Securities Regulation Outline

Part I - Regulation

1-6, 6-8, 99-111, 8-22 (optional), and 86-97 (optional)

I. Introduction: The Goals of Securities Regulation

A. Why regulate?
   • Consumer protection
     Historically, self regulation may have been a better solution in the earlier days of trading in this country. But the percentage of American investors in stocks has risen equally, if not faster, than the population. Securities regulation provides consumer confidence through protective measures and legal recourse, spurring more investment.
   • The informational needs of investors
     Mandatory disclosure information also spurs more investment. Investors like to know what a company’s forecasts, future products, and outlook are before sinking cash into any enterprise. Standardized methods mandated by the SEC and FTC help to limit abuses of prospective and current shareholder’s confidence and independent corporate investigation.
   • Allocative efficiency
     The notion that it is desirable to put resources to use in the most productive manner. Theoretically, disclosure informs securities prices, and information disciplines stock prices to accurately reflect a firm’s value. However, some argue that this goal contradicts consumer protection in that corporate fear of damages resulting from private causes of action for fraud actually restricts the information flow from firms to consumers. We’ll see on this later.
   • Corporate governance and “agency costs”
     Mandatory disclosure also minimizes shareholder costs in monitoring corporate managers. Some say that this doesn’t need the same type of disclosure system currently in use, though, and would rather see a modified or different one in its place.
   • Economic growth, innovation, and access to capital
     Securities-centered economies seem to tend towards better encouragement of entrepreneurial ventures, new entrants, etc. Bank-centered economies tend to encourage firm dominance and consolidation.

B. An overview of the financial markets
   i. The money market – T-bills, negotiable CDs, and commercial paper
   ii. Trading markets (stock markets) – primary (issue order transactions) and secondary (trading transactions) markets.

C. What shapes capital markets?
   Institutional investors
   • Currently own over 50% of the outstanding market
   • Does this require regulation overhaul to protect large investors?
   • Should it be more difficult for institutional investors to influence the companies that they own?

   Financing options
   • Are overlapping financial options creating a burden on the market?

   Globalization
   • Rising U.S. demand for foreign securities due to contrasts in market regulation
   • Market interrelation
   • “Race to the bottom” problem

   Restructuring of the financial services industry
   • From limited service to full-service firms (like CitiGroup)

   Technology
   1.
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II. The Regulatory Framework

Authority is shared among: 1) the SEC, 2) self regulation through exchanges and mandatory membership to the NASD, and 3) state security officials and laws (“Blue Sky laws”). Additionally, futures are regulated by the CFTC. The line between the SEC’s province and the CFTC is hazy and the source of regulatory tension.

A. SEC

- Headed by Commission, with one Chairman and four Commissioners. Each Commissioner is nominated for a five-year term.
- Divisions
  - Corporate Finance – Overall responsibility of ensuring that disclosure requirements are met by issuers registered with the Commission; also makes the agency interpretations for SE Act of 1933
  - Market Regulation – oversees secondary trading markets, registration of stock exchanges and participants
  - Investment Management – oversees mutual fund and investment advisors
  - Enforcement – investigation and enforcement of SEC regs. No independent prosecutorial power
  - General Counsel – legal advice and representation in appellate litigation
- Statutes
  - Securities Act of 1933 – Primary market regulation
    - Prohibits sale of securities without being SEC registered
    - Mandates disclosure of financial information to prospective buyers
    - Created causes of action for materially misleading statements or omissions to prospective buyers
  - Securities Act of 1934 – Secondary market regulation
    - Mandates continuous quarterly disclosure of financial information
    - Created self-governing stock exchanges with SEC oversight
    - Limits margins
    - Requires broker/dealer registration with SEC
    - Amendments to this act include the establishment of SIPC, like FDIC for brokerage firms
  - Public Utility Holding Act of 1935
    - Largely not effective because of deregulation
  - Trust Indenture Act of 1939
    - Applies to public offerings of debt securities in excess of $1M and specifies both what form they must be issued in, and what terms must accompany. Also regulates duties of trustee.
  - Investment Company Act of 1940
    - Governs standards for mutual funds
  - Investment Advisers Act of 1940
    - Requires professionals dealing in investing advice to register with SEC, provides cause of action for false or misleading statements
- Administrative procedure
  - Subject to Administrative Procedure Act (APA)
  - Holds open meetings and offers advance notice of regulatory changes to interested parties for comment
  - Beyond simple rulemaking, also executes policy through enforcement, i.e. insider trading
  - Provides guidance to violative parties through “no action” letters, which serve as rehabilitative roadmaps that will keep the SEC from pressing enforcement. Also serve as broad policy guidance beyond mere addressees. Courts have held that these letters are not judicially reviewable
- Self-Regulatory Organizations
  - NASD
  - Blue Sky Laws

For next week – 306-319, 319-324, 31-38 supp (Wed); 343-351, 351-362, 371-377 (optional) (Fri).

III. Definitions of “Securities” and “Exempted Securities”
A. “Investment contract”

1933 Act § 2(a)(1). Two-part test for determining what a security is. First, specific test is whether the item is a “note,” “stock,” “bond,” or “debenture.” Next, general test is catch all for 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 the context otherwise requires.”

SEC v. Howey 308 (1946)

First test. Howey sold parcels of citrus groves to investors, who would take no part in cultivation, and attached 10-year service contracts. Harvey would then harvest and pay investors according to yields. SEC filed suit for Harvey’s not registering as securities sales with SEC. US held that in the context of the business, the arrangement functioned as an “investment contract” (substance over form).

Test now read by lower courts in three parts: investment contract exists if there is (1) an expectation of profits arising from (2) a common enterprise that (3) depends predominantly for its success on the efforts of others.

Unsophisticated investors (as the plebes in this case apparently were) are who are in need of securities law protection. The goal is not to allow schemes to take advantage of unwitting morons with money. But does the need for information and disclosure really have to reach to this transaction? Couldn’t the buyers arguably have been informed by the mere purchase itself?

SEC v. Koscot 313 (5th 1974)

Modifies Howey. Mary Kay-like scheme that SEC files suit against for not registering. Make-up investors were solicited to attend presentations, and then were asked to invest in the company’s pyramid strategy. Since the investment’s return was primarily hinged on the investor’s ability to go out and solicit customers of their own, Koscot denies that the investment was a security. Lower court denied injunction because they found simple solicitation, but no investment contracts. CA reversed, changing the “efforts of others” requirement from Howey to “predominant” rather than “solely” (a functional rather than literal) approach as per SEC’s interpretation of the intent of the laws themselves (to, in essence, preserve the integrity of the goals of securities regulation in regulating capital markets). CA confined their decision to schemes in which promoters retain essential managerial control, and where promotion is the essential key in maintaining the investment structure.

Horizontal commonality: pooling of investor funds and pro rata distribution of profit. The pooling is essential for horizontal commonality.

Vertical commonality (Koscot): commonality between investor and promoter are dominant fact for success of business, regardless of high investor participation.

What about investor ability to opt out and hire their own managers/promoters? The right to remove and replace managers/promoters? Less clear reliance on the Koscot rationale. What extent of investor sophistication or control negates the practical approach of Koscot?

B. The Economic Realities Test – Downsizing the Definition of “Security”

United Housing v. Forman 319 (1975)

Second test. UHF offered stock sale for entrance into partially subsidized housing. Tenants had to purchase stock for possession rights, with the pre-construction the sale allowing UHF to defray some initial costs. When costs overrun, UHF increased monthly rent. Shareholders sued under securities laws saying they were deceived. District granted SJ to UHF, CA reversed. US reversed CA, saying that just calling it “stock” doesn’t make it a security. In this case, the “stock” had no investment or future profit value, but in economic reality was simply a tool to help pay construction costs. Since it didn’t satisfy the Howey test, which turned on investments designed to make money, UHF won.

If investor perception really mattered, why not let parties contract out of securities law protection?

If the court hadn’t drawn a line at economic realities, then what would have been the determining factor in applying security laws? There may be some hard-to-find economic value added to these stock purchases (maybe guaranteed lower rent, etc.), but is that really what should be the touchstone of judicial review? Well, according to the Court it should it be bottom line dollars in and out – “economic realities.”
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Looking to purpose of Act (securities regulation), this item was not a security and there was no ready markets for the instrument. If it’s not a security with a ready market, missed the purview of the Act.

Steinhardt v. Citicorp Supp. 31 (3rd 1997)

Do limited partnerships constitute investment contracts? The court focused on economic realities of the contracts to determine that they don’t. Not really useful unless dealing with limited partnership cases (which probably doesn’t happen to often). Steinhardt did not have to rely on others to make the business’ profit, so there was no investment contract. He had control of the business plan, he could remove the general partner, and the contract was a sophisticated, highly negotiated deal. This maintains a “degree of control” argument in justifying what is or is not a security, but that test seems to be problematic when considering Landreth, infra.

C. “Stock”

Landreth 343 (1985)

Clarifying Howey. Landreth sold the stock in their lumber business to Dennis and Bolton, who had formed Landreth Timber Company to make the purchase. The business underperformed, and Dennis and Bolton sued the Landreths under securities laws seeking rescission and damages. District court denied, claiming it was a sale of a business and not “stock.” CA affirmed. US reversed, saying that selling what is plainly stock invoked securities regulation protection. Howey may have defined “securities” as passive investments with no managerial control, but that was for those kinds of “murky” transactions that are not obviously stock sales. Regardless of the fact that Dennis and Bolton had managerial control of the lumber business, “stock” is stock, and it is the first thing that comes to mind when anyone thinks of the 1933 Securities Act.

Æ Investor definition is irrelevant. Sniff test defines stock, not investor classification.

What about structuring this as an asset sale instead of a securities purchase? In both cases, the buyer obtains control of the business interest.

D. “Note” – when debt is considered a security

Reves v. Ernst & Young 351 (1990)

Farmer Coop offered unsecured notes, payable on demand, to farmers and the public. The capital raised from the notes funded the Coop’s operations. The Coop went bankrupt, and Reves sued its accounting firm, Ernst & Young, for inflating numbers and not following GAAP. E&Y claimed that the notes weren’t securities under the 1934 SE Act. District court found for Reves and awarded $6.1M in damages, CA reversed, US reversed CA, holding under the “family resemblance” test that “notes” payable on demand offered by an organization to support its general operations are securities as defined in the 1934 Act. However, if a note is offered for the purpose of raising capital to make specific purchases, it isn’t a “note” under the 1934 Act. Dissent noted that the Act excludes notes that mature in less than nine months, and since these were P.O.D., they should have been excluded because they may be redeemed anytime.

The four-point “family resemblance” test for determining when a note is a security:

1. Examine motivations behind transaction that prompted seller and buyer to enter (as in this case, general business operations/profit from note = security)
2. Examine plan of distribution of instrument to see whether there is common trading for speculation or investment
3. Examine reasonable expectations of the parties
4. Examine if other regulatory schemes exist that reduce the risk of purchasing the note that may make application of 1934 Act is unnecessary (collateralization, contractual obligations, etc.)

For next week – 111-114, 119-122, 129-133 (Wed); 133-147, 147-153 (114-118 problems) (Fri). Registration process.

IV. Regulation of the Distribution of Securities: The Basic Structure and Prohibitions of the Securities Act
A. The Statutory Framework

Two basic aims of 1933 Act:

- Provide investors with material financial and other information concerning new issues of securities offered for sale to the public
- Prohibit fraudulent sales of securities

Basic prohibitions in § 5 (full disclosure and registration rules) and §§ 17 and 12(2) (criminal and civil sanctions for failure to follow 5). State law is partially preempted in 18, but also accounted for in 19(c)(1).

Act hinges on interstate commerce for jurisdiction.

- § 5 only applicable to issuers, underwriters, and dealers – does not reach secondary markets
- § 5(a) prohibits sale of securities without effective registration
- § 5(b) keys on issuance of prospectus, which must conform to content requirements of 10
- § 5(c) requires filing of registration statement
  - Regulation S-K, Forms S-1, S-2, and S-3 dictate contents of registration statement, generally separated into four categories – first three are contents of the prospectus
    - Information bearing on the registrant
    - Information on the distribution and use of the proceeds
    - General description of the securities
    - (Attachment of exhibits)
  - Regulation S-K
    - Risk factors – Item 503(c)
    - Offering price
    - Who is selling
    - Registrant’s business and property
    - MD&A – Item 303
    - Related parties and transactions
    - Indemnification of officers and directors
    - Company’s capital structure
    - Legal proceedings
    - Rule 421 proposes to switch to “common language” in registration statements
    - “Seasoned issuers” can use shorter forms and simply reference other SK disclosures – called “integrated disclosure”

Three time periods: pre-filing period, waiting period (pending effectiveness of security offering), and post-effective period.

B. The Pre-Filing Period (“Gun Jumping”)

§ 5(c) says pre-filing period is “quiet period,” so offers or communications interpretable as offers are prohibited. Issuers and underwriters come to a mutual understanding about the prospective offering of a security. The pre-filing period involves many parties into the preparation of the registration statement. CEO, CFO, attorneys, lead underwriter, and accountants collaborate. Registrant chooses filing date, but SEC chooses effective date of registration statement. No offers may be made during this waiting period for SEC go-ahead. Any announcement that piques interest in the investment opportunity may be deemed gun-jumping, so counsel must review all press releases, ads, etc., to make sure they don’t imply an offer to sell a security. Factual information may be disclosed, not prospective. Generally, compliance with Rule 135 will render the action NOT an offer for sale of a security. 135 also prohibits disclosure of the underwriter to the public.

Carve out: 2(a)(3) defines “sale” and allows preliminary conversations with underwriters and necessary parties to an offering during the waiting period, otherwise complete restriction would be handcuffing the entire offering process.

Rule 430A permits a registration statement to become effective without having finalized offering price, underwriter syndicate, and etc., even at the time of effectiveness.

C. The Waiting Period

May make offers to sell and buy. § 5(a) still prohibits consummation of sale during waiting period; unless the registration has been made effective, no offers to sell may be consummated. Nature of selling efforts
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restricted by 5(b)(1) – mandates selling offers to be accompanied by preliminary prospectus conforming to definition of prospectus under 2(a)(10)

8(a) – Registration statement can become effective 20 days after it or an amendment is filed.
5(b)(1) – Prospectus has to comply with 10.
5(b)(2) – Can’t deliver securities unless proceeded or accompanied by a prospectus that complies with 10(a).
5(c) – Registrant can’t do anything outside the carve-out for underwriters and lawyers unless the registration has been filed – NO offers to sell/buy whatsoever.

Five ways to reach potential investors during waiting period:
Oral offers (face to face, or by phone)
Tombstone ads
Identifying statement
Preliminary red herring prospectus
Preliminary summary prospectus

i. The preliminary or “red herrings” prospectus

430 says that since you have to have something that complies with 10, you can distribute a preliminary prospectus during the waiting period that includes substantially all of the information that will appear in the final prospectus. This eliminates the ban on offers to sell before SEC approval, but the offers are regulated. Therefore, a prospectus that meets §10 requirements may be used to make offers to sell during the waiting period. 5(b)(1). Regulation S-K, Item 501(8) carries forward the “red herring” tradition of stamping the top of the as-yet unapproved prospectus “Subject to Completion” in red ink.

430A allows a registration statement to become effective without published price information, with that information to be submitted to the SEC in a revision within 15 days.

NOTE: A section 10(b) prospectus satisfies the requirements of 5(b)(1), but NOT 5(b)(2).

ii. The summary prospectus

431 authorized, completely informational prospectus that may be filed with the registration application, provided that the registration form used allows such prospectuses. Unlike the preliminary prospectus, this one cannot be used to satisfy the prospectus requirements of 10(a).

iii. The “Tombstone Ad”

2(a)(10) carves out from possible prospectus definition these bare-bones ads announcing the sale of a security, the company offering the sale, and the underwriters. They are still prohibited from use in the pre-filing period. 5(c).

iv. The identifying statement

2(a)(10)(b) allows for an expanded tombstone ad, provided it meets the 14 informational requirements of Rule 134.

v. Testing the market

vi. Electronic communications: Of websites, electronic roadshows, and email

Don’t distribute a writing that may constitute a prospectus but doesn’t comply with 10(b). This includes research reports, etc., that may fall under the broad 5(b) prospectus definition.
Limit access to electronic roadshows. Roadshows begin to look like TV or general broadcasts, and would violate waiting period restrictions. Can solicit 134(d) statements of intent form prospective purchasers, but cannot consummate offers to sell.

D. The Post-Effective Period

5(a) – sales of a security
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5(b) – prospectuses

Prospectus requirements
The 5(a)(1) restrictions on prospectus use for offers to sell during the waiting period are relieved once the registration statement has become effective. A waiting period 10(a) prospectus can be used for 5(b)(1) purposes, but a 10(b) prospectus can only be used for informational and screening purposes. Any delivery of a security pursuant to a sale must be accompanied by the 10(a) version.

T+3 – The deal settles three business days after trade date.

Rule 434 – T+3 prospectus delivery rule. For offerings of stock or for certain investment grade securities, the information that traditionally is required to be delivered in the statutory prospectus may be delivered in pieces within the T+3 period.

Æ 10(b) delivered during waiting period, then go effective, and then deliver term sheet that includes the excluded information from the 10(b) prospectus to “10(a)” the preliminary prospectus. Satisfies 5(b)(2).
Æ Web posting isn’t good enough for follow up information distribution – if shareholder consent is required, some sort of receipt is needed.

Confirmations may be considered nonconforming prospectuses if they are delivered without transfer sheets under a 434 setup.

Electronic communications and the ’33 Act
Offeror can deliver the above information through email, but 1) buyer must consent to the format, 2) must be able to verify electronic delivery, and 3) must actually deliver info, can’t simply post it.

EDGAR – How SEC docs are filed.


V. The Registration Process

A. Disclosure policy and the debate over the efficient market

The Efficient Capital Market Hypotheses (ECMH) – stock prices in an efficient market fully reflect all available information. But do they? Let’s look at where regulation fits into pushing us towards a fair, efficient market. Shall we?

The Gilson/Kraakman argument – Market efficiency is determined by two factors: 1) The relative cost of acquiring, processing, and verifying different types of information, and 2) the initial distribution of the information among traders in the market. Thus, SEC filings are less costly because they are widely distributed and come partially verified (ha!). They argue that the underwriter (or investment banker) plays a large intermediary role in making information available at a lower cost

Weak – Market is efficient if the stock price reflects all historical prices.
Semi-strong – Market is efficient if it reflects all publicly available information.
Strong – Market is efficient if security prices reflect all (public and nonpublic) information.
Æ Why may the ECMH of our market be fundamentally wrong (and the market actually be fundamentally inefficient)? Market noise drives a wedge between trading price and the “true” value of the company. Fundamentals don’t rule supreme: sometimes people just freak and cause meltdowns.

Informationally efficient (market price reflects available info/hype/noise/etc.) – or – fundamentally efficient (where the price indicates concrete factors that are readily identifiable)?

B. Policy implications
Look, it be all about confidence in the market, baby. Should we divest analysts from investment bankers in consolidated firms through legislation? A new, heavy regulatory regime? What about liability for accounting firms/analysts/rating agencies? Heftier criminal sanctions for fraud?

The case for mandatory disclosure:
- Duplication of effort is inefficient
- “Public good” aspect of stock research levels playing field for entire investing public (no private hoarding of information to a select few’s benefit)
- Promotes fairness
- Reduce research costs for analysts, so should provide incentive to do more

The case against
- Strong enough incentives to disclose already, no need for mandatory
- “End game” problem – if up against a wall, there should be options on what must be disclosed
- Too much information already/too much excess disclosure

C. The SEC’s integrated disclosure system

The Securities Act of 1933 and the Securities Exchange Act of 1934 had different registration and reporting standards. They were first standardized with Reg S-K in 1977, and then further with 10-K, 14a-3, Reg S-X, and (again) Reg S-K revisions in 1980. Now, virtually all filings under either Act require uniform financial disclosure. Goal was to make it easier for existing companies to register under 1933 Act (policy: it’s cheaper and encourages formation of capital markets). Now, companies can take advantage of their 1934 Act filings when filing under 1933 Act.

1934 Act says must register:
12(b): If securities are listed on exchange.
12(g)(1) + Rule 12g-4: If you had assets of over $10M and over 500 security holders, whether or not you had already filed under 1933 Act, were traded on a board, or anything else.
15(d): If you have registered under the 1933 Act.

13 tells you what forms you have to file.

The integration continued with streamlining the 1933 Act’s disclosure requirements, reformatting the major registration forms S-1, S-2, and S-3 into a three-tiered system for most types of offerings (S-4, S-8, and S-14 are for special instances). Thus, the registrant category system is as follows:

S-3: Companies which are widely followed by analysts (S-3 short form registration statement, minimal disclosure in prospectus/maximum integration by reference to 1934 10 filings)
S-2: Companies which have been subject to the Exchange Act periodic reporting requirements for at least three years (combines incorporation by reference of Exchange Act reports with supplemental information contained in prospectus or in annual reports to shareholders)
S-1: Companies which have been subject to the Exchange Act periodic reporting requirements for less than three years (full disclosure)

The integrated disclosure system simplifies corporate reporting in three ways: 1) disclosure requirements are made uniform under the Securities Act and the Exchange Act; 2) Exchange Act periodic reporting is used to satisfy much of the disclosure necessary in Securities Act registration statements; and 3) the use of informal shareholder communications is encouraged, but not required, to satisfy formal statutory requirements under both acts.

D. Shelf registration

Shelf registration, or registering more shares than you intend to offer to keep some in the storehouse for later without having to file all over again, was hampered because of Act language that seemed to indicate that registration wouldn’t be effective unless all shares were offered. Rule 415 provides procedural
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flexibility in timing periodic offerings of S-3 registered securities so as to take advantage of favorable market windows. See and transcribe: 415(a)(1)(viii) – (x).

(x) – Securities registered on a form S-3 which are to be offered or sold on a continuous or delayed basis do not have to re-register.

415(a)(2) – Limitation on amount of securities that can be limited to shelf on basis of reasonable expectation of what you can sell up to two years from effective date.

415(a)(3) – provides for undertaking in the future that requires register to file amendments in post effective prospectus to ensure that information doesn’t go “stale” because of shelf provisions.

Æ S-K 512(a)(1) for update requirements

Rule 176 – Fraud considerations in registration statement and reasonableness of investigation.

E. New approaches to disclosure

Item 303: Management’s Discussion and Analysis

The MD & A Item is the SEC’s most significant innovation in mandatory disclosure in recent decades. It requires corporate managers to give investors a “big picture” overview of their corporation. MD & A often is an issue in SEC investigations when a troubled company is less than candid about known “material events and uncertainties.” One purpose of Item 303 is to avoid ugly surprises.

Item 303(a) generally requires: Discuss registrant’s financial condition, changes in financial condition and results of operations. The discussion shall provide information as specified in paragraphs (a)(1), (2) and (3) with respect to liquidity, capital resources and results of operations and also shall provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.

Instructions to Item 303(a) highlight the troubled company emphasis: The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

Liquidity: . . .

(2) Disclosure Requirement 303(a)(1): Identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant’s liquidity increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action that the registrant has taken or proposes to take to remedy the deficiency. Also identify and separately describe internal and external sources of liquidity; and briefly discuss any material unused sources of liquid assets.

Capital Reserves: 303(a)(2) provides: . . .

(ii) Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

Instruction 7 to 303(a) distinguishes mandatory forward-looking disclosures under Item 303 from voluntary disclosures encouraged by Item 10(b): Registrants are encouraged, but not required, to supply forward-looking information. This is to be distinguished from presently known data that will impact upon future operating results, such as known future increases in costs of labor or materials. This latter data may be required to be
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disclosed. Any forward-looking information supplied is expressly covered by the safe harbor rule for projections.

The most hotly contested provision in The 1995 Private Securities Reform Act was the new safe harbor for forward looking statements.

The Section 27A applies to a forward looking statement made by Sec. Act §27A, with several exceptions in §27A(b), by

1. An issuer that, at the time that the statement is made, is subject to the reporting requirements of section 13(a) or section 15(d) of the Securities Exchange Act of 1934;
2. A person acting on behalf of such issuer;
3. An outside reviewer retained by such issuer making a statement on behalf of such issuer; or
4. An underwriter, with respect to information provided by such issuer or information derived from information provided by the issuer.

There are three different types of safe harbor in §27A(c):

1. Securities Act §27(c)(1)(A) and Securities Exchange Act may immunize a deliberately false forward looking statement if the court concludes it was accompanied “by meaningful cautionary statements.” This is a codification of the bespeaks caution doctrine.

2. The defendant is given a second safe harbor in Sec. Act §27A(c)(1)(B) if he or she cannot offer and prove sufficient meaningful cautionary statements because the plaintiff is still required to prove a higher culpability standard “actual knowledge” rather than the lower recklessness or negligence standard available today under the Securities Exchange Act §10(b) and Rule 14a-9.

3. There is then a novel safe harbor for oral forward looking statements when appropriate reference is made to a readily available written document. Sec. Act §27A(c)(2).

Focus more on Virginia Bankshares!

Underlying the complex view new safe harbors is a simple, but as yet unproven belief: “Fear that inaccurate projections will trigger the filing of securities class action lawsuit has muzzled corporate management.” 1995-1996 Fed. Sec. L. Rep. (CCH) ¶85,710 at 87,208. Whether this belief is warranted – or whether corporate management is reluctant to publicly discuss projections for other reasons is an empirical question that time will answer.

175: Management will only be held liable if their forward-looking statement is knowingly false (reckless).

21E, 27A added in 1995 to further encourage by providing even more security from liability of accompanied by cautionary statement.

F. Regulation of underwriters and the distribution process

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For next week – 378-389, 399-400 (Wed); 401-402, 418-432, 441-445, Reg D (Fri).

VI. The Private Offering Exemptions: 4(2) and 4(6)
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What is an “issuer” (def: Sec Act), and what transaction exemptions are applicable to them in connection with the sale of securities?

- 2(a)(4): “every person who issues or proposes to issue any security[.]”
- Issuer doesn’t have to only be someone who follows through on a issuance, but can be someone who only proposes to issue.

4(2) private offering exemptions: exempts “transactions by an issuer, not involving any public offering[,]” from the registration and prospectus requirements of the 1933 Act. Question is, what defines a “private” offering, and why are they preferable in some situations?

*What characteristics may be considered when classifying what a nonpublic offering is?*

- See 381-82
- Number of offerees
- Availability of information
- Access to information
- Nature of the offerees
- Manner of offering
- Limitation on resales

*Why?*

- Less expensive
- Less time needed from business idea to funding
- Allows more accountability to investors

4(6) was passed in 1980 to allow exceptions for offers and sales to an unlimited number of “accredited investors,” as long as they remain under 3(b) dollar amount restrictions.

**Ralston Purina 384 (1953)**

4(2). Purported internal offering of corporate stock to “key employees” resulted in sale of around $2M in shares to both “key” and non-key employees. The offer was made in memo form through supervisors which disclaimed that it was not an offer for sale, but an offer to respond to random solicitation from interested employees. The qualifications listed on the memo were not determinative on who actually comprised the class of “key” employees. SEC interpreted this as a public offering because the restrictions arbitrarily delineated a private group from a public with no apparent reason and thereby creating Purina’s inability to justify the incentive motivation for the issuance. US held that an offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’ The “fend for themselves” criteria is intended to carve out those that may obtain access to the corporate information that §5 mandates disclosure for, without forcing §5 registration on the issuer.

What are proxies for sophistication?

- Income
- Education
- Profession
- History of private investments
- Competence
- History of business dealings
- Possession of comparable securities
- Prior relationship with the current issuer

What are the proxies for information?

- General registration statement and prospectus info
  - Management team
  - MD&A
  - Risk factors
  - Compensation structure
  - Auditors
  - Forecasts, etc.
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- Access to corporate officers/insiders if offeree is sophisticated

What are the proxies for number of offerees?

**Rule 701** – provides for non-34 Act reporting companies an exemption from registration for offers or sales pursuant to compensatory employee benefit plans, or included ... Theory: Goal is not to raise capital, but rather to compensate employees and bind them to the company (i.e. non-vested stock). Very limited disclosure is required. **701 exemption** can be used not only in offers to employees, but also to some consultants and advisors. → Harmonize 701 with Ralston? Ralston predates 701 exemption.

**VII. The Limited Offering Exemptions: §3(b), Regulation D and Regulation A**

4(2) is general statutory exemption for a private offering. Reg D is somewhat different.

**Regulation D** – replacement for Rule 146, relies on 3(b) and 4(2) for exemptions of “transactions not involving any public offering.” Responds to need for certainty and clarity in exempt offerings (unlike the murky **Ralston Purina** progeny). Preempts state securities laws for the reg’s covered securities. Rule 146 was designed as an exemption for private offerings to increase access to capital and equity markets for small business. Under the old rule, a “compliance system” emerged to establish a burden of proof for qualification for the exemption. It was adopted and clarified in Regulation D (17 CFR 230.501-508), and includes the following criteria as needed for submission of proof for qualification should the exemption be challenged:

1) A private placement master schedule, setting forth all significant events that must occur throughout the offering period to meet the conditions of the rule (now Reg D);
2) A private placement memoranda distribution record;
3) Potential offeree identification form;
4) Potential offeree evaluation form;
5) Offeree questionnaire;
6) Offeree representative documents; and
7) Final evaluation form.

**Reg D exemptions:**

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

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

506 – Satisfy this, and gain benefits of 4(2) private placement exemption. No limitation on maximum aggregate offering price. No more than 35 non-accredited investors as purchasers. Affirmative disclosure obligation with respect to non-accredited investors only. Non-accredited investors or their representatives must meet certain sophistication standards. Resale of 506 securities are restricted.

- Available for any offer of any size, but has most stringent disclosure requirements. Requirements for disclosure scale down as maximum amount of offering lowers to 504.
- Snophsnisticnation requirement: Each person who is not an accredited investor must be savvy enough to evaluate the risks and merits of the prospective investment, or the issuer believes that the potential buyer is so savvy immediately prior to the sale.

Avoid the snophsnisticnation requirement by using 504 or 505, given the caps.

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

**Problem:**
Securities Regulation Outline

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

504 – fine, except for $1M cap. Kinnaught do it, captain.
505 – Either eat the remaining $1M, or look elsewhere for investors.
506 – Make the non-accredited disclose, make sure the non-accredited are sophisticated (and if some aren't, then get ‘em sophisticated in a hurry), and we may be in Reg D business.

So, what is an accredited investor?
Definition in 501 – Banks, insiders of the issuer, mutual funds, natural persons with worth over $1M, or $200K annual income over the last two years (other info for married), any entity where all of the general partners are accredited investors.

4(6) – Provides exemption for offers or sales solely to one or more accredited investors, provided that there is no public solicitation, and provided that notice of the sale is filed with the SEC.

Problem:
Jane coordinates Hi-Tech’s lobbying and regulatory changes.

Credited investor?
No. 501(f) says that certain titles don’t meant that someone is accredited, but officers who perform business or similar policy functions (something close to the core competencies of the entity, not just a loosely-related department head).

So Reg D says that you can create a private offering, but how do you prove that it is private?
502(c) – Limitation on general solicitations. Factual determination on what does or does not constitute a general solicitation. Look for preexisting relationship between issuer and offeree, which may indicate less likeliness of a general offer. What constitutes a preexisting relationship? Perhaps the broker/dealer aspect. If you have a relationship with a broker, chances are you’ve done some kind of scouting on them. Provide paperwork proving that (questionnaires, etc.), and you establish a preexisting relationship.

What about normal informational distribution devices (e.g. quarterly updates to accredited investors) that should include upcoming offering information? Can announce a coming sale in an informative manner only, but disclosure can’t be used to condition the market – just very bare bones info.

502 disclosure obligations: only under 505 and 506, and then only to non-accredited investors. Should you disclose to accrediteds anyway? Might as well. 502(b) sets forth disclosure obligations, which vary with size of offering and nature of issue. General rule: if you are a reporting company required under the 34 Act, then those are adequate for disclosure obligations under Reg D. If not a reporting company, must disclose certain info to the extent of the material, issuer, and business being offered – like a summary of written material that was provided to accredited investors. Also need to have a Q&A session for investors to get any info they might feel missing prior to the issue. Limitation on resale in (d) to avoid back-door public offerings. Integration of a series of Reg D offerings will lump systematic offerings together for purposes of analysis under the provision. Look out for the limitations (same as “entire issue” criteria, infra)!

VIII. Intrastate Offerings: §3(a)(11) and Rule 147

A. Exemptions for entirely intrastate transactions
“Entire issue” must be offered and sold exclusively intrastate, where all issuers, offerees and purchasers are residents. Whether or not the offering is traceable to an integrated issuance may be made more obvious through one or more of the following:
- Are the offerings part of a single plan of financing?
- Do the offerings involve issuance of the same class of security?
- Are the offerings made at or about the same time?
- Is the same type of consideration to be received?
- Are the offerings made for the same general purpose?
Securities Regulation Outline

There is no partial coverage for exemptions if only a small portion are sold interstate to non-local residents. It’s either all or nothing at all, there’s nowhere else to fall when you reach the bottom it’s now or never...

Corp offering intrastate securities must also have nexus of substantial business operations within that state. Must be higher than minimum contacts. Also, issuance should be intended to finance the continuing intrastate operation. Exemption can’t be “relied on” if it’s going to fund interstate expansion of the offeree.

Resale out of state during the initial offering defeats the exemption, but securities aren’t strictly limited to where they end up. Question of facts as to whether a prompt resale to non-state residents is a mask to avoid registration.

No limitation on use of mails to make offer intrastate.

For next week: 515, 518-521, 541-43, 546-47 (Note C) (Wed); 548-568, 572-576, Rule 144, Rule 144A.

IX. Offerings by Underwriters, Affiliates, and Dealers


A. The concept of “underwriter”: Statutory and presumptive underwriters

The term “underwriter” in 5 is defined non-exclusively in 2(a)(11) as “any person who”: [1] “has purchased from an issuer [or controlling person] with a view to, or [2] offers or sells for an issuer [or a controlling person] in connection with, the distribution of any security, or [3] participates or has a direct or indirect underwriting of any such undertaking [as described above].” 4(1) exempts from registration anyone who isn’t the issuer, underwriter, or dealer – but what exactly are these?

Chinese Consolidated Benevolent Assoc. 518 (2nd Cir. 1941)

“In connection with....” A group of citizens with no official or contractual relation to the Chinese government solicited funds from Chinese Americans to purchase government bonds through the Chinese Embassy. SEC said that the securities had to be registered, Chinese Assoc. said that they didn’t because they weren’t statutory underwriters and had no official relation to the issuer, thus escaping that requirement of 5(a)(1). Gus Hand held that the solicitors, while not having an official relation to the issuer, were constructive underwriters because of both their efforts as a typical underwriter in soliciting and collecting purchase agreements, and also that if the defense that they were not officially 4(1) parties (issuer, underwriter, or dealer) were accepted, the policy goals of 5(a)(1) would be constructively thwarted.

→ Does this seem overly broad? That anyone in any way who has some involvement in any capacity may be considered a constructive party to an issuance? Like lawyers, newspapers that run the tombstone ads, etc., could be constructive underwriters?

→ What about historical significance? Was this an attempt by the government to make sure foreign powers couldn’t get finances to fuel the war against the US with fundraising campaigns right here at home?

A “control person” is only considered for purposes of determining who is an underwriter under 4(1). If the securities have not come to rest, control persons are not an issue in determining who is an underwriter. If the securities have come to rest, then non-control persons may take advantage and resell securities. Investment intent is not determinative of a control person, though: Don’t ask whether the securities have come to rest in the control person’s hands, but whether they are acting as an intermediary on behalf of another person.

Two questions:

▪ Is there a control person? 2(a)(11). “Control” fleshed out by Rule 405. If you have the ability to exercise control in certain circumstances, that satisfies the test.

▪ Is there only a normal sale, or is the dissemination of stock actually a distribution? Look to whom the sale is targeted, and whether or not those targets are capable of defending themselves.

Wolfson 541 (2nd Cir. 1968)
Control persons have to find their own exemptions. Wolfson and his cronies controlled Continental Enterprises, for which over a period of time they employed brokers to sell unregistered stock. DOJ sued as criminal violation of 5, Wolfson argued that the brokers were not in fact issuers, underwriters, or dealers. Court found that Wolfson had statutory control because of the block of shares he and his associates owned in Continental, and thus fell under the Act as an issuer.

- Underwriter is assumed if there is no intent to hold the security for long-term investment, but can be rebutted with reference to historical data on the firm’s past security investments and holding period thereof.
- Look for step transactions with multiple recipients of privately places securities as an ineffective tool to evade registration.

When control person wants to resell, they have to register their own block of shares.

B. The doctrine of “change of circumstances”

Only way to escape control person liability of stocks haven’t come to rest. If the holding period prior to resale of an initial security purchase does not manifest “investment intent,” then the purchaser must make a showing that the resale was solely the result of a “change of circumstances” between the original purchase and the resale. This is bullshit. The example the book gives shows a corp that bought debentures and then resold them 10 months later. The corp argued that the time lapse should establish a presumption of investment intent, and that the corp had only intended to retain the securities if they themselves were operating at a profit. The court didn’t buy it, saying that the conditional retention of the securities was equivalent to a “purchase...with a view to distribution” within the statutory definition of underwriters in 2(11). Horseshit.

- Holding periods: No hard and fast rules, but “three years is a safer bet than any to avoid these questions; 2 years presumption in Δ favor that securities were purchased for investment purposes; >2 presumption that only MAC can prompt resale, or constructive distribution.
- You’re the SEC: To get them, first relate to the holding period. If situation satisfies, then relate back to definition of underwriter. If that is satisfied, then look back to definition of public/private offering in Ralston Purina.

C. Restrictions on resales of control shares and restricted securities under Rule 144

Rule 144 – Persons Deemed Not to be Engaged in a Distribution and Therefore Not Underwriters

Non-exclusive safe harbor for resale of restricted securities (505 private placement or Reg D). Also controls resales by affiliates.

Applies to the sale of “control” securities or restricted securities if the following basic conditions are met:

1. Adequate current information with respect to the issuer is available.
2. If the securities are restricted securities, a one-year holding period has been satisfied.
3. The amount of securities sold by an affiliate [an affiliate of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer] in each three-month period [moving three months] does not exceed the greater of:
   - 1% of the outstanding securities of that class, or
   - The average weekly reported exchange volume of trading and/or reported through NASDAQ during the four-week period prior to the date of the notice referred to in (5) below, or
   - The average weekly volume of trading in that class reported through the consolidated transaction reporting system during such period.

The same limitation applies with respect to sales of restricted securities by non-affiliates unless the two-year low cutoff under 144(k) is available, in which case there is no limit to the amount.

4. The sales are made in either ordinary brokerage transactions or directly with a market maker.
5. Except for small sales (not more than 500 shares or $10K aggregate sales price in the three-month period), the seller files a notice of sale on Form 144 with the SEC and, in the case of listed securities, the principal stock exchange, concurrently with either placing the order to sell with a broker or executing the sale directly with a market maker.
Rule 144 is available for shares which are covered by an effective registration statement if (1) the registration statement expressly provides that the shares so offered may be sold either by means of the registration statement or by means of Rule 144, (2) the shares are withdrawn from a current effective registration statement, or (3) even if the shares are not withdrawn from the registration statement.

**Basic requirements:**

1. **Current public information**
   This requirement is met if the issuer has (1) securities registered under either the 33 or 34 Act, and (2) has been subject to the periodic reporting requirements for at least 90 days prior to the sale, and (3) files all 34 Act reports required to be filed during the 12 months (or such shorter period that the issuer was subject to the reporting requirements) preceding the sale.

Small companies not subject to 34 Act 12(g) registration (<500 shareholders, ≤$5M assets) may voluntarily register to allow Rule 144 access for their shareholders.

2. **Holding period**
   One year holding period from acquisition of securities either through issuer or issuer’s affiliate. Term doesn’t begin until full consideration is given for the securities (all purchase requirements are met). Certain taking rules are applicable to options, partnership securities, etc. See book pp. 552-55 for enumeration. If held for two or more years, none of the other conditions in this section need be met.

3. **Limitation on amount of securities sold**
   See (3), supra. Sales pursuant to a registered offering and pursuant to exemptions provided by Regulation A and 4 of the 33 Act are not aggregated into the Rule 144 tabulation. If securities are traded on NASDAQ and another exchange, NASDAQ volume may be used in lieu of the alternate exchange. If not on NASDAQ, then volume alone may be used.

Sales by persons acting in concert are aggregated. Determination of concerted action is based on subjective facts.

4. **Manner of sale**
   Sales can be made either through brokers’ transactions (def: 33 Act 4(4)) or directly with a “market maker” (def: 34 Act 3(a)(38)).

5. **Notice of proposed sale**
   Must file notice with SEC of intent to sell in reliance on Rule 144.

6. **Rule 144(k) – No restriction after three years**

7. **Exclusivity and operation of Rule 144**

8. **Relationship with other rules**
   144A – Provides nonexclusive safe harbor exemption on registration for resales of securities to qualified institutional buyers (QuIBs). Acquisition of securities in a private offering can avail themselves to 144A to avoid registration requirements.
   Requirements:
   - Securities NOT covered?
     - Securities that, when they were issued, are of the same class of securities listed on an exchange or NASDAQ
   - Who can buy?
     - QuIBs – must own and invest at least $100M in securities
     - Banks and S&Ls have to meet a net worth requirement
     - Broker/dealers only have to have $10M in discretionary investments in securities
   - Information requirements?
     - Buyer has to have the ability to obtain certain information from the issuer prior to the sale
     - If 34 Act company, periodic submissions satisfy information requirement
Securities Regulation Outline

Do holding period or volume limitations apply?
- No.

D. The Section “4(1½)” Exemption
Private resales by control persons of restricted securities that have come to rest. Allowed without having to
register by a series of non-action letters from SEC framing partial compliance with 4(1) and 4(2).

4(1)
- Private resales are from a “holder,” not an issuer.
- To avoid 4(1) tagging as “underwriter,” holder
  - Must not have purchased the shares from the issuer “with a view” to their distribution, and
  - Must not offer or sell the shares “for an issuer in connection with the distribution.”

4(2)
For non-control persons, sale after the securities has come to a rest is OK (“distribution” has ended).
For control persons, 4(2) substantive definition of “distribution” guides to whether 4(1½) exemption is
applicable.

Assume Candice is control person of Acme, and resold 2K shares from Acme private offering to Donald,
Acme’s new CFO, after two months. Can she resell?
- Securities haven’t come to rest, so will her resale run afoul of Amce’s offering?
  - Donald can invest for himself, and Acme could have sold to him earlier, so the sale is OK.
    → Technically not a 4(1½) case because it is a direct sale.
Assume same set of facts, but holding period of five years, and attorney negotiates resale to Donald
(control person, selling through intermediary, shares that have come to rest).
- No distribution as per 4(2) definition, so there is no underwriter this go around. She’s not an issuer
  under 4(1). She can resell under 4(1½).

For next week: pp. 882-908 (Wed), 913-918, 925-936 (Fri).

Part II - Liability

X. Civil liability under the 1933 Act

A. Section 11
Core principle: the issuer and a list of statutorily defined potential defendants (signees of the registration
statement, directors and partners, about-to-become partners, expert parties, underwriters) can be held liable
if the registration statement, when it became effective, contains a material misrepresentation or omission.
A suit may be brought by anyone who acquired a registered security, whether in the registration process or
in a secondary market, as long as they can prove that their shares are traceable to the errant issuing
statement.
  → Like in corporations, materiality is separate issue from misrepresentation or omission.
  Reliance doesn’t need to be proven, nor causation.
Issuer has only one defense: 11(a) Show that Π knew of the untruth or omission at the time of acquisition.

Other defendants have due diligence defenses, like:
- After 12 months of earnings statements, the Π can’t claim reliance on the registration statement.
- That Δ has, before effective registration date, resigned, or has taken appropriate steps to resign,
  from corp (severing ties as soon as aware of the material problem).
- Non-expert defendant reliance on reasonable grounds that after reasonable investigation believed
  that the misinformation was correct at the time.
- Non-expert defendant actual belief that material misinformation was wrong.
- Δ gives notice to SEC and public that portion of registration statement that isn’t right went
effective without Δ’s knowledge.

1. The due diligence defenses
   11(b)(3)
Securities Regulation Outline

Two portions: expertise (audits, attorney’s formal opinions) and non-expertise (unresearched statements). Basically a gatekeeper strategy: get as many people on the hook for liability to ensure compliance.

Expertise: Expert must show that expertise had grounds to believe that registration was true when issued. Only experts have some burden of investigation. Asleep at the wheel doesn’t work as a defense! Non-expert has no reasonable grounds to believe and didn’t believe that statements were inaccurate or false when issued.

Non-expertise: Directors, signatories, etc., are subject to duty to investigate. May rely on information if after reasonable investigation they still had reasonable basis for believing statement as true. Non-expert has to show they had no reasonable grounds to believe that information was untrue. No investigation required.

Standard of reasonableness? Prudent person.

Escott v. BarChris 884 (S.D.N.Y. 1968)
BarChris sold 15 year debentures to raise operating capital. Their registration statement contained several errors, and eventually the company filed for bankruptcy.

- Kircher was treasurer and CFO of BarChris and knew all of the relevant facts.
- Birnbaum was house counsel and assistant secretary who had no actual knowledge of the misstatements and relied on Kircher for the non-audited portions of the statement.
- Auslander was a non-officer director who signed amendments without reading them on Kircher’s word that they were correct.
- Grant was a director and outside counsel who prepared the statement. He relied on a 1960 audit by Peat, Marwick. For the non-audited figures, he relied on various officers’ words. He made no investigation of the books or contracts.
- Drexel & Co. was the lead underwriter.
  - Coleman was a Drexel partner and BarChris director.
  - Ballard was a Drexel attorney.
  - All Drexel parties relied on BarChris officers’ statements without investigating independently.
- Peat, Marwick did not conform to GAAuditingP, and did not record that a project had not been sold (which lead to overvaluation).

Holding: Everyone’s civilly sanctionable. No one made reasonable investigations, and therefore 11(b) exemption requirements aren’t met. Only those portions of claims against individual defendants that constituted reasonable reliance (like Grant’s reliance on Peat, Marwick) could take advantage of 11(b).

Why is it not enough to simply rely on those you have entrusted to do their jobs? Why do you have to make a “reasonable investigation” when you’ve hired competent people to allow you not to have to do their jobs? Is this statutory micromanagement?

Redundancy. A mistake at a low level replicates that mistake throughout the chain of command. This creates an extra step for caution when concerning issuing statements.

How much diligence is due?
Outside directors
- May delegate reasonable investigation efforts, but is liable of those efforts aren’t performed properly.
- Outside directors with relevant areas of expertise held to higher standard than other outside directors; usually the standards of the knowledgeable director substitute for normal director standards (e.g. lawyers, accountants, etc.)
- Other cases have held that reliance on management may not be inappropriate if management’s work has been audited (see Enron)
- Other cases have allowed directors to escape liability for simply being familiar and diligent in their duties as a director consistent with the knowledge of their company that they have reasonably acquired as a director

Inside directors and officers
Securities Regulation Outline

- Expected to make more complete investigations and have more extensive knowledge of facts supporting or contradicting inclusions in the registration than outside directors because of their familiarity with corporate affairs

Underwriters
- Lead underwriters and syndicate underwriters held to different standards: syndicates can rely on lead’s analysis and do not have to undertake independent investigations
- “Due diligence meetings” often held to bring lead, syndicates, and corp officers together before statement is issued

Experts and liability with respect to “expertised portions” of the registration statement
- An expert is only liable for the portions of the statement deemed to be within their area of expertise
- Burden on other defendants not the expert are more relaxed for expertised portions

2. Causation and damages

11(e)

“Negative causation”: The plaintiff doesn’t have the affirmative burden to prove either reliance or causation in a 11 case, but the defendant can advance causation as a defense to the plaintiff’s damages claim under 11(e).

In general, 11 creates a presumption in favor of rescission damages based on the difference in value from the original offering time to the stock price at the time the suit is filed (or the difference from issue price and resale price if stock was sold prior to suit, etc.).

⇒ Is there fudge room with the term “value”?

No privity necessary in 11, just traceableness of purchase to registration statement.

Damages: difference between the amount paid for the securities (as long as it doesn’t exceed offering price) and:
- its value at the time of the suit, or
- consideration on resale if after the suit, or
- consideration received after the suit but before the judgment.

Ackerman v. Oryx 925 (2nd Cir. 1987)

11 liability can be avoided if causation can be proved as resulting from other factors than a registration statement’s material misrepresentations or omissions.

3. 11 plaintiffs

Barnes v. Ososky 930 (2nd Cir. 1967)

11 claims must be traceable to the managerial misstatement, and do not arise simply because of stock ownership. Reliance must be made on the issuing statement. This bars claims by brokers or other secondary market traders to piggy-back on assumedly actual causation plaintiffs.

Week of 3/11: pp. 936-962, 918-921

B. Section 12

1. 12(a)(1)

Any person that sells or offers a security in violation of 5 is liable to the purchaser. Plaintiff need only prove that:
(1) Δ was a seller (seller is not only traditional person who transfers title, but one who participates in solicitation and is receiving some personal benefit – financial or otherwise),
(2) Interstate commerce jurisdiction
(3) Δ failed to comply with 5 or prospectus requirement, typically by such means as unregistered offer or sale or failure to timely deliver a prospectus,
(4) The action is not barred by statute of limitations, and
(5) Adequate tender is made when Π seeks rescission (rather than when Π seeks damages)
Securities Regulation Outline

The only defense is for $\Delta$ to prove that security or transaction was exempt from 5 – culpability is not a defense (“Well, I didn’t know I had to register these thingies!”).

Dahl purchased shares in Pinter’s oil exploration business and then recommended the buys to his friends. The business tanked and Dahl, et al. sued Pinter for rescission. Pinter counterclaimed that Dahl was liable as an offeror under 12(a)(1), to which Dahl countered that he only promoted the securities gratuitously to his friends. US held that such gratuitous promotion mitigates the predation factor that securities regulation liability for offerees intends to prevent. Whereas a promoter seeks to place securities en masse for their own profit or the profit of the issuer, Dahl was promoting the oil business as favors to friends. Main question to ask: is there a personal benefit to the promoter?

With insiders, pay close attention to the question of personal benefit and subjective facts. Is there a direct benefit, or is there a possibility of a step-transaction benefit? Keep your eyes open for things like lawyer’s contingency fees, conditional bonuses, etc.

$\rightarrow$ **Privity requirement in 12 not present in 11:** Courts have generally extended the Pinter analysis of who a seller is to 12(a)(2) – brokers or other agents – but have limited 12’s scope to sellers and buyers according to direct privity. That is, the seller only has recourse against the person they bought from directly.

2. **12(a)(2)**
Any person who offers or sells a security by means of a prospectus or oral communication containing a material misrepresentation or omission of fact is liable to the purchaser. Same interstate commerce applicability required.
Two defenses:
“Reasonable care”: If $\Delta$ can sustain burden of proof that they didn’t know about the misrepresentation or omission in the course of due care in their position.
$\rightarrow$ Play in the Circuits as to whether this reasonable care standard requires the reasonable investigation of 11.
12(b): $\Delta$ proof of negative causation will limit recoverable losses.

**Gustafson v. Alloyd Co. 946 (1995)**
US rules the term “prospectus” to include only those forms used for public offerings, and not for other contracts for sale as Alloyd was arguing in this case. Dissent said that the majority was ignoring the 33 Act’s definition of “prospectus” in 2(a)(10). Dissent was law of land until this case overturned.

$\rightarrow$ **Key question post-Gustafson:** Is it a PUBLIC offering? Public = liability.

**BIG INVESTOR LIABILITY SMACK:** 13 – Investors must bring suit within one year of discovery of the misstatement, or within one year after reasonable diligence would have uncovered the misstatement.

Week of 3/18: pp. 990-1000, 1011-1019 (through the text accompanying FN 20), 1035-1038, 1038-1045 (excluding the material under “The Fact-Opinion Conundrum”)

XI. **Securities Exchange (1934) Act Civil Liability Provisions**
A. **Rule 14a-9: Proxy fraud**
DOES NOT EXPLICITLY STATE A CAUSE OF ACTION.

31460

1. **Materiality**
The same law of materiality applies to 14a-9 and 10b5 and indeed generally in federal securities law. A fact can only violate proxy law if it is material.

a. **The General Standard**
**TSC Indus., Inc 990 (1976)**
**Definition of materiality:** An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. Compromise
between “might” and “would” standards. This does not require full disclosure, as some information may do more harm than good. Test IS NOT whether an individual investor may have considered something different if given the information, but rather that the fact materially changes the information that investors receive (i.e. misstatement of earnings, management group; misstatement of long-term contract dispositions; conflicts of interest on behalf of a manager, etc.). Content-specific standard.

The accounting standard of materiality: Material if there is a statement or omission of 10% or more. If less than 5%, immaterial.

- Two exceptions: criminal activity and conflict of interests.

Codified in 14a-9 (p. 818 in supplement).

Hypo:
Assume you are filing with SEC, and it contains a misstatement. Assume that the mistake has already reported the truth, ostensibly negating fraud-on-the-market. Liable for material misstatement? Think of how to argue both ways.

Given the definition of materiality, is there a question whether or not any information can be material in situations where the investor has no choice but to act in a certain way?

Burying material facts in disclosures so that they are difficult to find may fulfill disclosure requirement, but is there a fairness requirement?

b. Soft information (contingent events)

Basic Inc. v. Levinson 1011 (1988)

Probability magnitude test. In September 1976, Combustion representatives met with Basic’s officers and directors to discuss a merger. On September 25, October 21, and November 6, Basic three times denied that it was engaged in merger negotiations. On December 20, a merger with Combustion was announced.

Court held that materiality will depend on:
1) Probability of the event happening, and
2) The magnitude of that event when it happens.

Any fraud committed on defendants should be reflected in market value of the stock. Fraud-on-the-market theory creates a rebuttable presumption of reliance, refutable by showing defendant would have traded anyway, or that misrepresentation did not affect market price. Takes out causation element.

In order to prevail on a 10b5 claim, plaintiff must show that statements were misleading as to a material fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant.

“No comment” or silence, in the absence of a duty to speak, is not equal to misleading. There’s a difference between voluntary disclosure and mandatory disclosure. Requirements (Reg S-K, etc.) must be disclosed. Speech, if voluntary, must not be misleading.

Safe harbor: In situations where corporation issues statements in good faith (dividends and revenue forecasts), the corporation can insulate itself from liability by issuing cautionary language – effectively making misstatements immaterial.

Hypo:
What if a manufacturer says that car they’re producing is best you’ll ever drive? Or if restaurateur says that their restaurant is the best in town? These fall under “puffery.” In securities laws, some things will be considered puffery, and won’t lead to material liability. The test?
Securities Regulation Outline

The Supreme Court explicitly adopted the TSC standard of materiality for Rule 10b5 cases.

Safe harbors: Generally shield persons that are specified in provisions (issuer, person acting on behalf of issuer, or underwriter who has gotten information from an issuer) from private actions on forward-looking statements. Two different safe harbors:

1. First is that in addition to shielding immaterial forward-looking statements, safe harbor reaches statements conforming to Bespeaks Caution Doctrine (meaningful cautionary statements).

2. Second safe harbor is Π has to prove that forward-looking statement was made with knowledge that statement was misleading.

During any pending motion for a safe harbor action, discovery is stayed.

Hypo:
What about a knowingly false statement that is accompanied by meaningful cautionary statements? As long as you can avail yourself to the advantages of one of these safe harbors, you are in the clear.

Also see relation to Rule 175, MD&A.

Duty to disclose forward-looking statement
Mere fact that information is material does not necessarily require that it be disclosed. Has to be independent duty to disclose; materiality doesn’t give rise to such duty. Reg S-K, S-X do. Duty to disclose “soft” information primarily relates to fact that disclosures cannot be materially misleading by virtue of half-truths, etc.

c. Reasons, opinions, and beliefs
Virginia Bankshares, Inc 1038 (1991)
VBI owned 85 percent of FABI; 15 percent was owned by 2,000 minority shareholders. In recommending a merger, the FABI directors stated that the price offered per share was “high” and “fair.” Challenger believed that board agreed to the lower price as “fair” so that they could remain on the board. Minority shareholder had standing because her 14a belief was supported by objective evidence that the recommended price was not the maximum available. Board breached duty to seek best price. The case makes one clear holding: Statements of reasons, opinion, or belief can be misrepresented and material. Materiality turns on whether the stated opinion or belief is analogous to the facts and details that the shareholder has. Must look at a reasonable shareholder standard.

At Corp. pp. 825-827, the court explores half-truths. “If it would take a financial analyst to spot the tension between a [misleading statement] and [one that is not so] whatever is misleading will remain materially so, and liability should follow.” P. 826.


B. Rule 10b5: Fraud in connection with a purchase or sale of a security
Sciencter, materiality, damages and causation are all necessary elements for a 10b5 claim.

Rule 10b5 requires:
- When a firm sells a security to the public or is subject to disclosure requirements of the SEC, it will be required to disclose nonpublic info at least periodically
- Duty to update and duty to correct material disclosures
- Encouraged (but not required) to release quickly any news or info which might reasonably be expected to materially affect the market for its securities and to make a frank and explicit announcement if rumors or unusual activity indicate that info on impending developments has leaked out
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- SEC encourages (not requiring) prompt corporate disclosure of material business events
- A firm may not selectively disclose material info to some, but not to all

Rule 10b5 is not the only Rule that requires disclosure of material nonpublic information. (1) A corporation usually will be required to disclose material information when it sells new securities to the public or complies with the periodic disclosure requirements of the mandatory disclosure system; (2) there is a Rule 10b5 duty to correct or update prior material statements, see Corp. pp. 912-914; and (3) the securities exchanges encourage, but do not require, disclosure of important news developments. See Corp. pp. 914-915.

**Standing:** Either SEC or defrauded security holder have implied right to sue. Only protects fraud in connection with any purchase or sale of a security. Fairly loose standard; will work so long as fraud “touches” a trade, it will satisfy the requirement.

1. **The duty to update and the duty to correct**

   *Clause 2 of 10b5.* Separate duties to correct and update issuer statements and to correct statements by others that may be attributable to the issuer.

   If a disclosure is in fact misleading when made, and the speaker thereafter learns of this, there is a duty to correct it. Disclosure also needs to be made if a prior disclosure becomes materially misleading in light of subsequent events. *This duty to correct persists as long as the prior statements remain “alive.”*

   In limited circumstances an issuer may be responsible for correcting or updating third party statements when the issuer is the source of the inaccuracies or is responsible for their dissemination.

   ➔ Normally, however, the mere presence of rumors doesn’t invoke that duty unless issuer has somehow endorsed the rumor/report/third-party statement. I would have to point to a particular person as source of fraud (and not just PO) to meet pleading standard.

   **In re Time Warner 1072 (2nd Cir. 1993)**

   Knowledge of misleading (as opposed to only deceptive) insider information is subject to the duty to duty of disclosure. No affirmative misstatements or misrepresentations – case about omissions. Court acknowledges duty to update for statements made false or inaccurate by subsequent events, *supra.*

2. **Insider trading**

   The Disclosure or Abstain Rule: If you are in possession of material facts (corporate insider – insider theory expanded upon later), either have to disclose them or refrain from trading on them. If you disclose, you must use methods reasonably reliable to disseminate information. Or, you can wait until volume calms down if it is a lesser-traded stock. Use materiality standard from 14a-9 (proxy fraud).

   Not a universal duty, though. Narrowed by following cases.

   Why regulate? Fairness, etc. Why not regulate? Pricing efficiency, compensation for corporate officers, etc.

   **The duty element**

   While the reliance requirement (normally satisfied by the fraud-on-the-market hypothesis) is only applicable to material misrepresentation cases, the duty element is only applicable to material omission cases (such as insider trading). Duty is to the person on the other side of the transaction.

   **Chiarella 1088 (1980)**

   Rule of law: No general duty to disclose before trading on material, nonpublic information. Mere possession of material, nonpublic information does not violate 10b, but a duty to disclose vests with the existence of a fiduciary relationship. There must be fraud evidenced in the failure to disclose the use of the nonpublic information to the source of that information (from *O’Hagan*).
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Would have been a cause of action for the printing company, because Chiarella had duty to them. Chiarella owed no duty to the general public because he was not an insider. Dissent argued for absolute duty of disclosure when in possession of any material nonpublic information. This is the serendipitippee argument, which segues to Dirks n. 14 constructive insiders.

Only an element in omissions; not material misrepresentations.

General notion that officers do not have a duty to debt holders, only equity holders. Debt holders are protected by

Final point: What does it mean to trade “on the basis of material, nonpublic information?” Do you have to be using the information in some way to make a profit? See 10b5(1) – awareness standard (some courts prior to 10b5(1) had said mere possession fulfilled the standard). Affirmative defenses (clause C):
- Entered into binding contract to purchase or sell before became aware of info
- Instructed another person to purchase or sell on behalf
- Have adopted a written plan on trading that is autoexec

Dirks 1094 (1983)
Dirks is important for two primary reasons:

A. The case adopted the CONSTRUCTIVE INSIDER THEORY in footnote 14 — when outsiders have “entered into a special confidential relationship . . . and are given access to information solely for corporate purposes . . . See Corp. pp. 981-983, Notes 1-2.
- Includes corporate outsiders, such as accountants, lawyers, law clerks, etc.

B. Dirks also held that tippees who knowingly receive information in violation of the tipper’s duty also can be held liable if the following two-part test is satisfied: 1) The insider must breach a duty and the tippee must know or be reckless in not knowing of the fiduciary duty breach. 2) Look for a benefit (monetary, reputation, etc.) to tippee, tippee’s relatives or friends, etc. Tippee must show a personal benefit to inform the analysis of duty breach (1).

Dirks also emphasized that the tippee’s liability is derivative of the tipper. If the tipper did not violate a duty, the tippee can trade to his or her heart’s delight.

Footnote 14 – p. 1096 – Constructive Insider Theory
Fiduciary duty is only for the activity you were hired to do.

Footnote 22 – p. 979 – Walton v. Morgan Stanley
In the absence of any fiduciary relationship, there is no basis for imposing tippee liability on the firm. Fiduciary duty is removed by an arms length transaction.
If there was a confidentiality agreement, then they could’ve been liable. The key is to look at any financial benefit. For an insider to violate 10b5, there must be quid pro quo.

O’Hagan 1104 (1997)
Misappropriation theory holds that a person commits fraud “in connection with” a securities transaction and therefore violates section 10b and rule 10b5 when he/she misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information. The misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrust him with access to confidential information. The fraud against the tipper is not consummated until there is an actual sale or purchase of securities.

Limits of misappropriation theory:

Rule 14e3 prohibits trading on the basis of material nonpublic info whether or not there is a breach of fiduciary duty. Applies only to tender offers. Example: If a pizza delivery guy overhears the CEO of
a company disclose that they are going to merge with a target corporation, the delivery guy cannot act on that information if he’s aware that that person is the CEO. If he does trade, it would be in breach of a duty.

General rule: Only required to disclose nonpublic information if you have a duty to disclose. Insiders, constructive insiders, anyone who receives material, nonpublic information from an insider or constructive insider source and is aware of the source’s position as an insider.

10b5-2 – What constitutes the requisite fiduciary relationship for misappropriation theory liability:
1. Whenever a person agrees to keep information in confidence;
2. Whenever the parties involved have history, pattern, or practice of sharing confidences; and
3. Whenever information is received from parent, spouse, or sibling, provided that person receiving information cannot show that there was no expectation of confidence


3. **Scienter, reliance, and causation**
   a. **Scienter**
      
      **Ernst & Ernst 1129 (1976)**
      Private action under 10b5 requires that A acts with scienter. Negligence is not good enough to base a 10b5 claim on. Standard of scienter is:
      1. Attempt to deceive, manipulate, or defraud; and
      2. Recklessness or intent (not negligence or mere negligence)
      a. Recklessness is generally “highly unreasonable conduct involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”

      Why recklessness and not negligence? Argument for negligence is

   b. **Reliance**
      
      **Basic Inc. v. Levinson 1144 (1988)**
      Seligman: Any fraud committed on defendants should be reflected in market value of the stock. Fraud-on-the-market theory creates a rebuttable presumption of reliance, refutable by showing defendant would have traded anyway, or that misrepresentation did not affect market price. **Takes out causation element.**

      **Paredes:** Court is saying that at least in the case of face-to-face action or omissions, it is appropriate to presume reliance upon a showing of materiality – the rebuttable presumption of reliance. Strongest in a reliance case.

      Rebutting the presumption of reliance:
      i. Market makers are generally the big institutional traders. They are actually privy to the truth, so the truth is reflected in the market (market reflects truth).
      ii. Plaintiff would have bought or sold, regardless of reliance on integrity of the market place.
      iii.

      Larger issues for fraud on the market theory:
      What if informant was a liar? How would that reflect on plaintiff’s argument?
      What if plaintiff has no concept of market?

      Does anyone really rely on the integrity of the marketplace? By making a purchase, you are actually betting that the market doesn’t have your stock’s value right and that over time it will correct and reevaluate your stock higher.
What if a market is informationally efficient, but not allocatively efficient? It has all of the right info, but it just isn’t using it right.

Noise trading – how does it affect fraud on the market theory? Market efficiency isn’t as exacting as we thought it was, since psychological factors play a heavy role in trading. How does that effect the efficient market theory?

Final note: Who can sue? 120A of Exchange Act (1988) provides standing for “contemporaneous traders.” Any person who contemporaneously buys or sells securities when someone else is insider trading has standing to sue.

c. **Causation**
   Notion of loss causation applies under 10b5 as it does under 21D(b)(4) of the 1934 Act. Burden of Π to show that loss was related to or was due to omission.

C. **Regulation FD**
   Most recent iteration of SEC’s effort to deal with concerns of fairness, and more practically insider trading.

   **Selective private disclosure**
   Background:
   1. **Pro:** selective disclosure is unfair to investors and has the effect of undermining the market. Securities analysts’ benefit to the marketplace covered in Dirks. Companies would selectively disclose information to their analysts before everyone else knew. Analysts would then write up reports for their clients on material nonpublic information, but were not subject to liability under 10b5 because there was no “personal benefit” as required by Dirks. There was arguably no personal benefit because the analyst was just doing their job. But is there really no personal benefit? What about a reputational benefit received from the analyst firm? Appreciation of the analyst’s firm by the client corporations? Unclear that there were no personal benefits, but at the time they were given the benefit of the doubt. This is, in part, what FD tried to address. Also, there is a notion that selective disclosure is simply unfair. SEC specifically addressed selective disclosure in FD.
   2. **Con:** prohibition on strategic selective disclosure can lead to artificial restraints on the market. Notion that by selectively disclosing information to specific investors and players, you can diminish overreaction in the marketplace. Another notion is that corporations will never disclose in general.

   Fall 2000 SEC adopts FD. Boils down to reporting companies, senior officials, investor officers, PR persons, or anyone who regularly engages in these kinds of disclosures with investors regularly is subject to the 1934 Act. Not useable if the person issuing information is in breach of their duty. No definition of materiality, but there is notion of “mosaic” theory in which you can disclose a little information that isn’t necessarily material, but that an analyst can weave together with other sources to end up with a material nonpublic information.

   Example: Firing a mid-level manager in some department of the company. Analyst hears this, but knows that the company has fired several other mid-levels in the same area over the past few years. Analyst puts together his/her mosaic to make a judgment call on the facts as they know them.

   Example: Janus commercials with the details on the stuff they do to research companies may be nonmaterial information that could be thrown into a mosaic.

   What about *ex post* considerations?

   Exemptions/carve-outs: persons who owe duty of disclosure to issuer (lawyers, etc.); persons who expressly agree to maintain information in confidence (get them to sign confidentiality agreements); disclosures to rating agencies; disclosures for certain kinds of registrations; certain items in road shows

   Example: Analyst gets advance information on the promise not to disclose. Information is getting put to meaningful use, but is just not traded on until it becomes public. Violation? Technically, no, as long as there are no actual trades on the information.

   **Public disclosure**
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Simply posting on website isn’t enough. Press releases, conference calls, etc., required. Opening up calls to simply shareholders isn’t enough – everyone has to know. Problem is that small companies have a harder time disclosing that big corps. Simply issuing a press release may not be good enough (everyone sees GE; not everyone sees Imatron). “Reasonable steps” must be taken in both intentional and unintentional disclosures.

Reg FD doesn’t create an independent right of action, and does not create a 10b5 violation. It is not preclusive of other liability. Simple compliance with FD doesn’t ward off a 10b5 claim, etc.

Explanation for why disclosures haven’t really diminished or increased? Paredes thinks that it might be because FD doesn’t matter. Business reality is that businesses need to disclose to get analysts to follow them, so what difference does the formalism of FD make?

Materiality standard same as TSC standard.

Proposals for more guidance in certain areas: earnings, prior earnings, and plant and facility tours for analysts. SEC currently uses “telephone manual” of FAQs they receive on statutory application. Why give certainty? We don’t for 10b and 10b5 -in those instances, disclosure is mandatory and must be done so in a way that is not materially misleading. Under FD, that disclosure mandate is not compulsory. But if the ambiguous standard of 10b and 10b5 were applied to FD, there could be a chilling of voluntary information from corps to avoid lawsuits without fair warning that what they publish is or isn’t reachable with a lawsuit. Also: expand safe harbor provision to forward looking statements to help promote FD disclosure and prevent chilling.

Silicon Graphics Supp 122 (9th Cir. 1999)

i. 20(f) Private Securities Litigation Reform Act
   Heightened pleading standard. Two standards exist, 9th (stringent under PSLRA) and 2nd (lenient).

D. Secondary liability
   1. Controlling person liability
      Allows liability for secondary actors but requires primary actor. Germaine to all lawsuit types studied.
      Primary violator – person who actually commits violation
      Secondary violator – person who helps/assists/supports primary violator

      Why have secondary liability? Why expand the scope of defendants? Goals: compensation and deterrence.

      Under 15 of 33 Act and 4a of 34 Act. Controlling person is liable to the full extent of what they control. Notion of “control” is unclear. Even if you find a person satisfies control in some respects, what control must be shown to give rise to liability? Ability to influence? Ultimate supervision authority? Majority as opposed to minority shareholders? Outside v. inside directors? Two conceptual tests:
      - Person’s status
      - Function – did the person in fact have some control or attempt some control?

      Many courts have applied following test: to show Δ is controlling person, you must show that Δ: 1) actively participated in (exercised control over) operations of primary violator generally, and 2) Δ possessed power to control specific action or activity upon which the primary violation is predicated (but it need not be shown that this power was exercised).
      ➔ Examples: Member of audit committee signing bad 10K is control person. Outside directors generally are not control persons on the facts. ODs who are general counsel that draft and review corporate statements containing misstatements are controlling persons. NOT simply attorneys and accountants only providing their normal and routine advisory capacities, bankers in their normal lending capacities, etc.
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If we have to show involvement at some level, why not just go after person as a primary violator under 10b5 instead of using control person liability? Unlike 10b5, no fraud needs to be pleaded individually for each control person, and direct participation is easier to prove than 10b5 scienter. Basically a liberalization of 10b5 requirements.

Back to the goals of deterrence and compensation – possibilities for Requirement of culpable participation, short of primary violation but having a hand in the fraud. Impose liability on anyone who could have prevented the fraud (least cost avoider theory – could also be a notion of culpability).

15 33 Act
Knowledge requirement. No knowledge of underlying facts is an affirmative defense to controlling person liability.

20a 34 Act
Liability arises for a controlling person unless controlling person 1) acted in good faith and 2) did not directly or indirectly induce the acts leading to the violation. Notion of “good faith” subsumes some duty to monitor or supervise.

Hollinger v. Titan 1283 (9th 1990)
Broker/dealer is a control person under 20a with respect to its registered representatives. B/Ds have duty to supervise their registered representatives.

2. Aiding and abetting
Central Bank of Denver 1293 (1994)
Restrained extent to which you can go after secondary players. Different that control person liability, which is much more open.


E. Defenses
1. Plaintiff’s due diligence
Will Π be denied relief in claiming 10b5 violation where Π could have discovered actual fraud on behalf of the Δ? Is it enough for Π to have been negligent in investigating, or must Π have at least been reckless in investigation concerning their trade for Δ to defeat their 10b5 suit?

Dupuy v. Dupuy 1330 (5th 1977)
Yes, you have to take some effort to ferret out the facts under 10b5. What is that effort exactly – the standard of care? To the extent that IIDD exists, standard is reasonable investor recklessness – whether Π intentionally refused to investigate in disregard of a risk “known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.” Policy: Equity. This standard complements Ernst & Ernst standard of scienter/recklessness for defendants. Court is more concerned about rooting out recklessness than negligence. Policy, part deux: promotes antifraud measures.

What role for due diligence defense in market? This is a face-to-face phenomenon; it is not a faulty 10Q, a conference call, press release, etc. It arguably requires an investigation by any and every investor prior to purchase. However, this seems to be limited to face-to-face dealings.

On the exam: Multiple choice and essay 50:50. Probably one, maybe two essays. Open everything.