Course Outline for Securities Regulation

Materially misleading statements or omissions in connection w/ securities transactions –
- SA 11 – purchasers of registered offerings (registration statement became effective).
- SA 12(a)(1) – purchasers of offerings that either were registered or should have been registered (i.e.,
  that don’t qualify for an exemption).
- SA 12(a)(2) – purchasers of public offerings, registered or unregistered.
- SEA 10b-5 – purchasers or sellers of securities, including offerings not made “by means of a
  prospectus or oral communication” (i.e., made by means of a document that contains prospectus-type
  info but that doesn’t describe a public offering), and including transactions in the secondary market.
- SA 15/SEA 20(a) – control persons.

I. Registration under SA
   A. Types of direct offerings:
      1. Defn. of direct public offering – The issuer of a new security gambles upon its ability to sell
         the entire issue w/o the intervention of an underwriter or marketing syndicate. Method used
         rarely; appropriate for an issuer w/ a strong credit rating and existing demand for its
         securities, or a speculative business operation seeking to raise capital from a circle of
         investors w/ prior knowledge of the particular business enterprise.
      2. Defn. of direct offering limited to existing shareholders, usu. in the form of a rights offering
         – In a rights offering, existing shareholders are offered warrants or rights to subscribe to
         securities of the issuer, usu. at some small discount off the mkt. price. Rights are allocated
         in proportion to the size of the existing holdings of the issuer’s securities. Advantage to the
         issuer from this approach: the discount offered to existing shareholders (an obvious source
         of capital for a seasoned public company) may be less than the standard underwriter’s
         discount.
      3. Defn. of all-or-nothing offering – Where a min. amt. of funds is needed for a special
         purpose, securities may be offered by the issuer on an “all or none” basis. Unless a
         designated number of shares are sold and paid for in full within a specified period, the
         offering will be terminated and all funds returned, w/ interest, to the subscribers.
      4. Defn. of direct private placement – A private placement allows an issuer to sell securities to
         a legally restricted number of institutional or other sophisticated investors. Advantages to
         the issuer from this approach: necessity, secrecy, speed, and cost. There is a secondary mkt.
         for trading privately placed securities, known as PORTAL.

   B. Underwriters and types of underwriting:
      1. Defn. of underwriter – SA § 2(11) broadly defines an underwriter to mean any person who
         has purchased from the issuer (or controlling persons) (1) w/ a view to, or (2) offers or sells
         for an issuer in connection w/, the distribution of any security, or (3) participates in any
         such undertaking. Underwriters may be used in all types of public offerings; they render
         financial advice w.r.t. financing, the type of security to be offered, the mkt. to be reached,
         and the manner and mgmt. of the offering.
      2. Common types of underwriting: (1) Firm commitment underwriting – underwriter or
         syndicate agrees to purchase all or specific amounts of the offering for cash, subject to
         certain market-outs. (2) Stand-by underwriting – a new issue is offered only to existing
         shareholders. Underwriter agrees to stand by and purchase any shares not purchased by
         existing shareholders, at the expiration of a specified period. (3) Best efforts underwriting –
         underwriter neither purchases the securities from the issuer nor resells them to the investing
         public, but rather agrees only to act as an agent of the issuer in marketing the issue to
         investors.
C. **Two basic policies of the SA:** (1) to provide investors w/ material financial and other info concerning new issues of securities offered for sale to the public; and (2) to prohibit fraudulent sales of securities.

D. **SA § 5:** Overall purpose is to require that new issues of securities offered through interstate commerce be registered w/ the SEC, and that a prospectus (filed as a part of the registration statement) be furnished to the purchaser prior to the sale or, in some cases, at the time of the delivery of the security after sale. See elsewhere in the SA for lots of exemptions and exclusions.

<table>
<thead>
<tr>
<th>Pre-filing Period</th>
<th>Waiting Period</th>
<th>Post-effective period</th>
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<tbody>
<tr>
<td><strong>SA § 2(3)</strong> – OK for an issuer, or any controlling person proposing to offer securities, and an underwriter to engage in “preliminary negotiations and agreements,” such as underwriting agreements, b/c this term is excluded from § 2(3)’s defn. of “sell,” “offer,” and “offer to buy.”</td>
<td><strong>SA § 5(a)</strong> – It’s a crime to sell a security during the waiting period.</td>
<td><strong>SA § 5(b)(2)</strong> – It’s a crime to sell a security without distributing a prospectus that meets the requirements of SA § 10(a).</td>
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<td><strong>SA § 5(c)</strong> – It’s a crime to offer to sell or offer to buy during the pre-filing period. Note: A tombstone ad can be an offer.</td>
<td><strong>SA § 5(b)(1)</strong> – It’s a crime to distribute a prospectus during the waiting period that doesn’t meet the requirements of SA § 10.</td>
<td><strong>SA § 10(a)(3)</strong> – If the offering continues over an extended period, info in prospectus should be kept current.</td>
</tr>
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<td><strong>SA § 5(b)(2)</strong> – OK to distribute a preliminary prospectus (a/k/a red herring) during the waiting period. See Rule 430.</td>
<td><strong>SA § 10(b)</strong> – OK to distribute a tombstone ad or an identifying statement (See Rule 134) during the waiting period.</td>
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<td><strong>SA Rel. No. 5180</strong> – “A limited dispensation.” OK for an issuer to release factual corp. info (annual reports, answering questions about the corp.’s affairs, etc.). But issuer should refrain from disclosing predictions, projections, opinions, etc., w.r.t. sales, earnings, and the value of the issuer’s securities. Distinguish legitimate news from the issuer and publicity designed to condition the mkt. during the registration process (free-writing, which can trigger the gun-jumping doctrine).</td>
<td><strong>SA § 2(a)(10)</strong> – OK to distribute a tombstone ad or an identifying statement (See Rule 134) during the waiting period.</td>
<td><strong>SA § 10(b)</strong> – OK to distribute a preliminary prospectus during the waiting period (for informational and screening purposes, but not for selling purposes). See Rule 430.</td>
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and solicit indications of interest; but they may not make binding sales. Email OK so long as it’s oral in nature and doesn’t involve the dissemination of an offering document. Distinguish legitimate news from the issuer and publicity designed to condition the mkt. during the registration process (gun jumping). AFTER the 40- and 90-day periods: OK to distribute supplementary sales literature.

E. **What is a registration statement:** There are three basic types of registration statements. S-1: General Form – almost everything in Reg. S-K. S-2: SEA firms – shortened form, deliver a copy of stockholders report, incorporate by reference, Forms 10-K and 10-Q. S-3: Largest SEA firms – very short form – incorporate by reference. Registration statements are reviewed by the SEC’s Corporate Finance Division.

1. **SA § 2(a)(8)** summarily defines a registration statement as what’s referred to in SA § 6 and states that it includes any addenda and amendments.

2. **SA § 6** addresses the registration fee, the fact that registration statements are made available to the public, and the signature requirement.

3. **SA § 7** refers us to Schedule A for the list of documents required in a registration statement. Schedule A requires things like the names and addresses of the issuer and its directors/corporate officers, a description of the general character of the business, a description of the corp.’s capitalization, a description of the offering, the purpose(s) of the offering, and a balance sheet.

4. **SA § 2(a)(10)** broadly defines a prospectus, one part of the registration statement, as “any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.” Two exceptions: (1) a tombstone ad isn’t a prospectus; and (2) during the post-effective period, a communication won't be deemed to be a prospectus if you’ve already sent or are sending at the same time a prospectus meeting the requirements of SA § 10(a).

5. **SA § 10(a)** states that a statutory prospectus must contain that everything in Schedule A except items 28-32, inclusive. When a prospectus is used 9 mos. after a registration statement’s effective date, the info contained in the prospectus can’t be older than 16 mos. (i.e., issuer is obligated to update).

6. **SA § 10(b)** permits a preliminary prospectus (a/k/a red-herring, see Rule 430) and a preliminary summary prospectus (a/k/a summary prospectus, see Rule 431), both abbreviated versions of what’s required in SA § 10(a). These can be distributed during the waiting period and during the post-effective period for informational and screening purposes.

7. **SA § 8(a)** provides that a registration statement will go into effect at least by 20th day after filing.

8. **Rules 460, 461** outline the SEC’s acceleration policy. Acceleration may be refused if the registration statement isn’t concise and readable, and if inaccuracies aren’t corrected.

9. **SA § 8(b)** allows the SEC to prevent the registration statement from becoming effective if it detects any material incompleteness or inaccuracy. SA § 8(d) allows the SEC to issue a stop order suspending effectiveness (extreme measure) if it discovers a materially misleading statement or omission in the registration statement.

F. **What is (and what isn’t) an offer:**

1. **SA § 2(a)(3)** defines “offer” broadly to “include every attempt to offer or dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.” Includes oral offers.
2. Preliminary negotiations and agreements bet. an issuer, or any controlling person proposing to offer securities, and an underwriter aren’t offers under § 2(a)(3).

3. Tombstone ads can be offers.

4. Rule 135 notices of proposed offerings aren’t offers if they contain a legend (saying not an offer) and are limited in content to such items as the title, the amt. and basic terms of the securities proposed to be offered, and a brief statement of the manner and purpose of the offering, without naming the underwriters or stating the anticipated price. The notice may take the form of a news release, a published statement, or a written communication to offerees.

5. Rule 135a generic or institutional advertising (by underwriters or sponsors of investment company securities) won’t be deemed to be an offer, so long as the ad doesn’t mention a security subject to registration under the SA. Even then, descriptions of products and services can’t “relate directly to the desirability of owning or purchasing a security by a registered investment company.”

6. Rule 137 dissemination of info by a broker or dealer who isn’t involved in the offering isn’t an offer. If the registrant is required to file reports pursuant to SEA §§ 13 or 15(d), and the broker/dealer doesn’t propose to be a member of the underwriting syndicate, then the broker/dealer may continue to publish and distribute info, opinions, or recommendations w.r.t. the registrant or its securities in the regular course of its business, during the pre-filing, waiting, and post-effective periods, so long as no consideration is received from the issuer in connection w/ the distribution of such info.

7. Rule 138 dissemination of info by a broker or dealer who is involved in the offering isn’t an offer, so long as the registrant meets the registrant requirements for the use of Form S-2, Form S-3, or Form F-3 (i.e., is a seasoned issuer). The broker/dealer can publish recommendations and opinions concerning the issuer’s common stock during the pre-filing, waiting, and post-effective periods.

8. Rule 139 dissemination of info by a broker or dealer who is involved in the offering isn’t an offer. If the registrant is an SEA reporting company, the broker/dealer may continue to publish and distribute info, opinions, or recommendations w.r.t. the registrant or its securities in the regular course of its business, during the pre-filing, waiting, and post-effective periods, so long as either (a) the registrant meets the requirements of Form S-3 or F-3, and such info is contained in a publication which is regularly distributed in the normal course of business; or (b) such info, opinion, or recommendation is contained in a publication which (1) is distributed w/ reas. regularity in the normal course of business; (2) includes similar info w.r.t. a substantial number of companies in the registrant’s industry or contains a comprehensive list of securities currently recommended by such broker/dealer; (3) the info is given no greater prominence in the publication than that given to other securities; and (4) an opinion at least as favorable was published in the last publication addressing the subject prior to the commencement of participation in the distribution (i.e., can’t ride a security up, but can follow it down).

II. Shelf Registration and Electronic Filing

A. Rule 415: Certain issuers can register securities under the SA that they intend to offer or sell on a delayed or continuous basis in the future. Much cheaper than regular registration. Rule 415 allows, inter alia, Form S-3 or F-3 issuers (SEA reporting companies that are widely followed by professional analysts, for which disclosure is not as necessary) to file primary at-the-market offerings of equity securities which they plan to offer within two years of the effective date of the registration statement.

B. Electronic filing: All domestic registrants are required to file electronically through EDGAR.
III. What Is a Security

A. SA § 2(a)(1): The defn. in SA § 2(a)(1) describes over 20 different types of financial instruments, each of which is subject to a different type of analysis. The real issue is not what is a security, but rather when is each of the types of instruments in § 2(a)(1) a security. “Unless the context requires” means the context of the statute, and the factual or transactional context. The existence of another body of comprehensive fed. law (e.g., banking law, ERISA) providing the equivalent investment protection significantly undercuts the need for fed. securities regulation and the willingness of the S. Ct. to hold that an instrument is a security.

B. Investment contracts:

1. SEC v. W.J. Howey Co. (p.308) – The issue was whether an offering of units of a citrus grove development coupled w/ a contract for cultivating, marketing, and remitting the net proceeds to the investor was a “security” within the meaning of the SA. The S. Ct. held that an “investment contract” is a security within the scope of SA § 2(a)(1) when it involves: (1) an investment of money; (2) in a common enterprise (pooling of funds or interests, profit sharing, loss sharing); (3) w/ an expectation of profits (can’t be a purchase for consumption); (4) solely (read: predominantly) from the efforts of a promoter or a third party. The investment oppty. offered here was a security.
   i. The Howey test seeks to identify transactions in which investors count on others to manage an enterprise and expect investment returns – transactions in which ownership is separated from control.

2. SEC v. Life Partners, Inc. (p.311) – A viatical settlement is an investment contract pursuant to which an investor acquires an interest in the life insurance policy of a terminally ill person – typically an AIDS victim – at a discount, which depends on the insured’s life expectancy. The investor’s profit is the difference bet. the discounted purchase price paid to the insured and the death benefit collected from the insurer, less transaction costs, premiums paid, and other administrative expenses. Holding: The viatical settlement here wasn’t an investment contract b/c LPI’s and Sterling’s post-purchase services didn’t materially impact investors’ profits, which were mainly affected by the timing of the insured’s death. The fourth prong of Howey wasn’t met.
   i. Policy: “If the investor’s profits depend [after purchase] predominantly upon the promoter’s efforts, then the investor may benefit from disclosure and other requirements of the fed. securities laws. But if the value of the promoter’s efforts has already been impounded into the promoter’s fees or into the purchase price of the investment, and if neither the promoter nor anyone else is expected to make further efforts that will affect the outcome of the investment, then the need for fed. securities regulation is greatly diminished.”

3. SEC v. Koscot Interplanetary, Inc. (p.318) – The ct. held that an interest in a pyramid promotion enterprise involving cosmetics sales was not a conventional franchising arrangement, but rather an investment contract under the Howey test and thus a security. The investor’s realization of profits was inextricably tied to the promotional scheme, which was elaborate. In a conventional franchise arrangement, in contrast, the promoter exercises remote control over an enterprise and the investor operates largely unfettered by promoter mandates. The fourth prong of Howey wasn’t met.
   i. Vertical vs. horizontal commonality: Some cts. look for vertical commonality bet. investors and promoters. Under this approach, a common enterprise may be found when the activities of the promoter are the dominant factor in the investment’s success, even though there may not be pooling of funds or interests by multiple investors. Strict vertical commonality – direct relationship bet. promoter’s efforts its investors’ fortunes. Broad vertical commonality – investors’ fortunes tied to the promoter’s fortune. Other cts. look for horizontal commonality, a pooling of
investor funds. Under this approach, the disclosure requirements make sense if investors obtain the same thing, an undivided share in the same pool of assets and profits.

4. General partnerships and joint venture interests – Usu. aren’t deemed securities. But they can be designated as securities “if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he … can’t exercise meaningful partnership or venture powers.” (Fifth Cir. in *Williamson v. Tucker*.)

C. Shares of stock:

1. *United Housing Foundation, Inc. v. Forman* (p.325) – The S. Ct. held that “shares of stock” entitling a purchaser to lease an apartment in Co-op City, a state subsidized and supervised nonprofit housing cooperative, were not securities. Common sense suggested that these purchasers intended to acquire only living quarters for their personal use; they weren’t likely to believe they were purchasing investment securities b/c the transaction was evidenced by something called a share of stock. Also, these shares weren’t negotiable, didn’t entail the right to receive dividends upon an apportionment of profits, didn’t confer voting rights in proportion to the number of shares owned, couldn’t be pledged or hypothecated, and couldn’t appreciate in value; they lacked the characteristics traditionally associated w/ stock. (The third prong of *Howey* wasn’t met.)

2. *Landreth Timber Co. v. Landreth* (p.358) – The S. Ct. held that the sale of 85% of the stock of a closely held corporation is a securities transaction subject to the antifraud provisions of the fed. securities laws. The old owners continued to operate the mills, providing a service; the new owners didn’t operate the mills. (1) The stock here was called “stock” and had all of the characteristics traditionally associated w/ stock, as discussed in *Forman*; there really was no need to go through the *Howey* economic reality test b/c what was sold here fit one of the examples listed in the statutory defn. of “security” (namely, stock). Form triumphed over substance here b/c Ct. wanted to protect the expectations of the reas. investor. (2) The Acts’ antifraud provisions cover privately negotiated transactions involving the transfer of control to entrepreneurs, as well as transactions w/ passive investors.
   i. Although SA § 4(2) exempts transactions not involving any public offering from the SA’s registration provisions, any “securities transaction” (if it’s deemed to be that) is still subject to the antifraud provisions.

D. Notes: A note is a written promise by one party (the maker) to pay money to another party (the payee).

1. *Reves v. Ernst & Young* (p.366) – The Farmer’s Cooperative of Arkansas and Oklahoma sold promissory notes, payable on demand by the holder, in order to raise money to support its general business operations. After the Co-Op went bankrupt, a class of holders of the notes sued the firm that had audited the Co-Op’s financial statements. The S. Ct. held that the notes issued by the Co-Op were securities. (1) Begin w/ the presumption that every note is a security. (2) The presumption may be rebutted by showing that the note bears a strong resemblance to one of the enumerated categories of instrument. Go through four factors. (The “family resemblance” test.) (3) If an instrument isn’t sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors. The notes here weren’t similar to anything in the list, and nothing suggested that a new category should be added.
i. The list of notes that aren’t securities: a note delivered in consumer financing, a note secured by a mortgage on a home, a short-term note secured by a lien on a small business or some of its assets, a note evidencing a character loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business.

ii. The four factors (p.370): (1) Examine the transaction to assess the motivations that would prompt a reas. seller and buyer to enter into it. (Investment vs. commercial or consumer context.) (2) Examine the plan of distribution of the instrument to determine whether there’s common trading for speculation or investment (i.e., if the instrument is offered and sold to a broad segment of the public). The most important factor. (3) Examine the reas. expectations of the investing public. (4) Examine whether some other factor such as the existence of another regulatory scheme significantly reduces the risk of investment, thereby making fed. securities reg. unnecessary.

IV. Exemptions from Registration under SA

A. Remember:
1. Something can be exempt from the registration requirements but still subject to the antifraud, civil liability, and other provisions of the fed. securities laws.
2. Issuer and others relying upon an exemption have the burden of proof.

B. Exempted securities and exempted transactions: Unless otherwise noted, the SA (incl. antifraud provisions) doesn’t apply to the following classes of securities and securities transactions:
1. Securities offered or sold intrastate – See SA § 3(a)(11) and Rule 147. Examples: real estate partnerships, oil & gas ventures in Alaska and in Texas. An intrastate offering exempt from SA registration remains subject to state blue sky laws.

<table>
<thead>
<tr>
<th>§ 3(a)(11) (statutory exemption)</th>
<th>Rule 147 (safe harbor)</th>
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<tbody>
<tr>
<td><strong>Issuer (in-state)</strong></td>
<td><strong>Principal office within state; and 80% of gross revenues, assets, and proceeds use within state.</strong></td>
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<tr>
<td>“Resident and doing business” within the state. Can the state’s securities administrator exercise jurisdiction to investigate the issuer and its use of the proceeds.</td>
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<tr>
<td><strong>Offerees</strong></td>
<td><strong>Offerees must have principal residence within state.</strong></td>
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<td>Offerees must be domiciled within the state.</td>
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<tr>
<td><strong>Aggregate offering price</strong></td>
<td><strong>Sets of sales separated by 6 mos. aren’t integrated.</strong></td>
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<tr>
<td>All securities offered as “part of an issue” are integrated.</td>
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<tr>
<td><strong>Solicitation and advertising</strong></td>
<td><strong>No restrictions.</strong></td>
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<td>No restrictions.</td>
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<tr>
<td><strong>Disclosure</strong></td>
<td><strong>No requirements.</strong></td>
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<td>No requirements.</td>
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<tr>
<td><strong>Limitations on resale</strong></td>
<td><strong>During the period in which the securities are offered and sold, and for 9 mos. afterwards, the securities may only be resold to in-state residents.</strong></td>
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<tr>
<td>Securities must “come to rest” prior to being resold.</td>
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2. Rule 504 small offerings (worth less than $1mm) – Rule 504 exempts from § 5 offerings not exceeding $1mm in any 12-mo. period. The number of investors is unlimited, there are no investor qualifications, and no info need be specifically disclosed (under fed. law, w/ the exception of the antifraud provisions).

3. Rule 505 small offerings (worth less than $5mm) – Rule 505 exempts from § 5 offerings not exceeding $5mm in any 12-mo. period. The exemption is limited to 35 non-accredited purchasers plus an unlimited number of accredited investors. Bad-boy disqualifications. Specified info must be delivered to all non-accredited purchasers.
4. **Rule 506 offerings (no $ limit)** – Rule 506 exempts from § 5 offerings made to 35 non-accredited investors, who either come w/ a purchaser’s rep or are knowledgeable and experienced enough in financial and business matters to be able to evaluate the merits/risks of the prospective investment, plus an unlimited number of accredited investors. No bad-boy disqualifications. Otherwise, same requirements as in Rule 505.

5. **Integration of offerings** – This is the doctrine by which seemingly separate offerings are construed as one integrated offering, thereby vitiating otherwise exempt offerings and usually resulting in a violation of the SA’s registration requirements. 502(a) says 2 offerings are not integrated if they’re separated by 6 mos. If there are offers made within the 6 mos. either before or after the purported Reg. D offering, no presumption – SEC will consider factors to decide whether to integrate (and blow the exemption). Factors: sales part of single plan of financing, sales made for the same general purpose, etc. 147(b)(2) – same goes for intrastate exemption.

6. **Filing notice of sales w/ SEC** – Reliance on any of the Reg. D exemptions requires that notice be filed w/ the SEC within 15 days after the first sale. See Rule 503(a). Can use Form D.

7. **Incomplete compliance** – Rule 508. You won’t lose the exemption if you can prove: (1) the failure to comply didn’t pertain to something directly intended to protect the offerees/purchasers; (2) the failure to comply was insignificant w.r.t. the offering as a whole; and (3) a good faith and reas. attempt was made to comply.

<table>
<thead>
<tr>
<th>Rule 504 (safe harbor)</th>
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<th>§ 4(2) (non-exclusive statutory exemption)</th>
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<tr>
<td><strong>Issuer</strong></td>
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<tr>
<td>Can’t be an SEA reporting company, an investment company, or a development stage company. 504(a).</td>
<td>Can’t be an investment company and can’t be subject to the “bad boy” disqualifications (See Rule 262).</td>
<td>No requirements.</td>
<td>No requirements.</td>
</tr>
<tr>
<td><strong>Purchasers</strong></td>
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<tr>
<td>No limit on the number of purchasers.</td>
<td>35 non-accredited purchasers; unlimited accredited purchasers.</td>
<td>35 non-accredited purchasers, who each must have a purchaser’s rep or be knowledgeable and experienced enough in financial and business matters to be able to evaluate the merits/risks of the prospective investment; unlimited accredited purchasers.</td>
<td>Number unlimited, but they have to be able to “fend for themselves.” (Ralston Purina) Needs test, access test; not a numbers test.</td>
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<tr>
<td><strong>Aggregate offering price</strong></td>
<td>$1mm in 12 mos. Aggregation involves a calculation of whether the amt. to be financed in a 12-mo. period exceeds the dollar limit.</td>
<td>$5mm in 12 mos. Aggregation involves a calculation of whether the amt. to be financed in a 12-mo. period exceeds the dollar limit.</td>
<td>No limit.</td>
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<td><strong>Solicitation and advertising</strong></td>
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<td>No requirements.</td>
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8. **Private placements** – SA § 4(2) exempts from § 5 “transactions by an issuer not involving any public offering.”
   
i. **4 main types of private placements:** employees, debt offerings (vast majority), mergers and acquisitions, and the venture capital model.
   
   ii. **SEC v. Ralston Purina Co.** (p.397) – S. Ct. held that Ralston Purina’s offerings of treasury stock to its “key employees” (defined broadly by the company) were not within the § 4(2) exemption. The applicability of § 4(2) turns on whether the particular class of persons affected need the protection of the SA or whether they can fend for themselves b/c of their sophistication and access to info equal to what you’d find in a registration statement. An offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering. The burden of proof is on the issuer to show that the exemption is fair and reas. Here, chow-loading foremen were buying. The employees who purchased were not shown to have had access to the kind of info which registration would disclose.
   
   iii. Other factors distinguishing offerings from non-public ones: dollar amount involved, whether or not there’s general solicitation and advertising.

9. **Accredited investors** – SA § 4(6) provides a statutory exemption for offers and sales by an issuer to accredited investors, who are presumed to be sophisticated, where the offering is worth less than $5mm (or amt. allowed in § 3(b)). Offers and sales may be made to an unlimited number of accredited investors. “Accredited investors,” defined in § 2(a)(15) and Rule 501(a) of Reg. D, include various types of institutional investors, directors and executive officers, a natural person or married couple w/ a net worth greater than $1mm, and a natural person w/ an annual income greater than $200,000 (or $300,000 for married couple). This exemption has gotten little use. Issuers selling only to institutional investors often use § 4(2), which has no dollar limit, filing requirements, or fixed criteria for investor qualification and which also permits trading among institutional shareholders per Rule 144A.

10. **Secondary trading** – SA § 4(1) exempts from § 5 transactions by persons other than issuers, underwriters, and dealers. So § 5 doesn’t touch routine trading transactions between individual investors in outstanding securities.
   
i. Who are issuers, underwriters, and dealers? Cts. have held that one who participates in or is a substantial factor in an unlawful sales transaction satisfies the test for primary liability in an enforcement action for injunctive relief. See also the Preliminary Note to Rule 144, which sets out factors for determining whether or not a person is engaged in a distribution, within the meaning of the § 2(a)(11) definition of “underwriter.” For example, look at whether there was a holding period prior to resale s.t. the person assumed the economic risks of investment, and therefore wasn’t acting as a conduit for sale to the public of unregistered securities on behalf of the issuer.
   
   ii. An issuer creates a right in itself or some other person in the form of an investment contract, whether or not evidenced by a written instrument, such as a share of stock.
Example: A promoter proposes to take a pre-incorporation subscription for shares in a corp. not yet formed. He intends to issue a security in the form of a pre-organization certificate or subscription. The corp. can’t be the issuer b/c it’s not yet in existence. The contract is made w/ the promoter – he’s an issuer, whether he knows it or not.

V. Resale of Restricted Securities

A. What are “restricted securities”: Persons who acquire securities from issuers in a transaction complying w/ any of the registration exemptions receive securities that are unregistered. Unregistered securities are “restricted securities” and can only be reoffered or resold if registered, or pursuant to another registration exemption.

1. In re Ira Haupt & Co. (p.540) – The issue: When does a broker’s transaction become a distribution? David Schulte was the president of Park & Tilford, Inc. and owned 92% of its stock. He sold about 37% of the stock through his broker Haupt over 6 mos. Haupt was instructed to start selling in 200 share blocks “at $59 and every quarter up.” SEC called Haupt an underwriter; he was held liable for his role in effecting the unregistered offering. SEC found that Haupt had reas. notice that a distribution was anticipated (as opposed to a “transaction”), and so he didn’t get the § 4(4) or 4(2) exemptions. A distribution is “the entire process by which in the course of a public offering the block of securities is dispersed and ultimately comes to rest in the hands of the investing public.”

B. Safe harbors (non-exclusive) in Rules 144 and 144A:

1. Secondary trading – SA § 4(1) permits individual investors to resell w/o registration, provided that such resales are viewed as “transactions” (rather than part of a distribution) and such persons aren’t deemed to be underwriters.

2. Rule 144 – Safe harbor under the SA § 4(1) exemption for non-affiliated shareholders who sell their restricted securities and for affiliates who sell their unrestricted and/or restricted securities without registration. Also: safe harbor for brokers under the § 4(4) exemption who execute such transactions. If shareholders/brokers make a sale in compliance with the conditions of Rule 144, they won’t be deemed to be underwriters or involved in a distribution.

i. The conditions: 144(c) says the issuer has to be a reporting company, or there has to be certain other info about the issuer publicly available; 144(d) requires holding period of 1 year from the acquisition of the securities from the issuer or an affiliate of the issuer; 144(e) limits the amount of securities that can be sold; 144(f) requires that the sales take place in brokerage transactions, without solicitation and without payments to anyone besides the broker who executes the order. 144(e) – For an affiliate, the amt. of securities sold in a 3 month period can’t exceed the greater of 1% of stock outstanding, average weekly trading volume, or 1% of reported trades. For non-affiliates, the same, except that no limit after 2 years according to 144(k).

ii. Who’s an affiliate? An employee who has operational control over the issuer. CEO, director, etc.

3. Rule 144A – Safe harbor for resales to qualified institutional buyers (QIBs) of certain restricted securities. See defn. of QIB in 144A(a)(1) – one of the listed entities, acting for its own account or the accounts of other QIBS, that in the aggregate owns and invests on a discretionary basis at least $100mm in securities of issuers that aren’t affiliated with the entity. Any person other than the issuer or a dealer who offers or sells securities in compliance with the conditions won’t be deemed to be an underwriter within the meaning of SA §§ 2(a)(11) & 4(1). PORTAL is the electronic securities mkt. set up by NASD to allow trading of 144A securities.
VI. Civil and Criminal Liability for Fraud Under Rule 10b-5

A. SEA § 10(b): “Thou shalt have no other cunning devices.” Prohibits use of a manipulative or deceptive device in connection with the purchase or sale of securities, registered or unregistered, in violation of SEC rules and regulations.

B. Rule 10b-5: Proscribes in turn the following manipulative and deceptive devices: (1) to employ a device, scheme, or artifice to defraud; (2) to make any untrue statement of a material fact or omit any such fact necessary to make the statement not misleading; or (3) to engage in a transaction, practice, or course of business that would operate as a fraud or deceit.

1. Elements of the 10b-5 civil claim – To establish primary liability under SEA § 10(b), P must prove the following facts: (1) that the D made an untrue statement of a material fact, or failed to state a material fact; (2) that the conduct occurred in connection w/ the purchase or sale of a security; (3) that the D made the statement or omission w/ scienter; and (4) that P relied on the misrepresentation, and sustained damages as a proximate result. Note: The SEC and the DOJ only have to prove (1)-(3) for an administrative/criminal action.

C. What constitutes fraud: The conduct must be manipulative (in the technical sense of artificially affecting mkt. activity in order to mislead investors) or deceptive.

1. Santa Fe Industries v. Green (p.1045) – D corp entered into a short-form merger to buy out the shares of minority stockholders. The minority shareholders sued, contending that the transaction was unfair to them. S. Ct. held that a breach of a fiduciary duty by majority stockholders, without any deception, misrepresentation, nondisclosure, or manipulation, does not violate SEA § 10(b) and Rule 10b-5. Ct. refused to expand the scope of § 10(b) b/c DE law (place of incorporation) provided the minority stockholders with a cause of action to recover the fair value of shares allegedly undervalued in that kind of transaction.
   i. Note: This is one example of the “internal corporate mismanagement” exception to § 10(b)/Rule 10b-5 liability.

2. Wharf Holdings v. United Int’l Holdings (p.1055) – Wharf sold an option to United to buy stock in a cable system while secretly never intending to honor the option. United provided services – contract negotiation w/ the Hong Kong govt., system design, arrangement of financing – and the companies had orally agreed that United would be paid with a right to invest in the system. S. Ct. held that Rule 10b-5 covers oral contracts for the purchase/sale of securities, and Wharf’s secret intent to not honor its promise while making it constituted deceit within the meaning of the Rule.

D. The duty to update and the duty to correct: The duty to correct applies when a company makes a statement that, at the time made, the company believed to be true, but as revealed by subsequently discovered info actually was not true. The company must then correct the prior statement within a reasonable time. The duty to update (less clear than the duty to correct) concerns statements that, although reasonable at the time made, become misleading when viewed in the context of subsequent events.

1. In re Time Warner Securities Litigation (p.1059) (Second Circuit) – TW, seeking to reduce its debt, launched a highly publicized campaign in search of strategic business alliances. But the plan didn’t work out and it was forced to pursue an alternative method of raising capital – a new stock offering that substantially diluted the rights of existing shareholders. TW shareholders sued, alleging that TW and four of its officers misled the investing public by not disclosing problems in the alliance negotiations as those problems developed, and by not disclosing the active consideration of an alternative method of raising capital.
   Holding:
   i. (1) Pleading standard for actionable misrepresentations or omissions in anonymous statements to reporters and analysts – Ps have to identify the source from the corp.
of the allegedly fraudulent statements. (Issuers don’t have to respond to inaccurate rumors of which they aren’t the source.)

ii. (2) Attributed statements and corp press releases – For duty to correct, Ps have to show that assertions were false or materially misleading when made, or that favorable opinions were without basis in fact. For duty to update, Ps have to show that corp. failed to disclose new info that was material. Info is material if (from TSC) there’s a substantial likelihood that disclosure would’ve been viewed by the reasonable investor as having significantly altered the total mix of info available.

iii. (3) Ps stated a cause of action under Rule 10b-5 re: duty to update. When a corp is pursuing a specific business goal and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration.

2. **In re Burlington Coat Factory Securities Litigation** (p.1065) (Third Circuit) – Shareholders sued after Burlington’s fourth quarter and fiscal year results were below the investment community’s expectations – they sued b/c Burlington had expressed comfort with analysts’ projections and then didn’t update when those projections became no longer accurate. Holding: A simple earnings forecast contains no more than the implicit representation that the forecast was made reasonably and in good faith. It doesn’t contain the implication that the forecast will continue to hold good even as circumstances change. Therefore, the voluntary disclosure of such an earnings forecast doesn’t trigger any duty to update.

   i. Note the difference between the Second and Third Circuits. Second says corps always have a duty to update when new info renders a previous statement materially misleading. Third says duty to update under more limited circumstances – when the previous statement, true when made, contains at least an implicit representation that the trend will continue and when new info renders the first statement materially misleading.

E. **Materiality:** There are different ways of measuring the materiality of information. (1) Required disclosure items are presumed to be material. (2) Quantitative test: There is a presumption that info that accounts for more than a > 10% stock price movement, or an issuer or registrant’s total assets, gross sales or net earnings, is material, while info that accounts for < 5% is presumed to be not material, with a gray area bet. 5-10%. (3) Qualitative analyses. See 1999 SEC Staff Accounting Bulletin (SAB) No. 99, in which the SEC discouraged exclusive reliance on quantitative measures of materiality and enumerated various considerations which may render any misstatement of a financial statement item material. (See p.993).

   1. **TSC Industries v. Northway** – The S. Ct. held that in the proxy context an omitted fact is material if there is a substantial likelihood that a reas. shareholder would consider it important in deciding how to vote.

   2. **Basic, Inc. v. Levinson** (p.998) – Basic made public statements denying that it was engaged in merger negotiations, Basic shareholders sold their stock, and then Basic publicly announced its approval of a tender offer. The former Basic shareholders sued. The S. Ct. adopted the TSC Industries standard of materiality for the § 10(b)/Rule 10b-5 context. With respect to a corp.’s duty to disclose merger plans, the court explicitly rejected the bright-line “agreement-in-principle” rule of certain lower cts., instead holding that in such circumstances materiality depends upon a balancing of both the probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company’s business and affairs.

      i. Note: Silence, absent a duty to disclose, is not misleading under Rule 10b-5. “No comment” statements count as silence.
ii. Note: The Ct.’s analysis here has been held to apply to anything that SAB No. 99 addresses.

3. *In re Worlds of Wonder Litigation* (p.1009) – Ninth Cir. articulated the “bespeaks caution” doctrine w.r.t. forward-looking statements: Economic projections, estimates of future performance, and similar optimistic statements in a prospectus are not actionable if conspicuous and precise cautionary language elsewhere in the document adequately discloses the risks involved. Even if the optimistic statements are later found to have been inaccurate or based on erroneous assumptions when made.
   i. What the Ps needed to show w.r.t. the forward-looking statements: (1) statement in prospectus; (2) contradicted by evidence of the reality at the company at the time of the offering; (3) w/ insufficient or inadequate disclosure/disclaimer in prospectus; (4) actual knowledge.

4. *Virginia Bankshares, Inc. v. Sandberg* (p.1026) – Shareholders brought suit w.r.t. allegedly misleading statements in a proxy (proposed merger had “high value” and terms were “fair” to shareholders); SEA § 14(a) and Rule 14a-9 applies to proxies and is analogous to § 10(b)/Rule 10b-5. The S. Ct. held the corp. directors’ statements of opinion and belief could be the basis for liability, and that the statements in the proxy were materially misleading. Cautionary statements are well and good, but “not every mixture w/ the true will neutralize the deceptive. If it would take a financial analyst to spot the tension bet. the one and the other, whatever is misleading will remain materially so, and liability should follow.”

F. Culpable mental states: For historical statements, every single Court of Appeals after *Ernst & Ernst v. Hochfelder* has held that the standard for culpability is recklessness that’s getting pretty close to intent to defraud. The S. Ct. in *Ernst* had set the standard somewhere between actual knowledge (culpability) and negligence (no culpability). For forward-looking statements (except in financial statements or in an IPO), the 1995 Private Securities Litigation Act set the standard at actual knowledge. This is a very tough standard, particularly given that a P has to come up with documentation; litigation on the basis of forward-looking statements has dramatically decreased since 1995.

G. Reliance, causation, and the “in connection with” requirement:
   Reliance: P has to show but-for causation in misrepresentation cases only, not in material omission cases. The fraud-on-the-market presumption doesn’t apply to thinly traded securities or new securities offerings.
   Proximate causation (sometimes called loss causation, or damages): How much of the adverse stock price movement was the fault of the Ds? Have to find an appropriate index.
   In connection with: Have to show a material misrepresentation or omission preceding the purchase or sale. Need a temporal connection. If you can prove reliance and proximate causation, in connection with is usually a slam dunk. If you can prove actual reliance, you can always prove in connection with.

1. *Basic, Inc. v. Levinson* (p.1131) – Ps brought class action alleging that in reliance on Basic’s statements they sold their shares of Basic stock in the depressed mkt. created by the Ds. The S. Ct. approved the fraud-on-the-market theory. Ps were entitled to a rebuttable presumption, created by the fraud-on-the-mkt. theory, that individuals who traded Basic shares did so in reliance on the integrity of the price set by the mkt., but that b/c of Ds’ material misrepresentations that price was fraudulently depressed.
   i. Note: Elements of a Rule 10b-5 claim based on the fraud-on-the-mkt. theory: (1) D made public misrepresentations (2) that were material and credible; (3) the shares were traded on an efficient mkt.; and (4) P traded the shares bet. the time the misrepresentations were made and the time the truth was revealed.
ii. Note: How to rebut the presumption: Have to sever the link bet. the alleged misrepresentation and either the price received/paid by P or P’s decision to trade at a fair mkt. price. Example: If news of the truth entered the mkt. and dissipated the effects of the misstatements, or if P purchased/sold for other unrelated reasons (e.g., political pressure to divest from shares of certain businesses).

2. When P relies on oral statements that contradict previous written statements: P has to prove justifiable reliance. Factors that go into weighing whether P’s reliance was justifiable: (1) P’s sophistication and expertise in financial and securities matters; (2) the existence of a long-standing relationship or a fiduciary relationship bet. P and the person who made the oral statement; (3) P’s access to relevant info and opportunity to detect the fraud; (4) whether P initiated the stock transaction or sought to expedite it; and (5) the generality or specificity of the misrepresentations. (If the written statement comes after the oral statement, investors are expected to rely on the written form.)

3. Semerenko v. Cendant Corp. (p.1145) – Ds, former officers and directors of Cendant, allegedly made misstatements (in connection w/ accounting fraud) about Cendant during a tender offer for shares of ABI stock. Ps were purchasers of ABI stock. Ps brought suit under SEA § 10(b) and Rule 10b-5. The Third Cir., following the Second and Ninth Cirs., held:
   i. First holding: The “in connection with” requirement was met. “[W]here the fraud alleged involves the public dissemination of info in a medium upon which an investor would presumably rely [i.e., an efficient securities mkt.], the ‘in connection with’ element may be established by proof of the materiality of the misrepresentation and the means of its dissemination. * * * [Ps are] not required to establish that the Ds actually envisioned that Ps would rely upon the alleged misrepresentations when making their investment decisions.” The Ds’ purpose in making the misrepresentations is irrelevant to this issue.
   ii. Second holding: “Under the fraud-on-the-mkt. theory of reliance, the ct. presumes (1) that the mkt. price of the security actually incorporated the alleged misrepresentations, (2) that the P actually relied on the mkt. price of the security as an indicator of its value, and (3) that the P acted reasonably in relying on the mkt. price of the security.” D can rebut this presumption.
   iii. Third holding: Ps alleged sufficient facts to show that the alleged misrepresentations proximately caused their claimed loss. The alleged misrepresentations created in the mkt. an unrealistically positive assessment of Cendant’s financial condition; this, in turn, was a substantial cause of the artificial inflation of the price of ABI stock (and, later, of the price’s decline).

4. Angelastro v. Prudential-Bache Sec. – A class of investors sued a nat’l brokerage firm for misrepresenting both the specific interest rates it would charge in connection w/ a margin purchase and the formula it would apply in calculating those rates. The ct. held that Rule 10b-5’s “in connection with” requirement was met. “Rule 10b-5 also encompasses misrepresentations beyond those implicating the investment value of a particular security.”

5. SEC v. Zandford (p.1160) – SEC initiated a civil action under SEA § 10(b) and Rule 10b-5 against a broker who stole money from his clients’ discretionary mutual fund account. D wrote checks to himself, knowing that redeeming the checks would require the sale of securities. The S. Ct. held that the fraud met the “in connection with” requirement of Rule 10b-5. Three rationales: (1) Clients were duped into believing D would conservatively invest assets and that transactions made on their behalf would be for their benefit for the safety of their principal and income. In this sense D’s scheme to defraud and sale of the securities coincide; his actual misappropriation of the money is not relevant. (2) As in Wharf, D sold his clients’ securities while secretly intending from the very beginning to
keep the proceeds. His fraudulent intent at the time he sold on behalf of his clients deprived them of the benefits of the sales. (3) As in O’Hagan, the clients’ securities didn’t have value for D apart from their use in a securities transaction, and the fraud wasn’t complete before the sale of securities occurred.

VII. Civil and criminal liability for insider trading under Rules 10b-5 and 14e-3

A. Liability under SEA § 10(b), Rule 10b-5, SEA § 14(e), and Rule 14e-3. Anyone who makes a material misstatement or misrepresentation, or engages in a scheme to defraud, can be liable under SEA § 10(b)/Rule 10b-5. Not just corp. insiders – the 13-yr.-old in New Jersey, too. The S. Ct. defined the materiality standard in TSC Industries: A material fact is one which would have assumed actual significance in the deliberations of a reas. investor, which would’ve been viewed by the reas. investor as having significantly altered the total mix of info available. Insider trading is prosecuted under SEA § 10(b)/Rule 10b-5 on the theory that it constitutes a scheme to defraud. SEA § 14(e), analogous to § 10(b), prohibits making untrue statements and misleading omissions of material facts, and engaging in fraudulent, deceptive, or manipulative acts, in connection with any tender offer. Corresponding Rule 14e-3 proscribes (1) purchasing or selling a security (2) sought in a tender offer towards which a substantial step has been taken (3) on the basis of (4) non-public info (5) acquired directly or indirectly from anyone at the offeror or the target – unless within a reas. time before any purchase or sale the info and its source are publicly disclosed by a press release or otherwise.

1. Rule: If material misrepresentation, then automatic 10(b)/10b-5 liability. If material omission, then have to show duty to disclose – by arguing classical theory (Cady, Roberts duty), misappropriation theory, or tipper-tippee theory.

2. Cady, Roberts & Co. – [Classical theory] SEC decided that a corporate insider must abstain from trading in the shares of his corp unless he has first disclosed all material inside information known to him. His duty to the other shareholders of the corp with whom he transacts arises from (1) the existence of a relationship affording access to inside info intended to be available only for a corporate purpose, and (2) the unfairness of allowing a corporate insider to take advantage of that info by trading without disclosure. The theory applies to permanent insiders (corporate officers, directors, executives – those who have permanent responsibilities at the corp) and to temporary fiduciaries (lawyers, accountants, consultants, takeover specialists, investment bankers, etc.).

3. Chiarella – [Classical theory] An employee of a financial printer prepared documents announcing corporate takeover bids and made strategic trades based on the info he saw prepublication. The names of the corps were blacked out, but he was able to deduce their identities from other info. S. Ct. did not hold him liable for insider trading b/c he didn’t have a relationship of trust and confidence with the shareholders of the corporation (the target company) in which he traded stock. The trades were impersonal mkt. transactions; there was no duty to reveal material facts. (Note: Chiarella today could have been prosecuted under the misappropriation theory. He owed a duty to his employer, which in turn owed a duty to the acquiring company.)

4. O’Hagan (p.1087) – [Misappropriation theory] Lawyer who worked for firm that represented client corp re: a potential tender offer made trades on the basis of the confidential tender offer plans. He was held liable for mail fraud, securities fraud, and insider trading, even though he did no work for that client and the firm ceased to represent the client a month before the client announced its tender offer for another company’s stock. The misappropriation theory: D committed fraud “in connection with” a securities transaction, and thereby violated § 10b and Rule 10b-5, when he misappropriated confidential info for securities trading purposes, in breach of a duty owed to the source of the info, his employer. The fraud was consummated when, without disclosure to his firm,
he used the info to trade. (Note: Why wasn’t this classical insider trading? Because D’s duty was to the client corp and its shareholders, not to the shareholders of the target company.)

5. **Dirks** – [Tipper-tippee] Dirks, an officer of a broker-dealer firm who specialized in providing investment analysis of insurance company securities to institutional investors, received info from a former officer of Equity Funding re: fraudulent corporate practices. The former officer asked D to investigate the fraud and disclose it. D did investigate, and some employees corroborated the charges. D passed on the info to a WSJ reporter and to his clients, some of whom sold their Equity Funding holdings. S. Ct. held that he was not liable for securities fraud. He wasn’t a classical insider or temporary fiduciary of Equity Funding. He didn’t steal the info, so he couldn’t be held liable under the misappropriation theory. And the insiders didn’t breach their Cady, Roberts duty to shareholders in disclosing the info to D – didn’t derive personal/monetary benefit by disclosing to D – so neither they as tippers nor he as tippee could be held liable under 10b-5. The insiders were motivated by a desire to expose the fraud, not personal gain. A tippee is liable only if (1) if the tipper has breached a duty in tipping, (2) the tippee knows or should know that there has been such a breach, and (3) the tippee breaches a duty of trust and confidence to the tipper by either trading himself or deriving a personal benefit from tipping someone else.

   i. A tipper has breached a duty in tipping only if (1) the info was material, non-public info, (2) the tipper had a duty to refrain from trading on the basis of the info while it was non-public, and (3) the tipper received some sort of personal gain from the tipping. Look for quid pro quo pecuniary gain, reputational benefit (which could translate into future earnings), and/or a tip to a friend/relative (which may be characterized as a trade by the tipper followed by a gift to the friend/relative).

6. **Chestman** – The stockbroker (Chestman) of a couple (Susan and Keith Loeb) that was related to the founder of a publicly-traded supermarket chain (Waldbaum) made trades for his own account and for his clients’ discretionary accounts on the basis of info he received improperly. The info related to the pending sale of Waldbaum to A&P. The stockbroker was not held liable for insider trading. “Because Keith owed neither his wife nor the Waldbaum family a fiduciary duty or its functional equivalent, he didn’t defraud them by disclosing news of the pending tender offer to his stockbroker. Absent a predicate act of fraud by Keith, the alleged misappropriator, the stockbroker couldn’t be derivatively liable as Keith’s tippee.”

7. Rule 10b5-2 – Addresses the question, considered in Chestman, of when non-business relationships may give rise to a duty of trust and confidence for purposes of the misappropriation theory of insider trading. Section (b)(3) stands Chestman on its head – we now start with a rebuttable presumption that there is a relationship of trust and confidence whenever someone receives material, non-public info from a spouse, mother, etc. Section (b)(1) – agree to maintain info in confidence; (b)(2) – pattern and practice.

8. Rule 10b5-1 – Addresses the question of when a person in possession of material nonpublic information trades “on the basis of” the information. Definition in (b) codifies Teicher rule, that “on the basis of” means knowing possession. But the affirmative defenses in (c) accommodate some of the concerns of the Teicher defendants.

B. **Regulation FD (“Fair Disclosure”)**: Whenever (1) an issuer that’s a reporting company, or person acting on its behalf, (2) discloses material nonpublic info (3) to certain enumerated persons (in general, securities mkt. professionals or holders of the issuer’s securities who may well trade on the basis of the info), (4) the issuer must make public disclosure of that same info (a) simultaneously (in the case of intentional disclosures), or (b) promptly (in the case of non-intentional disclosures).
1. Note: Regulation FD addresses the problem of selective disclosure, e.g., the practice of securities analysts seeking “guidance” from issuers regarding earnings forecasts. There are 4 specific exclusions from coverage: (1) communications made to persons who owe the issuer a duty of trust or confidence (e.g., lawyers, investment bankers); (2) communications to persons who expressly agree to maintain the info in confidence (e.g., offerees in a private placement if they agree to keep the info in confidence); (3) communications to credit ratings organizations (whose own purpose is ultimately public disclosure); and (4) communications made in connection w/ securities offerings.

2. A selective disclosure is intentional when the person making it knows, or is reckless in not knowing, that the info being communicated is both material and non-public.

VIII. Civil Liability under SA § 11 (damages; investor’s loss recoverable)

A. SA § 11: If part of a registration statement (including the prospectus), when it becomes effective, contains a materially false or misleading statement, purchasers in a registered offering can recover damages from specified participants in the offering. All P has to prove is: (1) the registration statement, when it became effective, contained a (2) statement or omission (3) that was materially misleading. Any person who acquired a registered security in the registration process or in the after-mkt. can sue. P doesn’t have to prove reliance (except in limited circumstances), causation, or culpability. Issuers have only one possible defense: P knew about the untruth/omission at the time P purchased. For other Ds, some reas. care or due diligence defenses are available (see headings below).

B. Who can P sue? Every person who signed the registration statement, every director in the issuer at the time of the filing of the registration statement, every person who consents to be named as about to become a director, every “expert” (e.g., accountant, engineer, appraiser) who certifies any part of a registration statement, and any underwriter. But not the issuer.

1. Escott v. BarChris Construction Corp. (p.875) – BarChris built bowling alleys, suffered a downturn in its business. To raise capital, it issued debentures under a registration statement that misstated the company’s financial condition and its exposure to losses. Ps brought class action suit under § 11 against Ds statement signers (controller and directors), underwriters, and auditors. Noting that a prerequisite to liability was that the information falsely stated or withheld be material, the ct. determined that the following constituted material matters: gross overstatements of sales, profits, and customer orders; understatements of liabilities; and the failure to disclose officer loans, customer delinquencies, and application of proceeds. Each D’s standard for due diligence varied with his relationship to the issuer and his role in the offering:

   i. Note: Issuer not entitled to any of the defenses in § 11(b). Strict liability.

   ii. (1) Treasurer/CFO (Kirchner) was thoroughly familiar w/ BarChris’s financial affairs, couldn’t blame the auditors, especially given that he was less than frank in communicating w/ them. He must have known that the prospectus contained falsehoods. Liable for expertized and non-expertized portions. Easiest case. When you become aware of falsehoods, your burden ratchets up.

   iii. (2) Young lawyer (Birnbaum) who served as house counsel and relatively new director but wasn’t an exec. officer in any real sense, nevertheless kept the corp. minutes and should have seen some red flags. Liable for the non-expertized portion b/c he should have checked up. Not liable for the expertized portion b/c he had no personal knowledge of BarChris’s finances and was therefore entitled to rely on the auditors’ figures.

   iv. (3) Outside director (Auslander) who was new and who only signed the amendments to the registration statement was entitled to rely on the auditors for the expertized portion but was held liable for the non-expertized portion. He made no
investigation of the accuracy of the prospectus; he relied on the assurance of others and upon info he’d received in answer to very general inquiries (in the nature of a credit check) he made when he signed on. He didn’t have special access to company info. “Section 11 imposes liability in the first instance upon a director, no matter how new he is. He is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reas. care to investigate the facts which a prudent man would employ in the mgmt. of his own property. In my opinion, a prudent man wouldn’t act in an important matter w/o any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general info which doesn’t purport to cover the particular case.”

v. (4) Lawyer (Grant) whose law firm was counsel to BarChris w.r.t. securities registration was sued in his capacity as director. Accepted simplistic answers, didn’t ask for verification, missed plain errors. Held liable for failing to investigate sufficiently the correspondence, contracts, and corporate minutes that would’ve revealed the inaccuracies of the non-expertised parts. But the ct. accepted his defense as to the expertised financials b/c he had no reason to doubt their accuracy. Greater burden for directors who also have some other relationship to the corp.

vi. (5) Counsel (Ballard and Stanton) for Drexel, the lead underwriter were held liable for performing pretty much the same low level of due diligence as Grant. “In a sense, the positions of the underwriter and the company’s officers are adverse. It’s not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving.” Just like Grant, the underwriters needed to make some reas. attempt to verify the data submitted to them; they shouldn’t have just relied on the company’s officers or on the company counsel. The other underwriters were bound by Drexel’s failed diligence since they relied on Drexel. The ct. accepted the underwriters’ defense as to the expertised financials b/c Drexel and the other underwriters could rely on the auditors.

vii. (6) The auditor (Peat, Marwick) – Although an expert is liable only for expertised info, the ct. found that the auditor needed to review the unaudited financials to ensure that the certified financials were not rendered misleading. The auditor had accepted the insiders’ answers at face value – an effort inadequate to establish its due diligence defense.

2. In re Software Toolworks (p.899) – Software corp. specializing in computer gaming offered public stock in an effort to raise revenue. Corp. subsequently failed in numerous respects and investors (Ps) brought a class action suit under § 11 against directors, auditors, and underwriters (Ds), contending that Ds materially misled them as to the future of the company. Holding: (1) Reasonable investigation under § 11 is similar to reasonable care under § 12(a)(2) for purposes of summary judgment; (2) adequacy of due diligence may be determined by summary judgment; (3) underwriter need not conduct due diligence into expertised part of prospectus; (4) underwriter burden greater when underwriter helped write part of a registration statement that had red flags.

i. Reasonable investigation (§ 11) probably contemplates a greater undertaking than reasonable care (§ 12(a)(2)).

C. Exemption defense: If the offering wasn’t registered, there can be no § 11 liability, even if there is a circular containing prospectus-like info. Purchasers have a § 11 claim only when misinformation appears in a registration statement that becomes effective after being filed w/ the SEC.

D. The P-knew defense: D can argue that P knew of the untruth or omission at the time P purchased. § 11(a).
E. Another defense – earnings statement: If the issuer made available to its security holders an earnings statement covering a period of at least 12 mos. beginning after the registration became effective, and P purchased after, then P has to prove reliance on the untrue statement or omission in the registration statement. P can do this without establishing that he read the registration statement, though. D can argue that P failed to establish reliance. § 11(a).

F. The disassociation defense: D might establish that before the registration statement became effective he had taken steps to sever connections w/ the issuer, and had advised the issuer and the SEC in writing that he wouldn’t be responsible for that part of the statement. § 11(b)(1). Or, D might establish that part of the statement had become effective w/o his knowledge, and that upon finding this out he had severed connections w/ the issuer and given reas. notice to the public and to the SEC about that part of the statement becoming effective w/o his knowledge. § 11(b)(2).

G. The due diligence defense for a non-expert D sued on a “non-expertised” portion of a registration statement or an expert D sued on an “expertised” portion: D must establish that he had, (1) after reas. investigation, (2) reas. ground to believe and (3) did believe, (4) at the time the portion of the registration statement became effective, that it was true and complete. The standard of reasonableness is defined in § 11(c) to be that required of a prudent man in the mgmt. of his own property.
   1. Non-expertised parts – parts other than the lawyer’s tax opinion, the certified financial statement. Most of a registration statement is non-expertised.
   2. Experts are only liable w.r.t. the parts they expertised.

H. The due diligence defense for a non-expert D sued on an “expertised” portion: D must establish that he (1) had no reas. ground to believe and (2) did not believe, (3) at the time such portion became effective, that there were untrue statements therein or misleading omissions.

IX. Civil Liability under SA § 12 (rescission; price paid for security recoverable)
A. SA § 12(a)(1): Section 12(a)(1) provides if an offeror or seller violates the registration or gun-jumping requirements of §5, securities purchasers can rescind their investment. P must prove the following elements of the claim: (1) D was a seller; (2) interstate commerce; (3) D failed to comply w/ the § 5 registration or prospectus requirement (typically by such means as an unregistered offer or sale or failure to timely deliver a prospectus or securities); (4) the statute of limitations hasn’t expired; and (5) adequate tender of such security is made when the P seeks the remedy of rescission.

B. SA § 12(a)(2): Section 12(a)(2) provides that if offers or sales in a public offering (not subject to § 11 liability) are accomplished by means of materially false or misleading information in a prospectus or oral communication, purchasers can rescind their investment. Defenses: (1) P knew about the untruth/omission at the time P purchased; (2) the quasi due diligence defense (see heading below).

C. Exemption defense for § 12(a)(1): § 12(a)(1) imposes strict liability against “sellers” of unregistered securities when no § 5 exemption applies, so try to argue intrastate, Reg. D, etc.

D. The quasi due diligence defense in § 12(a)(2): Once the purchaser has established a prima facie case, the seller can argue that s/he didn’t know, and in the exercise of reas. care couldn’t have known, of the untruth/omission. Liability based on simple negligence.
   1. Pinter v. Dahl (p.928) – Who is a seller within the meaning of SA § 12(a)(1)? Investors in an unsuccessful oil & gas venture sued under § 12(a)(1) to get their money back from the venture’s promoter, Pinter. Pinter counterclaimed for contribution against Dahl, who had told the other investors about the venture and had assisted them in filling out subscription forms. Dahl argued he wasn’t a seller under § 12(a)(1). The S. Ct. held that, aside from one who transfers title (the easy case), any collateral participant can also be a “seller” if s/he (1) urges the buyer to purchase (2) in exchange for personal economic gain (special
compensation – Blackmun is formalistic about this) or to further the real seller’s financial interests. One can’t recover against the seller’s seller. Remanded.

i. Note: People who aren’t sellers: (1) those who gratuitously give advice on investment matters and who aren’t motivated by a desire to benefit the securities owner or themselves; (2) professionals, such as accountants and lawyers, whose involvement is solely for the performance of their professional services.

ii. Note: Lower cts. since Pinter have applied its holding to cases arising under SA § 12(a)(2), and have also rejected liability on an aiding and abetting theory. (It would be anomalous for a non-selling collateral participant to be insulated under Pinter and yet liable as an aider and abettor.)

2. Gustafson v. Alloyd Company (p.938) – The S. Ct. held that, within the meaning of SA § 12(a)(2), a “prospectus” is a document that describes a public offering of securities by an issuer or controlling shareholder. The shareholders of a closely held corp. sold all of their stock to a group of investors; the contract of sale (or purchase agreement) was not held out to the public and was therefore not a prospectus. § 12(a)(2) applies only to public offerings.

i. The Ct.’s reading of § 12(a)(2) to cover only “public” offerings is ambiguous in that many small offerings made pursuant to § 3 exemptions (such as intrastate offerings and smaller offerings made pursuant to Rules 504 and 505) are technically exempt “public” offerings. So, unclear whether one who purchases from an exempt, “public” offering can bring a § 12(a)(2) claim.

X. Pleading and Lead Plaintiff Provisions Under the Private Securities Litigation Reform Act

A. SEA §§ 21D(b)(1)-(2) and 21D(a)(3) and the pleading standard: The 1995 PSLRA was designed to make the pleading standard in securities fraud class actions more stringent and more uniform. Cts. since have divided over whether the standard is the same as the pre-1995 Second Circuit standard or stronger.

1. FRCP 9(b)’s pleading standard w.r.t. fraud – Whenever a complaint contains allegations of fraud, “the circumstances constituting fraud … shall be stated with particularity.”

2. SEA § 21D(b)(1) (PSLRA) – FRCP Rule 9(b)’s “particularity” requirement didn’t prevent enough meritless suits, according to Congress, and the requirement had been variously interpreted by the courts of appeals so that there were distinctly different standards among the circuits. Paragraph (b)(1) added specifics to the “particularity” requirement. That is, “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”

3. SEA § 21D(b)(2) (PSLRA) – Paragraph (b)(1) requires that Ps “w.r.t. each act or omission …, state with particularity facts giving rise to a strong inference that the D acted with the required state of mind.” The phrase “strong inference” raised the standard.

4. Novaks v. Kasaks (p.1227) – Ps brought a securities fraud class action against Ds at AnnTaylor Stores Corp. The Second Cir. held that the PSLRA raised the pleading standard to that previously existing in the Second Cir. (w/ the exception of the “with particularity” requirement) but that the standard could be articulated w/o the “motive and opportunity” concept. So the standard is that Ps have to plead with particularity facts giving rise to a strong inference that Ds had the requisite fraudulent intent. Such an inference may arise where the complaint sufficiently alleges that the Ds (1) benefited in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behavior; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information that they had a duty to monitor. The ct. further held that Ps here met this standard and that in general Ps don’t need to reveal the identities of their
personal sources to substantiate their factual allegations; documentary evidence and/or a
general description of the personal sources are OK.
i. Why Ps’ complaint was sufficient: Ps satisfied the pleading requirements by
showing that the Ds failed to distinguish in AnnTaylor’s public statements between
regular inventory and “Box and Hold” inventory (old stuff that was unlikely to sell)
and failed to write off the latter. This practice violated GAAP and the company’s
own publicly-stated markdown policy; the mgmt. discussed the need to mark down
inventory but refused to do so b/c that would damage the company’s financial
prospects. At the same time, Ds further misled the investing community by making
repeated public statements either offering false reassurances that inventory was
under control or giving false explanations for its growth.

5. The group pleading doctrine – An exception to the requirement that the fraudulent acts of
each D be identified separately in the complaint. P can rely on a presumption that
statements in prospectuses, registration statements, annual reports, and other group-
published information, are the collective work of those individuals w/ direct involvement in
the everyday business of the company. Cts. have held that this doctrine has survived
PSLRA.

B. Selection of lead plaintiff and lead counsel: The PSLRA encourages institutional investors to
serve as lead plaintiffs and then lets them select, retain, and monitor lead counsel. See SEA §
21D(a)(3) re: the procedure. The basic idea is that if an institutional investor has a large enough
financial interest in the litigation, then it will have the same kind of incentives to monitor counsel
as an individual plaintiff would in a non-class action case. Specifically: (1) A ct. starts w/ the
rebuttable presumption that the P-movant with the largest financial interest is the most adequate P
in the sense of FRCP Rule 23. (2) The ct. then inquires whether the P-movant ably selected
competent class counsel and negotiated a reas. retainer agreement.

1. In re Cendant Corp. Litigation (p.1246) – In a securities fraud class action, three huge govt.
pension funds were selected as a group (“the CalPERS Group”) to constitute the lead
plaintiff. The Group asked the District Court to appoint as lead counsel two firms w/ which
it had previously negotiated a retainer agreement. The court declined initially to approve
the Group’s choice, deciding instead to select the lead counsel via an auction but giving the
Group’s chosen counsel the option of matching what the court determined to be the lowest
qualified bid. Those firms exercised the option and ended up being appointed as lead
counsel anyway. The Third Cir. held that an auction is generally not permissible under the
PSLRA, because an auction would undermine the Act’s policy rationale that large investors
can do a better job at counsel selection, retention, and monitoring than judges. An auction
would permit a court to take these decisions away from the lead plaintiff. But, if there’s a
situation wherein none of the plaintiffs would be an adequate lead plaintiff, then a court
could step in to protect the interests of the class. In that case, an auction might be an
appropriate means by which the court could select and retain counsel on behalf of the class.
Here, the CalPERS Group was a properly selected lead plaintiff, and it conducted a good-
faithe counsel selection process with arms-length bargaining.

XI. Secondary Liability
A. Control person liability: Start w/ who can be held primarily liable, and then analyze control
person liability. SA § 15 provides that investors may also recover, on a joint and several basis,
from persons (whether individual or corporate) who control any person liable under §§ 11 & 12,
“unless the controlling person had no knowledge of or reas. grounds to believe in the existence of
the facts by reasons of which the liability of the controlled person is alleged to exist.” SEA § 20(a)
imposes SEC/criminal/private liability on controlling persons w.r.t. any SEA violation “unless the
controlling person acted in good faith and didn’t directly or indirectly induce the act or acts constituting the violation or cause of action.”

In both cases, D bears the burden of establishing the due-diligence/good-faith defense. Another defense: Representative acted outside of the broker-dealer’s statutory control.

1. Rule 405 – The SEC has defined “control” to mean “the possession, direct or indirect, of the power to direct or cause the direction of the mgmt. and policies of a person, whether through ownership of voting securities, by contract, or otherwise.”

2. Hollinger v. Titan Capital Corp. (p.1265) – Wilkowski, a dishonest securities salesman, embezzled money entrusted to him by four clients. S. Ct. held: (1) Control person liability can be applied to broker-dealers w.r.t. anyone they’re legally required to supervise, incl. representatives who are employed by or associated w/ it (incl. independent contractors). (2) P isn’t required to show culpable participation to establish that a broker-dealer was a controlling person b/c the statute premises liability solely on the control relationship, subject to the good-faith defense. (3) A broker-dealer can establish the good-faith defense only by proving that it maintained and enforced a reas. and proper system of supervision and internal control.

B. No aiding and abetting claims for private litigants under 10b-5:

1. Central Bank of Denver v. First Interstate Bank of Denver (p.1275) – S. Ct. held that private litigants have no cause of action under SEA § 10(b) against one who aids another, who commits a manipulative or deceptive act. While it’s true that an aider and abettor of a criminal violation of any federal securities law violates 18 U.S.C. § 2 (criminal conspiracy), Congress hasn’t yet enacted a general civil aiding and abetting statute – either for suits by the SEC or for suits by private parties.
   
i. Private litigants – Try to argue primary liability for the types of litigants who before Central Bank would’ve been liable as aiders and abettors. Who is a primary violator? Cts. have divided. Some say one who authors the statement(s) in the document or one who signs. But if you just provide assistance (even substantial), no liability. Other cts. say authorship plus something else.

ii. After Central Bank – In 1995, Congress restored the SEC’s authority to bring aiding and abetting actions when it enacted SEA § 20(f). But § 20(f) applies only to persons who “knowingly provide substantial assistance” to the primary violator. Note: The SEC may bring a 10b-5 aiding/abetting claim and a Rule of Practice 102(e)(iii) disciplinary claim for aiding and abetting (to suspend/disbar an atty or accountant from practicing before the SEC).

XII. More Defenses Against Private Causes of Action

A. Failure to plead with particularity: The most frequently and successfully invoked securities law defense. (See above.)

B. Statutes of limitation: Issues incl. finding the relevant statute of limitations (if it’s an implied cause of action) and determining when it starts to run (i.e., when P was put on inquiry notice).

1. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson (p.1293) – The S. Ct. addressed the issue of whether a federal or a state limitations period should be applied, and then which one, for a private litigant’s Rule 10b-5 claim, an implied cause of action. The Ct. held that a uniform, and therefore federal, period would be appropriate. All but one (§ 16(b)) of the SEA causes of action included some variation of a 1-yr. period after discovery combined w/ an outside limit of 3 yrs., so the Ct. held that that would be appropriate for 10b-5 claims. Section 20A, which has a 5-yr. limitations period and is part of the Insider Trading and Securities Fraud Act, was added to SEA in 1988; there was no indication that Congress sought to extend that enhanced protection to other provisions of SEA. Also, the equitable tolling doctrine is inconsistent w/ the 1-and-3-yr. period; the 1-yr. period, by its terms,
begins after discovery of the facts constituting the violation, making tolling unnecessary, and the 3-yr. limitation is supposed to be a cut-off.

i. After Sarbanes-Oxley: Sarbanes-Oxley extended the statute of limitations for implied causes of action such as Rule 10b-5 so that no private right of action may be brought later than the earlier of two yrs. after the discovery of the facts constituting the violation or five yrs. after the violation occurred.

2. *Law v. Medco Research, Inc.*, (p.1302) – The Seventh Cir. considered the issue of what constitutes inquiry notice for a 10b-5 claim, what starts the running of the statute of limitations. Holding: “[T]he P gets a yr. after he learned or should have learned the facts that he must know to know that he has a claim. In the case of a suit complaining of a false registration statement, all he has to know is that the statement was untrue; so, as soon as he knows or should know that, the 1-yr. period begins to run. In a fraud case, he needs to know more: that the D has made a representation that was knowingly false. When the P knows or should know this, the statute of limitations begins to run. * * * Suspicious circumstances, coupled w/ ease of discovering, without the use of legal process, whether the suspicion is well-grounded, may cause the statute of limitations to start to run before the Ps discover the actual fraud.” A price plunge, w/o more isn’t a reas. basis for suspecting fraud; neither is a period involving lots of short selling; and neither is an article showing that D’s representation was false for reasons unlikely to have been within the knowledge of D when making it, b/c it concerned conditions internal to a customer, supplier, or other outsider to D, and b/c of conditions which may have arisen after the representation was made.

i. Policy: Too much emphasis on the s.o.l. can lead to premature and groundless suits, as Ps rush to make the deadline w/o being able to obtain good evidence of fraud. But we need an outside cut-off to give Ds a definite limit beyond which they needn’t fear being sued.

C. The defenses of laches, estoppel, waiver by conduct, and P’s lack of due diligence: Have to look at whether the P was attentive to self-protection.

1. Elements of the defense of laches – (1) P didn’t act diligently; (2) D relied to D’s detriment on P’s conduct; (3) D’s detrimental reliance resulted in prejudice to D.

2. Elements of an estoppel defense – (1) P knew the facts; (2) P intended that his conduct would be acted on, or acted so that D had a right to believe that P so intended; (3) D was ignorant of the true facts; (4) D relied on P’s conduct to D’s injury.

3. Elements of a waiver defense – Whether or not P knew the facts, P (1) knowingly (2) failed to exercise P’s right to investigate before acting, (3) causing D to rely on P’s conduct to D’s injury.

4. P’s lack of due diligence defense – Very similar to the above defenses. See *Stephenson*.

5. *Stephenson v. Paine Webber Jackson & Curtis, Inc.*, (p.1309) – P, a tax atty., brought a 10b-5 claim against his stockbroker and his brokerage after his stockbroker traded securities on his behalf w/o his authorization. When he found out about the first such trade, he challenged his broker, but not Paine Webber. His broker said he’d correct “the error;” over the course of the next several mos., P didn’t read his monthly statements and didn’t follow up. Holding: After *Ernst*, many cts. have held that the relevant inquiry in determining P’s due diligence is whether P has “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.” P’s securities claim was barred by the equitable defenses of laches, waiver, and ratification. Key factors: P’s level of education, experience, and demonstrated prowess in financial and securities matters. He had traded securities for yrs. and had participated in securities fraud litigation. P should’ve discerned the pattern of error; he was reckless in the mgmt. of his affairs.
D. **In pari delicto:** Harder to win on this defense. With this defense, D argues that (1) as a direct result of P’s own actions, P bears at least substantially equal responsibility for the violations P seeks to redress, and (2) barring P’s claim wouldn’t significantly interfere w/ the effective enforcement of the securities laws and protection of the investing public.

1. *Pinter v. Dahl* – The S. Ct. held: “Because the SA is specifically designed to protect investors, even where a P actively participates in the distribution of unregistered securities, his suit shouldn’t be barred where his promotional efforts are incidental to his role as an investor. * * * [But] the *in pari delicto* defense may defeat recovery in a § 12(a)(2) action only where the P’s role in the offering or sale of non-exempted, unregistered securities is more as a promoter than as an investor.”

XIII. **Remedies**

A. **Rescissory damages under SA § 11:** Basically, the difference bet. P’s purchase price and P’s resale price, with no mention of interest or of deduction of income damages as in § 12, and in any event limited to not more than the price at which the security was offered to the public. D can argue that stock depreciation was caused by other factors and get damage award reduced. See § 11(e).

B. **Rescissory damages under SA § 12 and SEA § 10(b):** The difference bet. P’s purchase price and P’s resale price, plus interest, and less any dividends or other corporate distributions (w/ interest) that P received. See the last five lines of § 12(a)(2) and § 12(b).

1. *Randall v. Lofsgaarden* (p.1318) – Purchasers of interests in a real estate tax shelter scheme that failed sued, alleging securities fraud and raising claims under SA § 12(a)(2) and SEA § 10(b). The dist. ct. and the Eighth Cir. went back and forth over whether the Ps’ recovery should be offset by the tax benefits they received. The S. Ct. held that for § 12(a)(2) claims, damages should include the purchase price of a partnership plus simple interest, with no offset of tax benefits received by the Ps – either as “income received” or as a return of “consideration.” Same goes for SEA § 28(a) w.r.t. § 10(b) claims. Better to let the defrauded party get this windfall than the fraudulent party when it would deter this kind of misconduct.

2. *Miley v. Oppenheimer & Co., Inc.* (p.1330) – An investor sued her broker to recover damages that resulted from the broker’s excessive trading to generate additional fees, a practice referred to as churning. The broker argued that allowing recovery for both excess commissions and excess portfolio decline constituted double recovery. The Fifth Cir. held: (1) Once a jury finds that the broker has churned an investor’s account, it may also find that the investor would have paid less in commissions and that his portfolio would have had a greater value had the broker not committed the churning violation. At the margins, a windfall should go to the defrauded investor. (2) A ct.’s refusal to estimate the amt. of portfolio decline proximately caused by the churning of an account would yield an improper windfall for either the investor or the broker; a ct. should attempt to investigate how the investor’s portfolio would have fared in the absence of such misconduct. Use a mkt. index like S& P or Dow Jones.

C. **Arbitration:**

1. *Rodriguez de Quijas v. Shearson/American Express, Inc.* (p.1360) – The S. Ct. held that a binding arbitration clause in a standard customer agreement w/ a broker is enforceable under the SA §14 (“Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void.”). A P’s right to select the judicial forum is no longer such an essential feature of the SA. Concurrent jurisdiction allows Ps to opt out of the favorable rules of civil procedure that the fed. cts. offer anyway. Moreover, the SEC has authority to oversee and regulate arbitration procedures.
XIV. Broker-Dealer Liability, Supervision, and Qualified Immunity

A. Market makers and the over-the-counter mkt.: The over-the-counter market refers to securities transactions in the secondary mkt. which don’t take place on exchanges. A market maker is a broker-dealer in the over-the-counter mkt. who buys and sells securities as a principal for its own account on a regular and continual basis. The market maker conducts two-way bids; i.e., it stands willing to both buy and sell the securities for which it’s creating a mkt. Strike price = price at which dealer purchases. Execution price = price at which dealer sells. The difference is the dealer’s commission. Subject to NASD (e.g., mark-up policy & 5% guideline for commissions) and SEC regulation.

1. Lehl v. SEC (p.664) – D, a former securities salesman w/ First Choice Securities in Denver, petitioned under SEA § 25(a)(1) for review of an SEC order sustaining disciplinary action taken against him by the NASD. The NASD took disciplinary action against him for violating the NASD Rules of Fair Practice by charging unfair and excessive prices (mark-ups of 86%-100% over mkt. price) w/o proper disclosure to his customers. The Tenth Cir. affirmed the SEC order. Determine retail mark-ups based on the prevailing mkt. price; the best evidence of prevailing mkt. price is the dealer’s contemporaneous cost. D’s liability turned on the finding that he had reason to know that the mark-ups he charged were excessive. His firm’s 30% gross commission was excessive. “Lehl’s position as a registered securities representative required him to understand the basis for the prices he was charging the public and to assure himself those prices were fair. This he failed to do.”

2. The NASD’s 5% guideline – Just a guideline, not a prophylactic rule. The NASD has identified other factors that should go into determining the fairness of a mark-up: the type of security involved (equity securities get greater mark-up than debt securities, generally); the availability of the security (inactive mkt. means more time and effort needed to obtain the stock); the price of the security (handling costs are the same for high and low priced securities, justifying a commission that’s higher on a percentage basis for the low priced securities); the amt. of money involved in the transaction (again, smaller amt. – same handling costs – higher percentage of mark-up justified); disclosure to the customer about the mark-up; the pattern of mark-ups; and the nature of the dealer’s business (e.g., if dealer also provides research, financial planning advice).

3. Alfred Dempsey & Co. – SEC concluded that it’s a violation of the anti-fraud provisions to charge retail customers prices that aren’t reas. related to the prevailing mkt. price at which the customers make their purchase. How to determine the prevailing mkt. price: First look for the price at which dealers trade w/ one another, i.e., the current inter-dealer mkt. If there isn’t such a mkt., then “[p]rices paid for a security by a dealer in actual transactions closely related in time to his retail sales are normally a highly reliable indication of prevailing mkt. price.” This is the “dealer’s contemporaneous cost.”

4. Charles Hughes & Co. – The Second Cir. accepted the SEC’s position that the duty of fair dealing included an implied representation that the price a dealer charges bears a “reas. relationship” to the prevailing mkt. price. 10%+ mark-ups are probably fraudulent.

5. Rule 10b-10 – The Rule requires broker-dealers to disclose specified info in writing to customers at or before completion of a transaction. Subsections (a)(ii)(A)-(B) require a broker or dealer to disclose for risk-free transactions the difference bet. the price to the customer and the dealer’s contemporaneous purchase (for customer purchases) or sale price (for customer sales), and for all other transactions the reported trade price, the price to the customer in the transaction, and the difference, if any, bet. the reported trade price and the price to the customer.

B. Regulation aimed at establishing the duties of brokers to their customers: Two ways for a P-customer to establish that her relationship w/ her broker was a fiduciary one. (1) Traditional
common law standards – show that a relationship of trust and confidence was recognized on both
sides. (2) Shingle theory – argue that a broker-dealer impliedly represents that it’s a professional
and will deal fairly and competently in the manner of a true professional w/ their clients.
1. Duty of best execution – The NASD requires member firms and their representatives, in
any transaction w/ a customer, to “use reas. diligence to ascertain the best inter-dealer mkt.
for the subject security and to buy or sell in such mkt. so that the resultant price to the
customer is as favorable as possible under prevailing mkt. conditions.”
2. Duty to protect limit orders – A customer’s limit order to sell is an order to sell at or above
a certain price (the reverse for a limit order to buy). The NASD requires a market-maker
not to trade ahead of a customer’s limit order at a price equal to or better than the limit
order price.
4. Hanly v. SEC (p.705) – The SEC sued five securities salesmen for violating anti-fraud
provisions in the over-the-counter offer and sale of stock in U.S. Sonics Corp., a young
company that had recently developed a new filter for use in radio circuits but that was
insolvent at that time. Sonics was trying to raise capital to produce the filters. The salesmen
made affirmative misstatements when recommending the stock to customers (e.g., that
stock had fabulous potential and would double or triple) and failed to disclose material
adverse facts (e.g., like the fact that the company had never shown a year-end profits since
its inception). The Second Circuit held that brokers and salesmen have a duty to investigate
issuers whose stock they sell, even when the customers are sophisticated and
knowledgeable. Can’t just recklessly state facts about matters of which they’re ignorant –
they implicitly represent that they have a reas. and adequate basis for the opinions they
render. And they can’t simply rely on the issuer for info about the company – have to do an
independent investigation. The Ds here were held liable for securities fraud.
5. Clearing brokers and introducing brokers – Smaller brokers often use a clearing broker to
execute trades for them, hold the customer’s funds and securities, and handle the
paperwork. A recent case suggests that a clearing broker may have a duty to a customer to
investigate an introducing broker’s misconduct if things look suspicious – can’t remain
passive. Similar rule for brokers w.r.t. investment advisors who initiate trades. When the
broker knows that the transactions are inconsistent w/ the customer’s finances and
investment objectives, the broker can’t remain passive.
6. Unsuitability claims – When articulated under Rule 10b-5, an unsuitability claim can be
framed in one of two ways: (1) as a misrepresentation or omission of a material fact (i.e.,
the unsuitability of the securities to the investor), or (2) as fraud by misconduct. See
O’Connor. The NASD requires member organizations to “use due diligence to learn the
essential facts relative to every customer, every order, every cash or margin account
accepted or carried by such organization.” Also, the NASD requires that members making
recommendations to customers have “reas. grounds for believing that the recommendation
is suitable for such customer upon the basis of facts, if any, disclosed by such customer as
to [his financial situation].” Members have to make at least “an attempt to obtain info”
about a customer’s ability to bear risk.
7. O’Connor v. R.F. Lafferty & Co., Inc. (p.711) – O’Connor, recently divorced and
unemployed, deposited her $200,000 divorce settlement into an account w/ the investment
firm R.F. Lafferty, to be handled by Foulke. After O’C depleted her principal w/ monthly
withdrawals, she brought a series of fraud and negligence claims against Foulke and
Lafferty (as controlling person), including an unsuitability claim framed as fraud by
misconduct. Elements of an unsuitability claim: (1) the broker recommended (or in the case
of a discretionary account purchased) securities which are unsuitable in light of the
investor’s objectives; (2) the broker recommended or purchased the securities w/ intent to
defraud or w/ reckless disregard for the investor’s interests; and (3) the broker exercised control over the investor’s account. The Tenth Cir. held that P failed to establish the scienter element; Foulke properly disclosed all along.

i. Compare the Second Cir. test: (1) broker purchased unsuitable securities (2) knowing they were unsuitable.

8. Churning claims – P must prove: (1) trading in the account is excessive in light of the investor’s objectives; (2) the broker exercised control over trading in the account; and (3) the broker acted w/ intent to defraud or w/ willful disregard for the investor’s interests.

9. Violations of SRO rules – May be relevant to the scienter issue under Rule 10b-5.

C. Broker-dealer supervision and qualified immunity: SEA § 15(b)(4) allows the SEC to limit the activities of broker-dealers, even revoke their registration, if it finds, after notice and oppy. for a hearing, that such a measure would be in the public interest. Section 15(b)(4)(E) allows the SEC to get at one who “has reas. failed to supervise, with a view to preventing violations, … another person who commits such a violation, if such other person is subject to his supervision.”

Affirmative defense: (1) system of preventative procedures was in place, and (2) D had no reas. cause to believe that such procedures were not being complied with.

1. In the Matter of John H. Gutfruend, et al. (p.1426) – A Salomon trader submitted false bids in an auction for U.S. Treasury notes; Salomon’s response and subsequent supervision were deficient. Who is a supervisor under SEA § 15(b)(4)(E) – one who “has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.” The chief legal officer, who was part of a collective mgmt. decision re: the errant trader, was held to be a supervisor. He wasn’t just giving legal advice; he was organizing how employees at the firm would comply with the law. The other supervisors – Gutfreund, Strauss, and Meriwhether – were also held liable under § 15(b)(4)(E). The CEO and the president needed to take direct responsibility for addressing the matter (serious wrongdoing) and following up to make sure that proper steps in fact had been taken, even after delegation. The trader’s direct supervisor needed to continue with his supervising responsibilities until instructed to no longer do so.

2. Andrews v. Prudential Sec., Inc. (p.1442) – Ex-Prudential reps sued their former employer, claiming defamation, IIED, tortious interference w/ business relations, etc., in that it filed false Uniform Termination Notice of Securities Industry Registration forms (U-5 forms) w/ the NASD. Prudential disclosed on the forms that the reps had settled “an investment-related, consumer-initiated complaint” against them for $5,000 or more. The Sixth Circuit held that even though Prudential had solicited the customer claims (as a result of litigation against the firm) by sending out claim forms, the complaints were still “consumer initiated.” Prudential furthered the NASD’s purpose of the U-5 form filing requirement by informing the NASD of the conduct brought to its attention.

i. The NASD has proposed qualified immunity for broker-dealers for statements made on such forms. The SEC hasn’t adopted the proposal, but the Uniform Securities Act (2002) has (see § 507).

XV. Investment Advisors

A. Defn. of “investment advisor”: IAA § 202(a)(11) defines an investment advisor as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities…” The defn. excludes a lawyer or other professional “whose performance of such services is solely incidental to the practice of his profession as a lawyer, etc., and who receives no special compensation therefore.” The defn. also
excludes “the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation.”

1. **Lowe v. SEC** (p.1448) – D, as president and principal shareholder of Lowe Management Corp., defrauded investment clients. The SEC obtained an order revoking the registration of LMC and ordering D not to associate further w/ any investment advisor. Subsequently, D published investment newsletters and solicited subscriptions for a stock-chart service, which the SEC argued violated the order. The S. Ct. held: As long as the communications bet. D and his subscribers remain entirely impersonal (i.e., no personalized advice) and don’t develop into fiduciary, person-to-person relationships that are characteristic of investment advisor-client relationships, the publications are presumptively within the publisher exclusion.

2. Financial planners, brokers, dealers, professional persons – In borderline cases, have to (1) look at what services the person is in the business of providing and (2) distinguish bet. compensation for advice itself and compensation for services of another character to which advice is merely incidental.

**B. Scalping:** Scalping is the practice whereby an investment advisor purchases shares of a security for his own account shortly before recommending that security for long-term investment and then immediately sells at a profit upon the rise in the mkt. price following the recommendation.

1. **SEC v. Capital Gains Research Bureau, Inc., et al.** (p.1456) – The S. Ct. held that the SEC may obtain a preliminary injunction requiring an investment advisor suspected of scalping (a fraudulent practice) to disclose to his clients his dealings in recommended securities just before and after the issuance of his recommendations. For mild prophylactic measures like this preliminary injunction, the SEC doesn’t have to prove intent to injure or actual injury to a client. Ds’ contention that the recommendations were “honest” was no defense.

**XVI. Securities Attorneys**

**A. Dealing with out of control clients:** Below is a history of the development of the law.

1. **Rule 102(e)** – The SEC may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way. The bases specified for such a suspension or disbarment are that the person is found by the SEC: “(i) not to possess the requisite qualifications to represent others; or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the fed. securities laws.”

2. **Carter & Johnson** (p.1464) – Six months of melodrama in which lawyers were trying to tell a strong-willed CEO to disclose to the shareholders the truth about the company’s financial situation. The SEC said there was no violation of Rule 102(e) because the lawyers’ culpability fell short of “willfully aiding and abetting” the Nat’l Telephone’s material misrepresentations under (iii) and ethical/professional standards in this context weren’t well-developed enough at the time to justify a violation under (ii).

   i. Three-element test for aiding and abetting – (1) there exists an independent securities law violation committed by some other party; (2) the aider and abettor knowingly and substantially assisted the conduct that constitutes the violation; and (3) the aider and abettor was aware or knew that his role was part of an activity that was improper or illegal. For (3), have to show either conscious intent to assist violation or breach of a duty to disclose/act plus some lesser degree of scienter. The SEC found that the Ds didn’t have a duty and they didn’t have this conscious intent – “[r]ather, they seemed to be at a loss for how to deal w/ a difficult client.”

   ii. What steps can lawyers take to persuade a client to avoid/terminate proposed illegal action? Can approach the board of directors, or one or more individual directors or officers. Can appeal to other members of the law firm’s mgmt. for help. Prompt
action is required, but it’s up to the lawyers to decide what’s appropriate. If the situation is egregious, the lawyers can resign; but be careful b/c resigning is, in effect, reporting.

3. Old ABA Rule 1.6 – In 1983, the ABA promulgated new model rules, which were very weak. A lawyer “may” report out only if there’s a threat of “imminent death or substantial bodily harm.” Otherwise, a lawyer cannot reveal client confidences. Designed to promote full and open atty-client communication. Very few states followed this rule.

4. Sarbanes-Oxley, § 307 – When there’s “evidence of a material violation of securities law or breach of fiduciary duty or similar violation,” an atty is required to report up, first to the chief legal officer or the CEO and then (if they don’t appropriately respond) to the audit cmte. of the board or to the board. The SEC has yet to make rules and regulations under section 307.

5. Amended ABA Rule 1.6 (2003) – This year, by a very narrow vote, the ABA amended 1.6(b) to say that an atty may reveal info relating to the representation of a client if the lawyer reas. believes it necessary to prevent the client from committing a fraud that’s reas. certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer’s services. Atty. may also reveal confidential info to prevent, mitigate, or rectify injury. 1.6 remains a permissive standard, but hopefully the changes will placate the attys w/ consciences and, more importantly, the feds. If clients start demanding ironclad confidentiality agreements upfront (e.g., no reporting out unless required by law), firms can charge omerta fees and donate the proceeds to fund ethics chairs at law schools…

6. SEC Part 205 – Standards of professional conduct for attys practicing before the SEC.
   i. 205.3(b) – If an atty becomes aware of evidence of a material violation, the atty shall report such evidence to the issuer’s chief legal officer (CLO) or to both the CLO and the CEO. The CLO shall cause inquiry and, unless the CLO reas. believes that no material violation has occurred, is ongoing, or is about to occur, the CLO shall take all reas. steps to cause the issuer to adopt an appropriate response. Either way, the CLO has to report back to the atty. If the atty believes the CLO’s response was inadequate, or the atty believes reporting to the CLO and/or CEO is futile, the atty shall report to the audit cmte., an independent board cmte., or the board.
   ii. 205.3(c) – An issuer may form a qualified legal compliance committee (QLCC) pursuant to 205.2(k). The QLCC is designed to be an independent investigatory body within the firm. Atty would just have to report to the QLCC. How many firms will create the QLCC? Potentially expensive b/c QLCC may hire special counsel.

XVII. Corporate Officers and Directors

A. Books and records, Foreign Corrupt Practices Act of 1977, SEA § 13(b)(2), Rule 13b-2:

   Every reporting corp. must (A) keep accurate books and records reflecting the transactions and dispositions of the assets of the issuer, and (B) maintain a reliable and adequate system of internal accounting controls. Rule 13b-2 prohibits corp. officers or directors from making materially false or misleading statements or omitting to state material facts “to an accountant in connection w/ (1) any audit or examination of the financial statements of the issuer … or (2) the preparation or filing of any document or report required to be filed w/ the SEC.” This creates a second or internal audit system to buttress the external auditor. SEC enforces; no private cause of action.

1. SEC v. World-Wide Coin Investments, Ltd. (p.1507) – SEC sought a permanent injunction against World-Wide and individual Ds as well as an order for a full accounting and disclosure of wrongfully received benefits. After Hale took over the mgmt. and control of World-Wide, the business was managed extremely poorly. Inventory problems, no separation of duties, incomplete and disorganized books and records. “Sheer chaos.”
Holding: Ds violated all provisions in SEA § 13(b)(2). Even though this was a small company, it was the lack of any control over the inventory and the inadequate accounting procedures which led to World-Wide’s demise. Can’t ignore FCPA completely. Plus, common sense dictates the need for such internal controls and procedures in a business with an inventory as liquid as coins, medals, and bullion.

i. What are records – “any tangible embodiment of information made or kept by an issuer.” Corporate transactions should be recorded in a journal.

ii. Accuracy of records – records need to include transactions, or economic events, in reasonable detail.

iii. What is an accounting system – system that processes, classifies, summarizes and reports transactions.

iv. What are internal accounting controls – system that safeguards assets, reviews financial records for reliability, ensures that the accounting system is working properly.

v. Factors in evaluation of a company’s internal controls – supervision of personnel, segregation of custodianship and authorization functions, periodically there should be comparison of accounting records with actual inventory of assets. Evaluation is subjective; reason to do a cost-benefit analysis when designing internal controls. BUT – can’t skimp on internal controls if the reason for your company’s unprofitability is pilfering. See holding.

vi. Materiality – keep in mind, materiality in proportion to the size of the company.

B. Executive certification of filings, Sarbanes-Oxley, § 302: Principal executive officers and principal financial officers of reporting companies now have to certify quarterly and annual reports. Reinforces their existing duties. Rule 13a-4 specifies what they have to certify. The term “disclosure controls and procedures” means essentially the same thing as “internal controls,” refers to a company’s system for ensuring that info that’s required to be disclosed is done so in a timely manner.

C. Audit committees, Sarbanes-Oxley §301, SEA §§ 10A(a),(k),(m): SROs required to de-list issuers that don’t have proper audit committees. An issuer’s audit cmte. is to be composed of independent (outside) directors, incl. at least one person who’s financially literate. The accounting firm is required to report to the audit cmte. all critical accounting policies and practices to be used, all alternative treatments of financial information, and other material written communications (esp. “mgmt. letters”) bet. the accounting firm and the mgmt. of the issuer. The audit cmte. is directly responsible for the appointment, compensation, and oversight of the issuer’s accounting firm. Cmte. empowered to hire outside auditors and outside counsel w/o asking permission of CEO and CFO.

D. Recently adopted NYSE and NASD rules of corporate governance: Attempt to change the power relationship bet. the CEO and the board.

XVIII. SEC Remedies (Civil Injunction Proceedings and Administrative Proceedings)

A. Injunctions and ancillary relief (freeze orders, disgorgement, appointment of Special Agent): With respect to injunctions, cts. assess the likelihood of future violations: (1) whether the D committed a violation; (2) the degree of scienter involved in the violation; (3) whether the violation can be properly characterized as an isolated occurrence; (4) whether the D has acknowledged the wrongfulness of the conduct and given assurance that the violation will not be repeated; and (5) whether the D’s occupation puts him or her in a position to commit further wrongs.

1. SEC v. Unifund, SAL (p.1524) – Unifund and Tamanaco, two investment companies, appealed a preliminary injunction obtained by the SEC against them in an insider trading case. The injunction (a) prohibited further violations of the fraud provisions, (b) froze Ds’
accounts, subject to trading approved by the SEC, and (c) barred disposal or alteration of Ds’ books and records. The Second Circuit held:

i. (1) To obtain a preliminary injunction, the SEC must establish a prima facie case of a violation and a reas. likelihood that the wrong will be repeated.

ii. (2) The SEC failed to establish a prima facie case for insider trading b/c it didn’t identify the person or entity alleged to have conveyed inside info to the Ds, so the ct. couldn’t see the breach of duty claim. Speculation based on circumstantial evidence isn’t enough.

iii. (3) The freeze order, to facilitate enforcement of disgorgement and civil penalty remedies (penalty of 3x profits) that might be ordered in the event a violation was established at trial, was warranted. But it was modified so that Ds could keep trading in their accounts, so long as they maintained enough to cover the remedies that might be ordered. And if they failed to maintain their account balances at or above the requisite amt., then the SEC could impose its restriction on permissible trading. This gave the SEC some security w/o unduly burdening the Ds by denying them the oppty. to invest as they saw fit. Also, the freeze order was limited to 30 days.

2. SEC v. First Jersey Securities, Inc. (p.1532) – First Jersey was a discount broker-dealer, and it sold to its customers securities at illegal mark-ups w/o disclosing the mark-ups. First Jersey and its director/chairman/CEO/sole-shareholder Brennan appealed a judgment (a) ordering Ds jointly and severally to disgorge profits from fraudulent activities plus prejudgment interest; (b) enjoining them from further securities laws violations; and (c) appointing a Special Agent to determine whether, in 1982-1987, Ds had committed violations beyond those proven at trial. The Second Circuit held:

i. (1) Once the dist. ct. has found fed. securities law violations, it has broad equitable discretion to fashion appropriate remedies, incl. ordering disgorgement of profits. The primary purpose of disgorgement as a remedy is to deprive violators of their ill-gotten gains; it’s a deterrence tool. That Ds already settled a class action to reimburse defrauded customers doesn’t mean that disgorgement is inappropriate; “[s]ince disgorgement is a method of forcing a D to give up the amt. by which he was unjustly enriched, it’s unlike an award of damages.” But the discount for the settlement was reas. Also, it was proper for Brennan to be held jointly and severally liable w/ First Jersey to the disgorgement order, given that he was a controlling person.

ii. (2) Permanent injunctions are appropriate when there’s systematic wrongdoing, as opposed to an isolated occurrence, and the Ds refuse to admit any wrongdoing – b/c then there’s a likelihood that, unless enjoined, the violations will continue.

iii. (3) Neither the SEC nor the ct. had the authority to appoint the Special Agent – SEC can’t appoint someone to unearth claims not previously pursued by the SEC, and ct. can’t appoint someone to investigate past acts in order to recommend new charges.

B. New statutory remedies (monetary penalties, cease and desist orders, corporate bar orders): With respect to monetary penalties, SEC must determine whether a penalty is in the public interest. Factors relevant to the determination: (1) whether the act/omission involves fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the resulting harm to other persons; (3) the extent of any person’s unjust enrichment (any restitution being taken into account); (4) the degree of recidivism; (5) the need to deter the D and others; and (6) other such matters as justice may require. With respect to cease and desist orders, the SEC may proceed against anyone SEC suspects has violated or is about to violate the fed. securities laws, and order the person to cease the violation, disgorge profits, and take affirmative steps to comply w/ the
securities laws. SEC can also issue a temporary cease and desist order w/o notice and w/o a hearing. With respect to corporate bar orders, SEC may bar an individual from serving as an officer or director of any publicly reporting corp.

1. *Valicenti Advisory Serv., Inc. v. SEC* (p.1548) – Valicenti was the president/sole owner of Valicenti Advisory Services (VAS), an advisory org. registered w/ the SEC. It sold securities to clients w/ fraudulent misrepresentations in marketing materials. The SEC sanctioned Valicenti and VAS w/ a censure, a cease and desist order, and individual fines, and it required them to send copies of the SEC’s opinion and order to all existing clients and, in the following year, all prospective clients. The Second Circuit held: These remedies were all justified in light of the finding that Ds acted w/ intent to defraud. In particular, the distribution requirement was rationally related to the Ds’ misconduct and wasn’t too harsh. It informed Ds’ clients so that they could decide whether to continue doing business w/ Ds, and it discouraged Ds from committing further violations. Also, it wasn’t imposed in a discriminating manner.

2. *SEC v. Patel* (p.1551) – D was the founder/director/senior-VP-for-R&D of Par Pharmaceutical, a company that submitted to the FDA an application for approval of a drug incl. false statements. D sold his stock in Par before a disclosure that the application had been falsified. The SEC obtained a judgment against him which permanently enjoined him from future securities law violations, ordered him to disgorge illegal profits plus prejudgment interest, and barred him from serving as an officer or director of any public company. The Second Circuit held: To permanently enjoin D from serving as an officer or director of any public company, the SEC needed to show that D was substantially unfit to hold such positions. Six factors in the determination of substantial unfitness: (1) the egregiousness of the underlying securities law violation; (2) D’s repeat-offender status; (3) D’s role or position when he engaged in the fraud; (4) D’s degree of scienter; (5) D’s economic stake in the violation; and (6) the likelihood that misconduct will recur. The district ct.’s findings – “D was a founder of Par and used his position as an officer and director to engage in misconduct” – were *insufficient* to justify the imposition of a lifetime ban (loss of livelihood, stigma). The findings don’t justify the prediction that future misconduct will occur. Should have considered a conditional bar (e.g., limited to a certain industry) and/or a bar limited in time (e.g., 5 yrs.), esp. where there’s no prior history of unfitness.