**I. Gatekeeper question: Is it a “security”?**

IF transaction involves a “security”🡪it may trigger regulation under the securities laws!

Note: IF “exempt security” or “exempted transaction”🡪not subject to the registration and disclosure requirements but may be subject to general antifraud and civil liability.

|  |
| --- |
| 1. Does it fall under the **list of specific instruments** (note, stock, bond) in Securities Act, §2(a)(1)?
2. IF enumerated in the list🡪is it a “security” in **economic reality**?
3. If NOT in the list🡪it is an “**investment contract”?**
 |

**1. List of specific instruments** Sec. Act, § 2(a)(1), Ex. Act § 3(a)(10)

* “The term "security" means any note, stock, treasury stock, security future, 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.”
* Under Dodd-Frank, security definition includes “security-based swap agreements”
	+ A swap agreement of which a material term is based on the price, yield, value or volatility of any sec. or any group or index of securities, or any interest therin.
	+ “Based on” does NOT imply an exclusive dependent relationship. Rorech (SDNY)
* **Note:** It is a sec “unless the context otherwise require”

**2. Economic reality test: *Forman, Reves***

**A. Stock (Forman)**

In the case of **stock**, the label is dispositive IF it has typical characteristics:

* give rights to dividends that are contingent on profits,
* are negotiable
* can be pledged or hypothecated,
* confer voting rights in proportion to number owned
* can appreciate in value

AND under the circumstances it was reasonable for the investor to rely on the word “stock” in assuming that the transaction was covered by the sec. law.

**Do NOT apply Howey test! (Landreth)**

**B. Notes (Reves)**

|  |
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| 1. **Rebuttable presumption** that every note is a sec.
2. Presumption can be rebutted if note is falls w/in **family resemblance** test OR
3. Meets Reves’ **multifactor test**
	1. Motivation of buyer and seller
	2. Plan of distribution
	3. Reasonable expectations of investing public
	4. Other factors that reduce risk
4. **Check maturity date** for exemption
5. Do NOT apply Howey test
 |

**2. Family resemblance test**: NOT a security, if it falls into a category of instruments:

* + Notes used in consumer lending
	+ Notes secured by a mortgage on a home
	+ Short-tem notes secured by an assignment of accounts receivable
	+ Consumer financing
	+ “character” loans to bank customers
	+ short-term secured financing of accounts receivable
	+ commercial bank loans for current operations
	+ short-term open-account debts incurred in the ordinary course of business

**3. OR if meets multifactor test**

* What is the **motivation** of buyer/seller?
	+ IF to raise money for a business/finance substantial investments🡪more like sec.
	+ IF to finance purchase or sale of minor asset or consumer good, correct for seller’s cash-flow difficulties, or advance some other commercial or consumer purpose🡪less like sec.
* **Plan of distribution**?
	+ IF widely offered and traded🡪more like sec.
	+ IF given face-to-face or to limited no of investors🡪less like sec.
* Reasonable **expectations of investing public** suggesting that product was marketed like an investment?
* Is there any factor that significantly **reduces the risk** of the instrument?
	+ If note is secured, collateralized or regulated by another regime🡪less like a sec.

**4. IF “note”**🡪**check maturity date to see if exclusion applies!**

* Note is not a sec IF it has a maturity date of less than 9 months. §3(a)(10)
* A note “payable upon demand” does not necessarily fall into this exception bc demand could be made immediately or could be made past the 9 mo window.

**5. Do NOT apply Howey test!** Landreth

**3. Investment Contract: *Howey***

|  |
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| 1. **Investment**
2. **Commonality**
3. **Expected profits**
4. **Efforts of others**
 |

1. **A person invests value**
	* Can be in the form of goods and services, not just money (Daniel)
	* = investor seeks financial return on investment, NOT consumption (Forman)
		1. = in mixed cases, court should see which was “purely incidental” and look to primary motive (C.f., Howey, transfer of rights in land was purely incidental w/ Forman, living quarters was primary motivation)
	* = specific consideration in return for a separable financial interest (Daniel) (rejecting argument that P had invested in the pension plan by permitting part of his compensation to take the form of a deferred pension benefit.)
2. **In a common enterprise**
	* **Horizontal commonality**: pooling of investment funds, profit sharing and loss sharing. (Life Partners)
	* **Vertical commonality**: promoter’s efforts impact individual investors collectively, but investor(s) could earn different returns;
		1. Broad VC: Enough that investors fortunes is linked to promoters’ efforts
		2. Strict VC: Investors fortunes must be linked to promoters *fortunes* (direct correlation between parties’ financial success)
	* **Three different rules**
		1. HC Required
		2. VC Sufficient
		3. Either
3. **With the expectation of profits**
	* “By profits, the Court has meant either **capital appreciation** resulting from the development of the initial investment … or a **participation in earnings** resulting from the use of investors' funds …” Forman (dictum)
		1. FYI Life Partners (DC Cir.): REJECTED LPI’s argument based on this dictum. It found that a claim on future death benefits was a form of financial return.
	* Return must come from earnings/appreciation of the investment—NOT merely from additional contributions (Daniel)
4. **From the efforts of a third party or promoter**
	* “Solely” (Howey) or “predominantly” (lower circuits) from efforts of others?
	* Pre-purchase or post-purchase? (Life Partners)
		1. Pre-purchase services is NOT enough to make the profits of an investment arise predominantly from the efforts of a third party.
	* Entrepreneurial or ministerial? (Life Partners)
		1. Post-purchase ministerial functions should receive a good deal less weight than entrepreneurial functions.
		2. Dissent: What matters is the kind and degree of dependence between profits and promoters’ overall activities

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| **Howey in context:*** **Franchise agreements**
* **Partnership interests**
* **Pension Plans**
* **Bank instruments**
 |

**Franchise agreements as securities.** Koscot

* An investment contract may arise out of a franchise scheme IF (i) promoters retain “immediate control” over “essential managerial conduct” and (ii) investors’ profits are “inextricably tied” to the scheme.
* Conventional franchises in which promoter exercises “remote control” and investor operates independently is NOT a security.

**Partnership interests as securities**

**1. Limited partnerships** Steinhardt (3d Cir)

LP interests is NOT an “investment contract” IF the limited partner can and does exercise “pervasive control” of the partnership.

* To resolve whether limited partner was a “passive investor,” ct should look at the transaction as a whole including the limited partnership agreement.
* Issue does NOT turn on whether investor actually exercised its rights.
* The Del. Revised Uniform Limited Partnership Act, which gives limited partners approval rights without deeming them to having exercised control, is NOT controlling.

**2. General partnership interests** Williamson v. Tucker (5th Cir)

A general partnership interest is NOT a security UNLESS P can establish that he had

* **NO legal control:** a partnership agreement leaves little power in the hands of a partners such that the distribution of power is like that of a LP OR
* **NO capacity to control:** the partner is so inexperienced and unknowledgeable that he is incapable of exercising power OR
* **NO practical control:** the partner is so dependent on some unique ability of the promoter that he cannot replace the promoter or otherwise exercise meaningful power.

**Pension Plans** Intl Brotherhood of Teamsters v. Daniel

Employer funded, compulsory pension plans are NOT securities.

* Note: Leaves open the question as to whether employee funded, variable benefit plans are securities.
* Key dicta: “If any further evidence *were needed* to demonstrate that pension plans of the type involved are not subject to the Securities Acts, the enactment of ERISA in 1974 would put the matter to rest.” The outcome of the case was controlled by Howey test and legislative history.

**Bank Instruments** Marine Bank v. Weaver

Certificate of deposits issued by a bank regulated by the fd government (and its banking laws) and insured by the FDIC are NOT securities.

**II. Materiality**

|  |
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| * Was there a **misstatement/omission**?
* If yes🡪was the misstatement/omission **material**?
* If yes🡪did the defendant have a **duty**?

*\* Just bc information is false or misleading does NOT make it material! Just bc it is material does NOT mean it must be disclosed!* |

* **Duty** stems from two things:
	+ **Duty of accurate disclosure:** In addition to mandatory line-item disclosure, the SEC requires these companies to include in filings any other “material” information necessary to make sure the disclosure is not misleading. Sec Act. Rule 408, Exch. Act Rule 12b-20
	+ **Duty of honesty**: Once a speaker discusses information about a security, they must be honest in connection w that security. But if company does not speak and has no duty to speak, they can keep things confidential. Basic.
* Materiality is a **mixed question of law and fact**.
	+ Only if the omission/misrepresentation is so obviously important to an investor, that reasonable minds cannot differ on the question of materiality, is the ultimate issue of materiality appropriately resolved as a matter of law by summary judgment.
* Materiality in fraud is **lower than the materiality threshold in MAC/MAE clauses**
	+ E.g., IBP Shareholders Litig: Chancellor Strine said for an event to be material it must “substantially threaten the overall earnings potential of the target” in a manner that is “durationally-significant”
	+ Burden of proof is on person trying to get out of the deal
* **Total mix of information defense**
	+ = Info already in the public domain & facts known or reasonably available to shareholders
	+ = May include normal business practices in the industry (e.g., World of Wonders, not material to omit practices of stock balancing & price protection as this is common in the toy industry)
	+ Does NOT include disclosures few in number or remote in time.
	+ **Buried facts doctrine:** A disclosure is NOT adequate if it is presented in a way that conceals or obscures the information sought to be disclosed

|  |  |  |
| --- | --- | --- |
| **Type of disclosure** | **Test** | **Issues** |
| **Historical facts** | TSC v. Northway: Substantial likelihood that reasonable investor would consider such facts important. | * Who is reasonable investor?
* How important is information to company’s finances?
* Did information, when revealed, affect stock price?
 |
| **Speculative information** (e.g., merger) | Basic: current information bears on probability and magnitude of future event | * How does information affect probability of event?
* What is magnitude (price) effect?
* How far along are merger talks?
 |
| **Forward-looking projections and opinions** | Virginia Bankshares: opinions actionable only * if not believed,
* speaker’s statements are important to reasonable investor (Basic/TSC),
* and they mislead about subject matter in light of objective evid
 | * Is forward looking statement voluntary or mandatory?
* Was there basis for opinion or prediction?
* Is there safe harbor?
 |
| **Information on management integrity** | In re Franchard (SEC 1964): management conflicts of interest highly material, though not failures in board oversight | * Does information reveal mgmt conflict of interest?
* Is noncompliance w other laws clear (criminal, state, fiduciary)?
 |

**A. Historical Facts**

**1. TSC Indus. objective test: (i) Substantial likelihood** that (ii) **reasonable investor** would consider such facts important to his decision making process

* NOT but for test: does not require proof that disclosure would have caused the reasonable investor to act differently (ex, to change his vote)—only that it would have altered the **total mix** **of information**.
* REJECTS 7th Cir test: “All facts which a reasonable shareholder *might* consider important.”

**2.** SEC requirements might create a **presumption of materiality**

**3.** Materiality does NOT adhere to specific **numerical benchmarks.** (Ganino, 2d Cir)

* Qualitative factors may cause misstatements of quantitatively small amounts to be material, e.g. if: (SAB No. 99)
	+ Misstatement masks change in earnings/trends.
	+ Misstatement hides failure to meet analysts’ consensus expectations for the enterprise.
* See also SAB No. 99 (rejecting 5% benchmark)

4. Materiality does NOT rely on whether evid is **statistically significant**. Materiality of such evid is fact-specific inquiry. (Matrixx Initiatives)

* Rationale: Medical experts and govnt agencies rely on evid. other than statistically significant data—so it stands to reasons reasonable investors would act on this evid. as well.

**B. Speculative information**

* **Basic test**: materiality depends on balancing of the **probability** that event will occur against the **magnitude** of the event in light of the totality of the company activity
	+ **In context of merger:** Relevant factors in determining probability include board resolutions, instructions to investment bankers, negotiations btw principals or their intermediaries. And for magnitude: potential premiums over market value
	+ Dicta: Merger is an important event in a corp.’s life and thus can become material at an earlier stage than would be the case as regards lesser transactions
* REJECTS **agreement-in-principle** theory, which says merger discussion does not become material until agreement as to price and structure of the deal has been reached
* Probability must be seen from **ex ante** point of view. (“Plaintiffs cannot use the benefit of 20/20 hindsight to turn management’s business judgment into sec. fraud.” WOW)

**C. Forward looking statements and opinions**

|  |  |  |
| --- | --- | --- |
| **Safe harbor** | **Coverage** | **Conditions** |
| Sec Act Rule 175(subjective test) | Forward-looking statement by issuer (or his agent, outside reviewer retained by issuer) in SEC filings | Statement not fraudulent UNLESS * shown to be without reasonable basis OR
* not made in good faith
 |
| PSLRA § 27A(objective test) | Forward-looking statement by issuer (or his agent, outside reviewer retained by issuer).Applies whether or not statement is filed w the SEC.EXCEPT- nonreporting corporations- noncorporate entities (like partnerships)- recent fraud violators -investment companies- penny stock issuers- initial public offerings- tender offers- going private transaction- beneficial ownership reports under § 13(d) | § 27A(c)(1): No private liability for written statements, IF* statement is identified as forward-looking AND is “accompanied by meaningful cautionary statements identifying important factors”\* OR
* statement is immaterial OR
* P fails to prove that the statement was made with “actual knowledge”

\* For oral statements, (i) there must be a cautionary statement that the oral statement is a forward-looking one, (ii) and that the actual results would differ materially from those projected, (iii) and there must be a statement that risk factors are in a readily available in a written document. (iv) The statement must identify where in the document the disclosure is and (v) the disclosure itself must have cautionary language. |
| Judicial (bespeaks caution) | Forward-looking statement by ANY person and applies whether or not statement is filed w the SEC | Statement not material IF * statement cautions AND
* describes possible risk factors
 |

**1. Forward Looking Statements**

**Bespeaks caution** **defense**: IF forward-looking statements are accompanied by disclosure of risks🡪 statements NOT material. World of Wonders

* Applies ONLY to “**precise cautionary language** which **directly addresses** itself to future projections, estimates or forecasts”
* Blanket warnings of risk are NOT enough

**PSLRA/Rule 175 definition of “forward looking statement”:**

* A statement containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items;
* A statement of management's plans and objectives for future operations;
* A statement of future economic performance
* Disclosed statements of assumptions underlying or relating to any of the statements described in bullets 1, 2, or 3 above.
* Any report issued by an “outside reviewer” retained by the issuer to the extent it assesses a forward looking statement made by the issuer (PSLRA only)
* A statement containing a projection or estimate of such other items as may be specified by the SEC (PSLRA only)

**PSLRA analysis** Harris (11th Cir.)

* Was the statement **forward looking?** A present tense statement can be forward looking (E.g., “the challenges unique to this period in our history are now behind us.”)
	+ If the truth of a statement can only be discerned after the speaker declared it, then it is forward looking. (E.g., “our fundamental business and underlying strategies remain intact ... IVAX is certainly well positioned.”)
	+ A court can apply the statutory harbor to a “mixed list” IF (i) the allegation that it is misleading applies to the entire “unit” AND ii) it contains assumptions underlying a forward looking statement
* If so, was there **meaningful cautionary language**?
	+ The language does NOT have to explicitly mention *all* risk factors—failure to include the particular factor that ultimately causes the forward looking statement not to come true will not necessarily mean the statement is not protected. (E.g., D’s press release did not mention risk of goodwill writedown)
	+ **Boilerplate** is good enough as long as it is “detailed and informative” (D’s press releases appended italicized warnings that were sufficient)

Duty typically arises from Reg S-K for disclosure in RSs and filings under Ex. Act:

* **Item 303** requires that mgmt disclose, in the MD&A portion of filings, known trends, demands, commitments, events or uncertainties that will result or reasonably likely to result in registrant’s liquidity increasing or decreasing in any material way.
* **Item 503(c):** requires registrant to include a discussion of the most significant factors that make the offering speculative or risky.

**2. Opinions**

Statements of reason, opinion, or belief may be actionable IF

* the speaker did not believe opinion,
* there’s a substantial likelihood that reasonable investor would consider the speaker’s opinion important AND
* opinion was misleading in light of “objective” evid. Virginia Bankshares (finding that a statement of belief by *corporate directors* about a recommended course of action can be important under Basic test & allegation of falsity was factually provable bc statement depended on Bank’s assets).

**Mere puffery** is NOT actionable.

**D. Information on management integrity**

Management **conflicts of interest** highly material, though not failures in board oversight as this is regulated by state fiduciary law. In re Franchard (SEC).

* Rationale: 1) Glickman’s need for cash gave him a strong motive to put his needs in front of corp thereby creating risk of conflict of interest and 2) the risk of a change of control was crucial as public offerings were predicated on Glickman’s personal reputation

Duty typically arises from Reg S-K for disclosure in RSs and filings under Ex. Act:

* **Item 401(f)** requiring registrants to disclose (i) certain legal proceedings (ii) that occurred during the last ten years and (iii) that are material to an evaluation of the ability or integrity of any director, person nominated to be a director or executive officer of the registrant.
	+ Bankruptcy or reorganization petitions
	+ Criminal convictions and “pending crim. proceedings” (other than traffic offenses and similar minor offenses)
	+ Orders, judgments or decrees enjoining/limiting person from engaging in business
	+ Any finding in a civil action that the person violated sec law
* **Item 402** requiring disclosure of executive’s compensation
* **Item 403** requiring disclosure of mgmt’s sec ownership including any pledge that may later result in a change of control.
* **Item 404** requiring disclosure of conflict of interest transactions, including loans to mgmt and transactions between the registrant and any business entity in which a “related person” has a significant business interest

**III. Section 5 of the Securities Act: Registration Process**

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| **Section 5** broadly prohibits the sale of any security using the mails or other interstate means of communication UNLESS (1) the issuer has filed a RS and (2) the RS has become effective. * **The pre-filing period** (period before filing date): The marketing & sale of any sec is prohibited.
* **The waiting period** (period between filing date and the effective date): Sales are prohibited and written marketing is heavily regulated.
* **The post-effective period** (period after effective date until the offering ends): Sales are permitted but written marketing continues to be regulated; purchasers must receive a prospectus that complies w statutory and SEC specs.

**Defenses:** 1) Not a “public” offering (private placements), 2) mere re-sale**Note:** Even if there is no gun jumping liability, D may still face § 12(a)(2) liability, Reg. F-D liability or fraud liability. |

**SEC review process + shelf registration**

**Review process:** RS becomes effective 20 days after filing; clock resets if co. makes an amendment. Co. stipulate to a delaying amendment in their RS—per Rule 173—so as to give SEC more time to review.

**Shelf registration**

* Shelf-Registration **is permitted for 3 types of registrants:**
	+ Reporting companies that are widely followed by professional analysts.
		- Permitted to use short-form registration statement.
			* Use form S-3, which relies on incorporation by reference to Exchange Reports.
		- Permitted to have minimal disclosure in prospectus.
		- *Can use shelf-registration in “at the market” offerings.* Rule 415.
	+ Companies that have been reporting companies for at least 3 years, but not widely followed.
		- Incorporations from Exchange Reports AND supplemental info contained in prospectus or in annual reports to security holders.
			* Use form S-2.
		- Abolished in 2005.
	+ Companies that have been reporting companies < 3 years.
		- Require full disclosure per form S-1.
		- No incorporation by reference.
* Shelf-registration statements are effective for 3 years. But issuer can file new registration statement covering same securities and continue offering them on continuous basis.
* **WKSIs 🡪 automatic shelf registration**
	+ Can register unspecified amount of different types of securities on registration statements that become effective immediately on filing. Statement effective for 3 years.
	+ *To qualify as WKSI:*
		- Must have worldwide market capitalization for common stock of at least $700 million, excluding shares held by affiliates, OR
		- For debt/non-convertible preferred stock offerings 🡪 must have issued $1 billion in non-convertible securities other than common stock over last 3 years, in registered primarily offering for cash
* *Impact of Rule 415*
	+ - Underwriting Fees
			* Introduced heightened degree of competition in market for underwriting services
			* Smaller underwriting commission for shelf offerings
		- Equity Offerings
			* Rule 415 wasn't used for equity offerings at first. Because issuer’s stock price declines usually on announcement of equity offering. This is because market senses management decides to sell stock when price has peaked.
			* In response, SEC amended rule so that *don't need to specify # of shares being registered – only need to identify class of securities & aggregate expected profits from all sales.*
		- Due Diligence – Rule 176
			* Rule 176: encouraged year-round due diligence, but did not reduce required due diligence efforts to not be found liability under section 11
			* Hard to observe norms of ‘reasonable investigation’ in shelf offerings. So underwriters merely have to accept risk of liability.

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| **Safe harbors against integration w private placements** (Rule 506, 4(2) and 4(6) transactions)* Withdrawal from registration can be achieved automatically on filing of withdrawal application. Rule 477
* If **public offering is abandoned** before any sales by withdrawing RS under Rule 477, issuer can do private offering by waiting 30 days. Rule 155(c)
	+ - The issuer must notify each offeree in the private offering that the offering is not registered, the securities will be restricted, purchasers do not have Sec 11 protection and a RS for the abandoned offering was filed and withdrawn
		- Any disclosure document used in the private offering must disclose any material changes in the issuer's business/financial condition that occurred after the issuer filed the RS
	+ If **private placement was abandoned** before any sales and issuer/agent terminates all offering activity before filing RS, issuer can begin a public offering by disclosing this in final prospectus and any prelim prospectus and waiting 30 days to file RS if any offers had been made to nonaccredited investors. Rule 155(b).
		- The prospectus must disclose the size and nature of the private offering
		- the date on which issuer abandoned the private offering
		- that any offers to buy given in private offering were rejected
		- and that the prospectus delivered in the registered offering supersedes any offering materials used in the private offering
	+ If you have a **completed *or* abandoned private placement under § 4(2),** followed by a registered public offering, the § 4(2) PP is not subject to the integration doctrine. Rule 152
		- Not clear as to whether *the decision* to make a public offering and/or file a registration statement must be made *after* the abandonment or completion of the § 4(2) transaction.
 |

**Prohibitions against Gun Jumping**

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|  |  |  |
| **Prefiling period** | **Waiting period** | **Posteffective period** |
| § 5(c) – no “offers” |  |  |
| § 5(a)(1) – no “sales”§ 5(a)(2) – no “deliveries” |  |
|  | § 5(b)(1) – no “prospectus” unless complies w § 10 |
|  |  | § 5(b)(2) – no delivery, unless accompanied by § 10(a) formal prospectus |

**“Offer”** = (i) every attempt or offer to dispose of OR (ii) solicitation of an offer to buy, a security or interest in a security for value. § 2(a)(3)

* **Construed broadly by the SEC.** E.g., Loeb, Rhoades (SEC): Commission found that underwriters had violated § 5(c) by issuing a press release about a proposed offering of a Florida land development company. SEC held that 5c is applicable whether or not the issuer or the circumstances have “news value.”

**“Sale”** = (i) every contract of sale OR (ii) disposition of a security or interest of a security for value. § 2(a)(3)

* Disposition**:** the act of transferring something to another’s care or possession. (e.g., bank liquidating a security pledged as collateral for a debt. (Guild Films)
* Offers cannot be accepted!

**“Prospectus”** means any written or graphic communication which offers sec. for sale. § 2(a)(10), Rule 405

|  |  |  |
| --- | --- | --- |
| **Prefiling period** | **Waiting Period** | **Posteffective Period** |
| **Non reporting issuers** |
| *Permitted** Prelim negotiations & agreements among/with underwriters (§ 2(a)(3))
* Issuer announcements of proposed offering (Rule 135)
* Issuer communications 30+ days before offering (Rule 163A)
* Regularly released information (Rule 169)
* Research reports (Rules 137, 138)
 | *Permitted:** Oral offers
* Prelim negotiations & agreements among/with underwriters (§ 2(a)(3))
* Issuer announcements of proposed offering (Rule 135)
* Tombstone ads, identifying statements, requests for interest (§ 2(a)(10)(b), Rule 134)
* Preliminary (red herring) prospectus (§ 10(b), Rule 430)
* Summary prospectus (§ 10(b), Rule 430)
* Regularly released information (Rule 169)
* Free writing prospectus accompanied/preceded by prelim prospectus (§ 10(b), Rule 164, 433)
* Road shows (Rules 405, 433)
* Press interviews (Rule 433)

*Required** Distribution of prelim prospectus (rule 15c2-8)
 | *Permitted:** Oral offers
* Distribution and sale of sec.
* Tombstone ads, identifying statements, requests for interest (§ 2(a)(10)(b), Rule 134)
* Free writing communications, accompanied by final prospectus (§ 2(a)(10)(b)
* Final prospectus (§ 10)(a)
* Regularly released information (Rule 169)
* Notice of registration (Rule 173)
* Road shows (Rules 405, 433)
* Press interviews (Rule 433)

*Required** Written confirmations for sales from allotment and dealer sales (§ 5(b)(1), Rules 172, 174, Rule 10b-10
* Filing by issuer of final prospectus (§§5(b)(1), 5(b)(2), Rules 153, 172
* Delivery of notice w/in two days after sale (Rule 173)
 |
| **Reporting Issuers**Same, except: |
| *Permitted** Oral offers
* Free writing prospectus need not be accompanied/preceded by any prospectus for WKSIs *only* (Rule 163)
* Regularly released, forward looking information (Rule 168)
* Research reports (Rule 139)
 | *Permitted** Free writing prospectus need not be accompanied/preceded by prelim prospectus (Rule 433)
* Regularly released, forward looking information (Rule 168)
 | *Permitted** Free writing communications need not be accompanied/preceded by prelim prospectus (Rule 433)
* Regularly released, forward looking information (Rule 168)

*Required** Delivery of notice only applies to sales from allotment (§ 4(3), Rule 174)
 |

**A. Prefiling period safe harbors**

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| --- |
| * **Preregistration communication**—Rule 163A
* **Regularly released info**—Rules 169, 168
* **Preliminary negotiations**—§ 2(a)(3)
* **Research reports**—Rules 137, 137, 139
* **Company announcement**—Rule 135
* **WKSI communications**—Rule 163
 |

**Preregistration communication** Rule 163A

* any communication made by issuer or agent; no protection of underwriters or dealers
* more than 30 days before the date of the filing
* that does not reference the securities offering
* provided that the issuer takes “reasonable steps within its control” to prevent further distribution *or* publication of such communication during the 30 days before the filing date

**Regularly released information** Rule 169

* any communication made by issuer or agent; no protection of underwriters or dealers
* that does not reference the securities offering
* and involves the regular release/dissemination of “factual business information” (including advertising)
	+ - Available if issuer has (i) previously released this info in ordinary course of business,
		- (ii) the timing, manner, and form in which the information is released is consistent w/ similar past releases AND
		- (iii) to a limited audience of customers and suppliers other than in their capacities as investors or potential investors
		- (iv) by issuer’s agents/employees who have historically provided such information

**Regularly released information – reporting co.** Rule 168

* any communication made by *reporting* issuer (and seasoned reporting foreign issuers) or agent; no protection of underwriters or dealers
* that does not reference the securities offering
* and involves the regular release/dissemination of “factual business information” (including advertising) or forward-looking information
	+ - Available if issuer has (i) previously released this info in ordinary course of business,
		- (ii) the timing, manner, and form in which the information is released is consistent w/ similar past releases

**Preliminary negotiations** § 2(a)(3)

* Prelim negotiations between issuer and the UW, or among UW, that will be in privity w issuer

**Research reports by non participants** Rule 137

* any research report about an issuer in registration
* by a sec. firm who is not participating in the offering and does not intend to participate,
* has not received any direct or indirect compensation from the issuer, any participant in the offering or any other person interested in the securities
* and issues the research report in the regular course of his business

**Research reports on issuer’s non-offered securities** Rule 138

* any securities firm participating in the equity offering, can continue to distribute research about the issuer’s non-convertible debt or preferred stock.
* if the sec. firm is participating in the non-convertible debt or preferred stock offering, he can distribute research about the issuer’s equity securities.
	+ The reports must be published/distributed during regular course of business
	+ and must be about reporting companies

**Research reports by participants** Rule 139

* + A sec. firm may publish *company-specific* research reports on certain issuers even if he is participating or intends to participate in the offering IF (i) the firm has previously covered the issuer in a regular publication AND (ii)
		- the issuer is a large seasoned Form S-3 issuer
		- the issuer is a WKSI
		- the issuer is a large foreign issuer that is either seasoned on a foreign stock market or has a $700m global public float
	+ A broker dealer may publish *industry* research reports on reporting companies and large foreign issuers even if he is participating or intends to participate in the offering IF it includes
		- similar information with respect to a substantial number of issuers in the issuer’s industry or contains a comprehensive list of sec. currently recommended by the broker or dealer,
		- gives no materially greater space or prominence in the publication to the issuer and
		- the broker dealer distributes this report in the regular course of business and
		- has previously covered the issuer in past reports

**Company announcement** Rule 135

* Available only to issuer
* A notice released by issuer/selling shareholders/their agents
* that has legend w a disclaimer that the document is not an offer for securities
* does not mention the underwriters and the expected offering price
* includes no more than following information:
* The name of the issuer;
* The title and amount of the securities offered
* The amount of the offering, if any, to be made by selling security holders;
* The anticipated timing of the offering;
* The manner and the purpose of the offering
* Whether the issuer is directing its offering to only a particular class of purchasers;
* Any statements or legends required by the laws of any state or foreign country or administrative authority; and
* The notice may contain additional information in:
	+ Rights offering
	+ Offering to employees
	+ Exchange offer (see below)

*Rule 135 and materiality standard under Rule 10b-5*

* Notice for exchange offer should NOT go beyond basic terms of Rule 135. This discloses all material facts needed to avoid Rule 10b-5 liability. Chris-Craft.

**WKSI communications** Rule 163

* Available only to WKSI in prefiling period; not underwriters and dealers
* They are exempted from quiet period prohibition but any “written communication that is an offer” must bear a mandated legend (where to get copy of prospective once available and instructions to read it) and be filed with the SEC after filing RS
* Note: This is not a safe harbor from Regulation F-D liability

**B. The waiting period safe harbors**

|  |
| --- |
| * **Preliminary prospectus (red herring)**
* **Summary prospectus**
* **Tombstone ad**
* **Identifying statement**
* **Free writing prospectus**
* **Mandatory prospectus dissemination**
 |

**Rule 430**

**Preliminary prospectus**, aka **red herring prospectus,** that is contained within the RS that the issuer has filed can be distributed to investors during this period

* Must include legend that cautions that sec cannot yet be sold
* Contains the information found in the final prospectus but omits info on the offering price and the underwriting discounts and commissions.

**Rule 431 - Summary prospectus** can be distributed

**Tombstone ad** can be published during this period. §2 (a)(10)

* Tombstone ads can state from whom a written § 10 prospectus meeting may be obtained
* and can identify the security, the price, and who the underwriters are.

**Rule 134 - Identifying statement** **(term sheet)**

* Available to issuer, UW, or other participant
* You can give specified written information about the issuer, the underwriters and the offering
	+ - IF RS not yet effective, you must include a legend and explain where to obtain a prelim prospectus
		- OR you can avoid legend req, if tombstone ad *or* accompanied by a preliminary prospectus
	+ Information may include
		- issuer info, info about sec, issuer’s business, price of sec., use of proceeds, identify of sender, names of UWs, schedule and nature of offering
	+ You can also ask investors to indicate their interest in the offering by return card, if you also send a preliminary prospectus and explain there is no commitment.
		- Must contain mandatory legend indicating offer to buy may not be accepted nor even partial payment made until registration statement is effective

**Rule 163/433 - FWP**

A written or graphic communication that constitutes an offer is a **free writing prospectus**

* Available to issuer, UW or other participant
* Not available to ineligible issuers (Rule 405), not current w Exchange Act filings, “bad boys,” or subject to SEC investigation

Can be used if it satisfies following conditions under R. 433

* **Consistent information and legend**
	+ - Any FWP must include alegend specifying a number where investor can request a copy of the prospectus, the SEC’s web site address where it can be obtained and any email address/web site where prospectus can be accessed. Rule 433(c)(2)
		- FWP may include info not included in RS but it must not conflict w info in the RS. R. 433(c)(1)
	+ **Filing**
		- Issuer must file w SEC any FWP it prepares or a participant prepares based on info that the issuer provides it.
		- Offering participants must file any FWP that they use if they distribute it in a way designed to lead to broad dissemination. Rule 433(d).
		- Filing must be on or before first day of use.
		- Must retain FWP for 3 yrs, if not filed.
	+ **Prospectus accompaniment**
		- Non reporting issuers and unseasoned issuers must precede/accompany free writing prospectus w a copy of the prelim prospectus. (If electronic, it can be hyperlinked.)
		- No accompaniment is needed for seasoned issuers and WKSIs. Rule 433(b)(2)

*Rule 433(e) and the issuers’ Web site*

* Any offer on the issuer’s web site or linked from the issuer’s web site to a third party will be an FWP and must satisfy above conditions
* BUT historical issuer information that is identified as such and located in a separate section of the Web site, that has not been incorporated or otherwise included in a prospectus of the issuer for the offering, will not be considered a FWP

*Rule 433(f) and the media*

* As long as publisher or broadcaster is in the media business and has not been compensated by the issuer or other offering participants, media stories based on interviews w issuer and participants can be disseminated. Rule 433(f)
* The issuer, offering participant, or agent must file the media story (e.g., filing transcript) and includes a legend w/in 4 days of becoming aware of it. Rule 433(f)(1), (f)(2)
	+ - Unless info in story has previously been filed
		- If the media story has any misstatements, the issuer is under no duty to correct (assuming it was not responsible for the misinformation) but may choose to include additional info in its filing to correct the story or simply give transcript of what was provided to the media. Rule 433 (f)(2)(ii).
	+ Not subject to prospectus-accompaniment rules, need not be legended

*Rule 433 and road shows*

* Live or real time webcast road shows are oral communications
* PPT presentations and handouts distributed at road shows *and* videos of road shows posted on issuer web site are FWP subject to consistency, legend and prospectus-accompaniment restrictions
* But they do not generally have to be filed w the SEC
	+ - Filing of presentations required only in equity offerings by non reporting issuers unless the latest version of the road show w mgmt presentations is posted on issuer’s web site. Rule 433(d)(8)

**Rule 164 – FWP safe harbor**

* An issuer or offering participant
* that fails to file a FWP by the time of its first use or fails to include the mandatory legend
* can provide a defense for “an immaterial or unintentional failure to file or delay in filing a FWP”
* if “a good faith and reasonable effort was made to comply”
* and corrective action was taken as “soon as practicable.”
* **Note:** Safe harbor does not apply to FWP that are inconsistent OR do not comply w the prospectus-accompaniment condition

**Mandatory prospectus dissemination**

* Prelim prospectuses must be made available to all participating dealers and UWs as a condition for acceleration. Rule 460
* UWs and dealers must make prelim prospectuses available to salespeople as well as any investor who requests a copy. Rule 15c2-8
* For non-reporting issuers, the broker or dealer must deliver a copy of the final prospectus to any person who is expected to receive a confirmation of sale upon effectiveness. Delivery must be at least 48 hours prior to the confirmation. Rule 15c2-8.

**C. The post-effective period**

**Prohibited activities**

* Section 5(b)(1) prohibits any prospectus unless it complies with § 10
* Section 5(b)(2) prohibits delivery of sec. unless accompanied/preceded by a § 10 final prospectus

**Permitted activities**

**Free writing**

* §2(a)(10) permits selling literature as long as the communication is preceded or accompanied by a final prospectus
* For non reporting and unseasoned issuers, FWP must be accompanied by final prospectus.

**“Prospectus” types**

* **Rule 430A prospectus:** In cash offerings, permits a RS to be declared effective without inclusion of price-related information. Issuers have 15 business days after the effective date of the RS to file a prospectus containing the price related information. If the issuer waits more than 15 days, the price related information must be filed as a post effective amend to the RS.
	+ **Rule 430C prospectus:** for non-cash offerings
	+ **Rule 430 B shelf registration prospectus**

**Rule 153 prospectus delivery for securities firms**: For broker dealer confirmations, access equals prospectus delivery.

* + - For securities trading on stock exchange or Nasdaq
		- Provided issuer files or plans to file final prospectus
		- and provided there is no pending SEC proceedings against the offering, the issuer or other offering participants

**Rule 172 prospectus delivery**

* For confirmations, access equals prospectus delivery provided issuer files or plans to file final prospectus
	+ Confirmation must include information required by Rule 10b-10
	+ Confirmation may include a Rule 173 notice and incidental information about offering allocations, pricing and settlement procedures. Rules 172(a)(1).
	+ For deliveries of stock certificates, access equals prospectus delivery provided issuer files or plans to file final prospectus
	+ provided there is no pending SEC proceedings against the offering, the issuer or other offering participants

**Rule 173 notice of registration**

* Any sale by issuer, UW or dealer that is subject to prospectus delivery obligations under § 4(3) must provide the purchaser a notice (or final prospectus) w/in 2 days after the sale. Rule 173
	+ Notice must state that the sale was made pursuant to an RS and the purchaser who receives notice has right to request physical delivery

**Duration of Rule 173 notice requirement**

* An **issuer** must deliver notices or prospectuses indefinitely for any sales it makes. § 4(1).
* An **UW** or sec. firm that is a member of the selling group must deliver notices or prospectuses indefinitely for any sales from its original allotment. § 4(3)(C)
* Resales by **non participating sec firms** that transact the offered sec in the postoffering market must deliver notices or prospectuses for a specified period. This includes all “dealers”. §§ 4(3)(B), 2(a)(12)
	+ - Zero days if issuer was a reporting co. Rule 174(b)
		- 25 days if sec are to be listed on exchange or Nasdaq. Rule 174(d)
		- 40 days if issuer had made other registered offerings
		- 90 days or until allotment is sold if it is the issuer’s first registered offering
* No prospectus delivery obligation for sec firm acting as **a broker** on customer orders. § 4(4).

**Incorrect disclosure**

* If change is substantive though minor, issuer can place a sticker on the prospectus w the new information. Rule 424(b)(3)
* If the event is “fundamental” the issuer must amend the RS and wait for the SEC to declare it effective.

**Staleness:** If a prospectus is used more than 9 months after the effective date, the information in the prospectus cannot be more than 16 months old. § 10(a)(3)

**Manor Nursing Centers (2d Cir***)—not good law*

* Court implied that purchasers could rescind under § 12(a)(1) on theory that a fundamentally deficient prospectus could not be a “final prospectus” and thus sales violated § 5.

**V. Exemptions to Section 5 of the Securities Act**

|  |
| --- |
| The following are **defenses** to dealing in unregistered securities in violation of Section 5:**Note:*** Any exemption does NOT excuse seller from antifraud provision of sec. laws and Rule 10b-5
* Purchasers of securities may have a private § 12(a)(2) rescission remedy for misrepresentations in an offering that can be viewed as a “public offering.”
 |

**A. Was there an “offer” or “sale”?**

**“Sale”** Sec. Act § 2(a)(3)

* (i) every contract of sale OR
* (ii) disposition of a security or interest of a security for value
	+ Disposition**:** the act of transferring something to another’s care or possession.

**“Offer”** Sec. Act § 2(a)(3)

* (i) every attempt or offer to dispose of OR
* (ii) solicitation of an offer to buy, a security or interest in a security for value.

Options/Warrants/Convertible Securities

* May require multiple registration of securities
	+ E.g., convertible security with a guaranty requires registration of 3 sec. and involves 2 different issuers (the parent company and the subsidiary)
* IF immediately exercisable🡪both the rights and the underlying securities are treated as being sold, and each must be registered, even before use
* IF exercisable only at some future date🡪only the rights is treated as being sold and only the right must be registered

Stock Dividends

Conventional stock dividends do NOT constitute a sale

* Where a corp. declares a dividend payable either in cash or sec *depending on decision of shareholder*, neither the declaration of the dividend nor the distribution of securities to stockholders who elect to take the dividend in that form will constitute a “sale”
	+ Even though waiver of right could easily constitute “value” under § 2(a)(3)
* BUT where the corp. declares a cash dividend payable to shareholders and thereafter shareholders are permitted to waive their right to payment in cash and receive the dividend in stock, then a sale might entail (bc upon the public declaration of a cash dividend, shareholders become creditors of the corp. and cannot be divested of these rights).

“Free” stock

* “For value” is broadly construed!
* E.g., SEC believes that the issuance of securities in consideration of a person’s registration on, or visit to, an issuer’s Internet site would be a “sale”

Pledge of securities: Pledge of securities as collateral for a loan entails a disposition of an interest in a security for value within the meaning of § 2(a)(3).

* + E.g. Bank liquidating a security pledged as collateral for a debt. (Guild Films)

Exchanges

* Exchange of one security for another—whether physical or through amendment of economic or voting rights—is a sale
	+ E.g., extension of a maturity date on a bond was the issue and sale of a new sec.

**B. Is it an exempt security?**

|  |
| --- |
| **Note:** An exempt security is ALWAYS exempt from registration—both when issued and later when traded.An exempt security is NOT exempt from the antifraud provisions. |

1. **Government securities**
	1. § 3(a)(2):any sec. issued/guaranteed by any fd, state, or governmental entity
	2. Note: While §5 registration is not required, municipal bonds issuers have to comply w SEC Rule 15c2-12, requiring underwriters to obtain an official statement from issuers. (The importance of disclosure in bond market)
2. **Commercial paper**
	1. § 3(a)(3):short term notes or bills of exchange that mature in less than nine months
	2. Court defines comm. paper as “short-term, high quality instruments issued [by companies] to fund current operations and sold only to highly sophisticated investors” (i.e., banks and other institutional investors). Reves
3. **Securities subject to non-SEC regulation**
	1. § 3(a)(2): securities issued by banks
	2. § 3(a)(5): securities of federal or state regulated savings and loan assoc.
	3. § 3(a)(8): ins policies and annuity contracts issued by state regulated ins companies
	4. § 3(a)(2): tax qualified employee pension plans
	5. § 3(a)(7): certificates issued by bankruptcy trustees pursuant to court approval
	6. § 3(a)(6): participation interests in railroad equipments trusts
4. **Securities of not-for-profit issuers**
	1. § 3(a)(4): securities of nonprofit, religious, educational, fraternal or charitable institutions

**C. Is there a transaction exemption?**

|  |
| --- |
| **Note:** * **Transaction exemptions include**
	+ Statutory private placement under § 4(2) (Ralston Purina/Doran)
	+ Reg A, Rule 701, Reg CE ($5m cap)
	+ Regulation D
	+ Issuer exchanges §3(a)(9)
	+ Regulation S
* These securities are not themselves exempt. So **each** time they are transacted, the seller must find a transaction exemption to avoid registration (unless it is a Reg A offering)
* The party seeking exemption bears **the burden of proof.**
* When there is a series of offerings, each offering may be linked under **integration doctrine accord to five factor test:**
	+ Part of a single plan of finance,
	+ involve the same class of security
	+ Took place at the same time
	+ involve the same type of consideration to be received
	+ Were made for the same general purpose
* IF integration applies🡪see **safe harbor**
	+ Rule 502(a) for Reg D
	+ Rule 152 for § 4(2) private placement
	+ Rule 155(c) for all private placements
	+ Rule 251(c) for Reg A
	+ Rule 701—no integration
 |

**1. Statutory private placement under Sec. Act § 4(2)**

§ 4(2)excludes from registrations **“transactions by an issuer, not involving any public offering”**

**Ralston Purina test:** An offering to “those who are shown to be able to fend for themselves” is a private offering and do not need protection of sec laws.

* An example are key execs who through their position have “access to the same kind of information that the act would make available in the form of a RS.”

There is **NO numerical limit** to amount of investors (Ralston Purina, rejecting SEC’s “substantial number” test)

**Could the investors fend for themselves?** Doran v. Petroleum Mgmt. Corp (5th Cir)

* IF the information that would be afforded by a RS was available to all offerees AND
* other factors weighed against need for protection🡪then investors were able to fend for themselves

*(1) Information inquiry*

* Possession of information can be proven either by **actual disclosure** OR
* Showing that the offerees had **access** to relevant information.
	+ Education, business sophistication and net worth is NOT enough. Offerees must also “possess the information requisite for a RS” to bring their knowledge to bear
	+ To prove access, D must show that offeree could “realistically have been expected to take advantage of his access” bc of “privileged position relative to the issuer”
* The possession of information inquiry involves **all of the offerees**, not just plaintiff or actual purchasers.
	+ A sale or offer to just one unqualified investor causes the exemption to be lost for all.
	+ Because there must be proof that all offerees are qualified, general solicitation is not feasible

*(2) Multifactor test*

The court may consider following factors to determine whether exemption applies:

* number of offerees (not merely number of purchasers) and their relationship to issuer
* number of units offered
* the size of the offering
* the manner of the offering (was there general solicitation?)
* Note: Flexible test—court is free to consider other factors.

E&E says this is a **balancing test**: the less sophisticated the investor, the more disclosure is required; the more sophisticated, the less disclosure is required.

**NO resale without exemption.**

**2. Small offerings**

**Offerings up to $5 million**

**Regulation D (Rules 504 and 505 under § 3(b))**

* Small offering up to $1 million are exempted under Rule 504, see p. X.
* Small offering up to $5 million with 35 or fewer nonaccredited investors under Rule 505, see p. X

**Regulation A (§ 3(b)):**

* **Issuer qualification:** Available only to nonreporting US and Canadian issuers that are not disqualified under bad boy provisions which excludes:
	+ Issuers under pending SEC administrative review
	+ Issuers subject to SEC orders in the last 5 years
	+ Issuers convicted or enjoined for fd or state sec violations or postal fraud in the last 5 yrs
	+ Issuers whose execs or 10 percent shareholders have been subject to similar SEC sanctions or court orders
	+ Issuers who use an underwriter w a comparable tainted past
* **Dollar ceiling:** $5m for securities issued in a 12-mo period ($1.5m for existing security holders)
* **Number of investors** is unlimited.
* **Investor qualification**: none required.
* **Manner of offering:** NO limitations on general solicitations
* **Resale limitations:** None. Sec issued under Reg A are exempted securities and can be freely resold. Rule 251
* **Notice req:** Compliance requires that issuer file a Form 1-A offering statement. Offering statement is NOT a RS for § 11 purposes.
	+ Prior to the filing of any offering statement, an issuer may test the waters by publishing/disseminating to prospective investors a written document/TV broadcast/etc to determine whether there is investor interest in the contemplated offering. Oral communications can then commence. Rule 254. (Doc. not a “prospectus” for § 12(a)(2) purposes).
* **Information req:** During the waiting period before qualification, preliminary offering circulars may be used. Rule 255.
	+ Sales may commence once SEC qualifies the offering statement or 20 days after the filing or any amendment. Rule 252(g).
* **Integration safe harbor** Rule 251(c): NO integration of Reg A offering w/ either
	+ (i) ANY previous offerings or sales
	+ (ii) subsequent offerings that are
		- registered,
		- made in compliance w Rule 701 or Reg S,
		- OR made more than 6 months after the Reg A offering

**Rule 701:** Provides an exemption for offers and sales of sec. made by companies that offer stock compensation plans. Cannot be to raise money, only to bind employees to company. (Prelim Note 5)

* **Issuer qualification**:No reporting or investment companies
* **Dollar ceiling:** Total amount over a 12 mo period must not exceed $1 million, 15 percent of the issuer’s total assets or 15 percent of the outstanding securities of that class—whichever is greater. If more than $5m worth of sec are sold, the issuer must provide to each employee specific disclosure that includes a summary of the compensation plan, risk factors and financial statements used in a Reg A offering.
* **Number of investors** is unlimited
* **Investor qualification:** Investors must be employees or outside advisors who have rendered bona fide services
* **Manner of offering:**
	+ offering must be made under a written compensatory benefit plan of issuer, its parent or subsidiaries *or* a written compensatory contract w issuer
	+ NO restrictions on general solicitation
* **Resale limitations:** Restricted
* **Information req:** Does NOT require affirmative disclosure other than a copy of the plan and any written contract relating to compensation
* **Notice req:** Form 701 required—5 copies filed w SEC w/in 30 days after first sale that brings aggregate sales over $100k
* **Integration safe harbor:**ALL Rule 701 offerings are NOT subject to integration

**Regulation CE (§ 3(b)):** Permits California corporations and certain foreign business entities to sell up to $5m of their securities to certain qualified purchasers (similar to “accredited investor”)

* **Manner of offering:** Allows for general solicitation in the form of a test the waters document similar to Reg A’s Rule 245.

**3. Regulation D**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Rule 504(§ 3(b)) | Rule 505(§ 3(b)) | Rule 506(§ 4(2)) |
| Issuer qualification | No investment companies, reporting companies and blank check companies.  | No investment companies, bad boy issuers disqualified under Reg A | Any issuer (bad boy provisions issuers disqualified once SEC issues rule in 2011) |
| Dollar ceiling | $1 million (12 mo.) | $5 million(12 mo.) | No limit |
| Number of investors | No limit | Any number of accredited investors and up to 35 non-accredited investors |
| Investor qualification | None | None | Issuer must know or “reasonably believe” immediately prior to sale that non accredited investors is sophisticated (alone or with rep)Sophistication = “such knowledge and experience in fin. and business matters that he is capable of evaluating the merits and risks of the prospective investment” |
| Manner of offering | General solicitation OK if shares issued* in state(s) that require registration and disclosure doc
* in state(s) where purchasers receive disclosure doc made under a state’s registration and disclosure law
* in state(s) limiting the offering only to AI under a state law exemption that permits general solicitations
 | General solicitation prohibited.  | General solicitation prohibited.  |
| Resale limitations | Resales OK if subject to state law that allows resales  | Restricted.  | Restricted. |
| Info requirements | None (other than state law) | None for AIs.For non accredited investorsFor **all issuers** Rule 502(b)(2)(iv)-(v)* Issuer must also make available to each purchaser the opportunity to ask questions and receive answers.
* Provide info necessary to verify accuracy of mandatory disclosure items IF (1) requested by purchaser AND (2) possessed or acquirable w/o unreasonable effort or expense
* Brief written description of any material written info concerning the offering given to accredited investors.

If the issuer is a **reporting co**, it must furnish its most recent annual report, its PS, and any subsequent Exchange Act filings, along w a brief description of the particular offering. Rule 502(b)(2)(ii)Disclosure req for **nonreporting co** vary w size of offering* Up to $2m: info that would be contained in Reg A offering circular
* $2m - $7.5m: Part I of registration form for which issuer is eligible, w/ financials required of small business issuers
* Over $7.5m: Part I and financials of the registration form for which issuer is eligible
 |
| Notice of sale | Notices of sale on Form D must be filed w SEC 15 days after first sale. Rule 503(a). |
| Incomplete compliance | Under Rule 508(a), failure to file does not destroy exemption IF * the noncompliance did not undermine the protection available to the particular investor seeking to avoid the exemption AND
* the noncompliance did not involve the ban on general solicitations, the Rules 504 and 505 dollar limits or the Rules 505 and 506 limits on the number of nonaccredited investors AND
* the issuer made a good faith and reasonable attempt to comply w the rule
 |

**Integration safe harbors:** Offerings that are separated in time by more than 6 months are not a single offering. **Rule 502(a).**

**Aggregation** is calculated by adding

* the offering price of all securities sold pursuant to Rule 504 or 505 exemption
* the offering price of all securities sold w/in the previous 12 mo. in reliance on Rule 504, Rule 505, Reg A, Rule 701
* AND the offering price of all securities sold in the previous 12 months in violation of the § 5 registration requirements

**Rule 501:** **accredited investor** = any person who (i) comes within any of the following categories, OR

who the issuer reasonably believes comes within any of the following categories, (ii) at the time of the

sale of the securities:

* Institutional investors such as banks, insurance companies, investment companies, employee benefit plans, business development companies,
* Big organizations such as for-profit companies and charitable/educational institutions w assets of more than $5m
* Key insiders: any director, executive officer or general partner of the issuer,
* Millionaires: any person with a net worth of more than $1 m
* Fat cats: any person w annual income of more than $200k (or $300k w spouse)
* Venture capital firms
* Sophisticated trusts: any trust w more than $5m in assets managed by a “sophisticated person” and not formed specifically for purchase of sec.,
* Any entity in which all of the equity owners are accredited investors

**Counting non-AI’s:** When an investor buys for himself, an additional purchase by his spouse, relatives who live with him or purchases for a trust, estate or other organization in which he has a significant interest are NOT counted. A single nonaccredited investment decision, carried out through different channels, gets counted as one nonaccredited purchaser.

**Rule 502(c)’s general solicitation ban:** (i) Neither the issuer nor any person acting on its behalf shall (ii) offer or sell the securities by any form of (iii) general solicitation or general advertising

* To distinguish limited from general communications, SEC has considered whether the issuer/agent had some **preexisting relationship** w the recipient of the communication
* **Rule 135c safe harbor** permits reporting companies & certain foreign issuers to announce publicly their plans to make an unregistered offerings (so to inform shareholders of company activities). It requires that
	+ Notice is not used for the purpose of conditioning the market
	+ Notice alerts reader that the sec will not be registered under Act and may not be offered or sold in the US absent registration or transaction exemption
	+ Notice contains bare bone information (name of issuer, basic terms of sec offered, etc.)

**Rule 502(d):** **Resale limitations**

Issuer must take “reasonable care” to assure that purchasers are not statutory underwriters.

|  |
| --- |
| **Broker dealer duties under Reg D:** A BD that recommends a sec. is under a duty to conduct a reasonable investigation concerning that sec. and the issuer’s representations about it. (FINRA regulatory notice)Antifraud provisions* Duty emanates from the BD’s special relationship to the customer and from the fact that in recommending the sec the BD represents to the customer “that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation.”
* Failure to comply w duty can constitute a fraud under Section 10(b) and Rule 10b-5. It can also constitute violations under FINRA’s antifraud Rule 2020.
* Amount and nature of investigation required depends on
	+ nature of the recommendation
	+ role of the broker in the transaction (if BD is affiliated w issuer he must resolve any conflict of interest that could impair ability to conduct an investigation; if BD prepares private placement memorandum, he must ensure there are no material misstatements or omissions)
	+ knowledge of and relationship to the issuer
	+ size and stability of the issuer
	+ presence of any “red flags” (e.g., issuer’s refusal to provide a BD w info that is necessary for BD to meet his duty to investigation, lack of private placement memorandum (even if not required under Reg D may still be red flag))
* BD may NOT rely blindly on the issuer for information concerning a company nor may it rely on the information provided by issuer or its counsel in lieu of conducting its own reasonable investigation
* Investors’ knowledge/sophistication is NO defense

FINRA suitability obligationsRule 2310: BD must have reasonable grounds to believe that a recommendation to purchase/sell/exchange a sec is suitable for the customer* BD must have a reasonable basis to believe based on a reasonable investigation that the recommendation is suitable for at least some investors
* BD must determine in his “customer specific suitability” analysis that the sec is suitable for the customer to whom it would be recommended
* The fact than investor meets the net worth/income test for being an AI is NOT enough—BD must also consider other factors
	+ BD may consider investor’s other holdings, financial situation, tax status, investment objectives, etc
	+ BD must be satisfied that the customer fully understands the risks involved and is able to take those risks.
 |

**4. § 4(6) Offerings**

* Exempts offerings up to $5m made exclusively to accredited investors (same as in Reg D)
* No general solicitation
* Issuer must file notice w SEC
* FYI: has gotten little use

**5. Issuer Exchanges under § 3(a)(9)**

Section 5 does not apply to (i) Any security exchanged by the issuer with its existing security holders exclusively (ii) where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange.”

**Four main requirements**

1. Must be the **same issuer**
* Identity of issuer analysis may include the subsidiary depending on econ reality
1. **No additional consideration from the security holder.** The security holder must not be asked to part with anything of value besides the outstanding securities.
	* The *issuer*  can give additional consideration. Rule 150.
	* Under Rule 149, a sec holder can make any cash payments that may be necessary “to effect an equitable adjustment, in respect of dividends or interest paid or payable on the securities involved in the exchange, as between such security holder and other security holders of the same class accepting the offer of exchange.” (For example, an equitable adjustment may be necessary when, due to the timing of interest payments and sales between security holders, one security holder receives the benefit of an interest payment due to another security holder.)
2. **Must be the same class of security holders**
	* This req. will be violated if the exchange is integrated w/ another offering.
3. **No commissions can be paid**
	* A financial adviser may receive a fixed fee for its services, not contingent upon the success of the exchange, plus reasonable expenses related to the exchange.

**Solicitation**

* + As a general rule, an *issuer* may solicit holders of target securities without jeopardizing the use of the Section 3(a)(9) exemption.
	+ *Third parties* can play an informational role in the offering (i.e., not express its views or recommendations).

**Resale restriction:** The new securities issued are subject to the same restrictions on transferability, if any, of the old securities, and any subsequent transfer of the newly issued securities will require registration or another exemption from registration.

**Note:** Under § 2(a)(3), the issue of a convertible security is NOT an offer or sale of the underlying security if the right cannot be exercised until some future date. The subsequent conversion is a “sale” BUT § 3(a)(9) is available to exempt from registration both the continuing “offer” being made once right is exercisable and the exchange transaction once the right is exercised.

**D. Secondary Distributions**

**§ 4(1) prohibits transactions by issuers, underwriters and dealers**

|  |
| --- |
| THREE WAYS to becoming a statutory underwriter:* **Agent “for an issuer”**
* **Purchased from issuer “with a view” to distribute restricted sec.**
* **Underwriter for “control person”**
 |

**1. Agent “for an issuer”** Chinese Consolidated Benevolent Assoc. (2d Cir 1941)

* Underwriter = any person who offers or sells for an issuer. § 2(a)(11)
* Does NOT matter that statutory UW never made received any compensation
* Does NOT matter whether issuer authorized the solicitation or merely availed itself of the acts of the promoter
* Does NOT matter whether promoter had any dealings directly with the issuer as long as the person engaged in steps necessary to the distribution

**2. Purchased from issuer “with a view to distribute” restricted sec.** § 2(a)(11)

* Change in circumstance: under this theory investor could claim that he had an investment intent at the time of the purchase of restricted securities but because of unforeseen factual circumstances, he was forced to change intent and sell to public—doesn’t really work today.
* Holding period rule: investor could argue that his length of holding (1-5 years) indicates that he did not purchase w view to distribute
* NO good faith defense. Guild Films.
* A creditor may be seen as a statutory underwriter if it received pledged sec. expecting that the borrower would default. Guild Films Co. (2d Cir. 1960)

**3. Underwriter for “control person”**

* UW = Any person who has purchased from a control person w a view to distribute any sec OR any person who offers or sells for a control person in connection w distribution of any sec. § 2(a)(11)
* Control = (i) the possession, direct OR indirect (ii) of the power to direct OR cause the direction of the mgmt and policies of a person (iii) whether through ownership of voting securities, by k or otherwise. Rule 405
	+ May be enough to have power—person does not have to exercise it
	+ May be enough to have control in fact—person does not have to have a large share of stock or even be a shareholder
	+ 10 percent ownership shares is commonly seen as benchmark, but not a rule
* “Distribution” is not defined
	+ Predetermination of precise no. of shares to be sold or their price is NOT an essential element of distribution. Ira Haupt

**E. Safe Harbor Against UW Status**

**1. Broker exception § 4(4)**

* § 4(4) exempts “brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.” E.g., Wolfson
	+ Exempts ONLY the brokers’ part in the transaction, NOT the customer control person.
	+ Broker can rely on § 4(4) even when he is unaware that his customer is not exempt.
* Even w exemption, a broker may be found to be an UW if he’s actively soliciting buyers and selling a large amount of shares. E.g., Ira Haupt

**2. Dealer exception § 4(3)**

**Dealers are exempt EXCEPT when**

* Transactions taking place prior to 40 days after first date when security was bona fide offered to public
* Transactions in security as to which registration statement has been filed, taking place later of
	+ Expiration of 40 days after effective date of registration statement, OR
	+ Expiration of 40 days after 1st date when security was bona fide offered to public by issuer/underwriters, OR
	+ Shorter period as commission specifies
* Transactions constituting whole or part of unsold allotment or subscription by dealer of security

**3. Resale of Restricted and Control Person Sec. in Public Market: Rule 144**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Noncontrol\* persons selling restricted sec\* Person was not a control person for the 3 months prior to sale. | Control persons selling restricted sec | Control person selling nonrestricted sec (through brokers) |
| Holding period | * 6 months in the case of a reporting company
* 12 months in the case of a non-reporting company
 | * 6 months in the case of a reporting company
* 12 months in the case of a non-reporting
 | None |
| Trickle | N/A | * no more than 1% of outstanding equity securities OR average weekly trading in any 3 mo period—whichever is greater
* no more than 10% of tranche of debt securities in any 3 mo period
 | * no more than 1% of outstanding equity securities OR average weekly trading in any 3 mo period—whichever is greater
* no more than 10% of tranche of debt securities in any 3 mo period
 |
| Sale method  | N/A | Brokers’ transactions (can’t solicit buyers) for equity securities *only* | Brokers’ transactions (can’t solicit buyers) for equity securities *only* |
| Informational Req. | Publicly available information for reporting issuer (or equiv.) during the 12 mo before resale | Publicly available information for reporting issuer (or equiv.)  | Publicly available information for reporting issuer (or equiv.)  |
| Filing | N/A | Must disclose on Form 144 if sell more than 5,000 shares or more than $50k | Must disclose on Form 144 if sell more than 5,000 shares or more than $50k |

**Calculating the holding period**

* Tacking period: A new purchaser can tack previous period unless previous holder was a control person.
* Clock starts running once sec. is “fully paid” for
	+ If sec are purchased from issuer w notes or other obligations, they are not considered fully paid for UNLESS
		- i) the notes or other obligations provides for full recourse against purchaser,
		- ii) the note or obligation is paid in full before the sale AND
		- iii) there is adequate collateral, other than the purchased sec, the fair market value of which is throughout the holding period equal to the unpaid portion of the purchase price
	+ Shares of stock issuable upon exercise of option are not fully paid for until the option has been exercised and the exercise price has been paid
	+ If restricted sec are purchased on an installment basis, the holding period commences on a staggered basis
* Securities are NOT considered fungible:
	+ the acquisition of restricted sec will not restart the holding period on a different group of previously acquired restricted securities.
	+ The holder must merely be able to **trace** each group of sec to their purchase dates.

**Calculating volume:**

* For control persons the amount of equity securities sold in each **3-mo period** may not exceed the greater of
	+ 1% of the outstanding securities of that class OR
	+ the average weekly trading in any 3 month period
* In the case of debt securities, this maximum level is raised to 10% of the class over each 3 mo period
* Both restricted and unrestricted securities are **aggregated** EXCEPT for sales pursuant to registered offerings, Reg A, Reg S or Section 4 of the Sec Act. Rule 144(e)(3)(vii)
* Sales by control persons and others **“acting in concert”** are aggregated
	+ Selling at the same time does not necessarily mean acting in concert.
* Where both a convertible and an underlying sec are being sold, the amount of the underlying sec is aggregated w sales of the convertible.

**Manner of sale requirements for control persons selling equity sec.**

* The sales of nonrestricted *equity* securities must be made in either ordinary brokerage transactions or directly with a market maker
	+ **Market maker** = a specialist who is permitted to act as a dealer OR a dealer who acts as a block positioner OR a dealer who holds himself out as willing to buy and sell a particular security for his own account on a regular or continuous basis
	+ **Brokers' transactions =** (i) transactions in which the broker does nothing more than execute order to sell as agent for the usual commission and (ii) does not solicit buy orders
* Payment must not involve anything other than the usual commission to the broker who executes order

**4. Resale of restricted securities through private placements: § 4(1/2) and Rule 144A**

Restricted securities can be re-sold in secondary market as a § 4(2) private placement to avoid UW liability per § 4(1)—i.e., § 4(1/2).

**§ 4(1/2):** Available to BOTH individual investors and institutions

**Rule 144A**: Available only to certain institutional investors

**Four main requirements**

1. Reoffer or resale is made only to **qualified institutional buyers (QIBs)** or persons seller/agent “reasonably believes” is a QIBs. QIBs include
	1. any institution with more than $100m in investments
	2. A registered BD w an investment portfolio of at least $10m that buys for itself or QIB
	3. Any registered BD buying for QIB
	4. A registered investment co. that is part of a mutual fund family w a total investment portfolio of at least $100m
2. Reseller, or his agent, must take **“reasonable steps”** to ensure buyer is aware that seller may rely on exemption from Sec Act under R144A.
3. Sec reoffered or resold when issued were **not of the same class** as securities listed on a *U.S.* securities exchange or on Nasdaq
4. **Informational reqs:** In the case of sec of an issuer that is neither an Exch Act reporting co, or a foreign issuer exempt from reporting, or a foreign government, the holder and a prospective buyer designated by the holder must have the right to obtain from the issuer and must receive upon request, certain “reasonably current” information about the issuer.

**Calculating QIB value**

* May include sec of its consolidated subsidiaries if such sec are managed by that entity
* The amount of sec to be purchased in the R 144A transaction cannot be included

**Establishing “reasonable belief”:** Reseller may rely on

* purchaser’s public available annual fin statements
* information filed w Sec, another government agency, or a self regulatory organization
* information in a recognized sec manual
* certification by purchaser’s CFO or other exec officer specifying amount of sec owned & invested
* Etc.

If there is no red flags🡪reseller has no duty to verify info

**Reasonable steps to notify buyer**

* Legending sec
* Notification through offering memorandum

**Determining sec eligibility:**

Can’t be substantially identical to sec issued

* Common stock: look at whether holders enjoy substantially similar rights and privileges
* Debt: look to see whether the terms relating to interest rate, maturity, subordination, call redemption, etc. are the same
* A convertible sec w an effective premium on issuance of less than 10% will be treated as the same class as the underlying sec.
* A warrant w a term less than 3 yrs or an effective exercise premium on issuance of less than 10% will be treated as the same class as the underlying sec.

**Informational requirements**

* Reporting co must be compliant with filing req of Exch Act
* Non reporting co must make publicly available basic information about the issuer, including certain fin. statements (brief description of issuer’s business, issuer’s most recent balance sheet, profit and loss statement, retained earnings statement, and similar financial statements for the past 2 yrs.)

**A/B Exchange Offerings.**

Transaction in which sec are privately placed under 144A w the promise that the issuer will later exchange registered sec that are identical for privately placed sec held by the purchasers within a defined period (9 mo- yr). This arrangement is enforced by increasing interest rate if the exchange offering is not effected w/in the promised period.

* The SEC allows this but only for nonconvertible debt, preferred stock and IPOs of common stock by foreign issuers.
* Not allowed for U.S. common stock!

**F. International Transactions: Reg S**

**(Primary Issue and Secondary Resale)**

However, there is an exemption under **Reg S**

* Sec Act registration is required only for sec transactions “within the United States.” R. 901.
* Transactions are “without the United States” if they fall under
	+ **Issuer offerings.** Rule 903
	+ **Resale offerings.** Rule 904

**BOTH exemptions require**

* An “offshore transaction”
* that does not involve “directed selling efforts” in the US

**“Offshore transaction”**

*U.S. persons*

* No offer is made to person “in the United States”
* AND the sale is accomplished in one of the following three ways
	+ the *buyer* is outside the United States when the buy order is placed OR the seller “reasonably believe” this to be the case
	+ the sale—in an issuer offering only—is executed on any “established foreign securities exchange”
	+ the sale—in an investor resale—is executed on a “designated offshore securities market” (which includes the leading foreign stock exchanges) and the transaction is not prearranged with a buyer in the United States

*Non-U.S. persons*

* Offers and sales to non-U.S. persons are “offshore transactions” Rule 902(h)(3)
	+ Even if the transaction occurs inside the U.S.

**No** **“directed selling efforts”**

* Prohibits activities undertaken for the purpose of OR that could reasonably be expected to result in “conditioning of the market” in the United States for the securities being offered.
* The following are permitted
	+ Legal notices required by US or foreign authorities
	+ Tombstone ads or identifying statements (Rule 135)
	+ Stock quotations by foreign sec firms primarily in foreign ocuntries (Rule 902(c)(3))
	+ Foreign issuers are permitted to allow journalists to attend their press conferences held outside the US. Rule 902(c)(3)(vii)

**NO integration doctrine:** If the offshore transaction complies w Reg S there is NO integration w any domestic offering that is made pursuant to registration or exemption

**Resale safe harbor.** Rule 904

* This safe harbor is available for ANY securities, whether or not acquired offshore
* It thereby permits offshore resales of restricted US sec as well as sec acquired in foreign offerings
* It has additional requirements than the two listed above
	+ Securities firms and persons receiving selling commissions or fees in a Cat 2 or 3 issuer offering cannot, during the relevant restricted period, knowingly offer or sell the offered sec to a US person. Rule 904(b)(1)
	+ Offers and sales made by officers and directors of an issuer may be made only in typical trading transactions in which only the usual broker’s commission is paid. Rule 904(b)(2). Further those securities become “restricted securities” and therefore these control persons can only resell into public market by complying w the holding, disclosure and trickle conditions of Rule 144.

**IV. Civil Liability for Offers and Sales in Violation of Securities Act**

|  |
| --- |
| * **Statutory rescission for violations of §5.** Investors can rescind their investment if there was an any violation of the §5 registration and disclosure requirements. Sec. Act §12(a)(1)
* **Antifraud liability for false registration statement.** Investors in a registered offering can recover losses if there are material misrepresentations or omissions in the RS. Sec. Act §11
* **Antifraud liability for falsehoods in public offering.** “Sellers” in public offerings are liable for material misrepresentations made in the prospectus or orally. Sec. Act §12(a)(2)
 |

**A. Securities Act §12(a)(1)**

Any person who offers or sells a security in violation of §5 is liable to the purchaser, who may sue to rescind the contract OR if he no longer owns the security, to sue for damages.

**At a glance**

* ~~Misrepresentation~~
* ~~Materiality~~
* ~~Scienter~~
* ~~Reliance~~
* ~~Causation~~

**Burden of proof** on plaintiff to show

* the defendant was responsible for an “offer” or “sale” that violated § 5 requirements
* plaintiff was a “purchaser” and not merely an offeree
* the defendant was a **“seller”** either through **privity** or **solicitation**:
* A §12(1) “seller” solicitor is one
	+ (i) who “offers” or “sells” a security,
	+ (ii) to a purchaser because he “intends” to serve his own financial interests or those of the security owner. Pinter.
		- Subjective: he must be “motivated at least in part by a desire to serve his own financial interests or those of the securities owner”
		- Does NOT matter if the D is merely a solicitor and does not pass title himself
		- Substantial factor is NOT enough—this test states that a “seller” is one whose participation in the transaction is a substantial factor in causing the transaction to take place (e.g., lawyer)

Later compliance does NOT retroactively cure the defect

**Joint and several liability**: control persons are liable UNLESS the control person had no knowledge of or reason to know of the facts on which liability exists. § 15

**Statute of limitations:** action is not barred by SOL (purchasers must bring w/in 1 yr of violation)

**B. Securities Act §11**

Is a civil remedy for purchasers in a registered offering if they can point to material misrepresentation or omission in the RS.

**At a glance**

* Misrepresentation
* Materiality
* ~~Scienter~~
* ~~Reliance~~
* ~~Causation~~

**Standing**: “Any person” who has purchased registered securities has standing to sue. §11(a). Cts are split as to **when** the security must have been acquired.

* **Primary market rule:** you have to have bought from the underwriters, brokers or during the public offering period to be able to be a plaintiff
* **Tracing rule:** Plaintiffs have standing whether or not they bought in the original distribution or the post-offering aftermarket as long as they can trace their security to those sold in the initial distribution. E.g., Hertzberg

**Burden of proof** on plaintiff to identify

1. Plaintiff was a **“purchaser”** and not merely an offeree
2. There was **a misrepresentation/omission** **in the RS** **as of the date it was effective.**
	1. Different parts of RS may become effective on different dates (e.g., post-effective amendments) and thus may have different effective dates
	2. § 11 does not cover preliminary prospectus or FWP unless filed w RS.
	3. For shelf offerings, liability for issuers and UW will be determined on takedown date BUT liability for officers, directors, experts will be determined as of the effective date of the RS
3. **Materiality**

**Possible defendants.** § 11(a), § 15

* The issuer
* Anyone who signed the RS (including issuer’s senior executives)
* All directors and partners at the time of the filing of the RS (whether or not they signed the RS)
* Any person who is named in the RS as being or about to become a director or partner
* Any expert who consents to his opinion to be used in RS (e.g., accountants)
* Underwriters

**What defenses are available?**

1. **SOL:** Section 11 must be brought w/in 1 yr after P discovers (or should have discovered the alleged misinformation) and w/in 3 yrs after sec was first offered to public
2. **Whether the alleged misrepresentation was actually false**
3. **Materiality**
4. **Safe harbors for forward looking statements**
	1. PSLRA
	2. Rule 175
	3. Bespeaks caution doctrine
5. **Limited reliance defense**
	1. P knew of the misrepresentations or omissions at the time of purchase. § 11(a)
	2. Person acquired the sec. after the issuer has made an earnings statement covering past 12 months after the effective date of the RS. § 11(a)
6. **Loss causation:** defense available if P’s losses were due to factors other than misinformation. (E.g., if stock price declined after IPO but actually went up upon disclosure)
7. **Stepping down defense**: (i) before the effective date of that part of the RS or upon becoming aware of its effectiveness, the D had taken appropriate steps to sever connections w the issuer and had advised the issuer and the SEC in writing that he took such action and would not be responsible for that part of the statement OR (ii) the D gave reasonable public notice that part of the RS had become effective without his knowledge and the D subsequently severed all connections w issuer and gave notice to issuer and SEC. § 11(b)
8. **Due diligence defense** is available for all **non-issuer** **defendants.** It varies depending on (1) whether D is an expert and (2) whether the part of the RS at issue is expertised.
	1. Expertised portion = part of the RS “purported to be made on the authority of the expert” (BarChris; e.g., audited financial statements made by accountants)
		1. Not every accountant’s opinion qualifies as an “expert’s” opinion. (Worldcom)
		2. Accountant opinion is expertised when i) it is reported in the RS, ii) it is an audit opinion and iii) accountant consents to inclusion of the audit opinion in the RS (Worldcom)
		3. NO DD from reliance on an accountant’s comfort letters for interim financial statements as reviews of interim financial statement do not count as an audit. (Worldcom). See also Rule 436(c):independent accountant’s report on unaudited interim financial information is NOT part of the expertised portion of RS
		4. An entire RS is not expertised merely because some lawyer prepared it. (BarChris)
9. Due diligence defenses for experts (BarChris)
	1. No liability for nonexpertised portions §11(a)(4)
	2. Experts are liable for expertised portionsUNLESS (i) after a reasonable investigation (ii) they had a reasonable ground to believe and did believe that at the information was true and not misleading §11(b)(3)(B)
10. Due diligence defenses for nonexperts (BarChris)
	1. Nonexperts are liable for nonexpertised portions UNLESS (i) after a reasonable investigation (ii) they had a reasonable ground to believe and did believe that at the time that the information was true and not misleading §11(b)(3)(A)
	2. Nonexperts are liable for expertised portions UNLESS there was (i) no reasonable ground to believe and (ii) they did not believe the information was not true or misleading at the time §11(b)(3)(C)
11. **What is a “reasonable investigation”? “reasonable ground for belief”?**
	1. Standard of reasonableness is that of “prudent man in the management of his own property.” §11(c)
	2. **Rule 176**: Circumstances affecting what constitutes **reasonable grounds and reasonable investigation**
		1. Type of issuer (new entrant vs. well-established issuer)
		2. Type of security (investment grade or not)
		3. Type of person
		4. Office held when the person is an officer
		5. The presence or absence of another relationship to the issuer when the person is a director or proposed director
		6. Reasonable reliance on employees and others whose duties should have given them knowledge of the particular facts (who did they speak to?)
		7. When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information w respect to the registrant (was it a firm commitment underwriting? a shelf registration? were there many analysts reporting on the co?)
		8. Whether, w/ respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated
	3. **Rule 176 factors are NOT exhaustive.**
	4. Rule 176 does NOT modify the duties of underwriters and directors in the context of **shelf offerings**. Worldcom.
		1. Participants must do DD for the RS—including documents that are incorporated.
	5. **Outside directors** can delegate a duty of investigation but they will be liable if the person to whom this duty was delegated does not perform it properly. (In BarChris, Auslander relied on others but were liable for their mistakes).
	6. **Directors** with relevant areas of expertise will be held to a higher standard in accordance with professional standards. (E.g., Grant the lawyer in BarChris).
	7. **Experts**, like accountants, may be held to professional standards in their industry.
	8. **Underwriters** (Worldcom, SDNY 2004)
		1. IF underwriter’s reliance on audited/expertised portions of r/s is justified🡪EITHER (1) there are no red flags w/r/t those portions, OR (2) underwriter conducted reasonable investigation w/r/t red flags
		2. IF there are red flags🡪 underwriter must conduct reasonable investigation EVEN IF it would have proven futile
		3. Red flags = facts which come to D’s attention which would place reasonable party in D’s position on notice that audited company was engaged in wrongdoing to the detriment of its investors.
			1. Does NOT require “clear and direct” notice.
			2. = discrepancy between audited figures and comparable information from competitors (E.g., in Worldcom E/R ratios were red flags as they were “significantly lower” than competitors’ Sprint and AT&T)
		4. In respect to interim financial statements making up the non-expertised portion of the RS, comfort letters are NOT enough by themselves to establish DD.

**Joint and several liability**:

* Control persons are liable UNLESS the control person had no knowledge of or reason to know of the facts on which liability exists. § 15
* Except for managing underwriter, underwriters’ liability is limited to the amount of their participation in the offering. § 11(e)
* For outside directors, the director’s liability is proportionate to the damages he caused, unless the trier of fact determines the director knowingly violated the sec law. § 11(f)(2)(A)

**Damages:** Three formulas

* *Securities held at time of judgment:* Purchase price (not greater than IPO price) minus value at time suit brought
* *Securities sold before suit:* Purchase price (not greater than IPO price) minus sales price
* *Securities sold after suit, but before judgment:* Purchase price (not greater than IPO price) minus sales price, but not more than damages under formula 1.

**C. Section §12(a)(2)**

Purchasers in an offering may seek rescission or get damages (if they no longer own the sec.) from (i) “statutory sellers” (ii) if the offering is carried out “by means of a prospectus or oral communication” that is (iii) materially (iv) false or misleading

* What matters is the prospectus or oral statement *before time of sale*. There can be no liability or reliance defense based on post-sale information. Rule 159.

**At a glance**

* Misrepresentation
* Materiality
* ~~Scienter~~
* ~~Reliance~~
* ~~Causation~~

**Burden of proof** on plaintiff to identify

* Plaintiff was a **“purchaser”** and not merely an offeree
* Seller was **“statutory seller”** under Pinter
	+ ALSO seller can be an issuer if it is an initial distribution of securities—does not matter whether there is actual privity. **R 159A.**
		- This Rule does not apply to § 12(a)(1) actions.
* **Materiality**
* The misrepresentation/omission was made by a **“by means of a prospectus or oral communication”**
	+ “Prospectus” is a document that describes “a public offering of securities by an issuer or a controlling shareholder.” Gustafson
	+ For section 12 liability, the court should NOT use the defn of prospectus in §2(a)(10) as it is too broad.
		- Remember § 2(a)(10) says the term “prospectus” 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
	+ “Oral communications” are those that relate to a prospectus
	+ Query: Does this mean “a public *registered* offering” or merely a “public offering”? If latter, does this mean offering documents under Reg A or Rules 504 and 505 are prospectuses as they are technically exempt “public” offerings?

**Defendant’s defense**

* **SOL:** Action must be brought w/in 1 yr after P discovers or should have discover the alleged misinformation. In no event may an action be brought more than 3 yrs after sale.
* **Whether the alleged misrepresentation was actually false**
* **Materiality**
* **Safe harbors for forward looking statements**
	+ PSLRA
	+ Rule 175—if it is an SEC filing
	+ Bespeaks caution doctrine
* **Limited reliance defense:** P knew of the misrepresentations or omissions at the time of purchase. § 11(a)
* **Reasonable care** **defense** arises (i) if the defendants show they did not know AND (ii) in the exercise of reasonable care they could not have known of the misstatement or omission
	+ Cts split as to whether “reasonable care” is is the same standard as “reasonable investigation” under § 11
* **Loss causation defense** available if the plaintiff’s losses were due to factors other than misinformation. §12(b)

**Joint and several liability**:

* Control persons are liable UNLESS the control person had no knowledge of or reason to know of the facts on which liability exists. § 15

**D. Control person liability**

**Sec Act § 15.**Every person who, by or through stock ownership, agency, or otherwise ... controls any person liable under section 11 or 12, shall also be liable jointly and severally ... **UNLESS**

* the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

**Sec Act Rule 405 Control.**The term *control*means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

**Exch Act § 20***.* Every person who, directly or indirectly, controls any person . . . shall also be liable jointly and severally . . . **UNLESS**

* the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

**VII. Registration under Exchange Act**

The Exchange Act requires companies w publicly traded sec. to register their sec. w the SEC—this registration operates for all practical purposes as registration of the company.

* The only exempted companies are mutual funds, state regulated ins. companies (provided they are not listed on a stock exchange or subject to § 15(d) reporting). Ex. Act. § 12(g)(2).
* Note: Co. can also choose to become reporting co. by following process in § 12(b).

|  |  |  |  |
| --- | --- | --- | --- |
| **Section** | **Trigger** | **Requirements** | **Termination** |
| **§ 12(a)**  | Companies whose securities—debt or equity—are listed on a stock exchange | Ex. Act § 13(a) reqs:- Periodic filings- Proxy rules and annual report- Tender offer rules- Insider stock transactions (§ 16) | Delisting and either* <300 shareholders OR
* <500 shareholders and <$10m in assets for three yrs
 |
| **§ 12(g)** | Class of *equity* sec\* held by >500 shareholders\*\* AND co has >$10m in assets as measured by last day of fiscal yr.\*Does NOT matter if sec. were done through private placement.\*\*Issuers must count beneficial, rather than legal owners. Rule 12g5-1(b)(3). Under this rule, combining holdings of multiple owners may not work if it is being used to circumvent registration reqs. |  Either* <300 shareholders OR
* <500 shareholders and <$10m in assets for three yrs
 |
| **§ 15(d)** | Registered public offering—of either debt or equity sec | - Periodic filings | < 300 shareholders and no earlier than next fiscal year after offering\*\* Not permanent for domestic issuers—if at the beginning of any fiscal yr there are more than 300 shareholders, then issuer is public once more. |
| **Foreign issuer exemption from § 12(g): Rule 12g3-2(b)** |
| Foreign issuers can claim an exemption IF (i) they have not made a registered public offering, (ii) they are not listed on a US sec exchange or Nasdaq AND (iii) they furnish home country disclosure in English online.  |
| **Foreign issuer termination: Rule 12h-6** |
| A foreign private issuer (i) who has been a reporting co. for at least a yr (ii) and who has not issued a public offering requiring Section 5 registration: may terminate its reporting req. WRT a class of *equity* securities IF* less than 5% of the average daily trading volume of its equity sec. takes place in the US
* OR that the number of shareholders of its equity is less than 300 persons worldwide or 300 persons who are US residents
	+ The look through inquiry is limited to brokers, dealers, banks and other nominees (no counting of beneficial owners)

A foreign private issuer may terminate its reporting req. WRT a class of *debt* securities IF* Number of debtholders is less than 300 persons worldwide or 300 persons who are US residents
	+ The look through inquiry is limited to brokers, dealers, banks and other nominees (not beneficial owners)
* AND has filed or furnished all reports
 |

**Consequences of being a reporting company under Exchange Act**

|  |
| --- |
| * Registered co must file periodic disclosure documents w the SEC
* Registered co must keep records and maintain a system of internal accounting controls
* Registered co are subject to SEC proxy regulation
* Any person who makes a tender offer for the equity sec of a registered co must make disclosures to the SEC, mgmt and solicited shareholders
* The control persons of registered co must disclose their trading in the co publicly traded equity sec and are liable to the co if they make profits from such trading during 6 mo window
 |

**1.** Must comply with **Sarbanes-Oxley**—including foreign issuers as well.

* CEO and CFO must each certify that he reviewed the annual and quarterly report filed w the SEC and that 1) it does not contain material statements that are false or misleading and 2) that it fairly presents the financial condition and results of operation of the company. SOX § 906
* CEO and CFO must certify that they are responsible for establishing and maintaining disclosure controls and procedures that ensure material information is made known to them and that these internal control were evaluated before making the report. SOX § 404(a)
	+ If there are significant deficiencies or any fraud by those who operate them, the certifying officers must disclose this to the company’s auditors and the board’s audit committee.
* Mgmt’s assessment of effectiveness of company’s internal control over financial reporting must be attested to by the auditor auditing the financial statements. SOX § 404(b)
* Exchanges and Nasdaq must prohibit the listing of sec of co. that do not have an audit comm. of the board of directors. SOX § 301. Further,
	+ each member of the issuer’s audit comm. must be independent
	+ the commit must rake responsibility for selecting and overseeing the issuer’s public accountants
	+ the audit comm.. establishes procedures for handling complaints
	+ and the issuer provides appropriate funding for the public accounting firm performing the audit
* A co must disclose whether its audit comm.. has at least one “audit comm. financial expert” including their name and whether he is independent. If there I no such expert, co must disclose this fact and its reasons therefor. SOX § 407
* An issuer must disclose in periodic reports whether it has adopted a code of ethics for senior financial officers, including its reasons if it has not done so. SOX § 406
* Issuers must disclose all material off balance sheet transactions and explain their off balance arrangements in a separately captioned subsection of the MD&A. SOX § 401(a)
* Lawyers appearing and practicing before the SEC must report evid of a material violation of sec law or breach of fiduc duty to the company’s general counsel or CEO. Failing an appropriate response, the lawyer must then report to the co’s audit comm., a comm. of executive directors or the full board. SOX § 307.
	+ appearing and practicing before the SEC = providing advice WRT US sec laws or SEC rules w regard to any doc that the attny has notice will be filed w SEC

2. Must comply with the **Dodd-Frank Act**—including foreign issuers

* + *Say on Pay req:* Co. must provide shareholders the opportunity to have a nonbinding advisory vote to approve the compensation of named exec officers at least once every three yrs. At least once every six yrs, shareholders must be provided w a separate non binding vote on whether the say on pay vote should occur every 1, 2 or 3 yrs. Lastly, in connection w acquisition, merger, consolidation or sale, shareholders must be able to exercise a nonbinding vote to approve golden parachute payments. Dodd-Frank § 951.
	+ Exchanges must incorporate in their listings rules independence and other requirements for compensation comm. Dodd-Frank § 952.
		- In determining independence, exchanges can consider factors such as the source of compensation for the director and whether the director is affiliated w the company or its subsidiary or an affiliate
		- EXCEPT foreign private companies that disclose to shareholders annually why they do not have an indp comp comm.
	+ Comp comm. must have the authority to engage outside independent advisors. Dodd Frank § 952.
	+ Company’s proxy statement must include a description of the relationship btw the exec compensation actually paid and the financial performance of the company, taking into account any changes in the stock value and dividends paid. There must also be disclose on internal pay disparity (i.e., ratio of the median employee total comp to the CEO’s total comp). Dodd Frank § 953
	+ Listing rules must require companies to develop, implement and disclose policies providing for the clawback of incentive based compensation paid to current or former executive officers following a restatement due to material non compliance w financial reporting requirements under sec laws. Dodd Frank § 954
	+ Proxy statement must disclose as to whether directors or employees are permitted to purchase financial instruments to hedge against decreases in the market value of any equity sec of the co. Dodd Frank § 955.
	+ Proxy statement must disclose why the same person is serving as both CEO and chairman of the board of directors. Dodd Frank § 972.
	+ Stock exchanges must prohibit broker discretionary voting wrt to the election of directors, exec comp or any other significant matter UNLESS brokers receive specific voting instructions from beneficial owners. Dodd Frank § 957.

Must comply with **Foreign Corrupt Practices Act**

* FCPA prohibits reporting co from making payments to foreign govnt officials to influence their official actions or decisions
* FCPA requires reporting co (1) to maintain financial records in “reasonable detail” to accurately reflect co transactions and (2) to put into place internal accounting controls sufficient to provide “reasonable assurances” of internal accountability and proper accounting. Ex. Act § 13(b)(2).
	+ Reasonableness standard measured by “prudent officials in the conduct of their own affairs.” Ex. Act § 13(b)(7).
	+ Company officials or their agents are prohibited form attempting to influence an auditor in performing his duties. Ex. Act. § 13(b)(2).
* US companies are subject to extraterritorial juris. under FCPA
* Non-US companies are subject only to “territorial” juris. Can be broadly applied—e.g., through correspondent account liability (E.g., financial transactions between two foreign banks that include a transaction clearing through a correspondent account in NY)

**VII. Proxy Statements.**

|  |
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| Proxy regulation* Any person who solicits proxies from public shareholders must file w the SEC and distribute to shareholders specified info in a “proxy statement.” **Rule 14a-3(a).**
* Fraudulent or misleading proxy solicitations are prohibited **Rule 14a-9.**
	+ Exch. Act does not explicitly provide private right of action BUT the Supreme Ct has ruled that there is an **implied cause of action** for violations of §14(a). Borak.
* Written and oral communications about a voting issue is permitted before the filing of a PS so long as actual voting authority is not sought & any written communications are filed. **Rule 14a-12.**
* If the solicitation is for the annual election of directors, mgmt must send the corp’s annual report to shareholders. **Rule 14a-3(b)**
* Mgmt must include “proper” shareholder proposals w the company-funded proxy materials sent to shareholders. **Rule 14a-8.**
	+ The rule provides a list of grounds for mgmt to exclude improper proposals.
 |

**At a glance**

* Misrepresentation
* Materiality
* ~~Scienter~~
* Reliance
* Causation

**Standing:** Unclear from Exch Act § 14(a) whether any shareholder has a private right of action or merely shareholder whose vote was sought

**Possible defendants**

* Signatories to the proxy statement (directors, officers, experts)
* The issuer

**Burden of proof** on plaintiff to identify

* **Materiality**—see TSC Indust
* **Misrepresentation or omission** in proxy solicitation (proxy statement, form of proxy, notice of meeting or other communication used in proxy solicitation).
	+ Applies to written or oral communication. Rule 14a-9(a)
* **Scienter**—depends on D
	+ *Issuers, directors and officers:* negligence standard
	+ *Outside experts:* Intent to deceive or motive for deception should be an element of liability in suits involving outside accountants. Adams v. Standard Knitting Mills (6th Cir)
		- Rationale: Unlike issuer, they do not directly benefit from the proxy vote
* **Reliance**: Plaintiffs do NOT need to show actual reliance—if info was material, reliance will be presumed. Mills
* **Causation:** PS must be “an essential link to the accomplishment of the *transaction*.” Mills.
	+ IF no transaction🡪NO fraud.
	+ NOT but for causation—no need to demonstrate that the alleged misrepresentation had a decisive effect on the voting.
		- REJECTED Ct of Appeals argument which said that respondents could show as a defense that merger would have been voted through regardless of the misrepresentation if the transaction was “fair” to minority shareholders.
	+ Minority shareholder whose vote is unnecessary for approval of freeze-out merger AND have not lost any state law remedy cannot establish causation. Virginia Bankshares,
		- Left open the question whether causation could be established in a case in which minority shareholders had been induced to forfeit a state law right to an appraisal remedy by voting to approve transaction or had been deterred from obtaining an order for injunction.

**Damages:** Federal courts have power to grant all necessary remedial relief. Borak

* Remedies are NOT limited to prospective relief.
* But cts may award damages, instead of an injunction, if suit is brought after merger is completed.

**Defendant’s defenses**

* **Whether the alleged misrepresentation was actually false**
* **Materiality**
* **Causation**
* **Reasonable care/due diligence**—at least where the standard is negligence
* **Safe harbors for forward looking statements**
	+ PSLRA
	+ Rule 175
	+ Bespeaks caution doctrine

**Joint and several liability**

**VIII. Rule 10b-5: fraud “in connection with a purchase or sale of any security.”**

|  |
| --- |
| PRELIM ANALYSIS* Does the transaction involve a **“security”?**
* Has there been **“the purchase or sale of any security**”?
* Has there been a deception “**in connection with”** the securities transaction?
* Does it meet the heightened pleading requirements under the PSLRA?
 |

**A. Scope of Action**

**1. Standing:** Plaintiffs can only be actual purchasers or sellers. Blue Chips Stamp

* **Excludes:**
	+ Potential purchasers who allege that they *would have purchased* if there had not been an unduly gloomy misrepresentation or omission of favorable material,
	+ Actual shareholders who allege that *would have sold* if there had not been an unduly rosy representation or a failure to disclose unfavorable material
	+ Shareholders/creditors/investors who argue loss in the value of their investment bc of alleged fraud do NOT have standing.
* **Forced seller doctrine**: A minority shareholder who was cashed out by a short form merger of his corporation with its corporate parent was a forced seller but still had standing to sue.

**2. 10b-5 Defendants:** NO privity w P needed.

**Control persons:** A control personwill have joint and several liability UNLESS the person (i) acted in “good faith” AND (ii) did not “directly or indirectly induce” the violation. Exch. Act § 20 (a)

* + Control = “(i) the possession, direct OR indirect (ii) of the power to direct OR cause the direction of the mgmt and policies of a person (iii) whether through ownership of voting securities, by k or otherwise. Rule 405
* The control person defn may include **independent contractors**. Hollinger (9th Cir.)
* A **broker dealer** is a controlling person under § 20(a) WRT its registered representatives. Hollinger
	+ Particular business arrangement of broker dealer w rep does NOT matter.
	+ Rationale: 1) § 15 of Exch. Act imposes an implicit duty on broker dealers to supervise their reps. 2) Broker dealer has power under § 15 to deny reps access to the market thereby having control over them. 3) Broker dealer is required by stat to enforce a reasonable system of supervision which means they exert ongoing control
* IF P establishes that D is a controlling person🡪**burden of proof** shifts to D on the question of good faith and inducement. Hollinger.
	+ NO need for P to prove “participant culpability” to establish prima facie case
* IF broker dealer maintained AND enforced a reasonable system of supervision and internal control🡪 D establishes **good faith defense**. Hollinger
	+ NOT enough to say you merely had supervisory procedures in place

**Aiders and abettors:** A private P cannot maintain an aiding and abetting suit under § 10(b). Central Bank of Denver

* But SEC has power to seek injunctive relief or money damages when (i) there is a primary violation by another, (ii) reckless knowledge of the primary violation by A&A and (iii) “substantial assistance” by the A&A in achieving the primary violation. Exch. Act § 20(e).
* In SEC actions, there is a **recklessness** standard (formerly “knowingly” standard). Dodd-Frank § 929.
* NO good faith defense under § 20(e)
* Secondary participants like banks can still be liable as **primary** violators. Central Bank.

**Scheme liability:**

* IF D owed no duty to speak to investors AND the sham transactions were not disclosed to the public🡪there is NO fraudulent misstatement or omission.
* IF there is no reliance upon a misstatement or “omission”🡪a private plaintiff CANNOT maintain an action against customer/supplier companies. Stoneridge Investment
* D’s scienter (culpability) does NOT matter
* FOTM presumption of reliance does NOT apply to “ordinary business operations” “remote” to the injury.
	+ REJECTING petitioners’ argument that the public statements relating to a sec. incorporate underlying business transactions

**B. Fraud “in connection with” securities transaction**

* Action reaches *any* sec—whether publicly or privately traded.
* NO privity req. Fraud only has to affect the transaction.
	+ E.g., reaches outsider trading (misappropriation) cases.
* Rule 10b-5 applies to any purchase or sale of securities, including the sale of a business structured as a stock sale. Landreth (rejecting sale of business doctrine).

**C. Fraud Elements**

* Deception: misrepresentation or conduct (Stoneridge Investment, dicta)
* Materiality
* Scienter
* “In connection with”
* Reliance
* Economic loss
* Causation

**1. Deception**

* Fraud reaches misstatements, omissions. Rule 10b-5(b)
* AND manipulative conduct. Rule 10b-5(a) and (c)

**Misstatements**: Includes both written and oral misrepresentations

* A written nonreliance clause in a securities k may preclude any claim of deceit by prior verbal representations.
* Under Civ. Pro. Rule 9(b)’s requirement that averments of fraud are stated w/ “particularity,” alleged misstatements may NOT include completely unattributed statements. Time Warner (2d Cir) (finding that anonymous statements to reporters and analysts were not actionable)

**Omissions:** IF there is no duty🡪omission is NOT actionable

* **Duty to speak:** IF there is a “relationship of trust and confidence between parties to a transaction”🡪duty to disclose. Chiarella.
* **Duty to update:** A duty to update opinions or projections may arise IF (i) the original opinions or projections have become misleading (ii) as a result of material intervening events and (iii) such misrepresentation remained “alive” in the minds of investors as a continuing representation. Time Warner, Burlington
	+ BUT the opinion or projection must be “definite”—cannot be mere puffery
	+ Facts of Time Warner: Through a highly publicized campaign, Time Warner disclosed a business plan to its investors that it was seeking to reduce its debt by forming a strategic alliance with partner who would infuse billions of dollars into the company. Ultimately, that plan didn’t pan out and the company sought an alternative method of raising capital—a new stock offering that substantially diluted the rights of existing shareholders. These shareholders brought suit after the share price dropped dramatically, alleging that TW committed fraud by not disclosing the alternate business plan. The Ct agreed as the intervening event (alternate business plan) was material: the rights offering would have the opposite effect of a strategic alliance as the former would drive share price down and the latter would drive share price up.
	+ Fact of Burlington: A co. exec. stated in Nov. 1993 that he was comfortable w analyst projections for earnings per share for 1994. The plaintiffs alleged that the official had a duty to update that forecast. The ct disagreed—**a “single, ordinary” “run-of-the-mill” forecast should not result in expansive disclosure obligations!**
* **Duty to correct**: The duty to correct historical statements and a “narrow” range of forward looking statements may arise IF subsequently discovered information reveals that the statement is not true. Burlington Coat.
	+ “Narrow” range of FIL = forecasts based on erroneous, mistaken data
* Is there a duty to correct or update **third party statements**? Maybe
	+ Was the issuer the source of inaccuracies?
	+ Was the issuer responsible for dissemination?
* IF there is a duty to update or correct🡪**did it dissipate**?
	+ There is NO general rule of how long duty to update may last

**Manipulative conduct**: Practices “intended to mislead investors by artificially affecting market activity.” Santa Fe (e.g., wash sales, matched orders or rigged prices).

* Note: This would have succeeded as a material omission case if the shareholders had an available state law remedy *before* the merger was effected. If they had such a remedy (e.g., ability to get injunction), this would have changed the total mix of information, thus making the omission material. In Santa Fe, there was no materiality as the only remedy available was after the notice was sent out.

**Breaches of fiduciary conduct:** Actions do not reach breaches of fiduciary conduct under state law that do not involve any deception, misrepresentation or nondisclosure (i.e. corporate mismanagement). Santa Fe.

**2. Scienter:** “intent” to deceive, manipulate or defraud. Hochfelder

* **Spectrum**: actual intent 🡪 actual knowledge 🡪 reckless 🡪 negligent
	+ Negligence is NOT enough. Hochfelder
	+ Supreme Court left the question open as to whether “recklessness” is enough!
	+ Recklessness = (i) extreme departure from standards of ordinary care (ii) which presents a danger of misleading investors that is known to the D or is so obvious that D must have been aware of it
* **PSLRA: “**Plaintiffs must state w particularity facts giving rise to a strong inference that the D acted w the required state of mind.”
	+ A court must (i) take into account plausible opposing inferences from (ii) ALL the facts alleged, (iii) examining them collectively. Tellabs
		- Standing alone, factual allegations supporting a strong inference of fraudulent intent is NOT enough
		- For the claim to survive motion to dismiss stage, the inference of scienter must be more than plausible or reasonable—it must be “cogent” (convincing) and at least as compelling as any opposing inference of nonfraudulent intent
		- In making comparison, court must assume facts in complaint are true. Ct may also take judicial notice of documents incorporated into the complaint and any other matter w/in ct’s discretion.
	+ See also Avaya (3d Cir): Allegations of motive and opportunity are neither necessary nor sufficient to allege scienter under PSLRA; rather such allegations should be looked at in context of all the allegations in a complaint.

**3. Reliance**

* Ps do NOT need to prove reliance in **omission cases** bc the burden of proof would be too difficult
* In **face-to-face** transactions, P must prove actual reliance
	+ Justifiable reliance doctrine: some circuits consider the following factors in determining whether an investor is justified in relying on an oral statement that conflicts w contemporaneous written documents in investor’s possession:
		- Sophistication and expertise of P in financial matters
		- Existence of long standing business or personal relationship
		- Access to relevant information
		- Existence of a fiduc. relationship
		- Concealment of the fraud
		- Opportunity to detect the fraud
		- Whether P initiated transaction or sought to expedite it
		- Generality or specificity of the misrepresentations
* **In transactions in the public market,** P establish a **presumption of reliance** under the fraud on the market theory
	+ IF P shows that shares traded on an efficient market🡪then FOTM applies. Basic
		- Rationale: 1) It is too difficult to show individualized reliance in class action cases involving numerous Ps, 2) Investor relies on “integrity” of the market price, and price reflects all publicly-available info, including false information disclosed to public
	+ A market is efficient IF the market price of the stock “fully reflects” all publicly available information such that ordinary investors cannot make trading profits on the basis of new information. In re Polymedics
		- NOT enough to show that market professionals “generally consider” publicly announced material statements about companies, thereby affecting stock prices
		- Efficiency test does NOT mean you have to show that the stock is “fundamental value efficient”—i.e., accurately reflects fundamental value of stock
	+ **Factors indicating informational efficiency**
		- Is there a large weekly trading volume?
		- Is it followed by analysts and market professionals?
		- Are there market makers and arbitrageurs?
		- How quickly does the price adjust to new information?
* The D can **rebut that presumption** by ANY showing that severs link between the misrepresentation and the price of the stock OR investor’s decision to trade
	+ “Market makers” privy to truth about subject of misstatement/omission or market otherwise actually aware of the truth (truth on the market)
	+ P believed that alleged misstatement was false
	+ Market not efficient
	+ Investor forced to buy/sell securities (e.g., by consent decree)
	+ Investor would have made same decision anyway
	+ D made corrective statements
	+ The alleged misstatement did not affect stock price

**Causation and economic loss:** P must show that the misrepresentation **directly** caused the **economic loss**

* Generally can be established by showing a change in stock prices when the misrepresentations were made and then an opposite change when the correction was made (i.e., truth of the fraud is revealed).
	+ P can show this by event studies.
* D can defend by saying that losses were caused by extraneous causes (e.g., spike in oil prices)
* P cannot allege economic loss simply by saying that she “paid artificially inflated prices” for a security “on the date of purchase” bc of the misrepresentation. Dura Pharma.
	+ Rationale: 1) if P sold before truth came out the misrepresentation would not have led to loss. 2) If P sells after truth came out the misrepresentation *may* have lead to the loss—in the absence of other factors such as business conditions. 3) Sec. law is not meant to be a broad ins. against market loss but only to protect investors from the loss that the misrepresentations actually caused.
* Second Circuit test: P must allege that i) D concealed a risk that could forcibly cause P’s loss and ii) that the loss was caused by the materialization of the concealed risk. Lentell (2d Cir.)
	+ Facts: In this case there was no loss causation. The Ps alleged that analyst reports kept the stock prices of two Internet companies artificially high: from May 1999 through Nov. 2000 and from Aug. 1999 to Feb. 2001. However, the truth was revealed long after the prices came down—in April 2002 when the AG report came out on ML’s Internet Group. Further, the analyst reports did not conceal the risk that actually caused the price decline. The reports did not conceal the price-volatility risk of the stock.

**Contribution**

* There is a right of contribution w contribution shares being computed according to percentage of responsibility. Ex Act § 21D
* May be sought from any person whether or not joined in the original action

**D. Rule 10b-5: “Insider” Trading**

**Threshold assumptions:**

* Information is **material**
* **has not been disclosed to public**
* and relates to a **“security”** (e.g., Rorech (SDNY), applying insider trading to credit default swaps)

**A. Classic Trading cases:** D has inside information and trades on it.

* Under the **disclose or abstain rule**, if D has inside information he must either
	+ (i) disclose it to the investing public (in classic cases) or to the source of information (in misappropriation cases) OR
	+ (ii) if he doesn’t, he must abstain from trading in or recommending the sec. while the information remains undisclosed.
* The disclose or abstain rule operates ONLY if D has a **duty to disclose** “arising from a relationship of trust and confidence”
	+ (i) between the “parties to a transaction” [i.e., between D and shareholders], Chiarella, OR
	+ (ii) between D and the source of information, O’Hagan.
	+ REJECTS 2d Cir theory: There is NO general duty to the “market as a whole”—not every instance of financial unfairness constitutes fraud!
	+ Query: Does the duty to disclose arise from the “existence of a relationship affording access to inside information *intended to be available only for a corporate purpose”*? Cady, Robert.
* In a classic insider case, the **breach** comes from trading.
* The breach of duty must have been done with **scienter**
	+ **Rule 10b5-1** says the person trades “on the basis” of material, nonpublic information if the trader is “aware” of the material nonpublic information when making the purchase or sale.
* **A duty to disclose may arise when there are:**
	+ **Insiders** who obtain information bc of their corporate position, i.e. directors, officers, employees, controlling shareholders. Chiarella.
	+ **Temporary insiders** (e.g., consultant, accountant, etc.) are those who
		- (i) have entered into a special confidential relationship in the conduct of the business of the enterprise and
		- (ii) are given access to information solely for corp. purposes. Dirks.
		- BUT for duty to arise (i) the corp. must expect to keep this information confidential AND (ii) the relationship must imply such a duty. Dirks.
	+ **Familial relationships:** cts are split
		- Chestman (2d Cir): marriage, “without more,” does not create fiduc. relationship—there must be
			* (i) an express agreement of confidentiality or
			* (ii) the “functional equivalent” of a fiduc relationship must exist (“reliance and de facto control or dominance”).
		- SEC v. Yun (11th Cir): A spouse who trades in breach of a “reasonable and legitimate expectation of confidentiality” held by the other spouse subjects the former to IT liability.
			* Reasonable and legitimate expectation = spouses had a history or practice of sharing business confidences and those confidences were generally maintained OR an express agreement of confidentiality
	+ **Rule 10b5-2:** For misappropriation cases there is a “duty of trust or confidence”
		- whenever a person agrees to maintain info in trust or confidence
		- when two people have a history/pattern/practice of sharing confidences
		- when a person receives or obtains info from spouses, parents, children and siblings UNLESS D can show that no duty of trust or confidence existed in the actual family relationship.
		- *Query:* Outside of rulemaking authority? Is the SEC right that a simple confidentiality agreement without an express agreement not to trade enough to trigger a duty? (SEC v Cuban, dt ct decision). Is the SEC right that a contractual relationship—without an actual relationship of trust and confidence—is enough to trigger a duty?

**B. Tipper-Tipee cases:** Tipper has inside information which he passes on to tipee who trades/recommends on it.

* **Threshold queries:** Must first establish that tipper has a duty to source of information
* Tipper must make tip w **scienter.** E.g., Switzer (no IT when SEC could not persuade the ct that a CEO intentionally or recklessly tipped a coach who had overheard a conversation btw the CEO and his wife).
* IF tipper will **benefit**, directly OR indirectly, from his tip🡪there is a **breach of duty** to source of information. Dirks.
	+ Objective test: “whether the insider receives a direct or indirect personal benefit from the disclosure”
	+ Benefit = “pecuniary gain or reputational benefit *that will translate into future earnings.*”
		- E.g., Yun: SEC presented evidence of benefit by showing that tipper and tipee were friendly, worked together for several yrs and split commissions on various real estate transactions over the yrs
	+ Whether there is a “benefit” is a question of fact
* This liability extends to **subtippers** who know or should know a tip is confidential and came from someone who tipped improperly.
	+ Subtipper is liableeven though she does not trade, so long as subtippee down the line eventually does.
* IF (i) Ds tip constitutes a **breach of duty** AND (ii) tipee knows or should know there was a breach (i.e. that tipper was getting a benefit)🡪tipee cannot trade on that information UNLESS there is disclosure to the investing public. Dirks.
	+ REJECTS SEC’s information theory: an obligation of confidentiality does not arise merely bc tipee inherits from tipper inside information
* IT liability arises both from trading w shareholders and nonshareholders such as **options traders.** E.g., O’Hagan (call options).

**C. Safe harbor**: pre-existing trading plan. **Rule 10b5-1(c).**

To establish safe harbor for *individual corporate insider:*

* Corp. insider had entered in “good faith” into a binding k to trade the sec, instructed another person to execute the trade for her account or adopted a written plan for trading sec—when unaware of inside information.
* This trading strategy either
	+ 1) expressly specifies the amount, price and date of the trade,
	+ 2) includes a written formula for determining these inputs OR
	+ 3) disables the corp. insider from influencing the trades, proving the actual trader was unaware of the inside information
* The trade accords w pre-existing strategy.

To establish safe harbor for *entity* (nonindividual):

* Actual individual trading for the entity was unaware of inside information
* Entity had policies and procedures to ensure its individual traders would not violate insider trading laws.

**D. Tender Offers:** Rule 14e-3 prohibits (i) when there has been a “substantial step” to commence a tender offer (ii) trading by anybody, other than the bidder, (iii) who has material, nonpublic information about the offer that (iv) he knows or has reason to know was obtained from either the bidder or the target

* There is NO need to find breach of fiduc duty
* A substantial step to commence a tender offer can be taken EVEN IF no tender offer is actually made (e.g., when potential bidder acquires a large portion in a target)

**VIII. Regulation FD**

**Applies whenever**

* a reporting issuer or person acting on its behalf
* discloses (i) material (ii) nonpublic information to certain persons (sec. market professionals or holders of the issuer’s sec. who may trade on basis of info)

IF the selective disclosure is **intentional**🡪the issuer must simultaneously make public disclosure of that information

* Rule 101(a): A selective disclosure of material nonpublic information is "intentional" when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic.

IF the selective disclosure is **nonintentional**🡪the issuer must publicly disclose the information promptly after it knows OR is reckless in not knowing that the information selectively disclosed was both material and nonpublic.

**Material** – see generally TSC v. Northway and “total mix” test

* The following are items that should be reviewed for materiality (SEC Release 33-781)
	+ Earnings information
	+ Mergers, acquisitions, tender offers, joint ventures, changes in assets
	+ new products/discoveries/developments regarding customers or suppliers
	+ changes in control, mgmt
	+ changes in auditors or notification that the issuer may no longer rely on an auditor’s report
	+ events regarding issuer’s sec (e.g., class of sec. for redemption)
	+ bankruptcies
* An issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces! (SEC Release 33-781)
* Materiality is viewed from POV of issuer, not analyst (SEC Release 33-781)
	+ Issuer will not held liable for information that, unbeknownst to the issuer, helps analyst complete a mosaic of information, that taken together, is material.

**Public disclosure** can be made by filing a Form 8-K, talking to the media, holding conference call, etc.

**Exceptions** Rule 100(b)(2)

* Normal course of business such as to professional advisors (lawyers, consultants, etc) or business partners in k negotiations
* Disclosures made to those who expressly agree to maintain confidence
* Disclosures made in sec offerings registered under the Sec Act

**Note:** Does NOT give rise to 10b-5 liability or private enforcement. Rule 102.

* ONLY enforced through SEC actions

**IX. Extraterritorial reach of US sec laws**

* **Transactional test:** Section 10(b) and Rule 10b-5 actions apply only to transactions in sec. listed on US exchanges OR to securities transactions that take place in the US
	+ It is NOT enough for conduct to have occurred in the US if it did not result in a transaction in the US
	+ It is NOT enough that the fraud had an “effect” on US investors if it did not result in a transaction in the US