Securities Regulation Outline

INTRODUCTION

Two Statues govern this area of law:

(1) Securities Act of 1933

- enacted in response to '29 crash
- policy of regulation through disclosure
- requires registration of securities

(2) Securities Exchange Act of 1934

- deals with regulation of security exchanges
- once you have disclosed under the '33 Act you have continuing regulation under the '34 Act
- act seeks to insure fair and orderly securities markets by prohibiting certain types of activities and by setting forth rules regarding the operation of the markets and participants

Securities and Exchange Commission (SEC)

- administers federal securities law and issue rules and regulations to provide protection for investors
- independent commission
- 5 members serve staggered five year terms
- no more than 3 members of the same party

PURPOSE Registration is intended to provide adequate and accurate disclosure of material facts concerning the company and the securities it proposes to sell.

Division of Corporate Finance (of the SEC)

- ensures disclosure requirements are met (executive role)
- interprets security laws (judicial role)
- drafts rules and regulations (legislative role)

In administering the securities statutes, the Commission issues a large number of rules and pronouncements:

Releases: a type of pronouncement in which the Commission interprets rules and statutes that have been brought to their attention, do not have force of law but are given that effect as a practical matter

No-action letter: is only binding upon the person to whom the letter is issued – if action recommended is taken then the SEC will recommend to the Commission that no action be taken – however this does not preclude someone else in Commission from taking action

Note: one reason for the '29 crash was that shares were overvalued because investors did not have a lot of info on the companies – this is why the emphasis of the '33 Act is on disclosure

Financial info is the big component of the disclosure requirement. The info is disclosed through a registration statement. The most prominent form is the S-1. The prospectus is contained in the registration statement.

BUSINESS CONTEXT OF SECURITIES ACT REGISTRATION

"Going public" is the transformation of a closely held corporation to one in which the general public has a proprietary interest

A company goes public by selling its securities (*primary offering*) or by having present shareholders sell their securities to the public (*secondary offering*)

Both offerings are accomplished by means of a registration statement filed with the SEC pursuant to the '33 Act

Investment banking: term used to encompass such functions as acting as underwriter, dealer, broker, or market maker (see text p.29)

Underwriting: the function of helping a company, or one or more of its major shareholders, sell securities to the public through an offering under the Securities Act

Three types of underwriting: (text p.28)

(1) *Firm Commitment underwriting*: underwriter purchase securities from a company at an agreed price and then attempts to resell securities to the public.
(2) *Best efforts underwriting*: underwriter agrees to use its best efforts to sell an agreed amount of securities to the public
(3) *Standby underwriting*: company directly offers its existing security holders the right to purchase additional securities at a given price

If a company decides to go public, the management goes to investment bankers who agree to underwrite the stock offering – that is to buy all the public shares at a set price and resell them to the general public, hopefully at a profit. The underwriters help the company prepare a prospectus, a detailed analysis of the companies financial history, its products and services, and management's background and experience

The primary reason for going public is too obtain new capital. Other reasons include:
- Obtaining negotiability for securities
- Obtaining future capital on more favorable terms
- Prestige

Disadvantages of going public include:
- Expenses
- Additional disclosure obligations
- Market expectations may deter a company from making long-term investment decisions
- Loss of control
- Higher estate tax valuation

Some Definitions:

Dealer: refers to a firm when it buys and sells securities for its own account

Broker: refers to a firm when it buys and sells as an intermediary for a customer

Secondary market: market in which securities that have been bought and sold are traded – brokers and dealers make the trades in this market

Transfer agents: individuals who keep track of the stock ownership record – who owns what and how much

REGULATORY FRAMEWORK OF SECURITIES ACT REGISTRATION

Pre-Filing Period

There are three time periods in an offering:

(1) **pre-filing period** – period before a registration statement is filed

(2) **the waiting period** – the period after filing but before the registration statement becomes effective

(3) **post-effective period** – the period after effectiveness

These periods are important because you can't do publicity by virtue of a press release or other means – you have to use a prospectus – but cannot use prospectus until registration is filed

§5(c) "It shall be unlawful; for any person … to offer to sell or offer to buy … any security … unless a registration statement has been filed as to such agency"

§5(a) unless a registration statement is in effect it is unlawful to sell a security (there are exceptions to this rule – e.g. for small businesses)

Rule for the pre-filing period: no offers, no sales

It is a broad prohibition

What is an offer?

Is not a contracts definition of offer

Includes almost any insinuation

§2(a)(3) "the term offer to sell, offer for sale, or offer shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value

The test is whether the conduct has conditioned the public mind by generating an interest in securities

see examples on pg. 42

In Re Carl M. Loeb, Rhoades & Co. Arthur Vining Davis, a corporation with real estate holdings, incorporated Arvida. Davis planned to transfer the holdings to Arvida and then offer Arvida securities publicly. Before the filing of a registration statement, representatives of Davis issues press releases to inform the public of Davis' plans and to generate interest in

the offering. The SEC held that the press releases violated § 5(c) of the Securities Act.

In response to *In Re Carl M. Loeb, Rhoades & Co.* many companies refused to answer legitimate questions from stockholders, financial analysts, the press or other persons. The SEC released Securities Act Release No. 5180 to assure companies that factual information about the company's financial condition and business operations may be conveyed without violating the Securities Act.

Release No. 3844: publicity and public relation activities under certain circumstances may involve violations of the securities laws (text p.41)

There are two ***exceptions*** to the publicity prohibition:

1. Rule 135 (rulebook p.54) Notice of Proposed Registered Offering: provides a safe harbor and says that if you are going to say you might have an offering – you can do it by complying with 135 – If you comply with the rule then you will be protected -- allows the basic information of the offering to be advertised.

2. Company can still continue to engage in **past advertising practices** (but if it looks like you are engaging in publicity that you have not done in the past you will be in violation)

Rule 137: if a broker regularly publishes info/reports, and it is **not a part of** an issue, and he receives no compensation from participant in the distribution, he can publish written opinions

Rule 138: (is participant) can still recommend non-convertible stock

Rule 139: (is participant) any dealer can recommend a security as long as its last report was equally or more favorable to the issuer (underwriters often have analyst departments) plus registrant of securities must have been on market for at least 12months

Waiting Period

During the waiting period, §5(a) continues to apply, prohibiting all sales

§5(b)(1) becomes applicable: which makes it unlawful to transmit a prospectus relating to any security unless the prospectus meets the requirements of section 10

§2(a)(10) defines a ***prospectus*** as a written offer or confirmation of sale – specifically it means "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

Key language: written communication or communication by radio or television

Moreover, a prospectus shall contain the information contained in the registration statement (however, some info is unknown at the time of filing and hence a preliminary prospectus may contain omissions or contents may later be changed)

In SUM: during the waiting period, no offer, in writing or by radio or television, may be made except by a section 10 prospectus or a communication meeting the requirements of

exception (b) to sec. 2(a)(10). The sections prohibit confirmations of sale. The prohibition on oral offers is lifted.

So can have: ORALS OFFERS

Rule 134: you can have a tombstone as long as it meets the requirements of Rule 134

You can't deliver a prospectus unless it meets the requirements of §10 (which basically requires it to contain the info in the registration statement)

During the waiting period, underwriters try to sell securities and give out prospectuses but you cannot have a contract for a sale

§5(b)(2) It shall be unlawful for any person, directly or indirectly-- to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10 of this title.

What is a sale?

2(a)(3) defines sale as "every contract of sale or disposition of a security or interest in a security, for value"

Ordinary offers should not be made in the waiting period, rather offerors should condition their offers in such a way that they cannot be accepted until the registration statement is effective – so firms often make conditional offers and collects "*indications of interest*"

In Re Franklin, a securities firm was accused of selling unregistered securities in violation of §5(a)(1). Two violations: (1) salesman sent customer a preliminary prospectus and enclosed his business card, which instructed customer to contact him as soon as possible. Since business card was enclosed with the preliminary prospectus it is considered a prospectus and must comply with the requirements for a preliminary prospectus (§10).(2) the salesmen accepted orders for the stock prior to effective date of registration – (accepted checks that said they were for a number of shares of the stock.) though they invited "indications of interest" they accepted payments for the stock during the pre-effective period – and therefore went beyond the permissible scope of the Act. (contract for sale in violation of §5(a)(1))

What is a prospectus?

Under §2(a)(10), without the exceptions, any written offer, offer by radio or television, or confirmation of sale is a prospectus

§5(b)(1) makes it unlawful to transmit any prospectus after the filing of the registration statement unless the prospectus contains the info called for by §10

Exceptions: certain written offers in the waiting period are deemed not to be prospectuses and therefore are allowed. Written communications that meet the requirements of **Rule 134** are allowed, common examples include: press releases, tombstones, and letters

You are allowed to disclose names, dates, name of issue, title of security, and other such info – this is usually done in a tombstone

SA 10(b) provides that the Commission may permit the use of a prospectus which omits or summarizes some of the info required by §10(a) – these are called **summary prospectuses** and there are two types

Rule 430: allows offering price and related info to be omitted from a prospectus used prior to the effective date – special legend must be printed on the preliminary prospectus – Red line prospectus

Rule 431 – is a true summary prospectus but is only available for '34 act companies

Preliminary Prospectus Delivery Requirements

§5 allows, but does not require, that preliminary prospectuses be distributed during the waiting period

The commission tries to force distribution of prospectuses by two means:

1. Acceleration:
2. Exchange Act **Rule 15c2-8** requires underwriters and dealers to take reasonable steps to furnish copies or preliminaries to any person who makes a written request and salesmen must have copies, the managing underwriter must provide other underwriters and dealers with sufficient copies

Release No.4968: No acceleration unless preliminary prospectus is distributed to underwriters and dealers. Commission will also consider whether preliminaries have been furnished to those persons who may reasonably be expected to be purchasers of securities

Note: delivery of prospectuses can be made through electronic means (e-mail)

Look at problem on page 56

Post Effective Period

Except for a few exceptions, in the post-effective period the only prospectus that satisfies the requirements of §10 is the final prospectus called for by 10(a)

Free writing: an exception that provides that a communication is not deemed a prospectus when it is accompanied or preceded by a prospectus that meets the requirements of 10(a)

As a practical matter, a security may not be delivered to a buyer unless the buyer simultaneously receives, or has received, a copy of the final prospectus

Oral offers may be made during this period

Defective prospectus: *What if the final prospectus is defective*? One court (*Manor Nursing*, text p.73) held that a defective prospectus is materially false and misleading – which is a violation of §5(b)(2). Thus, a defective prospectus also violates the antifraud provisions of the Act.

Final Prospectus Delivery Requirements

Under §5(b)(2), a final prospectus must be delivered along with the security purchased, unless the security has been preceded by a copy of this prospectus

Confirmation of sale must be accompanied with a final prospectus §4(3)

Prospectus must be delivered:

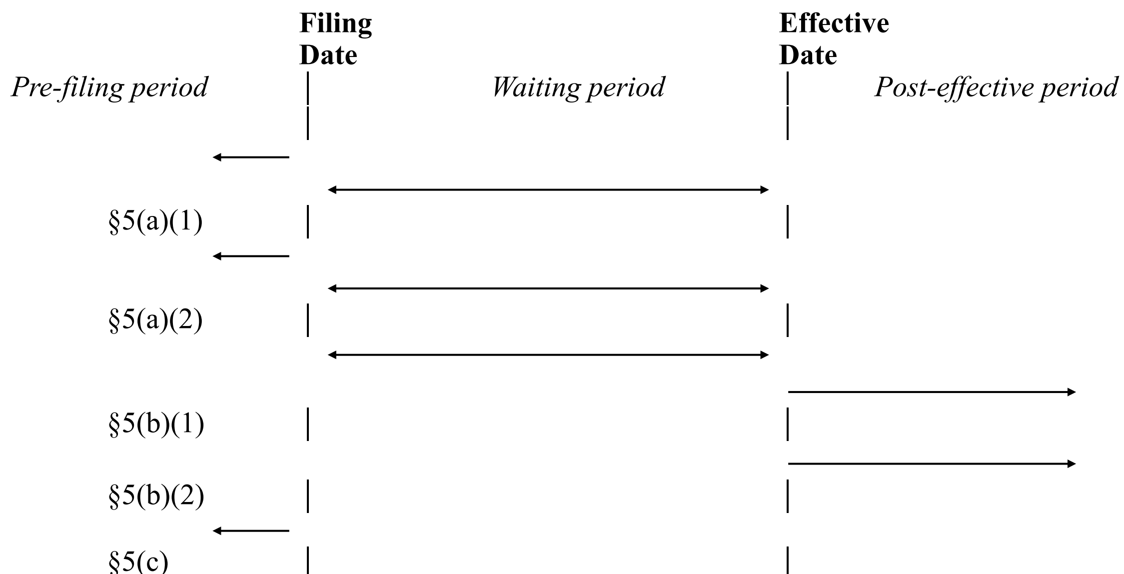
(1) on any sale of securities which are part of the underwriters original allotment which have not yet been publicly sold
(2) on nay resales by dealers, for a specified period after the commencement of the offering, of securities sold to the public and repurchased by the dealer (40 days if issue has had prior registered offering – 90 days if not))

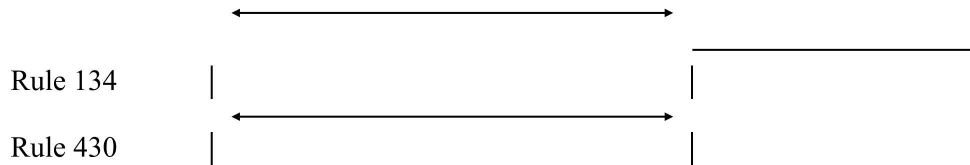
Exemptions:

- §4(1) exempts sales by anyone who is not an "issuer, underwriter, or dealer"
- §4(3) exempts all sales by dealers (except for 1 and 2 above)

However, the SEC has adopted **Rule 174**, under which a dealer need not deliver a prospectus on any resale of a security of an issuer which, prior to filing, was already subject to the reporting requirements of the '34 act

TIMELINE:





§5(a)(1): unless registration is in effect ***cannot sell*** securities or send through mail
§5(a)(2):
§5(b)(1): prospectus must meet requirements of §10
§5(b)(2): sales must be accompanied by a prospectus
§5(c): no offers can be made before you file a registration statement
Rule 134: written offers that meet the requirements of this rule are not considered a prospectus
Rule 430: preliminary prospectuses must conform to this rule
Rule 431: summary prospectus may be used at anytime – must meet requirements of rule

SECURITIES ACT REGISTRATION PROCESS

Registration Statement Preparation and Processing

§6 provides that

1. securities may be registered by fling a registration statement wit the Commission
2. specifies who must sign
3. sets out formula for registration fee

§7 deals primarily with what a registration statement must contain

Form S-1 : the general registration form
Form S-2: only available for issuers who have been subject to the 34 Act for at least 12 months
Form S-3: used in business combinations

Securities may be registered by filing a registration statement with the commission

Who must sign? CEO, chief financial officer, comptroller and a majority of directors (they are then liable for the contents of the statement)

Review and comment procedure: registration statements of first time issuers are given a thorough review by the commission and comments are then made by letter.

When the Act first became effective, the commission made a decision, instead of issuing stop orders, they would issue deficiency/comment letters that outline suggested changes to be made

There is no legal consequence to not making suggested changes, but commission can then start an investigation (during which you cannot make offers) or issue a stop order

If they do not start investigation or issue stop order, statement will become effective in 20 days

§8(a) provides a twenty day automatic effectiveness from date of filing but the review and documents procedure cannot take place during that short amount of time so companies file a ***delaying amendment*** (p.84)

> **Rule 473**: deals with delaying amendments – it allows issuer to opt out of the 20 day scheme
>
> **Rule 461** – deals with requesting acceleration: is to be made by the managing or principal underwriters – can be oral (see other requirements – rulebook p. 144)

The commission has the power to accelerate the twenty day period, the commission uses the threat of acceleration denial to force actions not required by the statute. The Commission dislikes indemnification provisions (provisions that require issuer to indemnify officers and directors) and will use its acceleration power to require the issuer to include a statement requiring a court test before paying any indemnity.(regulation S-K 5-12(h) is the provision about indemnity clauses)

However, the issuer has the right to go for twenty day effectiveness and not use a delaying amendment or ask for acceleration

> In *Las Vegas Development Co. v. SEC*, the company filed a registration statement and received comments from the Commission. The company did not want to comply with some of the comments so decide to go for twenty day effectiveness. The commission then initiated a "public examination", during which sales are blocked. The company filed complaint and sought a declaration that section of Securities Act of 1933 empowering Commission to make examination to determine whether stop order should issue could not be utilized by Commission to delay indefinitely their sale of securities, and defendants filed motion to dismiss, or in the alternative, for summary judgment. The District Court held that: (1) judicial proceedings could be invoked by registrant to question length of investigation conducted pursuant to power of commission to determine whether stop order should issue; (2) plaintiff registrant sufficiently alleged that it had exhausted its administrative remedies; (3) registrant, which did not allege that Commission's determination of whether to institute stop order proceeding had been "unreasonably delayed," and other two complainants, who alleged only that they had received offer to participate in registrant company as limited partners and were precluded from doing so because of Commission's examination, failed to state a claim upon which relief could be granted, and (4) Court was without power to delineate scope of examination conducted by Commission to determine whether stop order should issue.

The commission can issue refusal and stop orders.

The commission usually uses "stop orders" rather than "refusal orders"

§8(e) allows the commission to commence investigation to see if it should issue stop orders – the investigation has to end at some point

However, because of the Commissions review and comment procedure, refusal and stop orders are rarely used to prevent the effectiveness of a registration statement

When the Commission and an issuer cannot come to terms on a registration statement, voluntary withdrawal is the likely result.

Going Public

The securities of a company going public must be qualified under the "Blue Sky" or securities laws of each state in which they are intended to be offered (unless preempted by federal law or there is an exemption under state law)

NASD clearance: The registration statement and underwriting agreements must be filed with the National Association of Securities Dealers, Inc. so that it may determine whether the underwriting agreements are fair and reasonable

A binding legal agreement between the underwriters and the company occurs only on the morning of the date the registration statement is to be declared effective by the SEC

SEC Disclosure Requirements

In Re Universal Camera Corp., the company sought to dismiss a stop order proceeding. The company made cameras and binoculars and for the past four years enjoyed numerous war product contracts. The company sought to offer some shares and most of the proceeds from the offering would go to current shareholders. The court states that *the registrant is under a duty to describe the speculative features of the offering in the registration statement and the prospectus so clearly that they will be plainly evident to the ordinary investor*. Here, the company did not state that the new stock would have no asset value, that previous good earnings were due to war contracts, that current shareholders would receive most of the proceeds, and that post war market for binocular will be very limited. However, the company filed amendments and made modifications to correct the deficiencies, therefore there is no necessity for a stop order.

In Re Texas Glass, in its prospectus the company stated that prior sale of securities were made pursuant to an exemption. The SEC concluded that the exemption was not available and wanted to issue a stop order. The court concluded that it was materially misleading for the prospectus to state that the prior sales of securities were made pursuant to an exemption under Section 3(a)(11) of the Act and that the financial statements included in the prospectus were misleading in failing to disclose that there was at that time a contingent liability under Section 12(1) of the Act arising from the sales of unregistered securities.

The examiners task under securities law is to obtain full and fair disclosure.

In order to avoid delays the securities lawyer must anticipate the examiners comments (p. 111-113 lists some comments to anticipate)

Integrated Disclosure system

The '33 act regulates registration while the '34 act regulates trading, exchanges and public companies – both require disclosure

Form S-1 is the general catch-all form to be used in making disclosure – it contains the commissions most extensive disclosure requirements

Unless you qualify for another form you have to use S-1

"Seasoned" companies can use form S-2 – it is simpler and will incorporate other documents by reference. In order to use S-2 you must be a US company, already registered under the '34 act, timely file reports, recent history free of default or indebtedness, and have missed no preferred stock dividends

S-3 form

Forms S-2 and S-3 decrease the burden of "seasoned" companies

SB-1 and SB-2 are special forms that make registration easier and less expensive for small issuers

REACH OF SECURITIES ACT REGULATION

What is a Security?

§2(a)(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting- trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Interpretive questions under these provisions have generally involved three different types of instruments:

(1) instruments technically denominated "stock" or "notes", but issued for non-investment purposes (*Forman* case, *Reves* case)

(2) special types of investment instruments issued by financial institutions, such as insurance companies and savings and loan associations, and

(3) instruments evidencing investments in profit-seeking undertakings, which are not in the form of stock, notes or other traditional securities (*Howey* case, *Teamsters* case)

Investment Contract

The term investment contract has caused a lot of confusion since the term has no meaning in a commercial context, it is a legal construct

In *SEC v. Howey Co*., (involved warranty deed)the company was offering ***units of a citrus grove development*** coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor. (Investors would buy an acre of land and service contracts) The SEC claimed that this was the offer and sale of unregistered securities in violation of §5(a). The legal issue in this case turns upon a determination of whether, under the circumstances, the land sales contract, the warranty deed and the service contract together constitute an

'investment contract' within the meaning of § 2(1). The court holds that *an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.* The transaction here was an investment contract.

Future cases have not disputed the validity of the *Howey* test, but have construed it differently.

Elements of the test for determining the existence of an investment contract:

1. investment of money (gave money through contracts)
2. common enterprise (losses and profits were based on how everyone did)
3. expectation of profits
4. solely from the efforts of others (investors had no right to go on the land or to receive specific fruit – relied on others)

Investment of money and expectation of profits

There are two ways to get profits: dividends and/or appreciation in capital

In *United Housing Foundation, Inc. v. Forman*, the issue was whether shares of ***stock entitling a purchaser to lease an apartment in Co-op City***, a state subsidized and supervised non-profit housing cooperative, are "securities" within the purview of the '33 and '34 act. The court first holds that such shares are not "stocks." The court notes that the name given to an instrument is not controlling and that the shares had *none of the normal characteristics associated with stocks* – no voting rights, no dividends, cannot appreciate, non negotiable. The court holds that the shares are not investment contracts either. Investment contracts are investments entered into with a reasonable expectation of profit. Here, investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments.

The word "stock" or "security" is not controlling – the emphasis is on the economic reality

In *International Brotherhood of Teamsters v. Daniel* the court considered whether a noncontributory, compulsory pension plan constitutes a security with the meaning of the securities laws. The court cited the *Howey* test and held:

(1) that there was no investment of money by the employees because the employer makes the payments. In addition, the payments were not made on behalf of any employee because there was no obligation to pay to any particular employee.
(2) That there was no expectation of profit from a common enterprise because the employees did not profit from the financial health of the fund but rather from meeting the eligibility requirements. (here it did not depend on the efforts of others)

Common Enterprise and Solely from the efforts of others

The *Howey* requirement that profits come "solely" form the efforts of others has led to decision holding the securities laws inapplicable to ***franchise arrangements*** where the investor takes an active party in the business

However, courts have modified the interpretation of the word "solely" to reach fraudulent ***pyramid sale schemes*** in which the investor does have to exert some "efforts" in soliciting other persons to participate in the scheme, but where "the efforts made by those other than the investor are the undeniably significant ones":

> In *SEC v. Koscot*, the SEC brought action against corporation and others to bar them from marketing products through program characterized as a pyramid selling scheme. The court held that (1) in determining whether a promotional scheme constitutes an investment contract, the critical inquiry is whether the efforts made by those other than the investors are the undeniably significant ones-- those essential managerial efforts which affect the failure or success of the enterprise, and (2) the pyramid selling scheme in question constituted an 'investment contract' for purposes of the securities laws, notwithstanding promoters' claim that profits were not derived solely from the efforts of individuals other than the investors, where the promoters retained immediate control over the essential managerial conduct of the enterprise and where the investors' realization of profits was inextricably tied to the success of the promotional scheme. (here there was "vertical commonality" between the individual investor and the manager)
>
> In *SEC v. Life Partners*, the company was in the business of ***marketing fractional interests in viatical settlements*** (insurance policies on the lives of the terminally ill). The issue was whether the interests were securities – were the profits derived from the efforts of others? Court said that the company only performed "pre-purchase" efforts and with any "post-purchase" efforts the interests cannot be considered a security. The "efforts of others" happened before the sale. Therefore, there was no common enterprise.

Evidence of Indebtedness

Evidence of indebtedness is another broad term used in the §2(a)(1) definition of a security

> In *US v. Jones*, the question was ***whether an airline ticket was a "security***. An airline employee had been forging tickets, and SEC argued that since the tickets are redeemable for cash, it is an "evidence of indebtedness" and therefore a "security." Court disagreed and held that the term "evidence of indebtedness" embraces only such documents as promissory notes that on their face establish a primary obligation to pay holders thereof a sum of money. Since airline tickets do not establish a primary obligation to pay money, they are not evidences of indebtedness.
>
> Rule: the instrument must establish an obligation on its face
>
> Note that in holding that an evidence of indebtedness is the same as a promissory note (as *Jones* held) appears inconsistent with the statutory scheme that includes both notes and evidences of indebtedness in the definition of securities.
>
> *In re Tucker Corp*., the company sold ***car franchisees which required a $25 deposit per car with a promise of repayment in the future***. SEC held that since

the franchise agreements provides for the repayment of deposits received they were "securities" and required registration.

In *Procter and Gamble v. Bankers Trust*, the issue was whether "***interest rate swap agreements***" were securities? Procter argued that they were "evidence of indebtedness" because they contain bilateral promises to pay money and they evidence debts between the parties. Court held that they were not "evidence of indebtedness" as they do not involve the payment of principal, which is an essential element of debt instruments

"Unless the Context Otherwise Requires"

The phrase begins the definitional section of both acts

The phrase has sometimes been used to find that a security does not exist – usually in order to reflect economic reality or to prevent double regulation

For example, in *Marine Bank*, the Supreme Court held that a ***regular bank certificate of deposit is not a security*** since the holders "are abundantly protected under the federal banking laws." – the context of the situation does not require registration because the bank is a national bank that is already regulated and federally insured

Court have extended this analysis to two questions: (1) whether the sale of a business, which is consummated by the sale of stock of the Corp that conducts the business involves the sale of a security and (2) whether promissory notes are securities

Sale of a Business

Under the "*Sale of a business doctrine*" when a corporate business is sold by means of a sale of the corp stock the stock is not a security as the term is used in the securities act

The rationale was that from a business standpoint a stock sale and an assets sale look very much the same. By considering the stock sale a "security", the sale would be subject to all of the registration and anti-fraud requirements while an asset sale is only subject to common law fraud rules

In *Landreth Timber Co. v. Landreath*, shareowners of a timber company offered the stock for sale. Some investors bought all of the stock. However, investment went sour because some costs exceeded estimates and other problems arose. The purchasers argued that the sellers had failed to state material facts in violation of the Securities Act. Sellers argued that under the "sale of business" doctrine, no security had been purchased so the Act did not apply. The court rejects the doctrine and holds that a sale of securities which had all the attributes commonly associated with "stock" was a sale of a "security" within the meaning of the federal securities laws, regardless of the purpose of the transaction or the percentage of the securities being sold.

Thus, the U.S. Supreme Court has repudiated the sale of business doctrine.

The court did not apply the *Howey* test as that test is only relevant to "investment contracts" – instead the court applies a **"stock is stock" test** whereby the court looks to see if the instrument in question has the traditional characteristics of stock (for a list of characteristics see page 154)

Note: sellers always want to sell stock as they get rid of all the assets and liabilities plus they can get LTCG tax treatment. Buyers always want to but assets since it limits their liability and they can cherry pick assets and liabilities (you should sell assets if you want to avoid SA)

Promissory notes

The term note is mentioned in the definition of a security, but certain notes are not securities

The following case sets out the test for determining whether the instrument is commercial paper or investment paper:

> In *Reves v. Ernst & Young*, a co-op sold demand notes to members and the public. The company went bankrupt, so the holders sued the accounting firm under the anti-fraud provision of the act. The firm claimed the act did not apply since the notes are not securities. The court set out the test: any note which bears a strong family resemblance to one of the kinds of notes on the judicially crafted list of exception should be held not to be a security. The factors to be taken into account in determining whether there is a family resemblance are:
>
> - *the motivations of the lender and borrower in entering the transaction* (purchasers bought notes to earn profit)
> - *whether the note is the subject of common trading for speculation or investment* (notes were sold to broad segment of the public)
> - *how the note would be perceived by reasonable members of the public* (notes were advertised as investments)
> - *whether the transaction is subject to another regulatory scheme which makes the application of the securities laws unnecessary* (no other regulation applies)
>
> You start out with the rebuttable presumption that it is a note. Then you look at the list of exceptions (p.161), then see if the disputed note bears a "family resemblance" to the list

Notes:

- "*stock is stock*", but name alone is not controlling. If stock looks like an ownership interest in an ongoing enterprise then it will be stock.
- *Evidence of indebtedness test*: must have a sum certain payable on the face of the instrument

What is a "sale"?

Acquisitions, mergers, and spin-offs can all constitute sales

Acquisitions

When an issuer offers securities in exchange for other securities (stock for stock tender offer), the offer and subsequent exchange are considered an "offer" and "sale" for purposes of the '33 act

The act does not make clear whether there is an offer and sale when the exchange takes place pursuant to a merger, sale of assets, or recapitalization

Now under **Rule 145**: the solicitation of shareholders votes for approval of a reclassification, merger or sale of assets is considered an "offer" for '33 act purposes, requiring the filing of a registration statement and delivery of a prospectus to each shareholder – ***if transaction requires the vote of the target shareholders it will constitute a sale***

In an acquisition the acquiring entity wants the target entity, there are three ways to acquire:

(1) either for cash or stock of the acquiring entity (shareholders of target have to approve)
(2) acquiring entity purchases the assets of the target company (requires board approval and shareholder approval)
(3) by merger (which requires board and shareholder approval) two ways:

   i. merger between acquiring entity and target
   ii. acquiring entity sets up a subsidiary which acquires the target (most common way)

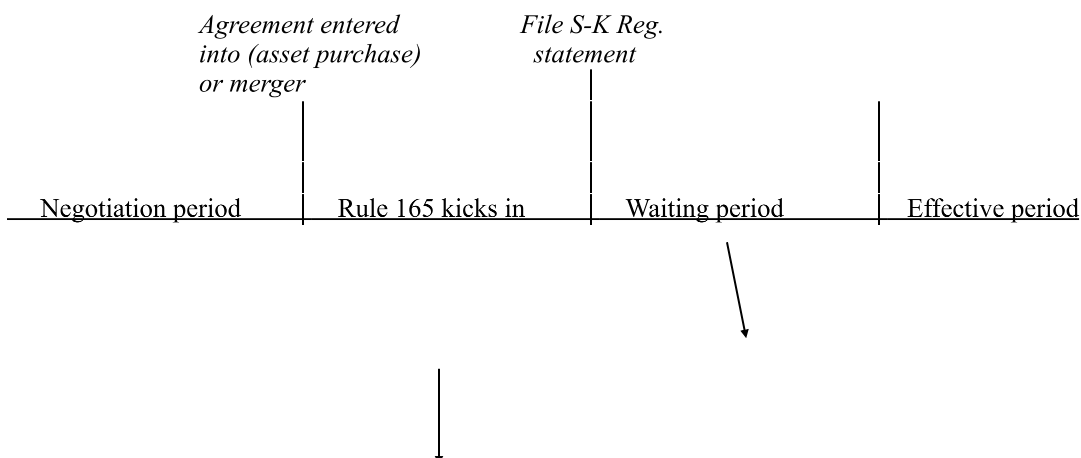
Now **Rule 14**5 says that if you have any of these transactions (above) and it is sent to the shareholder for a vote, then there is an "offer" and the target company is the underwriter

Under 2(11) an underwriter is any person who has purchased from an issuer and then distributes it. Why does it matter if target company is deemed an underwriter? Because §4(1) provides transactional exemptions (but they don't apply to an issuer, underwriter or dealer). So the target cannot use §4(1) exemption

COMMUNICATIONS: you can say what you want about the merger/acquisition as long as the comments are filed. **Rule 165**: Even communications after filing for registration do not have to comply with §10(b).

> **Rule 166** applies to rumors/leaks and says that any communication made before the public announcement does not constitute an offer – as long as participants take all reasonably necessary steps to prevent leaks

Timeline:



here, you can give out info that you otherwise would not be able to, as long as you file written statements	Rule 166 kicks in and says you can still have written communications

Spin-offs

Spin-offs: involves the issuance by a company, with little or no business activity, of some of its shares to a publicly-owned company for a nominal consideration. The publicly owned company then “spins off” the shares as a distribution to its shareholders, creating a public trading market into which the insiders can sell the remaining shares

The court have held that the total transaction requires registration under the ’33 act, even though the distribution to the shareholders of the public-owned company is not technically a sale

In a typical spin off, the main company will set up a new subsidiary. It will then merge the target into the subsidiary. After the merger the company’s shareholders will own shares of the subsidiary and will start to trade them without any info about the acquired target company.

Garden variety spin-offs may or may not involve sales and registration is not required if five requirements are met:

1. the spin-off is pro rata to the companies shareholders
2. the recipients of the spun-off securities provide no consideration
3. the parents provides to its shareholders and the public adequate information about the spin-off and about the company being spun-off
4. the parent has a valid business purpose for the spin-off
5. if the parent spins-off “restricted securities”, it has held the securities for at least two years

See example on page 164

When you do a spin-off, the parent company gives its shareholders shares in the subsidiary, this allows the parent company to give the shareholders extra value w/o really giving up anything since the parent will usually keep 51% of the subsidiary

Basic notion: you can’t take a non-public company public by a spin-off – unless you hold unto the company for two years or you register

EXEMPTIONS FROM SECURITIES ACT REGISTRATIONS REQUIREMENTS

§5 requires registration for any sale by any person of any security, unless it is specifically exempted from the registration provisions by §3 or §4

§3 *Securities exemptions*: securities themselves are exempt for the act (e.g. govt. securities, commercial paper, charitable securities)

§4 *Transaction exemptions*: exempts securities, which are sold in certain kinds of transactions

So if it is a §3 security or §4 transaction – no registration is required. However, the antifraud provisions continue to apply.

§3(b) commission can exempt any security it wants to, if an exemption is in the best interest of investors.

"come to rest" concept: do the original buyers intend to buy stocks for resale or investment purposes

Private Placements §4(2)

§4(2) provides that the registration requirements of §5 do not apply to "transactions by an issuer not involving any public offering"

The question is what constitutes a public offering?

In *SEC v. Ralston Purina*, the company had a policy of selling stock to its "key employees." (However, the definition of key employee included trainees and ordinary clerks – i.e. just about everyone). The court rejected the suggestion that the application of §4(2) should depend on the number of persons to whom the offer was made or the limitation of the offer to a defined class of persons (key employees). The court held that the application of §4(2) should turn ***on whether the particular class of persons affected needs the protection of the act.*** Here, the employees involved did not have access to the kind of info which registration would disclose.

The availability of this exemption is a question of fact

In Securities Act Release No. 4552, outlined some factors it would consider:

- identity of the offerees and their relationship to the issuer
- size of the offering
- use of investment bankers or stock exchange facilities
- was their public advertising
- length of time for which the original purchasers held the securities (have they come to rest)
- availability of info

The sale to one unqualified offeree will not blow the entire offer (as long as issuer made reasonable efforts to make sure all offerees were qualified)

Note: also see ABA article on p.182 – teacher says to study this

Article outlines attributes of a proper private placement:

1. offeree qualification (could mean sophistication, wealth, or ability to assume risk
2. information
3. manner of offerings (was advertising just directed at qualified offerees)
4. absence of redistribution (are they going to immediately resell them and how can issuer prevent this – one way is to place a legend on the security that's says it cannot be resold unless legend is removed)
5. number of offerees

Transactions look more like public offerings when the promoters begin to bring in a diverse group of uninformed friends, neighbors, and associates

Intrastate Offerings: §3(a)(11) and Rule 147 (under §3 but is really a transaction exemption)

§3(a)(11) exempts from registration "any security which is part of an issue offered and sold only to person resident with a single state where the issuer of such security is a corporation incorporated by and doing business within such state"

The exemption was designed to apply to local financing that may be consummated in its entirety within the state in which issuer is incorporated and doing business

Each purchaser and offeree must be a resident (domicillary)

One offer, one sale, or resale can destroy the exemption

Resales by the original purchasers to non-resident before the securities have "come to rest" may retroactively destroy the exemption

> In *Busch v. Carpenter*, the company sold shares of its stock to Utah residents and relied on the intrastate exemption. The company maintained its offices in Utah. It later merged with another company and transferred most of the proceeds from the original offering to the other state. P's, who are Ca. residents, bought some stock in the original company. They now argue that the stock did not qualify for the intrastate exemption. The Court considers two issues (1) whether the stock actually came to rest in the hands of resident investors and (2) whether the company was doing business in Utah. Court holds that (1) since first sale to non-resident did not occur until seven months after the offering, the purchaser had the burden of proving that the original purchasers had taken with an intent to resell and that (2) the company was not doing business in Utah as it invested the proceeds elsewhere and never did anything more than maintain it offices, books, and records in Utah.

Rule 147 clears the exemption by providing safe harbors for complying with the intrastate exemption: (is a safe harbor)

- "*come to rest" issue*: the offering will be considered "intrastate if no resales are made to nonresidents for a period of nine months
- *doing business requirement*: must derive 80% of gross assets in state, have at least 80% of assets in state, intend to use 80% of offering in state, have its principal office in state

If you do the above things you will be OK, you can still satisfy the exemption without doing these things but you take a risk

LIMITED OFFERINGS: §3(b), 4(2), 4(6), and 28, Regulations A, D, and CE, Rule 701

Regulation A: is a simplified form of registration for small issues. The amount of the offering may not exceed 5 million and there are "good guy" requirements (not available to anyone convicted of securities offenses). To comply, must file an offering statement 10 days before the offering -- provides a way to do a limited public offering (plus there is no offeree qualification)

Rule 254:

§4(6) provides a registration exemption to accredited investors as long as issuer files notice with commission

Regulation D: is composed of **rules 501-508**

501 defines "***accredited investor***: which includes

1. any bank, insurance company, or employee benefit plan
2. any business development company
3. any charitable or educational institution with assets of more than 5 mil
4. any director, executive director or general partner of insured
5. any person with annual income of 200,000 (or together with spouse 300,000)
6. any person with net worth of more than 1 mil
7. any trust with more than 5 mil in assets which is managed by a sophisticated person

Regulation D provides three exemptions: 504, 505, 506

One of the more important things to remember about regulation D is that when a Rule 506 transaction is attempted but fails, the requirements for the basic private placement exemption may still be met.(506 is a safe harbor under 4(2))But when a Rule 504 or 505 exemption fails, the seller has nothing in §3(b) to fall back on.

See table on pg.205

502 sets out certain conditions:

- Integration: offerings that are separated in time by six months are not deemed to be parts of a single offering
- Information: if an issuer sells securities to non-accredited purchasers under rule 505 or 506 certain information must be furnished to all non-accredited purchasers

Rule 701: deals with employee offerings, provides exemption for compensatory benefit plans. Non- 34 act reporting companies and non-investing companies are eligible. There is an amount threshold and some disclosure requirements. these securities are restricted securities for purposes of rule 144

Integration of Offerings

In determining whether an offering qualifies for a particular exemption, it is necessary to determine whether it is in fact a separate offering or whether it is part of a larger offering.

This comes up when an issuer, or a group of related issuers, engage in a series of "non-public" or "intrastate" offerings or some other combination of exempt offerings.

For example what if on 1/5 you have a Regulation D offering and then on 5/5 you have a intrastate offering – if integration applies, then they are considered the same offering and must fall completely within a single exception to escape registration.

502(a) says 6 months will be a safe harbor.

Under regulation D and rule 147, offerings separated by a period of at **least 6 months** will not be integrated – if that test is not met go to five-factor test

There is a five-factor test to be considered in determining whether offerings should be "integrated":

1. part of a single plan of financing
2. involve same class of security
3. are made at or about the same time
4. involve the same type of consideration
5. made for the same general purpose

If the offerings are "integrated" they are viewed as a single offering and must both fit under one exception – if you can't fit both under the same exception you are in violation.

If you know you are going to need another offering within 6 months, then make sure you use the same exception – plan for it (i.e. if you first have an intrastate offering then make sure next investors meet the same requirements, if you know you going to need out of state investors make sure first offering will fit another exception)

What happens if you have a private offering and 20-30 days later you file for public registration? The two offers will be integrated and under 5(c), they will be liable for making offers before they filed! But if you need to make an offering there are some options:

- go through the five factor test
- wait six months
- black box private offering – limited exception available for public companies. If the issuer completes the private offering by the time of filing, the offerings will not be integrated. However, the private offering may continue as to QIB's (qualified institutional buyers) or 2-3 Institutional Accredited investors.

What happens when you abandon an offering and then start another?

RULE 155 – integration of abandoned offerings (safe harbor)

If a private offering is abandoned before a registered offering: no integration if

- Can't have sold any securities in the initial private offering and must have demonstrated that private placement would have been valid
- Private offering terminates before the issuer files the registration statement
- Prospectus discloses the abandoned private offering

If the offerings starts public and then goes private: no integration if

- No securities were sold in the registered offering
- The registration statement is withdrawn
- The private offering must not commence until 30 days after the effective date of withdrawal
- The issuer must notify each offeree ensuring that they know the private nature of the offering
- must be valid under 4(2) or 506

plus they must have had a preexisting relationship

REGULATION OF RESALES OF SECURITIES

SA §4(1) exempts from the registration requirements "transactions by any person other than an issuer, underwriter or dealer."

Thus the only transactions not involving the issuer that require registration are those which involve an "underwriter".

Underwriter 2(a)(11): any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security

Issuer is defined to include any person who controls the issuer

If you have Controlled and Restricted securities, if they meet the requirements of 144, they will then fall under the §4(1) exception and you can have a resale

Control Securities

Control securities: securities owned by a person who is an affiliate of the issuer (an affiliate is an affiliate of, a person that directly, or indirectly controls or is controlled by, or is under common control) see **rule 405**

Director, officers and majority shareholders will always be affiliates

Control: the power to direct or cause the direction of the management and polices

Rule of thumb: shareholders who own 10% or more are considered affiliates (however, shareholder might own more and not be considered affiliate if he inherited shares and forgot about them – thus no control)

Remember: An underwriter purchases from an issuer – the underwriter then distributes the securities

Restricted Securities

These are also subject to the resale limitations.

The term restricted securities means:

> (i) Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a **transaction** or chain of transactions **not involving any public offering**;
>
> (ii) Securities acquired from the issuer that are subject to the resale **limitations Regulation D or Rule 701**
>
> (iii) Securities acquired in a transaction or chain of transactions meeting the requirements **of Rule 144A**;
>
> (iv) Securities acquired from the issuer in a transaction subject to the conditions of **Regulation CE**
>
> (v) Equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of **Rule 901 or 903 under Regulation S**

What all this means is that you have a transaction which may be found to involve an "underwriter", even though there is no investment banker performing the traditional functions of an underwriter in a formal public offering. There are two types of transactions where this might take place:

(1) when a person who "controls" an issuer sells securities of the that issuer through a broker or dealer, the broker or dealer is deemed to be "selling for an issuer" and may therefore be an "underwriter" (*see Ira Haupt* case)

(2) when a person has purchased securities directly from an issuer, and subsequently resells them, he may be deemed to have "purchased from an issuer with a view to distribution" and thus himself be an "underwriter"

In re Ira Huapt, Haupt was a broker-dealer who had a client, Schulte, who owned the majority of a company. The company was about to pay a dividend to its shareholders and the price of the share was going up. So Schulte sold a total of 93,000 shares through Haupt. The SEC said that the transaction should have been registered because Huapt was an underwriter (because Schulte owned a majority of the company, these were controlled securities). Haupt argued that there was no distribution, Schulte just gave him a series of small orders to sell. The SEC held that the circumstances clearly put Haupt on notice that a "distribution" was intended. Haupt then argued that the transaction was exempt under §4(4) (which exempts brokers transactions executed upon customer's orders). The SEC held that the exemption did not apply to situations where the broker/dealer was acting as an "underwriter"

Compliance with the safe harbor provisions of **Rule 144** will deem any sale of securities by an affiliate of the issuer (i.e. a controlling person) or a sale of restricted securities (securities acquired from the issuer in a non-public transaction) to not be a distribution. The requirements are:

1. ***Volume limitation***: sales under 144 during any three month period cannot exceed the greater of 1% of total units if the security or the average weekly trading volume for the preceding four weeks
2. ***Holding period***: if the securities are restricted must hold the securities for one-year

3. ***Current public info*** must be available
4. ***Manner of sale***: securities must be sold in ordinary brokerage transactions
5. ***Notice of sale***: file notice with SEC each time order is placed

If the securities are only restricted and not controlled, holding the securities for two years will terminate some of the requirements of rule 144. Rule 144(k).

If you have a "controlled" or "restricted" security and you meet the requirements of 144, the securities will fall under the 4(1) exception and can be resold. Rule 144 is not exclusive, and sellers may sometimes wish to sell outside the rule. However, in practice it is considered to be virtually exclusive.

Note: controlled securities are always subject to the volume limitations, restricted securities are only subject to volume limitation between year 1 and year 2. (can't sell them during year one)

Under the "*change in circumstances doctrine*" the inference of underwriter status that may accompany a too short holding period can be avoided when the holder of restricted securities proves that the desire to resell arose because of changed circumstances. However, a change in the stock's price will normally be considered investment risks and do not usually provide a basis for a claim of changed circumstances. Moreover, after the adoption of Rule 144, the SEC has indicated that the doctrine has retained little relevance. Securities Act Release No. 4552.

LIABILITY FOR SECURITIES ACT VIOLATIONS

Criminal Liability

Willful violations of the securities laws or the rules promulgated under them are punishable by fine or imprisonment §24

The "willfulness" requirement means only that the defendant must have intended the act which he did, and does not require a showing that he knew he was violating the securities laws.

In *United States v. Brown* the defendant was convicted of willfully violating § 17 (a) of the Securities Act. He argued that "willfully" requires that he knew that the investment contract in question qualified as a "security" under the securities laws. The court held that while specific intent must be shown as to the action constituting the fraudulent conduct, the government only needs to show that the security is *in fact* a security under the applicable laws.

as long as you knew you were doing a wrongful act

Because of the way the Securities Act prohibitions are tied to uses of jurisdictional means, each separate use of these means is a separate violation.

The SEC has no jurisdiction to bring criminal actions. Instead, the Attorney General must bring the charges. The SEC is authorized to seek injunctive relief whenever it appears that a securities law has been or is about to be violated (§ 20(a)) and may bring actions seeking civil penalties and to issue cease-and-desist orders (§§ 8A, 20(d)).

Civil Liability

§7

The Securities Act contains a number of provisions that may lead to civil liability, either under their explicit terms or as a result of an implied civil remedy found by the courts.

§11 impose liability for material misstatements or omissions

§12 imposes liability for selling unregistered securities

Section 11

Section 11 provides a civil remedy in the case of a registration statement that contains "an untrue statement of a material fact or [omits] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Joint and several liable extends to the issuers, its CEO, CFO, CAO, and each director, underwriter, and accountant or other expert that has signed the registration statement.

A complainant (P) must trace the security back to a registered offering. However, she may sue whether she purchased the security in a registered offering or in secondary trading.

Elements: p need only show (1) that there was a material misstatement or omission in the registration statement and (2) that he lost money

Damages may not exceed the difference between the offering price in the registered offering and the value of the securities at the time of suit.

The issuer is always liable for § 11 violations, but all others that may be liable may assert the ***due diligence defense***.

The due diligence defense requires that the defendant have had, after reasonable investigation, reasonable ground to believe, and he or she must have believed, that the statements in the portion of the registration statement in question were true and that there was no material omission. Ignorance is a sufficient defense for a non-expert as to an expertized portion of the registration statement. What is "reasonable investigation?"

In *Escott v. BarChris* Construction Corp., three classes of defendants were sued for violations of § 11 for inaccurate financial statements—(1) persons who signed the registration statement, (2) the underwriters, and (3) the auditors of the financial statements. The first issue was whether the inaccuracies were material. An item is material if there is ***a substantial likelihood that a reasonable investor would attach importance to the item in determining whether to purchase the security registered.*** (Rule 405). The second issue was which defendants were entitled to the due diligence defense. The issuer's CEO and CFO were not entitled to the due diligence defense because by nature of their position they should have known about the misstatements. Two inside directors and an outside director were not entitled to the defense because they had not conducted any investigation. The issuer's controller made no investigation and was held liable. The underwriters had relied on the lead underwriter who had in turn relied on its counsel. The court held that the lawyer's investigation was not extensive enough to establish the defense because he had not adequately reviewed the issuer's major contracts or required that minutes be kept at the executive meetings. Thus, all the underwriters were liable.

A claim can be defeated if D can show one of the following:

- purchaser knew of the untruth or ommiosn at the time he acquired security
- the decline in value resulted from causes other than the misstatement
- if an expert – he is only liable for misstatements or ommiosn in the portion he prepared
- if he can show due diligence

The due diligence defense id different depending on whether misstatement is in the expertized or non expertized portion

> *Expertized*: has to show he had no reasonable ground to believe and did not believe that there was an ommiosn or misstatement
>
> *Non-expertized*: d has to show he had, after reasonable investigation, reasonable ground to believe and did believe that there was no material misstatement or omission

Some recent cases are more favorable to underwriters and outside directors.

What is a reasonable investigation is a question of fact

See requirements for a due diligence defense on pages 260-265.

> In *In re Donald Trump* the prospectus stated that the "partnership believes that funds generated from the operation of the Taj Mahal will be sufficient to cover all of its debt service." The plaintiff brought suit for a § 11 violation but the court applied the "bespeaks caution" doctrine to negate the materiality of the statement. This doctrine provides that a misstatement may be overshadowed by extensive and specific cautionary language. It is essentially "shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law."

Section 27A and **Rule 175** provide safe harbors for forward-looking statements.

Section 12(a)(1)

§12 imposes civil liability on sellers of securities in two situations:

> (1) where a security is sold in violation of §5 (in an unregistered, non-exempt transaction) -- §12(a)(1)
> (2) where a security is sold by means of a prospectus or oral communication which contains a material misrepresentation or omission -- §12(a)(2)

§12(a)(1) provides for civil liability when a person offers or sells a security in violation of §5 – liability flows under this section when unregistered securities are offered or sold without an available exemption

A purchaser may not recover from an issuer or seller unless there is a direct link (privity) between the purchaser and the seller – but purchaser can always sue upstream

A successful P can recover recission of his purchase, recovery of interest and damages

In *Fuller v. Dilbert*, the sellers (Dilberst) entered into a contract to sell some unregistered stock to the purchaser (Abraham), Abraham's performance was guaranteed by the Fullers. The purchaser missed the first installment so sellers sought to enforce entire amount due. The Fullers argued that the contract for the sale of the stock was null and void and unenforceable because the sale was not for investment, but was a public distribution in violation of Section 5 (no registration). Sellers argue that no this was a private placement and hence exempted from registration under §4(2).(plus purchase agreement had clause that said no resales) Court agrees. But there was a sale to two others that might affect exemption. However, the sale was unknown to and concealed from the sellers by the purchaser. The court holds that Section 12 of the Securities Act which creates civil liability on the part of one who sells stock in violation of Section 5 does not require that a purchaser and his guarantor be permitted to escape their contractual obligations where the violation is brought about by the purchaser's wrongdoing in which the seller did not participate and of which he was without knowledge. No public interest requires this result.

The following case addresses the question of whether a claim for rescission or damages is allowed when an illegal offer is followed by registration or the offered securities, and delivery of a proper prospectus, prior to sale.

In *Diskin v. Lomasaney*, the buyer agreed to buy some shares of Ski Park. The seller sent him his confirmation and also a letter offering to sell shares of Continental. AT the time Continental was in its waiting period. (during the waiting period a prospectus must accompany all offers) After the effective date, the seller sent purchaser a confirmation and prospectus. Buyer then demanded recession and argued that the letter was a violation of §5(b)(1). Courts agrees and says that while such liability may be harsh Congress intended that §12(a)(1) apply to illegal offers as well as illegal sales. Here all the seller had to do was send a prospectus with the letter.

The problem in this case (or so critics say) is that the buyer got the prospectus before he paid – thus he had time to review all the material – but seller is still held liable, it is a harsh rule (any vilation of section 5)

§12(a)(1) is a strict liability section, to recover the plaintiff need only establish that the defendant sold the security to him and that it was not registered – D must then establish the availability of an exemption

Primary liability flows only to a seller – to a person who sells a security. The following case extends this language to include those who solicit with intent to benefit themselves

In *Pinter v. Dahl*, Pinter, an oil and gas producer and registered securities dealer, sold unregistered securities consisting of fractional undivided interests in oil and gas leases to respondent Dahl, a real estate broker and investor who was experienced in oil and gas ventures. Dahl touted the venture to the other respondents--his friends, family, and business associates--and assisted them in completing subscription agreement forms. Interests were being sold without the benefit of registration under the Securities Act, in reliance on SEC Rule 506 (exemption for limited offerings – still requires notice of sale be filed). The venture and buyers sought rescission under 12(a)(1). Pinter argued that Dahl was a seller and should be liable. Court says that a "seller": is not just limited to a person who passes title but also includes persons who solicit offers. Solicitation can render a person liable if there is an actual sale and the person who

successfully solicits must be motivated by a desire to serve his own financial interests or those of the securities owners. (Court remands for a determination as to Dahls motivation/interests in soliciting the others)

Liable as long as person gets some kind of benefit

Persons who might be liable as solicitors include; an agent who is soliciting for someone else and getting paid to do it or an investor who needs other investors to make his investment worthwhile

§12(a)(2) person can be liable who sells a security by means of a prospectus or oral communication which contains a material misrepresentation or omission

- government securities are exempt
- P cannot win if he knew about the misstatement or omissions
- an action under 12(a)(2) must be brought within one year of discovery

The following case addresses the question of whether section 12(a)(2) applies only to initial sales of securities by issuers or also to secondary trading transactions:

In *Gustafson v. Alloyd Co., Inc*., Buyers, who purchased substantially all of corporation's stock from sellers in private sale agreement, brought action under § 12(2) of Securities Act of 1933, seeking rescission of private sale agreement on ground that written sale agreement was a "prospectus" and contained material misstatements, which gave rise to liability under 12(a)(2). The parties executed a contract of sale. However the earnings estimates were lower than those originally relied upon. The sellers argued that 12(a)(2) claims can only arise out of the initial stock offerings. The issue is whether the contract is a "prospectus"? The court holds that held that term "prospectus" in provision of securities statute which gives buyers of securities express right of rescission against sellers who make material misstatements or omissions by means of prospectus, referred to document that describes public offering of securities by issuer or controlling shareholder, not private agreements to sell securities.

The court holds that ***12(a)(2) does not reach secondary trading***, moreover it does not even apply to initial offerings unless they are made publically by means of a statutory prospectus. Thus, there is no liability under the '33 Act for written or oral misstatements in offerings which are exempt from that Act's registration requirements

Potentially liable person under §11 have a "due diligence" defense if they conducted a reasonable investigation

Under §12, the seller has an affirmative defense if he can establish that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission

In *Sander v. Nuveen*, the P's bough some promissory issued by WH from the defendant. WH went belly up, its default was the product of fraud as it misrepresented financial statements. D's had no knowledge of the fraud and argue that they have established a defense under §12(a)(2) by sustaining their burden of proving that they in exercise of reasonable care could not have known of the claimed untruth. Court says that reasonable care and reasonable investigation are the same thing. Thus a securities dealer can only assert that

defense if it has made the kind of investigation that would enable it to assert a due diligence defense under §11.

§13 statute of limitations

§15 – deals with liability of controlling persons. A person who controls a person who is liable under §11 is also liable.

§15 seems redundant because §11 already requires most of the chief officers to sign the registration statement. But, §15 might extend liability to majority shareholders who exercise control and perhaps other important officers

Some court require a show of culpability by the plaintiff, other require a lack of culpability to be raised by the defendant as an affirmative defense.

§17 prevent fraud in the sale of securities (EA 10b-5 prohibits fraud in the purchase of securities)

It is analogous to 10b-5 – is a criminal provision and one court said there is a private right of action

SECURITIES EXCHANGE ACT OF 1934

Relates to the registration and regulation of issuers of securities

Commission's General Exemptive Authority

Under §36 the commission may conditionally or unconditionally exempt any person, security, or transaction from compliance with any provision or rule except that:

- any exemption must be necessary or appropriate in the public interest, and consistent with the protection of investors
- the authority to exempt does not extend to §15C which relates to government securities brokers or dealers

Registration of Securities Under the Exchange Act

Requires registration under two circumstances:

(1) issuer must register securities when the securities are to be traded on a stock exchange 12(h)
(2) when equity securities are held of record by at least 500 persons and the issuer has total assets that exceed 10mil (act says one mil but rule extends it to ten mil) 12(g)(1)

In a third situation the company is subject to the reporting requirements

(3) a company that has registered securities under the Securities Act is subject to the same §13 filing requirements as are companies that have securities registered under the exchange act – is for a yera – obligation cease if # of persons of record falls below 300

Registration is under §12 – you register a whole class of shares or if you are doing '33 Act registration you can file a form to incorporate the '33 registration by reference

Periodic Reporting

By registering securities under the Exchange Act, an issuer becomes a *reporting company* and must make two types of filings (under 13a):

(1) filings of such info to keep current the info provided at the time of registration (triggered when certain material events happen)

(2) filings of such annual and quarterly reports as the Commission requires irrespective of the updating requirement (there are four required reports – an annual report, quarterly and others)

form 10-K = annual, form 10-Q = quarterly, 8-K = periodic, Item 9 = make disclosure

Liability that may flow from misstatements or omissions in Exchange Act filings:

Act imposes *criminal liability* on any person who acts "willfully and knowing" – a D may be *convicted* of an Exchange Act violation without knowing of the section violated, but he may not be *imprisoned* if he proves that he did not know of the section. §32

§18 provides a civil remedy for false and misleading statements in Exchange Act filings. Requirements:

(1) plaintiffs must show they **purchased or sold** securities **in reliance** on a defective filing
(2) must prove that the **price** at which they purchased or sold was **affected** by the defective filing
(3) they had **no knowledge** of omissions from or misrepresentations in the report

Thus, P's often seek to have courts find an ***implied right of action*** under another section. The following cases deal with whether a private right of action exists under §12(b)(1) or §13(a):

In *Cramer* case, shareholders alleged violations of 12(b)(1). They claimed that material facts were incompletely and/or inaccurately disclosed to GTE's shareholders. Court says P's must meet the standing requirement of §18. Here, p's have no standing (court says implied right will only exist where the issuer has completely ignored the registration requirements)

In re Penn Central Securities Litigation, P's allege violation of §13(a) – say D's gave false and misleading financial information in order to

inflate the market price. Courts says there is no authority concerning the possible existence of a private right of action under 13(a), and thus P's must have standing under §18. Plus, in this case, the shareholders had never sold so there was no purchaser-seller relationship under §18.

In any action under §18, D's have protections from §21D and E, which limit damages, make liability proportional, provide some safe harbors, and require loss causation

Note: filings of Exchange Act registration statements and periodic reports must be made both on paper and electronically (through EDGAR)

FOREIGN CORRUPT PRACTICES ACT – was enacted because US companies were paying bribes to foreign companies and officials and not disclosing it – the Act says if you are a '34 act company, you have to maintain certain accounting standards (reasonable record keeping is required with deference to business judgment)

Proxy Regulation

SEA §14 makes it unlawful for a company registered under SEA §12 to solicit proxies from its shareholders in contravention of the rules and regulations prescribed by the Commission

Rule 14a-6 – filing requiremnst

14(a) gives Commission power to pass rules

14(b) makes it unlawful for securities firms, banks and others exercising fiduciary powers, to violate the Commissions proxy rules in respect of registered and certain other securities that "are carried for the customer" – owned by customer but owned of record by the firm or bank

14(c) even if company does not solicit proxies in connection with a meeting, it still must furnish them with info substantially equivalent to that, which would be required, if it did solicit proxies

Proxy statement: formal disclosure document that must be filed and given to security holders (copy of the statement must be filed with SEC when they are first mailed)

Public communications by shareholders as to how they intend to vote and their reasons for their decision are excluded from the definition of solicitation **Rule 14a-l(l)**

A security holder may solicit proxies from fellow shareholders (and management must include in its proxy, statement proposals made by security holders, but see p.332 for reason why issuer may refuse to include shareholder proposal)) **Rule 14a-8**

False or Misleading Statements

SEA rule 14a-9 makes it unlawful to solicit proxies by means or any proxy statement or other communication containing any statement which is false of misleading with respect

to any material fact -–or which omits to state any material fact necessary in order to make the statement therein not false – rule is an anti-fraud provision

A shareholder who alleges that the votes to approve a merger or other transaction were obtained by means of a misleading proxy statement (i.e. a violation of Rule 14a-9) has an *implied private right of action*

"Materiality" – a misstatement must be material before it gives rise to action. The following case sets forth the standard:

> In *TSC Industries v. Northway*, National acquired TCS. A TSC shareholder claimed that the joint proxy statement was incomplete and materially misleading. The court notes that the purpose of Rule 14a-9 is to ensure disclosures by corporate management in order to enable the shareholders to make an informed choice. The C of A definition of material is too low: a fact which a reasonable shareholder might consider important. The court held that an omitted fact is "material" if there is a ***substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote***, that the issue of materiality is a mixed question of law and fact, and that, under that standard, none of the omissions claimed to have been in violation of the rule against incomplete or material and misleading proxy statements was materially misleading as a matter of law.
>
> Test: an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote

Note: Under the "bespeaks caution" doctrine, a misstatement or omission can be rendered immaterial if it appears in the context of a document that contains sufficient cautionary language that the document bespeaks caution

How do you prove causation: (how do show that shareholder approval of the transaction was a result of the misstatement) (this is known as **transaction causation**)

> In *Mills v. Electric Auto-Lite*, Electric merged with another company. P's were shareholders of Electric and allege that the proxy statement was misleading in that it did not inform shareholders that Auto-lites directors were under the control of Mergenthaler. Mergenthaler owned 54% but needed 2/3, thus it needed minority votes to accomplish the merger. C of A said causation was to be determined by proof of the fairness of the merger. S Ct. held that where some votes of "outside" shareholders were necessary for approval, P was only required to show that the misstatement or omission was "material", not that it actually had a decisive effect on the voting.
>
> You must show that the proxy solicitation itself was an essential link in the accomplishment of the transaction

The following cases address the question of whether causation can be shown where the management controls a sufficient number of shares to approve the transaction without any votes from the minority.
The Supreme Court dealt with the same question in the next case:

> In *Virginia Bankshares*, Minority shareholders of bank brought action challenging "freeze-out" merger. The majority owned 85% of the shares but still solicited proxies. The minority shareholders were offered $42 a share but

believed shares were worth $60. One shareholder alleged that the solicitations violated §14(a). The directors said they approved the plan because it provided shareholders an opportunity to achieve high value for their shares. The minority shareholder alleged that the directors did not believe the price was high and only recommended so they could remain on the board. There were two issues:

(1) Whether a statement couched in conclusory terms purporting to explain the directors reasons can be materially misleading within the meaning of 14a-9?

Held: Yes, knowingly false statements of reasons may be accountable even though conclusory. Statements of belief by directors are material in that shareholders think these statements rest on factual basis. Moreover, the directors actual belief can be evidenced by company minutes and records.

(2) Whether causation can be demonstrated by a member of a class of minority shareholders ***whose vote is not required***?

Held: NO, private action does not extend to such shareholders in absense of congressional intent.

Degree of Fault Required

The Supreme Court has never determined the degree of fault required to support a finding of liability under 14a-9.

In *Gerstle v. Gambl;e-Skogmo, Inc.*, the minority stockholders attacked the merger, they argued that the acquiring company failed to disclose that they would be selling all the assets of the company. The issue was what level of scienter should apply? The court holds that **negligence** in the preparation of the proxy statement would be sufficient to warrant recovery. The plaintiff is not required to establish any evil motive or even reckless disregard of the facts where the corporation itself has made a material omission or misstatement.

No scienter except for outside accountants

In *Adams v. Standard Knitting Mills, Inc*., the plaintiffs alleged false proxy solicitation. They sued the accountants and alleged that they were reckless for a negligent error – they failed to point out certain restrictions on the payment of dividends. The issue was what standard of liability should apply to accountants? The court held that **Scienter** should be element of liability in private suits under the proxy provisions. – must show some knowledge on the part of **outside accountants** – not just negligence. (Applies to outsiders of the corporation generally.)

TENDER OFFER REGULATION

Two types:

(1) stock tender offer: the acquiring company offers its securities in exchange for shares in the target
(2) cash tender offer: the targets shareholders are offered cash in exchange for their shares

The act that regulates Tender Offers is called the Williams Act – the act was designed to give the SEC and the courts power to deal with problems arising in the course of takeovers or tender offers

§13(d) requires a person who owns beneficially more than 5% of a class of equity security registered under the exchange act to provide certain information to the issuer, the commission, and to each exchange on which the security is traded

§14(d) it is unlawful to make a tender offer for an exchange act registered equity security if success in the offer would result in ownership of more than 5% of the class, unless certain filings are made

> you must make certain filings anytime you wish to make a tender offer

14(e) deals with liability

If you are a beneficial owner and **do not** want to exercise control you look to the following rules:

> 5% → 13D/G
>
> 5% to 20% → look to (c) and G
>
> >20% → G and (b)(1)

If you want to exercise control – look at D

§'s 14(d) and (e) impose restrictions on the terms of tender offers:

- the offer must remain open for at least 20 days
- the offer must be open to all holders of the class of securities sought and the same price must be paid to all tendering shareholders
- where the offer is for less than all of the outstanding shares and is oversubscribed, shares must be taken up on a pro rata basis

What is a tender offer?

The term is not defined in the act

It does not encompass purchases on the open market

It has been held to include "any public invitation to a corporations shareholders to purchase their stock"

One court set out 8 factors, the presence of which would influence the court in determining whether or not there was a tender offer:

> (1) active and widespread solicitation of public shareholders for the shares of an issuer;
> (2) solicitation made for a substantial percentage of the issuer's stock;
> (3) offer to purchase made at a premium over the prevailing market price;
> (4) terms of the offer are firm rather than negotiable;

(5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;
(6) offer open only a limited period of time;
(7) offeree subjected to pressure to sell his stock
(8) public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of large amounts of the target companies securities

In *Hanson*, a company went out and made five private purchases and acquired 25% of the companies stock. The purchased company says that this was a tender offer and that the buying company did not fill out the proper forms and thus should be enjoined from buying any more shares. Court says it is the public who needs protection, here, the five sellers did not need protection as they were sophisticated investors. The court holds that 14(d) should only apply where there is substantial risk that solicitees will lack information needed to make a carefully considered appraisal of the proposal put before them.

Traditionally, cash tender offers were easier to effectuate than stock tender offers because the stock offered to solicitees had to be registered before the tender offer. Regulation M-A has lessened the burden on stock tender offers by allowing the tender offer to commence before the shares offered are registered.

Who may bring suit?

If there is a Williams Act violation the SEC can bring an enforcement action or the Justice Department can seek a criminal indictment if there is willfulness involved

In *Indiana National Corp*, the Plaintiff, Indiana National Corporation ("Indiana National"), is a bank holding company which engages principally in the banking business through its wholly owned subsidiary, Indiana National Bank. The defendants are a group of investors who acquired more than 5% of Indiana National's stock during 1981 and 1982. As required by Section 13(d) of the Act, they filed a Schedule 13D on September 4, 1981, and subsequently amended it six times between then and August 10, 1982. Indiana National filed a complaint in which it was alleged that the defendants' Schedule 13D contained materially false and misleading information, in that it failed to disclose the defendants' intention to acquire control of Indiana National. The defendants filed a motion to dismiss the complaint on the grounds, in relevant part, that Indiana National, as the issuer of the stock, had no standing to assert a claim under Section 13(d) of the Act because that section is meant to protect the shareholders of the corporation. The court holds that held that ***there is an implied private right of action*** for issuer corporation to seek injunctive relief under Securities Exchange Act provision

In *Piper v. Chris-Craft*, the Supreme Court held that a defeated tender offeror had no standing to sue for damages allegedly resulting from misleading statements made by its opponents in the struggle for control. The court indicated it would imply a private action under 14(e) only where it would benefit the shareholders of the target corporation.

Some cases have held that tender offerors may be entitled to injunctive relief enjoining other tender offerors from Williams Act violations – in order to get then to comply

In *Lewis v. McGraw*, the court held that shareholders cannot sue the management of the target company for making misleading statements that cause a tender offer to be abandoned. They reasoned that since the shareholders never had an opportunity to tender their shares, they could not have relied on the misleading statements. Rather, the shareholders should pursue a claim against the Board for breach of fiduciary duty in state court.

Substantive §13(d) Issues

One difficult question under 13(d) arise where a number of shareholders of a company, owning in the aggregate more than 5% of its shares, agree to act together for the purpose of affecting the control of the company, but do not acquire any additional shares. The courts have split as to whether the agreement to act together constitutes an "acquisition" by the "group" triggering the filing requirements

In *GAF Corp v. Milstein*, held that section of Securities Exchange Act which requires any person who, after acquiring beneficial ownership of equity security of issuer, is owner of more than 10% of outstanding shares of class to file statement with SEC, issuer and stock exchanges ***required registration by group of 4 stockholders who agreed, after effective date of statute, to hold their preferred shares for common purpose of acquiring control of corporation*** and group held more than 10% of the outstanding registered preferred shares, even though there was no acquisition of additional shares subsequent to the enactment of the section; the group "acquired" a beneficial interest in the individual holdings of its members.

In *Rondeau v. Mosinee Paper Corp.* a shareholder purchased more than 5 percent of the corporation's outstanding stock but failed to make the necessary filing requirements under § 14(d) because he was not aware of these requirements. Upon discovering of the filing requirements the shareholder made the proper filings. The corporation sought to enjoin the shareholder from purchasing any additional shares. The court recognized that the shareholder violated § 14(d) but noted that an injunction will only issue where there is "a cognizable danger of recurrent violation." Here, no such danger existed because the shareholder was not seeking control of the corporation and there was no indication that he would fail to make the proper filings in the future. Corp is not entitled to injunctive relief without a showing of harm

Conduct Prescribed by § 14(e) (the anti-fraud provision)

In *Schreiber v. Burlington Northern, Inc.* the acquiring corporation (Burlington) made a hostile tender offer in which the plaintiff shareholder tendered her shares in the target corporation (El Paso). However, the tender offer was rescinded when the target corporation's management negotiated a friendly takeover agreement with the acquiring corporation. Since the friendly tender offer was oversubscribed, the shareholders who tender in the first offering were harmed because they would have to tender their shares on a pro rata basis. Plaintiff-shareholder argues that Burlington committed fraud by (1) withdrawing the previous tender offer and substituting with a subsequent tender offer and (2) failing to disclose the "golden parachutes" offered to El Paso's management.

The court held that "manipulative acts" as required by § 14(e) to show fraud requires misrepresentation or nondisclosure. Plaintiff's first claim fails because the withdrawal of the tender was not accompanied by any misrepresentations. Plaintiff's second claim fails because the only damages sought are for the cancellation of the first tender offer, which bears no casual relationship to the payments made to El Paso's management.

FRAUD IN THE PURCHASE or SALE of SECURITIES: RULE 10b-5

The rule was adopted to address fraud in the purchase or sale of securities

Rule 10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

(a) to employ any devise, scheme, or artifice to defraud
(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security

An implied right of action exists under the rule (although refinements have made the rule less useful to private plaintiffs)

Situations where the rule applies:

- ***insider trading***: officer, director or other person with fiduciary relationship with a corp buys or sells the securities when in possession of material, non-public info

- when corp issues misleading info to public or keeps silent when it has duty to disclose

- when insider selectively discloses material, non-public info to another party who then trades securities based on that info

- when a person mismanages a Corp in ways that are connected with the purchase or sale of securities

- when a securities firm or another person manipulates the market for OTC securities

- when a securities firm or professional engages in certain forms of conduct connected with the purchase of securities

In re Cady Roberts, the issue was what are the duties of a broker after receiving nonpublic information as to a company's dividend action from a director who is employed by the same brokerage firm. The director found out company was going to have a reduced dividend, thus he let broker know so he could sell the stock. (The stock was trading at 40 when he sold and 34 when news broke) They were both charged with willfully violated the 'anti-fraud' provisions of Section 10

(b) of the Securities Exchange Act of 1934 (Exchange Act'), Rule 10b- 5 issued under that Act, and Section 17(a) of the Securities Act of 1933 ('Securities Act'). The court states that the rules are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit. The court stated that its task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited. The facts here impose on Gintel (broker) the responsibilities of those commonly referred to as 'insiders.' He received the information prior to its public release from a director of Curtiss-Wright, Cowdin, who was associated with the registrant. Cowdin's relationship to the company clearly prohibited him from selling the securities affected by the information without disclosure. By logical sequence, it should prohibit Gintel, a partner of registrant.

The *essence* of the Rule is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' (i.e., the investing public)

Rule: if you have a relationship that gives you access to insider info, you will come within 10b-5 (even if you are not an insider)

In *SEC v. Texas Gulf Sulphur Co*., the company was involved in mineral exploration activities and discovered a big mineral site. But they wanted to keep it secret so they could acquire more land. In the meantime the officers accepted stock options, gave friends "tips" to purchase the stock, and bought stock themselves – all without disclosing the strike to anyone. Moreover the company issued a press release saying there was no strike. When a public disclosure was finally made, the stock price went form $17 to $54. The SEC alleged violation under 10b-5: (1) officers purchased stock based on insider info, (2) they divulged info to others for the same purpose, (3) they issued a deceptive press release (4) they accepted sock options without disclosing the material info to the board.

A material fact must be disclosed to the investing public prior to insider trading in the corps securities, FACTORS:

- probability that event would occur
- anticipated magnitude of the event
- would it have been important to a reasonable investor deciding to buy or sell
- importance attached to fact by those who knew about it

Court holds that the knowledge was material and should have been disclosed

When can insiders act? can't try to "beat the news" – must keep out of the market until the established procedures for public release of the info are carried out

You can violate 10b-5 by accepting stock options without disclosing material info – they should have disclosed the info to the board

Elements of 10b-5 claim: (1) fraud or deceit (2) upon any person (3) in connection with (4) purchase or sale (5) of any security

In general, to prevail on a Rule 10b-5 claim, a plaintiff must prove that the defendant: 1) made a misstatement or omission, 2) of material fact, 3) with scienter, 4) in connection with the purchase or sale of securities, 5) upon which the plaintiff relied, and 6) that reliance proximately caused the plaintiff's injury

"In Connection with"

To be subject to the rule, the conduct prohibited by the rule must be in connection with the purchase or sale of a security

In *Superintendent v. Bankers*, a group conspired to buy a Corp with its own funds by writing a check, acquiring, the Corp, then selling off its assets (treasury notes) to cover the check. The group was charged with selling securities in violation of 10b-5. Group said there was no connection. S. Ct. held that since there was a sale of a security and since fraud was used in connection with it, there is a redress under 10b-5. Thus, the transfer of the securities does not need to be a part of the negotiated transaction for the "in connection with" requirement to be met.

In *Brown v. Ivie*, Minority shareholder sued the two other corporate shareholders alleging that they violated the Federal Securities Act antifraud provisions in inducing him to enter into an agreement to sell his stock for less than its fair value (they got him to sign another agreement that allowed them to oust him without disclosing their intent). Ct. held that if the majority shareholders presented the minority shareholder with an agreement requiring shareholders leaving the corporation to sell their shares back to the corporation at book value and to surrender possession of the stock certificates to a trustee and the majority shareholders informed the minority shareholder that the agreement was necessary to effectuate a change in insurance companies and to increase the amount of insurance held by the corporation on each shareholder, *but failed to tell him that they intended to oust him from the corporation and would be using the agreement to obtain his stock at less than fair value, the fraud would be in connection with the sale of a security* and would be actionable under Rule 10b-5. P says they violated 10b-5 by fraudulently inducing him to sign. To be "in connection with" the sale, the transaction – including ***the sale must "touch" the transaction involving the fraud***. Here it did.

. In *Ketchum* the plaintiffs alleged that they were ousted from the corporation as a result of defendants' misrepresentations and required by the terms of a "stock-retirement agreement" to sell their stock back to the corporation at less than fair value. The Ketchum court concluded that *the fraud was too remote to be "in connection with" the sale of a security*. The court stressed that the objective of defendants' alleged fraud was to expel plaintiffs from the corporation in order to gain control and that the resulting sale of securities was simply an "indirect" consequence of plaintiffs' expulsion.

SEC v. Texas Gulf (above) held that misstatements in a press release (issued by corp not engaged in buying or selling its stocks) may constitute a violation of Rule 10b-5 because they were made in connection with the purchasers and sale being made by shareholders on the open markets

<u>Manipulation</u>: is a term of art but generally refers to practices such as wash sales, matched orders, or rigged prices that are intended to mislead investors by artificially affecting market activity.

Congress by 10b-5 did not seek to regulate transactions, which constitute no more than internal corporate mismanagement

> *Santa Fe Case:* Santa Fe corp. acquired 95% of Kirby – then wanted to merge – statute (short term merger) says you can merge w/o vote if you own at least 90% w/o shareholder approval as long as minority are paid FMV (since no shareholder approval does not fit under rule 145). Minorities said shares were worth more than they were being offered. Court says there was no material misrepresentation in letter that offered a certain price, court said if they do not agree with the price they can take it up in state court, not under 10b-5.
>
> In *Heally* case, P owned 20% of CRS, another company wanted to buy CRS – so bought other 80% of the shares. Company decided to merge – P says he tried to acquire info from the company so he could seek to enjoin the merger (which he had the right to do in TX) Ct. says since he was not given access to info that might have enabled him to enjoin – there was a potential 10-b-5 violation. The corporation's activities constituted a deceptive omission.
>
> In *Maldonado v. Flynn* the board of a corporation, anticipating a tender offer, amended their stock option agreement to shift tax advantages from the corporation to themselves when the tender offer took place. The court held that since the only damages suffered were the loss of tax advantages, the fraud was too remote from a securities transaction to constitute a violation of Rule 10b-5.

Reliance and Causation under Rule 10b-5

<u>Transaction Causation</u>

Causation where there are fraudulent omissions.

> In *Affiliated Ute* the Supreme Court held that where the allegations involve the failure to disclose material information "positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material."

AN agreement between a tender offeror and management of target corp, under which shareholders received less than they could have under original offer is not a manipulative device

Is privity required in an insider trading case?

> In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (2nd Cir.) the plaintiffs established that the defendants had violated Rule 10b-5. (the company learned of undisclosed public info and shared it with some of their customers who were selling)P's (who were buying in the open market) brought suit. However, since the trading took place on the open market the plaintiffs could not show that the shares they bought had belonged to the defendants (i.e. no privity of contract). The court held that anyone who purchased in the market without knowledge of the inside information known to the defendants during the same time the

defendants sold their securities can adequately show reliance and causation. – ***court says no privity required*** (but this create Draconian liability)

Fridrick v. Bradford (6th Cir.) involved substantially the same facts as *Shapiro*. The court held that for the plaintiffs to show causation they must show that the defendants trading on the market without disclosing inside information impacted the market price of the shares. It held that the SEC should pursue these cases, rather than allowing private parties to recover. Court held that insiders who bought in open market were not liable to persons selling in the open market

Thus, there is a conflict among the circuits as to the causation requirements of Rule 10b-5.

Causation where there are fraudulent misstatements.

What disclosure must corp make concerning pending merger negotiations?

In *Basic Inc. v. Levinson* a corporation stated that it was not engaged in negotiations involving a potential merger. Then the corporation announced that it would accept a tender offer from an acquiring corporation. The plaitniff-shareholders had sold their shares after the release stating that no negotiations were taking place. The Supreme Court adopted the *fraud-on-the-market theory* for showing reliance that states that reliance is presumed where material public misstatements are made because the misstatements affect the market price upon which everyone relies in making investment decisions. The defendant must rebut the presumption of reliance.

The Corp made public statements denying that they were engaged in merger talks – the court looks at Congressional intent and says that the public should be able to rely on statements from companies

Loss Causation

There are two types of causation:

(1) Loss causation: that the transaction caused the loss to the P
(2) Transaction causation: that the transaction caused the loss to the P

In *Bastian v. Petren Resources Corp.* the plaintiffs invested in an oil and gas venture that later became worthless. They alleged a violation of Rule 10b-5 in the offering memoranda's misrepresentations and misleading omissions concerning the defendants' competence and integrity. They claimed they would not have purchased the securities had they known the truth about the defendants' competence and that therefore the misstatements had caused their loss. The court held that loss causation required that the plaintiffs show that the defendants' incompetence had caused the failure of the venture. Here, the venture became worthless because of turns in the market for oil and gas.

"Purchaser-Seller" Requirement

The plaintiff in a 10b-5 action must be either a purchaser or seller of securities in the transaction being attacked

In *Blue Chip Stamps v. Manor Drug Stores* potential purchasers who ultimately did not purchase stock in a corporation because the issuer's prospectus was overly pessimistic argued that the misstatements caused the plaintiffs to lose their opportunity to earn money but investing in it the corporation. The Supreme Court held that the purchaser-seller requirement was not satisfied. This holding is referred to as the *Birnbaum* Rule, named after the 2nd Cir. decision that created the rule.

In *Alley v. Miramon* a corporate insider fraudulently convinced the plaintiff to pledge his securities to him by telling him that he needed them to secure a loan to the corporation. The insider then liquidated the corporation and kept the money from the plaintiff's shares. The court held that the purchase-seller requirement was met because the plaintiff was a "forced seller". This is the "forced sale" doctrine.

Fault required

Rule 10b-5 is an anti-fraud provision – person cannot be held liable unless he acts with scienter

In *Ernst v. Hochfelder*, First Securities hired Ermst, an accounting firm, to perform periodic audits of the firms books and records. The president of First Securities was engaged in fraud and cheated customers out of their money. The customers filed suit against Ernst. P said that Ernst owed a duty to the public and were negligent in commission of that duty. Their premise was that Ernst & Ernst had failed to utilize "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm said to prevent an effective audit. The issue was whether a private cause of action for damages will lie under s 10(b) and Rule 10b-5 in the absence of any allegation of "scienter" intent to deceive, manipulate, or defraud. We conclude that it will not and therefore we reverse. Neither the legislative history nor the briefs supporting respondents identify any usage or authority for construing "manipulative (or cunning) devices" to include negligence

In order to be held liable, the person charged must have acted with scienter.

This is the same standard required in an enforcement action by the SEC – but recklessness is enough

Persons subject to trading constraints

Who is subject to the trading constraints? "any person"?, insiders?

In *Chiarella v. U.S.*, D was an employee at a printing company who printed announcements of corporate takeover bids. D was able to deduce the name of the companies and bought stock in those companies. He sold the stock when the takeover was announced. The Sec charged him with violating EA 10b and rule 10b-5. D argues he was under no duty to disclose. The Supreme Court held that: (1) employee could not be convicted on theory of failure to disclose his knowledge to stockholders or target companies as he was under no duty to speak, in that he had no prior dealings with the stockholders and was not their agent or fiduciary and was not a person in whom sellers had placed their trust and confidence, but dealt with them only through impersonal market transactions; (2) section 10(b) duty to disclose does not arise from mere possession of nonpublic

market information; and (3) court would not decide whether employee breached a duty to acquiring corporation since such theory was not submitted to the jury.

Chiarella did not decide the so-called "misappropriation theory" – *O'Hagan* does

Two theories:

Classical: Under the "traditional" or "classical theory" of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under § 10(b), because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." That relationship, we recognized, "gives rise to a duty to disclose or to abstain from trading because of the 'necessity of preventing a corporate insider from ... taking unfair advantage of ... uninformed ... stockholders.' ". The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation. (***insiders***)

Misappropriation: The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information. (when outsiders can become insiders)

In *US v. O'Hagan*, O'Hagan was a partner in a law firm. The law firm was hired to represent a company in a tender offer. O'Hagan, who was not working on the case, found out and began to purchased call options and stock in the company. He made 4.3 million. The SEC indicted him, it was argued that he defrauded his law firm and its client by using for his own trading purposes, non public info regarding the planned tender offer (misappropriation theory). The court held that (1) criminal liability under § 10(b) of Securities Exchange Act may be predicated on misappropriation theory; (2) defendant who purchased stock in target corporation prior to its being purchased in tender offer, based on inside information he acquired as member of law firm representing tender offeror, could be found guilty of securities fraud in violation of Rule 10b-5 under misappropriation theory.

If there is no breach of confidentiality, then no liability.

When it does not apply → "The misappropriation theory would not ... apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities."

Note: if person with inside info discloses that he has the info -- he can then trade or if fiduciary (O'Hagan) discloses to the source that he plans to trade on the info – there is no deceptive device and therefore no fraud

> In *Dirks v. SEC,* Petitioner Raymond Dirks received material nonpublic information from "insiders" of a corporation with which he had no connection. He was told that a mutual fund company was engaging in fraud and he set out to investigate the fraud. He disclosed this information to investors who relied on it in trading in the shares of the corporation. The question is whether Dirks violated the antifraud provisions of the federal securities laws by this disclosure. The court held that had no duty to abstain from use of the inside information that he obtained where the tippers, who were motivated by a desire to expose fraud, received no monetary or personal benefit from revealing the information nor was their purpose to make a gift of valuable information to petitioner; thus, there was no actionable violation of antifraud provisions of federal securities laws resulting from petitioner's disclosure of the information to investors who relied on it in trading in the shares of the corporation.

Test: whether the insider will benefit from his disclosure

Does D have to use the info or just possess it? 10b5-1 says you have to be aware of the info (and that it is non-public) when you make the sale or purchase

When does issuer have duty to disclose?

> In *Basic Inc,* company was engaged in merger talks but made three public statements denying that it was engaged in merger negotiations. Some shareholders, who sold their stock after the public statement, sued and argued that the company issued false and misleading statements in violation of 10b-5. The issue was whet disclosure must a company make concerning merger negotiations – when do the negotiations constitute "material info"? S.Ct. said that merger discussions are subject to the same test of materiality as other types of contingent or speculative info: a balancing of both the individual probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity

Whenever an issuer makes a public statement – the statement must be materially accurate and complete (issuer can just say "no comment")

> In *Ross*, company issued statements saying how safe its product was – it turned out not to be safe. P's say company failed to correct or revise the prior statements. Held: there is a duty to correct or revise a prior statement which was accurate when made but which has become misleading due to subsequent events – duty to correct exists as long as traders could reasonably rely on the statement

What if erroneous statements are printed by news media, does company have duty to correct? no duty to correct as long as the statements is not attributable to the company

> *Stransky* case: The predicate for this case is a familiar one: a company makes optimistic predictions about future performance, the predictions turn out to be less than prophetic, and shareholders cry foul, or more specifically, fraud. The avenues of proving a false or misleading statement or omission are still uncertain. The most common and obvious method is by demonstrating that the defendant fraudulently made a statement of material fact or omitted a fact necessary to

prevent a statement from being misleading. Two other avenues have been kicked around by courts, litigants and academics alike: a "duty to correct" and a "duty to update." Litigants often fail to distinguish between these theories (as did Stransky in this case) and to delineate their exact parameters. The former applies when a company makes a historical statement that, at the time made, the company believed to be true, but as revealed by subsequently discovered information actually was not. The company then must correct the prior statement within a reasonable time. The forward-looking statements (or projection) can lead to liability only if they were unreasonable in light of the facts known at the time or they were not made in good faith.

SHORT SWING PROFITS

Any company that is a '34 Act reporting company – its officers and directors have to file (plus the 10 % shareholders) a Form 3 that discloses of the securities they own of their corp, then, if they make a sale or purchase they have to file another form.

Why? Congress was concerned that insiders were in a better position than the rest of the market place to take advantage of momentary changes in the market

So, as a policy matter, any time an officer, director, or 10% shareholder buys and sells stock within 6 months – it is considered insider trading and the profits belong to the issuer

EA 16(b) "any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months"

The section is designed to minimize the unfair use of inside info

Profits made by insiders from transactions involving equity securities of publicly held companies when a purchase and sale are less than six months apart must be disgorged and paid to the issuer

The section is not a criminal provision – it merely provides that profits belong to the issuer

1. Persons liable

"*officers and directors*"

a purchase made by the person after he has ceased to be a director/officer can be matched against a sale/purchase made within 6 months previously while he still retained tat position

"10% shareholder"

Must own **greater than** 10% of common or preferred stock

In order to be held liable must be 10% shareholder at time of both sale and purchase

Deputization

A partnership or corporation that is found to have deputized one of its members or officers to serve as director of another company will itself be liable as a director (of the other company) for profits made on its own trades

If one company (A) wants to invest in another company and sends a director or officer to the other company (B) – the officer will be an insider for the second corp and is "deputized"

So If company A sells/purchase within 6 months – will be liable for profits to B

Is a question of fact

If you are responsible for the other corps finances or policy making – you will be deputized

Note: transactions by directors/officers can be matched against transactions by their spouse or of other family members if the officer/director has a "direct or indirect pecuniary interest" (can be broad) – thus depending on your relation w/ Corp you can be deputized

2. What constitutes a "purchase" or "sale"?

- exercise of put/call option = purchase or sale
- exercise of employee stock option – **not** purchase or sale
- "forced seller" because of tender offer – **not** purchase or sale

3. Timing of purchase and sales

A holder of 10% who sells enough to be a 9.9% shareholder and then sells remainder is not liable for the profit on the second transaction, even if the two sale were part of a single transaction

The purchase which makes a person a 10% shareholder cannot be matched against a subsequent sale to create liability

Must be a >10% shareholder at both the sale and the purchase

4. Standing to sue

Who can sue to enforce §16? anyone who owns at least one share at the time of the suit – so you can find out about a violation – go buy a share and then bring suit (must be within SOL)

P must be the owner of a security of the issuer at the tiem of the suit

A person who had been a shareholder at the time of bringing an action under §16 (b) could continue to prosecute the action after the issuer had been merged into another Corp as long as he maintained a "continuing financial interest" in the litigation through ownership of securities of the surviving Corp

5. Calculation of profits

There is profit whenever there is a purchase that can be matched against a sale at a higher price that is made less than 6 months after, or before, the purchase

EXAMPLE

	Purchase	Sell	Purchase (all within 6 mons)
# of shares:	100	200	5
Price:	$10	$20	$5

What is director liable for: first match lowest price with highest price and calculate difference (5 shares at $15 difference = $75) then match next lowest price with remaining highest price – or next highest price (100 shares at $15= $1500)

Total director must pay company = $1575

It has been argued that you have to match first purchase with sell price – court said no! – you match the highest sell with the lowest purchase (but you can only match the shares once)