAB No. 99

(1) Discourages exclusive reliance on quantitative assessments of materiality: “evaluation of materiality requires a registrant and its auditor to consider all the relevant circumstances, and the staff believes that there numerous circumstances in which misstatements below 5% could well be material.”

c) **Forward looking statements**

(1) **Basic, Inc. v. Levinson** (1988)

Application of §10b and Rule 10b-5 materiality requirement in context of preliminary corporate merger discussions. Basic deny several times that they’re engaged in merger negotiations. Plaint. sold their Basic shares after first denial and b/4 Basic admitted to being in merger talks. Say they were injured by selling shares at artificially depressed price b/c of false or misleading statements. S. Ct. express adopt TSC standard of materiality.

(a) 3d Cir. Agreement in principle test: preliminary merger discussions do not become material until “agreement-in-principle” as to price & structure of the transaction has been reached. REJECTED.

(b) **Probability and magnitude test** (2d Cir.): Probability that event will occur and magnitude of event in light of totality of the company

(i) **Probability**: look to indicia of interest in transaction at highest corp. level;

(ii) **Magnitude**: consider such facts as size of 2 corp. entities and potential premiums over market value.

(c) **NOTE: silence** absent a duty to disclose is NOT misleading under Rule 10b-5, i.e., if not meet TSC standard of materiality there is no duty disclose and silence is not actionable.

(2) **Bespeaks caution doctrine** (§§10(b) & 11 claims), e.g. **World of Wonder Lit.** (9th Cir. 1994)

WOW issue junk bonds. Defaulted on first interest payment and filed bankruptcy 6 mos. later, rendering securities worthless. Plaints. are “disappointed investors” who filed securities-fraud action under §11.
(action based on securities purchasers who rely on materially false or misleading prospectus.). S. Ct.: can’t expect issuer to predict future. Securities laws do not protect investor from downturn in market.

(a) Defendants assert **bespeaks caution doctrine** as affirmative defense: Economic projections, est. of future performance and similar optimistic statements in a prospectus are NOT actionable when precise cautionary lang. elsewhere in document adequately discloses the risks involved.

(b) **Risk disclosure must be conspicuous, specific, and adequately disclosed. (i.e., meaningful discussion):** Must be specific. Must state competitors, what industry/product compete in. Must tailor specific risks.) No general language.

(c) **NOT apply to historical data.** Only future projections.

(3) **§21E of 1934 Act** (CB 1035-38)

(a) Codification of bespeaks caution doctrine – only applies to forward looking statements in specific context (note exclusions in §21E(b); AND

(b) Must be accompanied by “meaningful cautionary statements” (§21E(c)) and

(c) Plaint. has burden of proving actual knowledge (§21E(b)).

(4) **Oral forward-looking statements**: safe harbor for oral statements when appropriate reference is made to readily available written document. §21E(c)(2)

d) **Reasons, Opinions and Beliefs** – *Virginia Bankshares, Inc. v. Sandberg* (1991)

Freeze-out merger. Directors solicit proxy to vote on share price stating they approved of merger plan b/co of its oppty for minority S/Hs to achieve “high” value, and “fair” price for their stock. Plaint. did not give her proxy and sued alleging that directors had not believed price offered was high or fair, but recommended merger only b/c they believed they had not alternative if they wished to remain on the board.

(1) Rule 14a-9: prohibit solicitation of proxies by means of materially false or misleading statements.

(2) Knowingly false statements of reasons for recommending certain corp. action may be material and actionable even though conclusory in form.

(3) “Not every mixture of true will neutralize deceptive” harmonize w/ bespeaks caution doctrine: truth must be specifically related to the deception.

5. **Reliance / Causation**

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<td>Fraud on the market hypothesis</td>
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<td>Causation</td>
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a) Reliance

Causal connection bet. def.’s misrepresentation and plaint’s injury.

(1) Fraud on the Market Hypothesis

(a) Rebuttable presumption that plaints. rely on defs material misrepresentation. Reliance on market’s interpretation of false information. Plaint. need not have seen prospectus or other docs. or false info., but merely relied on market’s response to false info.

(b) Only applies to secondary trading, not initial sales. However, if security after corrective disclosure would have been unmarketable then investor can use presumption. NOTE: under §11 not need to prove reliance.

(c) Efficient market hypothesis: market price is reflection of all publicly avail. info. (Basic)

(d) Allows easier proof of commonality for class certification

(e) Basic, Inc. v. Levinson: reliance on credible false statement. Can use fraud on the market theory to prove 10b-5 reliance.

(2) Justifiable Reliance Doctrine (1167-68) [face-to-face transactions] (is this a “defense” i.e. that there was justifiable reliance so plaint. can prove case?)

(a) When false oral statement is contradicted by true written statement b/4 transaction is complete, then plaint. is estopped from relying on false oral statement.

b) Causation – “in connection w/ purchase or sale”

At core of causation are 2 concepts: (1) is there suff. link bet. misconduct of def. and injury to plaint (nexus); and (2) if so, can plaint. carry burden of proving identifiable magnitude of damages?

(1) Transaction Causation : Would plaint. have acted differently had def. conduct NOT occurred?

(a) In material misrepresentation cases, can establish transaction causation by means of “fraud on the market” theory (here reliance is a type of transaction or “but for” causation) [i.e., plaint. rely on market which reflected def’s material misrep. to make transaction, had plaint. known info. was false plaint. would have acted different.]

(b) Affiliated Ute: reliance or transaction causation presumed where duty to disclose material info. is breached
(nec. nexus bet. plaint’s injury and def’s wrongful conduct is established)

(c) Presumption appropriate b/c of extreme difficulty in demonstrating trans. Causation.

(d) Transaction causation normally NOT required in material omission cases. See

(2) **Loss Causation**, a.k.a. Proximate Causation

(a) **Def’s conduct caused loss to plaint.**

(b) Difficult to prove in insider trading cases, see **Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc.** (2d Cir. 1992)

Litton was to bid on target co. but bad EEs of Lehman bought stock in target and forced priced up. Plaint. must show that taget co. would have accepted lower offer if the bad EEs had not bought stock.; or that plaint. lost money b/c of EEs insider trading.

(c) Must prove actual reliance by 3d pty: absent def’s insider trading, plaint.’s loss would not have occurred.

(i) In Litton, plaint. must show that def’s insider trading caused the market price of target co. stock to rise AND that the market price was a substantial factor in the target co.’s board assessment of Litton’s offer.

(3) **“In connection w/ purchase or sale” element (CB 1177-80)**

(a) Must show relationship bet. misconduct of def. and injury to plaint. (some courts say must include damages to have prima facie case)

6. **Derivative Liability**

a) **Control Person Liability, §20(a) (only private cause of action)** - **Hollinger v. Titan Capitol Corp.** (9th Cir. 1990)

Witowski, embezzle funds. Had prior criminal record. Plaint. sue brokerage firm and financial counseling firm w/ which Witowski was associated. Independent contractor. Dist. ct. hold: Witowski was indep. contractor over whom Titan had NO “power or influence.” However, 9th Cir. reserve issue.

(1) **Liability**: Joint and several liability of controlling person and controlled person. Like respondeat superior, but w/o strict liability.

(a) Statutorily, broker-dealers have duty to supervise its representatives. §15.

(b) Court hold broker-dealer is controlling person for §20(a). RR need B/D to gain access to securities market.

(c) “Registered representative”, whether EE or independent contractor, is a controlled person

(i) Generally, independent contractors do NOT trigger derivative liability.
(2) Hold: plaint. not req’d to show “culpable participation” to establish that B/D was controlling person under §20(a), i.e. not need to show B/D induced act(s) constituting violation.

(3) **Defense: Good faith defense**, i.e., adequate supervisory mechanism; “diligently enforce” system of supervision – review of trading records, etc.


   (1) Hold: No implied private cause of action under Rule 10b-5 for aiding and abetting. Strict “manipulative or deceptive” practice req. in statute.

   (2) Key unresolved issue: when is there primary liability. Court suggest that secondary actor such as lawyer (wrote text) or accountant (did audit) who employs manipulative device or makes material misrepresentation (or omission) on which purchaser or seller relies may be liable as primary violator under Rule 10b-5. See 1308-10.

   (3) SEC can bring aiding and abetting claims under §20(e) or Rule 102(e). Standard of proof is “knowingly”

   (4) **Prima facie A&A case**: (1) primary violation of securities laws; (2) knowledge of primary violation by alleged aider & abettor; (3) substantial assistance by alleged aider & abettor in achieving primary violation.

c) Other derivative liability

   (1) Respondeat superior? Post-Central Bank no longer implied cause of action.

   (2) Conspiracy? Cts. split.

7. **Defenses**

   (1) Failure to plead w/ sufficient particularity, Rule 9b (see above); (2) SOL; (3) Rule 12b-6.

   a) **Statute of Limitations**


         (a) Express & implied: In Rule 10b-5, Supreme Court “borrowed” §13 of ’33 Act express “1 yr. after discovery (or should have been discovered w/ reas. diligence) and 3 yrs after violation” standard for §11 and §12 claims.

         (b) No equitable tolling

      (2) *Law v. Medco Research, Inc.* (7th Cir. 1997)

         (a) 1 yr. after discovery includes inquiry notice, i.e. “when the plaint. knows, or should know [a falsehood] the statute begins to run.” (1326)
b) Should have known: Suspicious circumstances, coupled w/ each of discovery, w/o legal process... may cause the statute of limitations to run b/4 the plaint.s discover the actual fraud.

\[b\] Plaint’s due diligence

(1) **Dupuy v. Dupuy** (5th 1977)

Brother buys out sick/dying brother as price below the actual value of shares.

(a) Must show she/she was NOT **reckless** or **intentional** in failing to exercise due diligence in discovering def. fraud in face-to-face transactions, or otherwise be estopped. If have actual knowledge plaint. will be estopped.

(b) Flip side to “scienter” req. for defs. If def. can’t be sued for negligence, then plaint cannot be estopped by negligence. **Only actual knowledge or recklessness for plaint. due diligence.**

(c) Thus, in forward looking statements, per Dupuy’s logic, only actual knowledge will suffice for plaint.’s due diligence b/c def’s scienter standard is actual knowledge.

(d) Policy: if plaint. conduct due diligence then less chance of being duped and less chance of litigation.

8. Remedies

Possibilities: (1) rescission; (2) rescissory damages; (3) out of pocket (a) false statement, or (b) churning; (4) benefit of the bargain; (5) insider trading – disgorgement; (6) punitive damages. **Goal in securities law is to give back what was lost and no more.** If there is a situation in which the def. or plaint. may have a windfall in resolution of the case, then always rule against def. b/c trying to deter fraud.

a) **Rescission:** Randall v. Loftsgaarden (1986)

(1) Under §12(a)(2) rescission or rescissory damages available as a matter of right

(a) If rec. dividend b/4 tendering stock, rec. what you get for tendering stock minus dividends rec’d prior to tendering stock.

(2) **Rescissory damages**

(a) Plaint. is entitled to a return of consideration paid - amt. realized when he sold the security - any income/distribution rec’d on the security

(b) Tax shelter benefits do not reduce rescissory damages (Randall)

(c) Under Rule 10b-5, rescissory damages are discretionary w/ the court
(i) Not decide if court should be estopped from awarding rescissionary damages when plaint holds on to claim after the fraud has been uncovered.

b) **Damages** [NOTE: diff. from rescission]

(1) §28(a) limits 1934 Act damages to **actual damage ONLY**

(2) **Out-of-pocket damages**

   (a) Normal damages formula in misrepresentation or omission cases

   (i) Consideration – value of stock after corrective disclosure, **net of the market**. **Re: net of the market** see 1361-63.

   (ii) Wait until stock “settles down” i.e. volume of trading and price stabilizes.

   (iii) Calculate securities damages on **“net of the market”** (awarding damages b/c def. put out false statement; not b/c market has moved) – look at general indices, e.g. NASDAQ, to determine “net of the market”, some cts. look at industry specific indices.

   (iv) NOTE: as w/ §11(e), in 10b-5 claims def. can show market movements responsible for plaint. damages and NOT def’s actions.

(3) **Churning** – Miley v. Oppenheimer (5th Cir. 1981)

   (a) Double recovery of (1) excess commissions and (2) out-of-pocket damages

   (b) Policy: to deter fraud

   (c) Miley typical of churning cases. Some cts not give double recover, only ordinary compensatory damages.

(4) **Benefit of the Bargain** – Osofsky v. Zipf (2d Cir.)

   (a) Need **specific damages**

   (b) Contract damages (amt. promised vs. consideration rec’d) when express promise such as in **merger or tender offer**. Otherwise, too speculative.

(5) **Disgorgement**

   (a) In private action, limit damages to benefit def. rec’d from transaction

   (b) Rationalization: def. also subject to gov’t action and attys cost. HOWEVER, not effective deterrent.
VI. Broker-Dealer Regulation

Broker-dealer (fed. & state law govern) vs. investment advisor (don’t have to register, regulated by NISMIA, above $25M subject to fed. law) vs. agent (aka registered reps, “brokers”) vs. financial planner (may be insurance seller, investment advisor, B/D). NASD is self regulatory organization (SRO) that regulates agents. Every agent must be member of NASD.

Broker – Customer suits: $ smaller than corp. suits. No class actions. Possible causes of action based on:

1. Material misrepresentations & omissions (same law as w/ corp. issues);
2. Markups: B/D firms acting as dealer, price diff. bet. buying stock & reselling;
3. Duty to investigate: invented to police boiler rooms, only recommend a security only if have reasonable belief re: validity of stock;
4. Suitability doctrine: recommend stocks “suitable” for customers;
5. Excessive trading/churning;
6. Duty to supervise

A. Markups

1. **Lehl v. SEC** (10th Cir. 1996)
   a) 10% above prevailing price (dealer’s contemporaneous price) can violate Rule 10b-5.
   b) See summary of Halstead Dempsey handout.
   c) **Shingle Theory**: broker put self out as expert and professional and thus have certain obligations to client.
   d) **Fiduciary duty to disclose info** to customer b/c of asymmetry of access to info. Broker has access to inside information regarding pricing that customer doesn’t. Customer trusts broker to do right thing. To maintain integrity of the market, must treat retail customer w/ relation to inside sales. Not charge more than 10% markup.
      
      (1) NOTE: SAB No. 99 re: caution using qualitative indicator.

   e) **Markup calculation**:
      
      (1) Compare inside quote to retail quote (“contemporaneous” is key)
      
      (2) Not based on single transaction, but many.

   f) Rule 10b-10(a)(2)(ii)
      
      (1) Clear duty to disclose risk free transaction, i.e. if buy stock w/ ticket to resell back to seller if can’t sell stock to another person.

B. Duty to Investigate

1. **Hanly v. SEC** (2d Cir. 1969)
   a) Under some circumstances, broker has duty to investigate when he or she recommends a security. **Applied to boiler rooms primarily**, also IPOs, thinly traded securities (i.e. single B/D dominate security, not
followed by many financial analysts, low volume & short track record). Rarely used against larger, well-established broker-dealers.

C. Unsuitability

1. **O’Connor v. R.F. Lafferty** (10th Cir. 1992)
   a) Under Rule 10b-5, unsuitability claims can be analyzed as omission or fraudulent practice cases when broker
      (1) Recommends securities that are unsuitable in light of investor’s objectives;
         (a) Consider sophistication of client, level of knowledge of industry, trading, etc.
      (2) Was culpable; and
         (a) Intent to defraud or w/ recklessness
      (3) Controlled the account (this element NOT req’d in 2d Cir.), i.e. had discretionary control.
         (a) Even if dealing w/ client- directed, non-discretionary account, **does client understand risks & rewards?** Ct. more likely to find broker controlled acct. if client is unsophisticated.
         (b) Those clients less understanding of risk & rewards tend to file churning & unsuitability cases.
         (c) **Hecht** was successful unsuitability case b/c ct. was convinced plaint. could not evaluate risk & rewards.
   b) NYSE “Know your customer rule” see. FN 3, CB 702
      (1) Use due diligence to learn essential facts relative to every customer
      (2) Requires broker to at least try to get to know customer.
   c) Liability always under arbitration, but case law?

D. Churning

Fraud by conduct. Violation of §10(b) & Rule 10b-5 w/o material misrepresentation or omission.

1. Plaintiff must prove:
   a) **Excessive trading** in light of investor’s objectives;
      (1) Depends on client: buy/hold client vs. day trader
      (2) Cost of transactions can be excessive trading, i.e. turning over mutual fund account several times in a years could lead to 17% cost to client and could be considered excessive.
   b) **Broker exercised control** over trading; and
c) Broker was **culpable** [same culpability standards as under 10b-5, i.e. intent to defraud or willful disregard]

**E. Arbitration**

1. Predispute arbitration agreements bet. customers and brokers can be enforced under 1934 Act.

**F. Supervision**

1. John Gutfreund (SEC 1992)
   - Mozer, dir. of Salmon Bros. Gov’t Securities Trading Desk made trades in excess of the 35% limit set by gov’t. Meriweather, his immediate supervisor became privy and notified Strauss (Pres.) and Gutfreund (CEO). Meriweather, Strauss, Gutfreund and Feuerstein (chief legal officer) meet to discuss what to do. Nothing is done and Mozer violates law again and is caught.
   - Options avail. to supervisors: (1) dismissal, (2) report to gov’t, (3) internal investigation, (4) discipline Mozer/limit his activities, (5) suspend trading authority.
   - **Essential someone take charge.** One of supervisors should have done something. SEC: each one separately and collectively had responsibility to take action.
   - **Legal officer:** when b/came part of management team he crossed line and became “supervisor.” Future issue: at what point is legal counsel a supervisor? See ABA ethics code re: role of lawyer. Rule 1.3, 1.6. Who is client?
   - SEC can enforce regulation of gov’t securities under §15B & §15A of ’33 Act.
     a) Under §15(b)(4)(E), supervisors [branch managers, senior executives] of registered representatives have **duty to supervise** registered representative and respond to red flags.
     b) Pivotal case b/c
        1) role of chief legal counsel as supervisor
        2) focus on supervisors, not run of the mill branch manager or rogue broker

**G. Rule 102(e)**

1. **Checkosky v. SEC** (D.C. Cir. 1998)
   a) Lawyers & accountants subject to professional conduct rule under SEC. Usually involves intentional misconduct or part of professional duty.
   b) Improper professional conduct under SEC amendment to Rule 102(e) includes intent, recklessness or negligent misconduct. See supp. 157. **Checkosky** did not support negligence.
   c) Meaning of improper professional misconduct is open question
      1) **Argue Checkosky and Rule 102(e)**