SECURITIES REGULATION OUTLINE

§1: DEFINITION OF A SECURITY

§1.1: INTRODUCTION

I. Framework

Analytical Framework for Defining a Security: there is a 4-step analysis to go through when confronted with "defining a security."

1. First, apply the definitions in SA §2(a); and SEA §3(a)(10).
    a. Then apply the Rule that says they are interpreted the same.
    b. Apply generally policy of the Act; namely, that Congress sought to define the term security broadly and generally so as to include within that definition many types of instruments that in our commercial world fall within the ordinary concept of security.
        i. The purpose of the Securities Act was to regulate *investments*;
        ii. for the protection of the investing public at a time when the market was untrustworthy.
2. Second, state the economic reality test;
3. Third, state the *Weaver Test* for what constitutes a security; and then
4. Apply the facts and analogize to one of the instruments that have been held to be a security or not:
    1. Things that **are securities:**
        a. Stock, the quintessence of a security. If labeled stock and has the five common characteristics of common stock, it is a security and the analysis is over.
        b. Investment Contracts: apply the *Howey Test* to determine if a instrument or a transaction is an investment contract.
            i. Limited partnerships, condos coupled with an interest/or service contract, and LLC's (depending on the managing agreement) can all be investment contracts.
            ii. If *Howey Test* does not work, or as a counterargument, apply *Risk Factor Test*.
        c. Notes: if you encounter a note, apply the *family resemblance test* and determine if the note is more like a stock or investment contract or the list of notes which are not securities.
        d. Others: there are some other things that have been mentioned that are securities:
            i. certificates of deposit: instruments issued by protective committees in the course of corporate reorganization;
            ii. demand notes;
            iii. publicly traded bonds;
            iv. debentures.
    2. Things that **are not securities:**
        a. Under an investment contract analysis:
            i. general partnerships, franchisees, LLCs (depending on managing agreement);

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b. Purchasing an interest for consumption or use;
c. employee pension plans;
d. conventional certificates of deposit;
e. unsecured notes, the terms of which are negotiated face-to-face and given to a bank in consideration for a business loan;
f. instruments that are regulated by other federal law;
g. Bank CDs (convention certificates of deposit);
h. the notes on the list which have failed the family resemblance test.
i. certificates evidencing loans from commercial banks to their customers for sue by customers in current operations;
j. commercial paper.

II. Security Defined

A. **SA §2(a):** Definitions: …unless **the context otherwise requires--**

(1) the term "security" means any ***note***, ***stock***, treasury stock, *bond*, debenture, certificate of interest or ***participation in any profit-sharing agreement*** or in any oil, gas, or other mineral royalty or lease, any collateral trust certificate, pre-organizational certificate or subscription, transferable share**,** ***investment contract***, voting trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate or deposit, or group or index 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 commonly known as a security*****;** ….

A(1). **G/R:** the Supreme Court has repeatedly held that definitions of a security in SEA §3(10) and SA §2(1) are virtually identical and will be treated as such in decisions dealing with the scope of the term [*Landreth Timber Co. v. Landereth*].

A(2). **G/R:** Context Clause: The term security not only covers instruments commonly known in the investment world as securities, such as stocks and bonds, but may also include novel or unique instruments.

1. Although it is evident that the definitions are fairly broad on their face, this only the starting point because of the language "unless the context requires otherwise" [the context clause] which precedes each of the provisions.
*[*Wartzman v. Hightower Productions*].

B. **SA §5:** Prohibitions Relating to Interstate Commerce:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation of communication in interstate commerce or of the mails to sell such security through the use or medium of any *prospectus or otherwise*; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such ***security for the purpose of sale or for delivery after sale*****.**

B(1). **G/R:** as the §5(a)(2), make evident, not sale of a security can take place unless a registration statement is in effect, absent an exemption.

C. **G/R:** Jurisdictional Requirement: to invoke jurisdiction under the federal securities laws, there must be some use of the mails or instrumentalities of interstate commerce.

1. This is usually met without difficulty (i.e. phones, mail, computers across state lines, etc…).

D. **G/R:** Malpractice, Breach of Contract: an attorney, if he fails to recognize that a venture, item, or transaction is a security, may be held liable for breach of contract, malpractice, and damages arising from the negligence [*Wartzman v. Hightower*].

§2.1: INVESTMENT CONTRACTS

I. Howey Test for Investment Contracts

A. **G/R:** Investment Contract Definition: an investment contract, for purposes of the security acts, means:

1. a contract, transaction, or scheme;
2. whereby a person invests his money in a common enterprise; and
3. is led to expect profits solely from the efforts of a promoter or third party;
4. it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

Policy:* such a definition permits the fulfillment of the statutory purpose of compelling **full disclosure relative to the issuance of the many kinds of instruments that in the commercial world fall within the ordinary concept of a security.

B. **G/R:** Howey Test for Investment Contracts: the test for a contract, transaction, or scheme constitutes an investment contract is whether:

1. the scheme involves **investment of money**;
2. in a **common enterprise;**
3. with **profits**
4. to come *solely* from the **efforts of others**.

*[*SEC v. WJ Howey Co.*].

**If these elements are satisfied it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value.

B(1). **G/R:** Howey Analysis: the *Howey* analysis applied by the courts can be broken down into three issues:

1. *Common Enterprise:* are the investors' interests interwoven with those of other investors and/or the promoter for the return of their investment.
    a. EX: in *Howey,* to recoup their money, the investors had to rely on the orange pickers and cultivators in Florida; same with beaver farms, earthworm farms, and the like.
2. *Expectation of Profits:* is the interest bought in order to obtain a financial return or for other reasons; and
3. *Efforts of Others:* does the investor participate in the venture to such a degree that he is not dependent solely on the efforts of others for profits.

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1. The party exerting the significant efforts ***need*** **not** be owned or controlled by the seller promoter because the Supreme Court disregards form for substance and looks at the **economic reality** of the situation.

a. The more critical factor then ownership is the nature of the investor's participation in the enterprise.

b. If it is one of providing capital with the hopes of favorable return, then it begins to take on the appearance of an investment contract notwithstanding the fact there may be more than one party other than the principle party and his agent on the other end of the transaction.

i. EX: in *Continental Marketing*, the owners/sellers of the beavers to the investors, where not the one's that actually raised and cultivated the Beavers, (that was a different corporation) but it does not matter that the corporation taking care of the beavers was a separate entity from Continental Marketing.

*[*Continental Marketing v. SEC*].

B(2). Howey Investment Contract Test: Elements Explained: four elements must be satisfied under the *Howey Test* for an investment contract to exist:

1. **Investment of Money:** in every decision of the Court recognizing a security under the Securities Acts, the person found to have been an investor *chose* to give up a specific consideration in return for a separable financial interest with the characteristics of a security.

a. Even in cases where the interest acquired is intermingled security and non-security aspects, the interest obtained has to have the elements of an investment contract.

b. The purchaser must give up some tangible and definable consideration in return for an interest that has the substantial characteristics of a security.

i. The person's investment can take the form of a cash, or goods and services.

2. **Common Enterprise:** the investors' interest must be interwoven with those of other investors and/or the promoter for a return on their investment.

a. *Types of Common Enterprises:* there are two types of common enterprises:

i. Horizontal Commonality: [all courts have held sufficient to satisfy *Howey Test*]: horizontal commonality looks at relationships, which exist between an individual investor and the pool of other investors.

(A) Under this standard, a **pooling of interests of the investors** is essential to finding the existence of an investment contract.

--In other words, all of the shareholders, or investors, are pooled together and the success or failure of the enterprise will affect all the investors equally.

--EX: in *Howey*, it was horizontal commonality, same with the Beaver farm—if the farm did good all the investors would do well, when it failed, all the investors did bad and sued.

--all investors put their money in a pot and get pro rata share out of the pot equally if success, or lose money equally.

(B) Thus, non horizontal common enterprise can exist unless there exits between the **investor**s themselves some **relationship,** which ties the fortune of each investor to the success of the overall venture.

ii. Vertical Commonality: [split between Circuits on whether it satisfies the *Howey* Test]: vertical commonality exists where the **fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or third parties, i.e., promoter.**

(A) Thus, the promoter must share the risk with the investor, or there must be some link between the *fortunes of the investor* and the *efforts of the promoter.*

--EX: a coal purchase program the success of which is dependent on the promoters unique ore processing technique.

(B) There is also another type of vertical commonality wherein the investor puts his money in, and some works for him (not the promoter) and the fortunes are dependent on who the investor gave his money to.

--EX: a discretionary trading account, the investor gives his money to the broker who invests it, and then the success is dependant on the market.

*NOT many courts accept this notion of vertical commonality.

3. **Expectation of Profits:** the interest must be bought in order to obtain financial returns:

a. There are two main forms of profits that meet the *Howey Test:*

i. capital appreciation resulting from the development of the initial investment; and

ii. a participation in earnings resulting from the use of investors' funds.

b. The securities laws will generally *not* be applicable where the purchaser is principally motivated by a desire to use or consume the particular item required (such as tax returns).

4. **Profits Solely from the Efforts of Others:** the investor must participate in the venture to such a degree that he is not dependent solely on the efforts of others for profits.

a. *Solely Element:* most courts reject a literal interpretation of the word solely instead using the:

i. Koscot/Turner Test: the critical inquiry under this element is whether the efforts made by those other than the investor are undeniably sufficient ones, those essential to managerial efforts which affect the failure of success of the enterprise.

(A) In other words, the profits must derived from the entrepreneurial or managerial efforts of others.

**THE *HOWEY TEST* IS CONFINED TO INVESTMENT CONTRACT ANALYSIS [*Reves*].

C. **G/R:** Risk Capital Test: [an alternative to the *Howey Test*. Although generally rejected by the federal courts, the Supreme Court explicitly reserved ruling on whether it is viable for finding an investment contract and many states use it; hence, on the exam, use it as a counterargument or if cannot satisfy the elements of the *Howey Test*, state that the risk capital test can be argued, and then apply the elements]. Under the **risk capital test, an investment contract is created whenever:**

1. an offeree furnishes initial value to an offeror;
2. a portion of this initial value is subjected to the risks of enterprise;
3. the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and

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above the initial value, will accrue to the offeree as a result of the operation of the enterprise; AND;
4. the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.
*[*St. Commn'r of Securities v. Hawaii Market Center, Inc*][The Supreme Court left open the question of whether the risk capital test is viable in *United Housing Foundation v. Forman*].

II. Application of the *Howey Test:* Things that are or are not Investment Contracts

A. **G/R:** Franchise Agreements: conventional franchise agreements (McDonalds, Burger King, etc…) generally have been held not to constitute investment contracts because pursuant to these arrangements the franchise exerts substantial efforts; hence, the third requirement of the *Howey Test* is not satisfied.

B. **G/R:** General Partnerships: [and most joint ventures] general partnerships are normally not held to constitute investment contracts because the third element of the *Howey Test* is not satisfied because general partners normally share in the in the management [share equal under RUPLA]; hence, the profits are not derived from the efforts of others.

1. Three Circuits follow a bright line rule and hold that interests in general partnerships are not securities.
2. Exception: ***Williamson Test****:* a couple Circuits hold that a general partnership or joint venture can be a security if the investors (and plaintiff has heavy factual burden) can establish one of the following:
    1. that an agreement among the parties leaves so little power in the hands of the partner that the arrangement distributes powers as a limited partnership;
    2. the partner is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or
    3. the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manger that he cannot replace the manger or the enterprise or otherwise exercise meaningful partnership powers.

C. **G/R:** Limited Partnerships: interests in limited partnerships are generally securities because the limited partners ordinarily rely on the general partners to exercise essential efforts.

1. *Caveat:* in those situations where limited partners can exert managerial efforts, the *Howey Test* is not met and no investment contract exists.

D. **G/R:** LLC's: the issue is not yet resolved as whether interests in an LLC are securities:

1. It may be argued that LLC interests are not investment contracts since most of the state statutes vest managerial power in the LLC members and this signifies they are not relying on the efforts of others.
2. Nonetheless, the same arguments could be made under the *Williams Test*, as to general partners.

**Much of the analysis will turn on the "manager agreement" (like articles of incorporation) and if it is set up more like a general partnership, then it will not be a security, and if it is more like a limited partnership, it could be held to be a security.

E. **G/R:** Condominiums: [Property Interests Coupled with Service Contracts]: when the offering of a condominium is coupled with a service contract, and profits are expected from the purchase of the condo, then it will be probably be held to be a security.

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1. When the offering of a condominium in conjunction with any of the following, it will cause the offering to be viewed as an offering of securities in the form of investment contracts:
a. the condo, with any rental arrangements or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, form the rental of units;
b. the offering of a participation in a rental pools agreement; or
c. the offering of rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.

§1.3: EMPHASIS ON ECONOMIC REALITY

I. Economic Reality Test

A. **G/R:** Economic Reality Test: in searching for the meaning and scope of the word security in the Security Acts, form should be disregarded for substance and the emphasis should be on economic reality.
1. The primary purpose of the Security Acts was to eliminate serious abuses in a largely unregulated securities market; thus, the focus of the act is on the capital market of the enterprise system: the sales of securities to raise capital for *profit making purposes*, the exchanges on which the securities are traded; and the need fro regulation to prevent fraud and *protect the interest of investors.*
2. The name given to an instrument is not dispositive; however, the name is not wholly irrelevant to the decision of whether the instrument constitutes a security.
a. There may be occasions when the use of traditional names such as "stocks" or "bonds" will lead a purchaser to justifiably assume that the federal securities laws apply.
3. EX: in *Forman* the P's bought "stock" in a housing development as a form of rent; however, the S.Ct. held that it was not "stock" as defined by the Act, primarily because they were not *investing* for profit but rather to consume (use) the product (the rooms); hence, it was not a security transaction. It was not an investment contract either because it was not an investment for money, hence the third element was not satisfied.
*[*United Housing Foundation v. Forman*].

B. **G/R:** Using or Consuming the Interest Acquired: when a purchaser is motivated by a desire to use or consume the item purchased the securities laws do not apply.
1. In other words, the securities laws do not apply where the purchaser engages in the transaction principally to *use or consume the interest acquired.*
2. If there are no profits attached to an investment, then the investor is probably merely purchasing something for use or consumption and it is not a security.
*[*United Housing Foundation v. Forman*].

C. **G/R:** Traditional Characteristics of Stock: [if something on the exam is labeled as "stock" you must apply these characteristics and see if it really is stock, and if it does have these things, it is probably not stock, and may have to use investment contract analysis, to see if it can fall under that.] There are several common features of "stock" notwithstanding whatever label is given them:
1. The right to receive dividends (this is the most common feature);

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2. negotiability;
3. stock can be pledged or hypothecated;
4. the attachment of voting rights in proportion to the number of shares owned;
5. stock can appreciate in value.

II. Stock as a Security [Rejection of the Sale of Business Doctrine]

A. **Generally:** if an item is labeled as a stock (or even if it is not) and possesses all of the attributes of stock, based on the analysis below, then it is covered by the plain language of the Securities Acts, and protection is afforded to investors or purchasers.

1. The *Howey Test* **does not** need to be applied to traditional stock because it is listed in the plain definition of the Acts and comes within that plain meaning.

B. **G/R:** the starting point in every case involving the construction of a statute begins with the language itself; hence, **SA §2(a)(1)** defines a security to include any …stock.

1. The fact that the definition shows that "stock" is considered to be a security within the meanings of the Securities Acts, it is covered by the Acts if it possess the attributes of stock, and is actually stock.
2. The fact that instruments bear the label "stock" is not dispositive; hence, the court must also determine whether the instruments possess some of the significant characteristics commonly associated with stock because if an instrument is a stock, and bears the label stock, investors may justifiably rely on the Federal Securities Laws. The common attributes of stock are:
    a. the right to receive dividends contingent upon an apportionment of profits;
    b. negotiability;
    c. the ability to be pledged or hypothecated;
    d. the conferring of voting rights in proportion to the number of shares owned; and
    e. the capacity to appreciate in value.

*[*Landreth v. Landreth Timber Co.*].

C. **G/R:** Stock as a Security: instruments that bear both the name and all the usual characteristics of stock are covered by the plain language of the Securities Acts because:

1. traditional stock represents to many, both trained and untrained in business matters, the **paradigm of a security**; thus, person trading stock are likely to have a high expectation that their activities are governed by the Act; and
2. stock is relatively easy to identify because it lends itself to a consistent definition unlike other instruments (notes, bonds).

*[*Landreth v. Landreth Timber Co.*].

D. **G/R:** Sale of Business Doctrine and Tender Offers: the sale of business doctrine held that transfer of stock incidental to the sale of a closely held business did not constitute a sale of securities.

1. The Supreme Court rejected this doctrine in *Landreth* because the Securities Acts were not intended to cover only "passive investors" and were intended to cover privately negotiated transactions involving the transfer of control to entrepreneurs because the SEA contains several provisions governing such transactions (tender offers) and eliminating from the definition of security instruments involved in transactions where control passed to the purchaser would contravene the purposes of these provisions.
    a. In other words, the sale of all the stock of a company is a securities transaction subject to the provisions of the Federal Securities Acts because "stock" is covered by

the plain language of the definition and therefore the sale of business doctrine does not apply.
*[*Landreth v. Landreth Timber Co.*].

E. **G/R:** Investments and Stock: the economic reality test need not be applied in every case because some instruments are obviously within the class Congress intended to regulate because they are by their nature investments, which is what Congress principally sought to regulate when it enacted the Securities Acts.
1. An instrument bearing the name stock, that among other things, is negotiable, offers the possibility of capital appreciation, and carries the rights to dividends contingent on the profits of a business enterprise is plainly within the class of instruments Congress sought to regulate under the Securities Laws.
a. Stock, as a practical matter, is always an investment if it has the economic characteristics traditionally associated with stock.
i. Even if sparse exceptions to the general rule can be found, the public perception of common stock as the paradigm of a security suggests that stock, in whatever context it is sold, should be treated as within the ambit of the Securities Acts.
2. Common stock is the **quintessence of a security** and investors may justifiably assume the sale of stock is covered by the Securities Acts.
*[*Reves v. Ernst & Young*].

III. Employee Pension Plans as Securities

A. **Generally:** neither SA §2(a)(1), nor SEA §3(a)(10), refer to employee pension plans in their definitions, which give numerous examples of securities, refers to pension plans of any type.

B. **G/R:** Pension Plans: a non-contributory, compulsory pension plan **does not** constitute a security within the meaning of the Securities Acts because:
1. pension plans are not investment contracts within the meaning of the definition of a security because:
a. there is no investment of money (first element of *Howey Test*) when the plan is compulsory and non-contributory; and
b. there is no expectation of profits from a common enterprise (second and third elements of *Howey Test*); and
c. the adoption of ERISA (a federal statute regulating pension plans) renders the application of the Federal Securities Laws needless.
i. **Note:** the use of this third justification was a step away from the traditional *Howey* analysis. If there is another federal (and sometimes state) law regulating the instrument sought be categorized as a security, then that *should be used* as an argument against extending the definition of security.
(A) In other words, if the person is already protected by another statute, the federal securities laws do not need to also extend protection.

§1.4: THE PRESENCE OF OTHER REGULATION AND CONVENTIONAL CERTIFICATES OF DEPOSIT

I. Conventional Certificates of Deposit

A. **G/R:** Certificates of Deposit: the SEA §3(a)(10) definition of a security includes the term "certificate of deposit" which refers to instruments issued by protective committees in the course of corporate reorganization.

B. **G/R:** TEST for What Constitutes a Security: the definition of "security" in the Securities Acts is quite broad; hence, the coverage of the antifraud provisions of the securities laws is not limited to instruments traded on securities exchanges and over the counter markets, but extends to uncommon and irregular investments.

1. **Test:** the test for what constitutes a security is what character the instrument is given in commerce by terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.
    a. A security is an instrument in which there is common trading whereby the instruments traded have an equivalent in value to most persons and can be traded publicly.
2. Context Clause: the context clause indicates that Congress did not intend to provide a broad remedy for all fraud.

*[*Marine Bank v. Weaver*].

C. **G/R:** Conventional Certificate of Deposit (bank CD): a bank certificate of deposit **is not** a security because:

1. The context clause of SEA §3(10) provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context requires otherwise; and
2. the context requires otherwise because it is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the Securities Acts because holders of bank certificates are *adequately protected under the federal banking laws*.
    a. **Note:** the presence of other federal regulation was used again to prevent the expansion of the definition of security under the Federal Securities Acts.
        i. The presence of other federal regulations in the field in a **major element** in party's arguments to the Supreme Court not to extend the definition of security.

*[*Marine Bank v. Weaver*].

D. **G/R:** Private Agreements: in a private contract or business agreement between two people, over an instrument that is not covered by the plain language of the Securities Acts, are not intended to be covered by the Securities Acts in some instances because the parties have more of an opportunity to protect themselves, even if the contract is conducted for profit.

1. *Caveat:* an item, such as stock, which is covered by the plain terms of the Act, is not subject to this rule.

*[*Marine Bank v. Weaver*].

E. **G/R:** Unsecured Notes: an unsecured note, the terms of which are negotiated face-to-face, given to the bank in consideration for a business loan is not a security.

F. **G/R:** Certificates of Deposit (Bank CDs): when a domestic or foreign bank is sufficiently well regulated that there is virtually no risk that insolvency will prevent it from paying the holder of one of the certificates of deposit in full, the certificate **is not** a security for purposes of the federal securities laws [*Marine Bank v. Weaver*].

§1.5: DEBT SECURITIES

I. Notes as Securities

A. **G/R:** Investments: Congress' purpose in enacting the Securities laws was to regulate **investments**, in whatever form they are made, and by whatever name they are called.

1. The court has consistently identified the fundamental essence of a security to be its characteristic as an investment.
*[*Reves v. Ernst & Young*].

B. **SA §2(a)(1); SEA §3(a)(10):** Definition: the term security means *any note*, ….

C. **G/R:** Notes: a *per se* rule for notes, like stock, would be unjustified.

1. *Definition:* unlike stock, a note may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context.
   a. A note, unlike stock, is the quintessence of a security because they are used in a variety of settings, not all of which involve investments.
2. Thus, the term "any note" should not be interpreted to mean literally "any note" but must be understood against the backdrop of what Congress was attempting to regulate in enacting the securities acts.
3. Thus, to determine if a note is within the statutory definition the courts will apply the family resemblance test.
*[*Reves v. Ernst & Young*].

D. **Family Resemblance Test:** the test and analysis for determining what constitutes a note is:

1. Because the Securities Acts define every note as a security thee is a presumption that **every note** is a security;
   a. This presumption exists, notwithstanding the 9-month or less exemption for notes, which the Supreme Court did not address but the 2d Circuit presumes are *not* notes.
      i. The Court impliedly assumed that Congress only intended the 9-month exception to apply to *blue chip, high quality, commercial paper*.
2. The presumption is rebuttable.
3. The court will apply a four-factor analysis to determine whether a note is a security:
   a. *Motivations:* the court will examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into the transaction.
      i. If the seller's purpose is to raise money for a general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, **the instrument is likely to be a security.**
         (A) Profit: in this context means "a valuable return on investments", which undoubtedly includes interest. Thus, the issuer must pay interest to the holder above the generally prevailing rate offered by instruments that are *safe* (Such "safe" instruments would include notes that are adequately insured and other instruments where the rate of default is practically nil.
            --**Note**: this definition is broader than the one used by the court in the *Howey Test* and analysis.

ii. If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct the seller's cash flow difficulties, or to advance some other commercial or consumer purpose, the note **is less likely to be a security**.

b. *Plan of Distribution:* The court will then examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is common trading for speculation or investment.

c. *Reasonable Expectations of Investors:* The court will then examine the reasonable expectations of the investing public: the court will consider instruments to be securities on the basis of such public expectations, even where economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in the transaction.

d. *Presence of other Regulation:* Last, the court will examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the securities acts unnecessary.

**These factors are non-exclusive, that is, they do not all have to satisfied for the court to hold that a note should not be considered a security.

4. These factors can be used to determine whether any transaction constitutes a security; the term "family resemblance test" gets its name from the list of notes that have been **held not to be securities**. If the note in question is analogous to the list of items not securities then it is held not be a security if the four factors are satisfied.

a. <u>Notes that Have been Held Not to Constitute Securities:</u>

i. a note delivered in consumer financing;

ii. the note secured by a mortgage on a home;

iii. the short-term note secured by a lien on a small business or some of its assets;

iv. the note evidencing a "character loan" to a bank customer;

v. short term notes secured by an assignment of accounts receivable;

vi. a note which simply formalizes an open account debt incurred in the ordinary course of business (particularly, if as in the case of a customer of a broker it is collateralized); and

vii. notes evidencing loans by commercial banks for current operations.

viii. Short term loan participations [*Blanco v. Security Pacific*].

ix. certificates evidencing loans by commercial banks to their customers for use in the customer's current operations [*Blanco v. Security Pacific*].

*[*Reves v. Ernst & Young*].

E. **G/R:** <u>Investments Covered by the Securities Acts:</u> if a note is more analogous to an investment that has been held to be covered by the securities acts, then it is *more likely* that the note will be categorized as a security. Investments which have been held as securities are:

1. common stock traded on a national exchange is the paradigm of a security and is readibly convertible into cash (as is a demand note);

2. The same is true of publicly traded bonds, debentures, and any number of other instruments which are plainly within the Securities Acts

**Hence, demand notes are securities.

*[*Reves v. Ernst & Young*].

F. **G/R:** <u>Commercial Paper:</u> the *Reves* decision signified that commercial paper **is not** a security.

1. The majority would exempt from securities law coverage only that short-term commercial paper that is of "blue chip" quality; namely, short-term high quality instruments issued to fund current operations and sold only to highly sophisticated investors.
*[*Reves v. Ernst & Young*].

II. Summary

A. **Generally:** the *Howey Test* is confined to investment contract analysis and the *Family Resemblance Test* is confined to "note" analysis.
1. However, the *Howey Test* and the *Family Resemblance Test* apply many of the same factors—under either test in order for a security to exist:
a. there must be an investment (as compared to commercial) motives underlying the transaction;
b. the investing public must reasonably believe that such instrument is being offered as a security; hence, with investors having a reasonable expectation of profit;
c. the instrument must be subject to mass distribution or widespread trading; and
d. there is no alternative regulatory framework present that significantly reduces the investment's risk of loss.
2. The main differences between the tests are:
a. the most significant is that "profit" is defined expansively under the *Family Resemblance Test* thereby having the effect of bringing certain notes within the securities law coverage that would otherwise be excluded under *Howey*; and
b. a security may be present even if all the factors of the *Family Resemblance Test* are not met; whereas, all factors of the *Howey* investment contract test must be satisfied in order for an instrument to come within the purview of the federal securities laws.

§2: PRIMARY ISSUER TRANSACTIONAL EXEMPTIONS FROM REGISTRATION

§2.1: OVERVIEW

I. Framework

A. **Analytical Framework:** there are _____ steps to the analysis:
1. In order to establish a *prima facie case* for violations of the Securities Acts, the plaintiff must show:
a. no registration statement was filed with the SEC;
b. the defendants offered or sold securities; and
c. the defendants used interstate transportation or communication in connection with the sale of offer.
2. The defendant can then raise the affirmative defense that the securities, and relevant transactions therewith, fall within an exemption to SA §5 registration requirements.
3. There are eight main exemptions that could apply:
1. **SA §4(2):** private offering exemption;
2. **Rule 506:** safe harbor for §4(2) exemption;
3. **Rule 504:** exemption for small issues;
4. **Rule 505:** limited offering exemption;
4. **Rule 701:** exemption for benefits and compensatory plans;
5. **Regulation A:** exemption for "mini public offerings"

6. **SA §4(6):** exemption for sales to accredited investors; and
7. **SA §3(a)(11):** intrastate exemption.

4. If an exemption applies, then the issuer is only exempt from the registration requirements, this *does not* exempt them from the antifraud provisions of the securities laws, so determine if any of those apply.

II. Overview

A. **SA §5:** Prohibitions Relating to Interstate Commerce:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation of communication in interstate commerce or of the mails to sell such security through the use or medium of any *prospectus or otherwise*; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such ***security for the purpose of sale or for delivery after sale.***

*This is the heart of the Securities Act of 1933.

B. **G/R:** the general rule is that, absent an exemption, all offers or sales of securities **must be registered.**

1. The securities antifraud provisions apply irrespective of whether an exemption from registration exists.
2. The requirement for a registration statement, as contained in SA §5, serves several purposes:
   a. gives a description of the business, the prospectus, the history of the business, etc…;
   b. the registration statement and prospectus are supposed to be given to persons purchasing shares before the SEC gives its approval;
      i. *Efficient Market Theory:* it also serves to inform the market by allowing it to set prices for the shares of stock when they ultimately go to market because the price is based on the prospectus.
   c. it allows the SEC to review the registration statement and make suggestions;
   d. the issuer **cannot** sell anything until the registration statement is *in effect*.
      a. the issuer pursuant to **SA §5(c)** cannot even offer to sell a security until the statement has been filed with the SEC.
3. *Liability:* if there is a material misstatement or omission in the registration statement, the following persons may be liable:
   a. the issuer is strictly liable;
   b. directors and other officers can be liable;
      i. directors and officers, however, have due diligence defense.

C. **G/R:** Types of Exemptions: there are two general types of exemptions:

1. *Transactional Exemptions:* these are the most important and will be covered below.
2. *Securities Exempt from Registration:* these exemptions are contained in **SA §§ 3(a)(2)-(8)** cover securities, which are never required to be registered under SA §5, largely due to the intrinsic character or nature of the issuer itself. These exempt securities include:
   1. short-term promissory notes or bills of exchange;
   2. securities issued or guaranteed by municipalities, state or federal governments; and
   3. securities issued by non-profit, religious, education, or charitable organizations.

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§2.2: SA §4(2)--THE STATUTORY PRIVATE OFFERING EXEMPTION

I. <u>The Chart</u>

A. **Item Requirements for SA §4(2), Private Offering Exemption:**

1. <u>Aggregate Offering Price Limitation:</u> unlimited.

2. <u>Number of Investors:</u> uncertain, but a finite number of offerees depending on the circumstances.

3. <u>Investor Qualification:</u> exact requirements uncertain, *but*:
    a. offeree must receive or have access to the type of information that registration would disclose;
    b. sophistication requirements apply;
        i. offeree must be financially sophisticated (alone of with representative).

4. <u>Commissions:</u> permitted.

5. <u>Limitations on Manner of Offering:</u> no general solicitation or advertising permitted.

6. <u>Limitations on Resale:</u> restricted.

7. <u>Issuer Qualifications:</u> None.

8. <u>Filing with SEC:</u> no notice of sales required.

9. <u>Information Requirements:</u> investors receive or have access to the type of information that registration would disclose.

II. <u>General Requirements for Private Offering Exemption</u>

A. **SA §4(2):** exempts transactions by an issuer not involving any public offering from the registration requirements of **SA §5.**

B. **G/R:** <u>Size of the Offering:</u> the size of the offering is not dispositive on the issuer of whether it is a public or private offering; in fact, to be a public offering within the meaning of the Act, an offer need not be open to the whole world.

C. **G/R:** <u>Private Offerings:</u> the applicability of **SA §4(2)** turns on whether the particular class of persons affected need protection afforded by the Act.

1. An offering to those who are shown to fend for themselves is a *transaction not involving a public offering*.
    a. In other words, if the offerees are shown to have access to available information, which provides substantially the same substance as one would find in the registration statement; and
    b. the investors are sophisticated (i.e. can "fend for themselves"); *then*
    c. the offering is private.

*[*SEC v. Ralston Purina*].

D. **G/R:** 4-Factors in Determining whether an Offering Qualifies as a Private Offering: there are four factors the courts consider in determining if the exemption applies:

1. *The Number of Offerees:* [it is offerees, NOT purchasers]
    a. The more offerees, the more likelihood the offering is public;
        i. the number of offerees, however, is not dispositive in determining the availability of the public offering;
    b. The offerees must have a relationship with the issuer in order to have access to *available information*;
        i. when the offerees have access to, or there has been disclosure of, information registration would provide, that information is available.
    c. *Offerees Sophisticated:* There is a sophistication requirement for the offerees; however, there must be sufficient basis of information upon which the sophisticated investor may exercise his skills.
2. *Number of Units Offered*;
3. *Size of the Offering;* and
4. *Manner of the Offering*.

*[*Doran v. Petroleum Management Corp.*].

**There are no set requirements for #2-4, hence, the exemption is not very reliable to use because most of the analysis turns upon whether the offerees where sophisticated and had access to information.

***__Policy:__ the policy behind the exemption is that it is efficient, lowers transaction costs, should provide disclosure to investors.

§2.3: REGULATATION D: RULE 504: EXEMPTION FOR SMALL ISSUES

I. The Chart

A. **Item Requirements for Rule 504, Exemption for Small Issues:**

1. Aggregate Offering Price Limitation: $1,000,000 (1-million) in any 12-month period.

2. Number of Investors: unlimited.

3. Investor Qualification: None required.

4. Commissions: permitted.

5. Limitations on Manner of Offering: NO general solicitation and/or advertising permitted.

6. Limitations on Resale: restricted.

7. Issuer Qualifications: no reporting or investment companies.

8. Filing with SEC: Form D required, but not as a condition of exemption.

9. Information Requirements: no information specified.

II. General Requirements for Rule 504

A. **Rule 504:** provides an exemption from Securities Act registration for securities offerings of non-reporting companies that do not exceed an aggregate annual amount of $1-million.

1. Rule 504 is the limited offering exemption designed to aid small businesses in raising capital.
2. Rule 504 permits a non-reporting issuer to offer and sell securities to an unlimited number of persons without regard to:
    a. their sophistication or experience; and
    b. without delivery of any specified information in a public offering.

§2.4: REGULATION D: RULE 505: LIMITED OFFERING EXEMPTION

I. The Chart

A. **Item Requirements for Rule 505, Exemption for Limited Offerings Not Exceeding $5-million:**

1. Aggregate Offering Price Limitation: $5,000,000 ($5-million) in any 12-month period.

2. Number of Investors: 35-(purchasers) and unlimited number of accredited investors.

3. Investor Qualifications: no sophistication requirements.

4. Commissions: permitted.

5. Limitations on Manner of Offering: NO general solicitation or advertising permitted.

6. Limitations on Resale: Restricted.

7. Issuer Qualifications: No investment companies or issuers disqualified under Regulation A (i.e. No reporting or investing companies, "bad boy" disqualifications apply).

8. Filing with SEC: Form D required, but not as a condition of exemption.

9. Information Requirements: the Requirements of Rule 502(b) must be satisfied (i.e. a non-financial statement; and a financial statement of information).

II. General Requirements for Rule 505:

A. **Rule 505:** exempts offerings where the aggregate offering price of an issue which does not exceed $5-million in any twelve month period.

1. *Number of Investors:* a Rule 505 offering may be made to an unlimited number of *accredited investors*.
    a. **Rule 501(a):** an accredited investor is any person who comes within any of the following categories, or who an issuer reasonable believes come within any of the following categories, at the time of the sale of the securities to that person:
        --Generally these categories include wealthy and financially sophisticated investors, such as:
            i. banks,

ii. insurance companies,
iii. tax exempt organizations,
iv. directors and executive officers of the issuer, and
v. natural persons who have a large net worth (more than $1-million net worth; or made more than $200 thousand in the previous year).

2. *Issuer Qualifications:* in order to be able to take advantage of the Rule 505 exemption the issuer must be neither:
   a. An investment company; nor
   b. subject to any of the "bad boy" disqualifications contained in **Rule 262(a):**
      i. The "bad boy" disqualifications basically disqualify any person who has been subject to a criminal conviction, civil judgment, or SEC order, for violating the securities laws or failing to comply with registration.

§2.5: REGULATION D: RULE 506: SAFE HARBOR FOR PRIVATE PLACEMENTS

I. The Chart:

A. **Item Requirements for Rule 506, Safe Harbor for Private Placements under §4(2):**

1. Aggregate Offering Price Limitation: unlimited.

2. Number of Investors: 35 (purchasers) and unlimited number of accredited investors.

3. Investor Qualification: investor must be sophisticated (alone of with representative) and accredited investors are presumed to be qualified.

4. Commissions: permitted.

5. Limitations on Manner of Offering: NO general solicitation or advertising permitted.

6. Limitations on Resale: restricted.

7. Issuer Qualifications: None.

8. Filing with SEC: Form D required, but not as a condition of exemption.

9. Information Requirements: the Requirements of Rule 502(b) must be satisfied (i.e. a non-financial statement; a financial statement of information).

II. General Requirements for Rule 506:

A. **Rule 506:** relates to transactions that are deemed to be exempt under SA §4(2). Rule 506 is a "safe harbor" for the §4(2) exemption, if the conditions for Rule 506 have been met, then the issuer has come within the private offering exemption.

1. *Investor Qualification:* Sophistication: [**Rule 506(b)(2)(ii)**]: each person who is not an accredited investor either or alone or with his representative must have knowledge and experience in financial and business matters so that he is capable of evaluating the merits and risks of the prospective investment.

§2.6: RULE 701: EXEMPTION FOR COMPENSATORY BENEFIT PLANS

I. The Chart

A. **Item Requirements for Rule 701, Exemption for Certain Compensatory Benefit Plans**

1. Aggregation Offering Price: depending on certain factors, between $500,000 and $5-million in any 12-month period.

2. Number of Investors: unlimited, but must be an eligible purchaser.

3. Investor Qualifications: purchaser must be an employee, officer, director, consultant or advisor of an eligible company who has acquired the securities as compensation.

4. Commissions: permitted.

5. Limitation on Manner of Offering: general solicitation and advertising *permitted.*

6. Limitations on Resale: restricted.

7. Issuer Qualifications: No reporting companies.

8. Filing with SEC: Form 701 required, but not a condition of exemption.

9. Information Requirements: no information specified.

II. General Requirements of Rule 701:

A. **Rule 701:** the rule provides an exemption from registration for offers and sales of securities for certain compensation benefit plans adopted for the participation of employees, officers, directors, consultants, and advisors of an eligible company (companies eligible to use the Act must not be subject to the periodic reporting requirements of the SEA).

1. The exemption provided in Rule 701(a)-(b) permits the offer and sale of securities by a non-reporting company pursuant to the terms of compensatory benefit plans or written contracts between the issuer or its partners or majority owned subsidiaries and their employees, directors, directors, general partners, trustees, officers, and advisers.

§2.7: REGULATION A: EXEMPTION FOR "MINI PUBLIC" OFFERINGS

I. The Chart:

A. **Item Requirements for Regulation A, the Mini Public Offering Exemption:**

1. Aggregate Offering Price Limitation: $5-million in any 12-month period.

2. Number of Investors: unlimited.

3. Investor Qualification: none required.

4. Commissions: permitted.

5. Limitation on Manner of Offering: general solicitation and advertising permitted.

6. Limitation on Resale: not restricted.

7. Issuer Qualifications: Among others, no reporting or investment companies; bad boy disqualifications apply.

8. Filing with SEC: filings required.

9. Information Requirements: information specified in Regulation A (see below).

II. General Requirements for Regulation A

A. **Regulation A:** was enacted in an effort to enhance capital formation by small business. Regulation A exempts public offerings of non-reporting companies of up to $5-million in any 12-month period (and no more than $1.5 million in non-issuer re-sales) and permits the use of a simplified question and answer disclosure document.

1. Companies conducting Regulation A will be able to "test the waters" for potential interest in the company before having to prepare the mandated offering circular.
2. *Information Requirements:* Regulation A requires the qualification of a prescribed offering statement, which has been filed with the SEC and delivery to the prospective investor of a required offering circular.
    a. Issuers may begin to sell and offer the securities to be sold as soon as the offering statement is filed, a written offer can be made only through the use of a preliminary of final offering circular.
3. Testing the Waters: companies relying on Regulation A exemption can test the waters for potential interest in the company before filing and delivery of the mandated offering statement.
    a. The regulation requires that the testing of the waters be with a written solicitation of interest to be submitted to the SEC at the time of first use, the document must include two mandated statements:
        i. that no funds are being solicited or will be accepted; and
        ii. that a detailed offering document will follow solicitation.

§2.7: SA §4(6)—SALES TO ACCREDITED INVESTORS

I. The Chart

A. **Item Requirements for §4(6), Exemptions for Sales to Accredited Investors**

1. Aggregate Offering Price Limitation: $5-million in any 12-month period;

2. Number of Investors: an unlimited number of *accredited investors only*;

3. Investor Qualifications: accredited investors only.

4. Commissions: permitted.

5. Limitations on Manner of Offering: NO general solicitation or advertising permitted.

6. Limitations on Resale: restricted.

7. Issuer Qualifications: none.

8. Filing with SEC: Form 4(2) required.

9. Information Requirements: no information specified.

II. General Requirements of §4(6)

A. **SA §4(6):** exempts from the registration requirements transactions in which the aggregate sale price does not exceed the maxium amount permitted by section 3(b)--$5 million, provided all of the sales are made to accredited investors.

1. Accredited Investors: [**SA §2(15)**] are defined to include institutional investors such as banks, registered investment companies, employee benefit plans subject to ERISA, and insurance companies.

a. In addition, a person with financial sophistication, high net worth, knowledge and experience in financial matters, can also qualify as an accredited investor. [**Rule 215** also defines accredited investor].

§2.8: SA §3(11): INTRASTATE EXEMPTION

I. Exempted Securities: Intrastate Securities

A. **SA §3(a)(11):** Intrastate Exemption: provides an exemption from registration with respect to "any security which a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident doing business, or, if a corporation, incorporated and doing business within, such State or Territory.

1. The exemption is categorized as exempt securities rather than transactional exemptions from registration. In practical effect, however, these exemptions come into play only where there is a transaction which meets the criteria of the applicable exemption.

B. **Rule 147:** serves as a safe harbor for the intrastate exemption. Rule 147 narrows the statutory exemption in several ways and it is all inclusive—to qualify for its safe-harbor the issuer must satisfy every condition of the Rule:

1. *Nature and Business of Issuer:* Rule 147 requires the issuer to be a resident and doing business with the state where its offerees and purchasers reside.

a. For a business association this means the state of incorporation or legal organization;

b. For general partnerships it means where the principle office is located.

2. *Residence of Offerees and Purchasers:* all offers and sales must be made to persons resident within the state where the issuer is doing business. For individuals, the Rule only recognizes their "principle residence" as satisfying the criteria (e.g. where he maintains his home at the time of the transactions, and the SEC has held that it looks down upon summer homes and the like in determining residence).

2.5. *Doing Business within a State:* Tripe 80% Rule: in order to be deemed to be doing business within a state under Rule 147:

1. 80% of the gross revenue has to be taken from the state;

2. 80% of the assets of the business have to be in the state; and
3. 80% of the proceeds of the offering must be in the state.

3. *Advertising:* §3(a)(11) contains no limits on advertising; an issuer might legitimately fear however, that an advertisement for its securities might be circulated outside the state might be deemed an offer to non-residents and hence destroy the exemption.

a. The SEC has taken the position however that if an advertisement contains explicit language limiting the offering to in-state residents the issuer will not lose exemption status.

4. *Resales:* the Rule expressly prohibits resales to out-of-state residents for 9-months after the last sale of the issue. The offering, by conclusive presumption, has then come to rest in the state.

5. *Integration:* Rule 147 also contains a specific safe harbor for integration that provides that other offerings which take place either 6-months before or 6-months after a valid Rule 147 offering shall not be deemed part of that issue.

6. *Burden of Proof:* a person claiming to have complied with Rule 147 has the burden of proving compliance with all of its provisions.

§2.8: INTEGRATION OFFERINGS and RESCISSION OFFERS

I. Integration

A. **G/R:** Integration: under the concept of integration of offerings, what apparently may seem to be separate offerings instead are construed as one integrated offering. Because of the fairly distinct requirements for each exemption, otherwise exempt offerings are unlikely to qualify for an exemption once they are integrated, thereby resulting in a violation of the Securities Act §5 registration requirements.

1. Integration under the Securities Act is designed to prevent an issuer from avoiding registration of a non-exempt transaction by accomplishing the transaction through two or more ostensibly distinct offerings each which, if treated separately, would conform to the exempt provisions—this is to protect investors.

B. **G/R:** Rule 502(a) Safe Harbor: if the issuer engages in offers or sales during the 6-month period prior to commencement or after completion of the purportedly exempt offerings, as long as the securities are not of the same or similar class as offered or sold under Regulation D. If the safe harbor period is not complied with, the SEC or court will apply the 5-factor test to determine if the offer was integrated.

C. **G/R:** Test for Determining when an Offer is Integrated: the SEC has established a five factor test for determining whether offers and/or sales of securities should be treated as integrated; namely, whether the offerings:

1. are part of a single plan of financing;
2. involve issuance of the same class of securities;
3. have been made at or about the same time;
4. are made for the same general purposes; and
5. whether the same type of consideration is received.

D. **G/R:** Aggregation: distinguish the principles of aggregation and integration.

1. Aggregation is the principle by which an issuer determines the dollar worth of exempt sales available under SA §3(b).
2. Integration is the principle under which an issuer determines overall characteristics of its offering.

E. **G/R:** Rescission Offers: generally, if an issuer of securities discovers that he has made a material violation of the securities laws; insofar as purchasers are concerned, the issuer may make a rescission offer that fully informs the purchaser of all material facts and provides such purchasers with the right to rescind.

1. A rescission offer is an offer to rescind a transaction in which a securities violation has occurred or believed to occurred.
    a. The mechanics of a rescission offer may entail an offer to buy securities. Unlike other offerings of securities, however, and regardless of whether a rescission is treated as both an offer to sell, or an offer to buy the subject securities; hence, compliance with the Securities Laws may be necessary.

**REMEMBER: THE EXEMPTIONS ONLY APPLY TO REGISTRATION REQUIREMENTS AND NOT THE ANTIFRAUD PROVISIONS.

§3: THE CONCEPT OF DUE DILEGENCE AND ITS RAMIFICATIONS

§3.1: THE REGISTERED OFFERING—STATUTORY FRAMEWORK OF §11

Analytical Framework: if confronted with a due diligence, or §11 problem, go through this analysis:

1. Policy*:* start with the policy of the Securities Act of 1933; namely:
    a. the fundament purpose of the SA was to substitute a philosophy of full disclosure for a philosophy of caveat emptor and thus to achieve a high standard of business ethics in the Securities Industry. The Act mandates disclosure of all material facts relating to the sale or offering of covered securities; that is, the prospective purchaser of a new issue of securities it entitled to know what the deal is all about [*Akerman v. Oxy Communications*].
2.

I. Persons Subject to §11 Liability

A. **SA §11(a):** in case any part of the registration statement, when such part became effective, contained an *untrue statement of material fact* or *omitted to state a material fact* required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such a security…may…in any court of competent jurisdiction sue…[the person subject to liability].

B. **Persons Subject to §11(a) Liability:** §11(a) of the SA specifies the classes of person who may be subject to liability for material misstatements or omissions contained in the registration statement (including the prospectus). Parties subject to liability are:

1. *Issuers:* All persons who sign the registration statement including, pursuant to §6(a), the *issuer*, its principal executive officer or officers, its principal financial officer, its controller or principal accounting officer, and the majority of its board of directors or persons performing similar functions;

2. *Directors:* every director (or persons performing similar functions) or general partner of the issuer;
3. *Prospective Directors:* every person with his or her consent in the registration statement as being or about to become a director or general partner;
4. *Experts:* every expert who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to such statement in the registration statement, report, or valuation which purport to have been prepared or certified by him;
5. *Underwriters:* every underwriter of the offering; and
6. *Control Persons:* every control person of the issuer [**SA §15** provides that every person who controls any person liable under §11 or §12 shall also be held jointly and severally liabile].

C. **G/R:** <u>Aiding and Abetting:</u> due to the statutory language and the exhaustive enumeration of those parties subjection §11 liability, the courts have refused to impose "aiding and abetting" liability pursuant to that provision.

II. <u>Elements of the §11 Right of Action</u>

A. **Elements of a §11 Right of Action:** under section §11, **a *plaintiff*** :

1. must have purchased the security where a means or instrumentality of interstate commerce was used in connection with the offer or sale;
2. at the time of the purchase, must NOT have known of the misrepresentation or nondisclosure;
    - a. the plaintiff purchaser cannot recover if he knew of the misstatement or omission at the time of purchase.
3. must show that the misrepresentation or nondisclosure was <u>*material*</u>, meaning that reasonable investors would have considered the pertinent information important in making their investment decisions;
4. need not establish privity;
5. can recover for aftermarket purchasers subject to the tracing requirement;
    - a. <u>*tracing requirement*</u>: stockholders lack standing under §11 with respect to those shares that they are unable to affirmatively trace to the public offering. Pursuant to the tracing requirement, plaintiff's must show *not* that they *might* have purchased shares by means of a deficient registration statement in a particular offering, but that they in fact did purchase such shares pursuant to that specific offering (and registration statement).
    - b. given the practical difficulties of "tracing" this requirement is a difficult one for "aftermarket" §11 plaintiffs.
    - *see below
6. normally **need not show reliance** upon the misrepresentation or nondisclosure;
    - a. in fact, a plaintiff need not have read the prospectus;
    - b. pursuant to §11(a), however, where the plaintiff acquired the securities more than 12-months after the effective date of the registration statement and the issuer has generally made available an earnings statement covering the 12-month period, the plaintiff *must prove reliance* on the misstatement or omission;
        - i. such reliance may be shown by means other than the actual reading of the prospectus.

7. need not prove that the misrepresentation or nondisclosure *caused* the loss (in other words, causation is presumed once a material misstatement or nondisclosure has been shown to exist);

a. *caveat:* §11(e) permits the defendant to prove the defendants loss was due to factors other than the material misrepresentation or nondisclosure contained in the registration statement.

8. must bring the action within the limitation period set forth by §13's statute of limitations.

a. **SA §13** provides that an action pursuant to §11 must be brought *within 1-year after discovery of the untrue statement or omission*; or after such discovery should have been made by the exercise of reasonable diligence BUT *in no event may the action be brought more than 3-years after the security was offered to the public*.

B(1). **Element of a §11 Cause of Action:** [in short form]: the plaintiff must prove 4-elements:

1. *Purchased Element:* the plaintiff must have purchased the security where a means or instrumentality of interstate commerce where used in connection with the sale of offer of securities;
2. *Knowing Element:* the plaintiff, at the time of purchase, **must not have known of the misrepresentation or non-disclosure**;
3. *Materiality:* the plaintiff must show that the misrepresentation was material; that is, a reasonable investor would have considered it important in information in making their investment decision; and
4. *Statute of Limitations:* the purchase occurred one year before the discovery of the untrue statement or 3-years after the stock was offered to the public.

C. **G/R:** <u>Aftermarket</u>: [tracing requirement]: the civil remedies accorded by §11 are given to all purchasers regardless of whether they bought their securities at the time of the original offer or at some later date, provided of course, that the remedy is prosecuted within the period of limitations provided by §13.

1. Purchasers in the aftermarket are intended to have a cause of action under §11.
2. The basis of §11 is that in all likelihood the purchase and price of the security purchased after publication of such an earning statement will be predicated upon that statement rather than upon information disclosed in registration.

a. If there is a mixture pre-registration stock and stock sold under the misleading statement, a plaintiff show either:

i. that he purchased his stock in the initial public offering; or

ii. trace his later purchase back to the initial offering.

b. In other words, if there is only one offering, then there is no secondary market, and the plaintiff doesn't have to worry about tracing; on the other hand, if there is more than one offering, the plaintiff must trace the security back.

*[*Hertzberg v. Dignity Partners, Inc.*].

III. <u>Defenses to a §11 Cause of Action</u>

A. **SA §11(b):** <u>Defenses</u>**:** §11(b) provides a number of due diligence defenses for persons *other than* the issuer.

1. *Issuer Defendants:* generally, the only defenses available to the issuer, which otherwise is strictly liable, are:

a. the purchaser's knowledge of the misstatement or omission;

b. lack of materiality;

c. lack of causation;
d. equal fault (*in pari delicto*); and
e. expiration of the statute of limitations.
**These defenses are available to any defendant.

2. *Non-Issuer Defendants:* a non-issuer defendant who discovers a material misstatement or omission in the registration statement may avoid liability by taking the action specified in §11(b)(1) or (2):

a. resigns from takes such steps as are permitted by law to resign from, or ceases or refuses to act in, every office, capacity or relationship ascribed to him in the registration statement; or

b. advises the SEC and the issuer in writing of the action taken and disavowing any responsibility for such part of the registration statement.

3. *Due Diligence Defenses:* are contained in §11(b)(3):

a. *Non-Experts:* as regards the unexpertised portion of the registration statement, a defendant must show that, *after reasonable investigation* he had reason to believe and did believe at the time such part of the registration statement became effective, there were no material misstatements or omissions.

i. A non-expert is not required to make an investigation of expertised information, he must have *no reasonable ground to believe* such information is inaccurate

b. *Experts:* as regards the expertised part, a defendant (other than the responsible expert) need show only that he had no reasonable ground to believe and did not believe that the expertised portion of the registration statement was defective.

i. An expert is required to show that after reasonable investigation, he had reasonable ground to believe and did believe his statement to be accurate.
ii. In other words, an expert is required to exercise the same standard of care regarding the part expertised by him as a non-expert is required to exercise regarding the non-expertised portion of the registration statement.
iii. Experts are not subject to liability for misstatements or omissions in the unexpertised portion of the registration statement merely be reason of their involvement has experts.

IV. <u>Due Diligence Standard</u>

A. **SA §11(c):** <u>Due Diligence Standard</u>**:** §11(c) provides that the standard of reasonableness by which the concept of "reasonable investigation" is to be measured is that required of a "prudent man in the management of his own property." The "prudent man" standard applies not only to the reasonableness of one's investigation but also to the reasonableness of one's belief.

1. The degree of responsibility, and the extensiveness of the investigation required to establish due diligence, largely will depend upon the type of person and the nature of his relationship with the issuer.

2. **Rule 176:** lists a number of factors to be taken into consideration as circumstances affecting the determination of what constitutes reasonable investigation. These factors are:

a. the type of issuer;
b. the type of security;
c. the type of person;
d. the office held when the person is an officer;

e. the presence or absence of another relationship to the issuer when the person is a director or proposed director;
f. reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts;
g. 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 with respect to the registrant; and
h. whether, with 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.

V. Causation and Reliance

A. **G/R:** Causation and Reliance**:** in an action brought pursuant to §11, causation is presumed (which may be rebutted by the defendant) once a material misstatement or omission has been shown to exist.
1. Moreover, the plaintiff/purchaser need not establish reliance.

VI. Materiality and Reliance

A. **G/R:** Materiality and Damages**:** §11 imposes liability only for material misstatements or omissions in the registration statement. Therefore, materiality is a threshold determination.
1. Similarly, the plaintiff must have suffered damages (but need not establish causation) compensable within the provisions of **§11(e).**
2. The defendant however, pursuant to **§11(e)** can reduce (either in part or totally) the plaintiff's monetary damages by showing that the loss (or portion thereof) was attributable to other factors than the pertinent misrepresentation or nondisclosures. The other factor pertinent to the misrepresentation or nondisclosure is:
a. *Loss Causation:* the court is always looking for the relationship between the misstatement and the decrease in the cost of the stock.

B. **G/R:** Test for Materiality: the question of materiality is an objective one, involving the significance of an omitted misrepresented fact to a reasonable investor. An omitted fact is material if there is a substantial likelihood that a reasonable investor would have considered it important in deciding how to invest in securities [*Akerman v. Orxy Comm.*].

C. **G/R:** Damages: §11 imposes civil liability for any materially untrue or misleading statements in registrations on every person who **signed** the registration statement and every underwriter with respect to such security.
1. The **issuer** is strictly liable without regard to scienter.
2. *Amount of Damages:* the statute offers three alternative measures of damages:
a. the difference between the amount paid for the security and its value at the time the suit was brought;
b. the difference between the purchase price and the price at which the security was disposed of in the market prior to suit; and
c. the difference between the purchase price and the price for which the security is sold after suit, as long as this *does not exceed* the difference between the purchase price and the price at the time of suit.

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3. Defenses: **SA §11(e)** expressly allows a defendant to limit his liability by showing that a drop in the market price is **unrelated to the material misstatements**.

1. This can be proven, as in *Akerman*, by expert statistical analysis of the market and the stock price overtime, etc…

*[*Akerman v. Orxy Comm.*].

D. **G/R:** Evidence of Damages: a market decline after an announcement of an error (material misstatement) is the most obvious evidence of a ***causal relationship*** between a misstated fact and the stock's inaccurate valuation.

1. If the market initially overvalues a stock due to erroneous information, the price will drop upon disclosure to a level the represents the consensus of buying and selling opinion of the value of the securities as the actually are.
2. *Conversely*: if the stock price does not drop after the announcement of the misstatement then the defendant could use that as evidence, under §11(e), that the market price was unrelated to the material misstatements.

*[*Akerman v. Orxy Comm.*].

VII. Contribution and Indemnification

A. **G/R:** Contribution and Indemnification**:** under §11, violators are generally subject to joint and several liability. Accordingly, a plaintiff is entitled to recover the entire judgment against any violator.

1. *Caveat:* an exception to this framework exists with respect to outside directors who are liable only in proportion to their fault unless they had actual knowledge of the falsity.
2. In order to distribute judgment and settlement costs among joint violators, the two common techniques used are contribution and indemnification.
   a. *Indemnification:* involves a shifting of the entire loss from one defendant to another person;
   b. *Contribution:* involves a sharing of the damages among tortfeasors.
3. **SA §11(f):** clearly provides for the right to contribution (unless the person who has become liable was, and the other was not, guilt of fraudulent misrepresentation).
   a. The traditional view is the parties share the entire loss on a pro rata basis (i.e. equally among joint tortfeasors irrespective of individual fault).
   b. The emerging view is that the apportionment of damages should be premised upon a proportionate fault or pro tanto basis.
4. The right to indemnification is far more uncertain because neither §11, nor any other provision of the securities laws provide for such a right.
   a. The SEC's position, as contained in **Item 512(h)** of regulations S-K, is that indemnification of officers, directors, and controlling persons of the registrant for liabilities arising under the S.A. is **against public policy**, and hence, unenforceable.
   b. The SEC's position contained in Item 512(h) is that indemnification is basically like an insurance policy; the corporation will indemnify the corporate directors for their misstatements. This is against public policy for two basic reasons:
      i. it has the effect of making the directors unaccountable for their actions; and
      ii. the shareholders of the corporation would ultimately bear the cost.

*[*Eichenholtz v. Brennen*].

B. **G/R:** Underwriters Indemnity Contracts: pursuant to an underwriting indemnity contract with the issuer or its controlling persons, whereby the underwriter may avoid liability, the courts have generally

held that permitting a party to avoid monetary liability for his own recklessness or willful misconduct, is contrary to the Securities Acts objective of inducing parties to be scrupulous about their disclosure obligations.

1. Moreover, the issuer's indemnification of the underwriter is suspect in that funds ultimately come out of the shareholders pocket, the very individuals who were damaged by the misconduct.

2. The foregoing reasons also are applicable for prohibiting indemnification where the underwriter has been negligent.

*[*Eichenholtz v. Brennan*].

§3.2: DUE DILIGENCE IN THE REGISTERED OFFERING CONTEXT

I. <u>SA §11(b)(3): The Due Diligence Defense</u>

**All Rules are from *Escott v. Barchris Construction Corp.*

A. **SA §11(b)(3):** <u>Due Diligence Defense:</u> §11(b)(3) provides the "due diligence defense." Due diligence an affirmation defense which requires the defendant show that he had, after reasonable investigation, reasonable ground to believe and did believe, that there were no material misstatements or omissions in the registration statement.

1. Strictly speaking, due diligence is a defense that may be asserted by the subject party rather than an affirmative obligation. If the statements made in the registration statement are true; or alternatively, if no lawsuit is brought, no liability will be incurred for an individual's failure to exercise due diligence.

a. On the other hand, if an action is brought and a material misstatement or omission is shown, liability may often be avoided under §11 only by proving the exercise of due diligence—for this reason, due diligence is necessary.

B. **SA §11(c):** <u>Reasonable Investigation:</u> §11(c) defines reasonable investigation, and reasonable ground for belief, as the standard of reasonableness that shall be required by a prudent man in the management of his own property.

1. The extensiveness of the investigation required to meet one's due diligence defense depends upon the standard of care appropriate for a particular defendant in view of his position, relationship with the issuer, and the involvement in the preparation of the registration statement.

a. Hence, the action to be taken in order to meet one's due diligence obligation may vary.

b. When analyzing a §11 issue, there are several categories of defendants that must be analyzed:

i. issuers;
ii. directors;
iii. signatories;
iv. attorneys;
v. accountants; and
vi. underwriters.

C. **G/R:** <u>Issuers:</u> the issuers (the company) is always held strictly liable.

D. **G/R:** Directors**:** *Barchris* draws a distinction between: (a) inside and outside directors; (b) and between inside directors based upon the extent of their knowledge of or access to the pertinent facts.

1. *Inside Directors:* certainly one would expect a director who also serves as CEO to be required to perform more diligently than outside director who otherwise has no relationship with the issuer.
    a. §11 impose liability in the first instance upon a director, no matter how new he is because the director is presumed know his responsibility when he becomes a director.
    b. A director can only escape liability by using reasonable care to investigate the facts which a prudent man would employee in the management of his own property.
        i. To rely on the sole representations of other directors, even if he is a new director, is minimal conduct that does not measure up to the statutory standard.
2. Another example, many corporations have established executive committees, comprised of two or three directors who, in many cases, make decisions that otherwise would be within the province of the entire board of directors. Depending upon the circumstances, an inordinate hardship would be imposed upon directors not serving on those committees if they were held to the same degree of responsibility.

D(1). **G/R:** Outside Directors: *Barchris* indicates that, while less may be required of certain director in order to meet their due diligence obligations, reasonable investigation still requires affirmative action.

1. Hence, even outside directors must endeavor to make some type of independent verification of the information contained in the registration statement.
2. Clearly, a director who makes no effort to investigate will not be able to sustain his burden of establishing that he acted with reasonable due diligence.
3. An outside director should:
    a. seek to attend board of director meetings regarding the offering;
    b. review the registration statement with care (probing relevant corporate personnel and counsel on the factual contents and representations made therein);
    c. review the Exchange Act filed documents that are incorporated by reference into the registration statement;
    d. with the aid of competent advisers, assess the abilities of management as well as the company's reputation;
    e. ask question and follow up if necessary.

**Although the performance of the foregoing actions may not guarantee absolution from liability, it should provide persuasive evidence that the outside director met his due diligence obligations.

D(2). **G/R:** Outside Director Liability: outside directors, if found not to have exercised due diligence, are liable only in proportion to their fault under §11 unless they had actual knowledge of the falsity.

1. Hence, an outside director who is deemed 2% responsible for the violation is liable for damages on that proportion of fault basis unless he acted with actual knowledge.
    a. Ex: damages of $1 million, such an outside director would be liable for $20K.

E. **G/R:** Signatories: persons who sign the registration statement (normally inside directors and officers of the issuer) may be held to stringent due diligence obligations.

1. This is despite the fact that, had they not signed, their respective duties of investigation, particularly in the case of officers not holding directorships, may have differed.

a. This is because potential investors reasonably may assume that by signing the registration statement, the signatories represent that it is an accurate statement of the information contained therein.

2. The liability of a signatory who signs the registration statement is—strict liability; that is, it does not depend upon whether or not he read it, or, if he did, whether or not he understood what he was reading.

F. **G/R:** Attorneys: due diligence is a concern for lawyers who are involved in a registered offering because a lawyer may (a) serve as a director of the issuer; (b) act as an expert within the meaning of §11(a)(4); and (c) perform due diligence obligations on behalf of the client in its stead.

1. Lawyers are *not* experts for the entire registration statement, only the portions that the certify; hence, just because a lawyer prepared the registration statement and is privy to a lot of information does not mean he is an expert.

2. A lawyer's duty, and role, under the securities law are:

a. to investigate the corporate minutes; executive minutes; and all material contracts.

b. to make sure corporate formalities are followed; and

c. look for any information that may be a "red flag" such as:

F(1). **G/R:** Attorneys as Directors: if an attorney is a director, and works on the preparation of the registration statement, he may be liable as both a director and signatory.

1. The court will take into account his role of being primarily responsible for drafting the registration statement, and even more may be required from him in the way of a reasonable investigation than could fairly be expected of a director who had no connection with this work.

F(2). **G/R:** Attorneys as Experts: a lawyer who renders a *formal legal opinion* which is included in the registration statement with his consent is considered an expert within the ambit of §11.

F(3). **G/R:** Comfort Opinions: a comfort opinion is essentially a statement, that based on the lawyer's participation in the preparation of the registration statement and conferences with representatives of the issuer, underwriters and accountants, he has no reason to believe that the registration statement violates §11.

1. In order not to be subject to liability under §11, the lawyer should ensure that neither the opinion, nor its contents, appear in the registration statement.

F(4). **G/R:** Legal Advice: it is clear that an attorney who renders legal advice, or assists in the preparation of the registration statement, does not thereby become an expert within the meaning of §11.

1. The Supreme Court has held that certain individuals who play a role in preparing the registration statement generally cannot be reached by §11 and these include lawyers *not acting as experts*.

2. *Caveat:* lawyer can, however be held liable under §§ 12(a)(2) and 10(b) of the SEA.

G. **G/R:** Accountants: suits against accountants under §11 typically relate to the certified financial statements contained in the registration statement.

1. To the extent that the registration statement is inaccurate in any respect other than the part expertised by them, the accountants are not subject to liability under §11.

a. *Caveat:* the accountants may, however, be liable under §10(b) of the SEA.

2. *Standard of care*: accountants are generally required to meet only that standard of care expected of persons holding themselves out as skilled accountants, e.g. to generally accepted accounting principles (GAAP).
3. *S-1 Review:* the accountants have a duty to review events subsequent to the date of the certified balance sheet to ascertain whether any material change has occurred in the company's financial position which should be disclosed in order to prevent the balance sheet figures from being materially misleading.
a. The purpose of such a review under GAAP is limited and is not required to be a complete audit.

H. **G/R:** Underwriters: a rigorous degree of representation is imposed on underwriters because (a) the underwriter is uniquely situated to verify the accuracy of the contents of the registration statement because they have access to the information and leverage under the securities laws to compel the issuer to furnish an adequate and fair registration statement; and (b) the investigating public relies upon the reputation of the underwriter and upon its participation in the offering as endorsement of the correctness of the registration statement.
1. The SA makes no distinction in the issuance of a prospectus between the company and an underwriter. The underwriters are just as responsible as the company if the prospectus is false.
2. In order to make the underwriters participation in the registration statement of any value to investors, the underwriters must make some reasonable attempt to verify the data submitted to them.
a. Underwriters may not rely solely on the company's officers or counsel.

I. **G/R:** [Un]Expertised Sections of the Registration Statement: only those portions of the registration statement that purport to be made by experts (i.e. accountants) are expertised portions; that is, to say the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute.
1. *Unexpertised Postions:* all participants in the registration statement are liable for the unexpertised portions to the statement except for the experts, which are liable for the expertised portions. Therefore, all participants in registration statement do not need to do a reasonable investigation into the expertised portion, and only experts have to do a reasonable investigation into their respective parts.

J. **G/R:** the easiest way to defeat the due diligence defense is to show that the participants in the registration statement did not exercise a reasonable investigation because it is not subjective; the plaintiff must show objectively that the participants did not perform their respective duties to investigate.

II. §12(a)(2) and the Judicial Extension of the Due Diligence Defense

A. **Distinction Between SA §§11 and 12:** §11 and §12 are parallel statutes, however, their wording is significantly different as to who can bring suit.
1. §11 permits suit without restriction by *any person acquiring such security*.
2. §12 permits suits against a seller of a security by prospectus only by the *person purchasing the security from him*.
*[*Hertzberg v. Dignity Partners*].

B. **SA §11(a):** imposes liability in case any part of a *registration statement* contains an untrue statement of material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

C. **SA §12(a)**: imposes liability for using *a prospectus,* which includes an untrue statement of material fact or omits to state a material fact in order to make the statements, in light of the circumstances under which they were made, not misleading.

D. **G/R:** Underwriter Liability: liability under §§11 and 12(a)(2) properly may fall on underwriters of a public offering. Underwriters, however, may absolve themselves from liability by establishing a due diligence defense.

1. Under §11, underwriters must prove that they had, after **reasonable investigation**, reasonable ground to believe, and did believe, that the statements therein where true and thee no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.
2. Similarly, under §12(a)(2), underwriters must show that they did not know, and in the exercise of **reasonable care**, could not have known, of the untruth of the omission.
3. Because §11's "reasonable investigation" standard is similar, if not identical, to §12(a)(2)'s "reasonable care" standard, the analysis of **each is the same.**
    a. Thus, in determining whether an underwriter (and this could apply by analogy to any participant in the registration/prospectus statement) meets the due diligence test under either provision, the standard of reasonable is that of an ordinary prudent man in the management of his property.
4. An underwriter need not conduct a due diligence investigation into the expertised parts of a prospectus, such as certified financial statements. Rather, the underwriter need only show that it had reasonable ground to believe, that the statements therein were not untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements not misleading.
*[*In Re Software Toolworks Inc. Securities Litigation*].

§3.3: CIVIL LIABILITIES ARISING IN CONNECTION WITH PROSPECTUSES

I. SA §12(a)(1)

A. **SA §12(a)(1):** any person who offers or sells a security in violation of §5 shall be liable to the person purchasing the security from him.

B. **Generally:** §12(a)(1) gives teeth to SA §5 by providing the purchaser of securities with an express private right of action against his seller if such seller offers or sells securities in violation of §5.

1. In action brought under §12(a)(1) the purchaser may seek rescission, or if he no longer has the securities, damages.
    a. The plaintiff, however does not have a choice of remedies:
        i. If the plaintiff owns the stock he is entitled to rescission but not damages;
        ii. If the plaintiff no longer owns the stock, he is entitled to damages, but not rescission.
2. *Strict Liability:* if a violation of §5 has been committed by the seller, the purchaser ordinarily is entitled to recovery. In other words, strict liability against the seller.

a. The exercise of reasonable care, or bona fide but unsuccessful efforts to perfect an exemption from registration, are irrelevant.

3. Hence, upon the purchaser establishing a prima facie case that the seller violated §5, a seller may avoid liability only by showing that the offering qualifies for an exemption or that the purchaser is *in parli delicto*.

a. **NOTE:** this could be a method for testing on the exemptions.

4. That statute of limitations for §12(a)(1) actions is one year.

II. SA §12(a)(2)

A. **SA §12(a)(2):** any person who…offers or sells a security…by prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading…shall be liable [subject to paragraph (b)—loss causation].

A(1). **G/R:** Elements of a Cause of Action under §12(a)(2): to bring a cause of action for rescission under §12(a)(2):

1. the stock purchase agreement must have contained a material misstatement of fact made by the sellers;

2. the sellers must not have sustained the burden of proving due diligence (in parli delicto defense does not apply); ***then***

3. the buyers would have the right to obtain rescission if those misstatements were made by means of prospectus or oral communication.

B. **Generally:** aggrieved purchasers of securities acquired in a public offering by an issuer or its controlling shareholders may seek to invoke §12(a)(2) of the SA.

1. §12(a)(2) affords an express right of action to a purchaser against his seller for rescission, or damages if the securities have been disposed of, where the purchaser acquired securities by means of prospectus or oral communication (that relates to the prospectus) which contained material misstatements or omissions.

a. Proof a reliance is not required under §12(a)(2); indeed, a plaintiff need not prove that he ever received the misleading prospectus.

2. The §12(a)(2) remedy is limited to purchasers of securities in a public offering by an issuer or its controlling shareholders; hence, the remedy is available in registered offerings.

a. §12(a)(2) may also apply to exempt transactions under Regulation A, Rule 504, and §3(a)(11)—private offering exempt from registration.

3. *Loss Causation:* the defendant may avoid all or part of the damages that otherwise would be incurred by proving that all or part of the depreciation in the value of the securities in question resulted from factors unrelated to the material misstatements or omissions.

4. §12(a)(2) extends liability ONLY to those who **sold the securities** to the allegedly aggrieved purchasers.

a. **Note:** this may make a "dealer/broker" liable under §12(a)(2); whereas, he is not liable under §11.

5. Defenses: the defense of "reasonable" care has been held to the same standard as "reasonable investigation" under §11 [*In Re Software Toolworks Litigation*].

III. The Meaning of Seller and the In Parli Delicto Defense

A. **G/R:** In Parli Delicto: the equitable defense of *in parli delicto*, which literally means of equal fault, is rooted in the common law notion that a plaintiff's recovery may be barred by his own wrongful conduct.

1. Traditionally, the defense was limited to situations where the plaintiff bore at least substantially equal responsibility for his injury, and where the parties' culpability arose ouft of the same illegal act.
2. Contemporary courts have expanded the defense's application to situations more closely analogous to those encompassed by the "unclean hands" doctrine, where the plaintiff has participated in some of the same sort of wrongdoing as the defendant.

*[*Pinter v. Dahl*].

B. **G/R:** 2-Prong Test for *In Parli Delicto Defense:* the in parli delicto defense is only available where:

1. **Prong 1:** as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress; AND
    a. Under this prong:
        i. a defendant cannot escape liability *unless* as a direct result of plaintiff's own actions, the plaintiff bears at least substantially equal responsibility for the underlying illegality;
        ii. the plaintiff must be an active, voluntary participant in the unlawful activity that is the subject of the suit;
        iii. unless the degrees of fault are essentially indistinguishable or the plaintiff's responsibility is clearly greater, the *in parli delicto* defense should not be allowed and the plaintiff should be compensated;
        iv. in the context of a private action under **§12(a)(1)**, the first prong of the test is satisfied if the plaintiff is at least equally responsible for the actions that render the sale of unregistered securities illegal—the issuer's failure to register the securities before offering them for sale, or his failure to conduct the sale in such a manner as to meet the registration exemption provisions;
        v. a purchasers knowledge that the securities are unregistered, **cannot**, by itself, constitute equal culpability, even where the investor is a sophisticated buyer who may not necessarily need the protection of the securities act.
2. **Prong 2:** preclusion of suit would not significantly interfere with the effective enforcement of the essential elements of the classic *in parli delicto* defense.
    a. Under this prong:
        i. a plaintiff's recovery is barred only if preclusion of the suit does not offend the underling statutory policies of the Securities Act.
            (A) The primary purpose of the SA is to protect investors by requiring publication of material information thought necessary to allow them to make informed investment decisions concerning public offerings.
        ii. where the §12(a)(1) plaintiff is primarily an investor, precluding suit would interfere significantly with effective enforcement of the securities laws and frustrate the primary purpose of the SA.
        iii. apply the promoter/investor test.

*[*Pinter v. Dahl*].

C. **G/R:** Promoter/Investor test: the *in parli delicto defense* under the second prong demonstrates that the defendant may defeat recovery in a §12(a)(1) action ***only*** where the plaintiff's role in the offering or sale of non-exempted, unregistered securities is more as a promoter than investor.

1. Whether a plaintiff in a particular case is primarily an investor or primarily a promoter depends upon a host of factors:

a. the extent of the plaintiff's financial involvement compared to that of third parties solicited by the plaintiff;
b. the incidental nature of the plaintiff's promotional activities;
c. the benefits received by the plaintiff from his promotional activities; and
d. the extent of the plaintiff's involvement in the planning stages of the offering;

i. Such as, whether the plaintiff has arranged an underwriting or prepared the offering materials.

*This list is not exhaustive.
**[*Pinter v. Dahl*].

D. **G/R:** <u>§12(a)(1) Purchaser/Seller Requirements:</u> the language of §12(a)(1) contemplates a purchaser-seller relationship not unlike tradition contractual privity. Thus, it is settled that §12(a)(1) imposes liability on the owner who passed title, or other interest in the security, to the purchaser for value.

D(1). <u>Seller Requirement:</u> [potential defendants who may be liable under §12(a)(1)]:

1. **SA §2(3):**"<u>sale" or "sell</u>" is defined to include every contract of sale or disposition of a security or interest in a security, for value.
2. **SA §2(3):** "<u>Offer to Sell or Offer"</u> includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value.
3. Under these definitions, the range of persons potentially liable under §12(a)(1) is not limited to persons who pass title:

a. An individual who engages in a solicitation of an offer to buy is within the definitions, although it is an activity not inherently confined to an actual owner.
b. These definitions are expansive enough to encompass the entire selling process, including the seller/agent transaction.

4. Thus, persons who are sellers under the act are:

a. persons who owned the security and sold it to the buyer;
b. an agent for a vendor (such as a broker); and
c. one who solicited the purchase with the intent to personally benefit thereby.

D(2). <u>Purchaser Requirement:</u> the purchaser requirement clearly confines §12(a)(1) liability to those situations in which a sale has taken place; thus, the prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.

E. **G/R:** <u>Broker Liability:</u> the applicability of §12(a)(1) liability to brokers and others who solicit securities purchases has long been recognized since the passage of the SA.

1. It has long been clear that when a broker acting as an agent of one of the principles to the transaction successfully solicits a purchase, he is a person for whom the buyer purchases within the meaning of §12 and there is liable as a statutory seller.
2. ***Caveat:*** [<u>Benefits Test</u>] a person who solicits the purchase of securities *solely* for the benefit of the buyer (such as a friend, business partner, etc…) is not covered by the act.
*[*Pinter v. Dahl*].

IV. <u>Secondary Liability</u>

A. **G/R:** Statutory Sellers and Collateral Participants: the Supreme Court, in *Pinter* expressly held that only statutory sellers of securities may be liable under §12(a)(1) and that collateral participants who do not solicit sales cannot be held liable, whether or not loss causation is proven.

1. Thus, although privity is not essential, the language of §12(a)(1) contemplates a buyer/seller relationship not unlike traditional contractual privity.
2. The court have held that §12(a)(1) and §12(a)(2) are identical, and hence, this reasoning applies to the latter, as well as the former.
3. Thus, under §12(a)(1), and §12(a)(2), collateral participants cannot be held to secondary liability under the Securities Act.
    a. Thus, lawyers are not liable for their participation in an offer to sell.

*[*Wilson v. Saintine Exploration and Drilling Corp*].

B. **G/R:** Aiding and Abetting: under §12(a)(2), persons who do not meet the test for statutory sellers may not be held liable as aiders and abettors [*Wison; Central Bank of Denver*].

a. Thus, the provision of §12 do not apply to lawyers who have performed only their usual professional functions in preparing documents for offerings.

V. Limited to Public Offering

A. **G/R:** Public Offering Requirement: §12(a)(2)'s right to rescission does **not** extend to private secondary markets or transactions; hence, in order for §12(a)(2) to apply, the there must be a public offering.

1. Thus, under the private offering exemption, Rule 506, a plaintiff could not invoke §12(a)(2).

VI. Reasonable Care Defense

A. **G/R:** Reliance: it is well settled that §12(a)(2) imposes liability without regard to whether the buyer relied on the misrepresentation or omission.

1. The statutory language, as amplified by the legislative history, indicates that the plaintiff need not prove that he ever received the misleading prospectus.
2. The statute imposes liability in favor of a purchaser on any person who offers or sells securities by means of a prospectus or oral communication that is misleading.

B. **G/R:** Reasonable Care Defense: the reasonable care defense, in §12(a)(2), is the functional equivalent of the reasonable investigation defense under §11 [*Sanders v. John Neeveen & Co.*].

§4: SEA §10(b) and RELATED ISSUES

§4.1: OVERVIEW

Analytical Framework: there are several questions to ask when confronted with a section 10(b) problem:

1. Policy: always start with the policies underlying the Securities Acts:
    a. **SA:** was enacted to provide full disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof.

b. **SEA:** was enacted to provide for the regulation of securities exchanges and over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets.

2. Pleading and Statute of Limitations: did the plaintiff meet the pleading requirements of FRCP 9(b) and SEA §21D(b)? And the implied 1-and-3 year statute of limitations?

1. If not, the plaintiff loses (this is essentially a defense for the defendant).

3.Standing: Does the plaintiff have standing?

a. *Birnbaum Rule:* under a §10(b) private cause of action, the action is limited to purchasers and sellers of securities.

4. Materiality: is the misstatement or omission material? [*TSC Industries Test*].

5. Degree of Culpability: did the defendant act with the required degree of culpability?

a. In actions under SEA §10(b), Rule 10b-5, and SA §17(a)(1) scienter is required, that is, the defendants actions must have been intentional, or willful (and lower federal courts hold reckless satisfies this requirement).

b. In actions under SA §§ 17(a)(2) or 17(a)(3), negligence only has to be shown.

5. Reliance and Causation: has the plaintiff proven reliance and causation?

a. *Reliance:*

i. If the case is an omission case, then reliance is presumed;

ii. If the case is a misrepresentation case, then plaintiff has to prove reliance.

iii. The plaintiff must have justifiably relied:

(A) Objective/Subjective Standard;

(B) Apply 8-Factor Test;

(C) Can reliance by proven by "fraud on the market"

(D) Does the bespeaks caution doctrine, constructive knowledge of written statements, make reliance unjustifiable?

b. *Causation:* the plaintiff must prove:

i. Transactional causation—but for the misrepresentation the deal would not have gone through; and

ii. Loss causation—the plaintiff's loss is directly attributable to the defendants misstatement or omission.

6. In Parli Delicto: can the defendant assert an *in parli delicto defense*? That is, show the plaintiff was at substantially the same fault for the violation.

7. Damages: if the plaintiff is liable, what his damages? Normally out of pocket actual damages are the measure.

I. Elements of a §10(b) Cause of Action

A. **SEA §10(b):** It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of an national securities exchange—

(b) to use or employ in connection with the purchase or sale of any securities registered on a national securities exchange or any security not so registered, *any manipulative or deceptive device* or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

A(1) **Rule 10b-5:** It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of an national securities exchange,

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

A(2). **G/R:** Private Cause of Action: §10(b) does not create an express private right of action; nonetheless, the federal courts have routinely recognized the existence of this implied remedy and so has the Supreme Court [*Blue Chips Stamps v. Manor Drugs; Ernst & Ernst v. Hochfelder*].

B. **G/R:** Primary Violators: liability under §10(b) may be imposed in private actions only against primary violators; in other words, §10(b) liability may not be ordered against aiders and abettors in private actions.

C. **G/R:** Elements of a Cause of Action Under §10(b): there are 10-key elements which must be satisfied in order to bring a cause of action under §10(b):

C(1) Requisite Jurisdictional Means: this requirement is normally met without difficulty, it means that the offer or sale of securities must have used some means of interstate commerce (the mails, phones, etc…satisfy this requirement).

C(2) Plaintiff as Purchaser or Seller: the status of the *plaintiff* as a purchaser or seller of the securities.
a. The defendant need *NOT* be a purchaser or seller of securities.

C(3) Manipulative or Deceptive Practice: the plaintiff must show that the defendant was a primary participant who bears responsibility for the material misrepresentation or non-disclosure; or other deceptive or manipulative practice.
a. Mere breach of fiduciary duty, standing alone, is insufficient to state a §10(b) right of action.

C(4) Materiality: the misrepresentation, half-truth, or omitted statement must be material. The test for materiality is:
1. *Test for Materiality:* an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote, or make an investment decision. For an omission to be deemed material, there must be a substantial likelihood that that the disclosure would have been viewed by the reasonable investor as having significantly altered the **total mix of information** made available.
i. This standard does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote, or investment decision.
ii. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in deliberations of a reasonable shareholder.
(A) Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

C(5) Defendant's Scienter: establishing that the defendant acted with scienter, signifying knowing or intentional conduct (more than negligent).

C(6) Plaintiff's Reliance: where called for, showing that the plaintiff relied on the alleged misrepresentation and exercised due diligence.

C(7) Causation: establishing causation between the defendant's wrongful conduct and the plaintiff's loss [SEC §21D(b)(4)].

C(8) In Connection With: related to the causation requirement, the plaintiff must prove that the manipulative or deceptive practice was "in connection with" the purchase or sale of a security.
  a. Generally, in order to meet this requirement, the proscribed practice must touch upon and be integral to the purchase or sale of security.

C(9) Damages: proving the extent of damages suffered.

C(10) Statute of Limitations: the plaintiff must bring the action within §10(b)'s statute of limitations, which is one year after the violation was, or should have discovered by the plaintiff, and in no event more than three years after the violation.

D. **G/R:** Defenses: the defendant may assert a number of defenses, including:
  1. *in pari delicto*;
  2. laches; and
  3. waiver.

E. **G/R:** Indemnification: because the Supreme Court has ruled that scienter (e.g. deliberate or perhaps reckless misconduct) is required to state a successful §10(b) and Rule 10b-5 claim, it appears that indemnification would frustrate the public policy as well as the statutory underpinnings of the Act and therefore is prohibited in the §10(b) context.

F. **G/R:** Contribution: there is right to contribution under §10(b).

§4.1: STANDING: THE PURCHASER-SELLER REQUIREMENT

I. Purchaser-Seller Requirement

A. **G/R:** Birnbaum Rule: the **plaintiff** [the defendant does not have to be a purchaser or seller of securities] class in a §10(b) or Rule 10b-5 private damages action is limited to actual purchasers and sellers of securities [*Blue Chip Stamps v. Manor Drugs*].

B. **G/R:** Standing for a §10(b) Cause of Action: to have standing to bring a §10(b) action, the plaintiff must be a seller or purchaser or securities. Thus, three principle classes of potential plaintiffs are presently **barred** by the *Birnbaum Rule:*
  1. the potential purchasers of shares, either in a new offering or on the Nations' post-distribution trading markets, who allege that they decided *not to purchase* because of an unduly gloomy representation or the omission of favorable material which made the issuer appear to be less favorable investment vehicle than it actually was;

2. actual shareholders in the issuer who allege that they decided to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material; and
3. the shareholders, creditors, and perhaps others related to the issuer who suffered loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10b-5.
*[*Blue Chip Stamps v. Manor Drugs*].

C. **Policy:** the virtue of the *Birbaum Rule* is that it limits the class of plaintiffs to those who have at least dealt in the security to which the prospectus, representation, or omission relates; and, their dealing in that security, whether by way or purchase or sale, will generally be an objectively demonstrable fact in an area of law otherwise very much dependent upon oral testimony.
1. In the absence of the *Birbaum Rule* bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused non-selling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow, retrospectively, golden opportunities to pass.
*[*Blue Chip Stamps v. Manor Drugs*].

D. **G/R:** Exceptions to the *Birnbaum Rule*: the lower federal courts, in applying the purchaser-seller requirement, have recognized a few limited exceptions to the requirement:
1. in a shareholder derivative action brought on behalf of an allegedly defrauded corporation where the corporation was a purchaser or seller of securities;
2. in a *forced sale* transaction, such as a share exchange or a "freeze out merger;"
3. where the plaintiff has pledged the securities; and
4. where the plaintiff ahs entered into a contract to buy or sell securities.

§4.2: REQUISITE CULPABILITY LEVEL

I. Scienter Requirement in Private Cause of Actions

A. **G/R:** Scienter: §10(b), and Rule 10b-5, are intended to apply **only** to activities that involve scienter.
1. *Scienter:* refers to a mental state embracing intent to deceive, manipulate or defraud.
2. Hence, **intentional** and **willful** conduct is a required element for a §10(b) cause of action.
3. *Recklessness:* in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act; however, the Supreme Court did not address whether recklessness is considered to be a form of intentional conduct for purposes of imposing liability under §10(b).
a. An argument exists that it should be used to impose liability because reckless conduct is a conscious disregard for the well being of others; hence, liability could be imposed based on a theory of "virtual intent" and Gelb thinks it should.
*[*Ernst & Ernst v. Hochfelder*].

B. **G/R:** a private cause of action for damages under §10(b) and Rule 10b-5 *cannot* be predicated on mere negligence; that is, scienter is a necessary element of the cause of action, therefore, there must be the intent to deceive, manipulate or defraud for civil liability to be imposed on a defendant in a §10(b) or Rule 10b-5 cause of action.
*[*Ernst & Ernst v. Hochfelder*].

C. **G/R:** Manipulative and Deceptive Acts: §10(b) makes unlawful the use or employment of any manipulative or deceptive device or contrivance, in contravention of the SEC's Rules.

1. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that §10(b) was intended to required knowing or intentional misconduct.
2. *Manipulative:* is a term of art when used in connection to the securities markets.
    a. It connotes **intentional or willful** conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.
3. *Negligence:* §10(b) does not impose civil liability by mere proof of negligent conduct.

*[*Ernst & Ernst v. Hochfelder*].

D. **G/R:** Aiders and Abettors: aiders and abettors cannot be held liable in a §10(b) cause of action because liability was not intended to be imposed upon them under §10(b) [*Central Bank of Denver v. First Interstate Bank of Denver*].

II. Scienter Requirement in SEC Actions for Injunctive Relief

A. **SA §20:** Injunctions and Prosecutions of Offenses:

(a) Whenever it shall appear to the Commission,…that the provisions of [the Securities Act], or of any rule or regulation prescribed under authority thereof, have been or are about to be violated, it may, in its discretion, …investigate.

(b) Whenever it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices which constitute or will constitute a violation of the provisions of [the Securities Act], …it may in its discretion bring an action…to enjoin such acts or practices….The Attorney General may, in his discretion, institute the necessary criminal proceedings under [the Securities Act].

*****[This is the civil enforcement mechanism for SA §17].

A(1). **SEA §21(d)(1):** Whenever it shall appear to the Commission that any person is engaged, or about to engage in acts or practices constituting a violation of any provision of [the Securities Exchange Act], the rules or regulations thereunder,…it may in its discretion bring an action…to enjoin such acts or practices.

*[This is the civil enforcement mechanism for SEA §10(b) and Rule 10b-5].

A(2). **G/R:** SEC Private Actions for Monetary Damages: another facet of civil enforcement is a private cause of action for money damages; this remedy, unlike the SEC's injunctive actions, is not expressly authorized by statute, but rather has been judicially implied [*Aaron v. SEC*].

B. **SA §17:** Fraudulent Interstate Transactions: [general antifraud provision of the SA, only applies to sellers].

(a) It shall be unlawful for any person in the offer or sale of any securities by use [of interstate commerce], directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchasers.

C. **G/R:** Scienter Requirement in Private Cause of Actions for Damages: a private cause of action will not lie under §10(b) and Rule 10b-5, even if brought by the SEC, in the absence of an allegation of scienter.

1. This is because the language of §10(b) evidences a Congressional intent to proscribe only **knowing** or **intentional** misconduct.
    a. Hence, a §10(b) cause of action cannot be premised merely on negligence.
2. Since the SEC's rulemaking power is necessarily limited by the ambit of its statutory authority, Rule 10b-5 is likewise restricted to conduct involving scienter.

*[*Aaron v. SEC*].

D. **G/R:** Scienter Requirement in Injunctive Actions: in certain injunctive actions, scienter is required to be demonstrated by the SEC, and in others it is not:

1. **Scienter Required:** scienter is required to be shown to find a violation of:
    a. SEA §10(b);
    b. Rule 10b-5; and
    c. SA §17(a)(1).
2. **Scienter NOT Required:** scienter is not required to be shown to find a violation of:
    a. SA §17(a)(2); or
    b. SA §17(a)(3).

*[*Aaron v. SEC*].

E. **G/R:** Injunctive Relief: SA §20(b); and SEA §21(d)(1), provide that the SEC may seek injunctive relief whenever it appears that a person is engaged, or about to engage, in any acts or practices constituting a violation of the SA or SEA or regulations promulgated thereunder and that, ***upon a proper showing*****,** a district court shall grant an the injunction.

1. The elements of a proper showing thus include:
    a. proof that a person is engaged, or about to engage in;
    b. a substantive violation of either the SA or SEA or rules promulgated thereunder.
    c. Generally, a *proper* showing requires the SEC to establish that, absent the ordering of the injunction, there is a reasonable likelihood that the defendant will engage in the violative conduct.
        i. The defendant's state of mind (i.e. scienter or lack thereof) is an important element in the court's determination whether to order an injunction, even if the underlying violation only requires negligence, such as §17(a)(2) or (a)(3).
2. Accordingly, when scienter is an element of the substantive violation sought to be enjoined, it must be proved before the district court can grant an injunction.

*[*Aaron v. SEC*].

III. Recklessness

A. **G/R:** Recklessness as an Element of Scienter: the Supreme Court in *Hochfelder* and *Aaron*, did not address whether reckless conduct constitutes scienter for §10(b) purposes.

1. Overwhelmingly, the lower federal courts have concluded that recklessness satisfies the scienter requirement.
2. *Definition:* the lower courts have construed recklessness to mean:
    a. conduct which is highly unreasonable and which represents an extreme departure from the standard of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.

b. This definition of recklessness appears nearly unanimous under federal securities laws today.

i. Hence, if the Supreme Court ever considers the issue, this is the standard they will apply, and if you need to argue for the adoption of a recklessness standard, this is the one to use (as opposed to the older less strict standard which did not contain an element of intent).

IV. Cease and Desist Authority

A. **G/R:** SEC Cease and Desist Authority: the SEC also has authority to issue cease and desist orders. Pursuant to this authority the SEC may proceed administratively against any person for a violation of the federal securities laws (as opposed to only proceeding in federal court under SA §20; and SEA §21(d)(1)).

1. In SEC cease and desist actions, the substantive conditions for finding a violation of the underlying statute **are not** changed.

2. In other words, the Supreme Court's decision in *Aaron* requires that scienter be shown to find a violation of SEA §10(b) and SA §17(a)(1).

a. Scienter is *not* required to be shown to find a violation of SA §17(a)(2) or (a)(3).

§4.4: THE DECEPTION or MANIPULATION REQUIREMENT

I. Rejection of a Federal Fiduciary Approach

A. **G/R:** Breach of Corporate Fiduciary duty: a cause of action under §10(b) and Rule 10b-5 for breach of corporate fiduciary duty **does not exist**. This is because:

1. *Manipulation does not Cover Common Law Fraud:* As used in the securities acts, manipulation is a term of art and refers generally to practices such as wash sales, matched orders, or rigged prices, that intended to mislead investors my artificially affecting market activity.

a. §10(b)'s general prohibition of practices deemed by the SEC to be manipulative—in this technical sense of artificially affecting the market activity in order to mislead investors—is fully consistent with the fundamental purpose of the SEA to substitute a philosophy of full disclosure for caveat emptor.

2. *Corporate Mismanagement is a State Cause of Action:* this term of art (manipulative) **was not intended** to bring within the scope of §10(b) instances of corporate mismanagement, which in essence allege that shareholders were treated unfairly by a fiduciary.

a. Corporate fiduciary duties are governed largely by the states and to federalize state law breach of fiduciary duties, which vary in every state, would be antithetical to the notion of Federalism and would displace the states ability to regulate in an area which they have traditionally had authority.

3. This is similarly true under Rule 10b-5; that is, a cause of action under Rule 10b-5 for breach of corporate fiduciary duty does not exist.

*[*Santa Fe Industries v. Green*].

B. **G/R:** corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to shareholders, state law will govern the internal affairs of a corporation.

1. Congress by enacting §10(b) did not seek to regulate transactions, which constitute no more than internal corporate mismanagement.
*[*Santa Fe Industries v. Green*].

C. **G/R:** Sue Facts Doctrine: if there is a remedy (such as an injunction) for shareholders with respect to a course of corporate action (such as a merger) then failure by the management to give advance notice of the proposed course of action is a material misstatement which gives rise to a cause of action under §10(b).

1. In other words, if there are material omissions by corporate management, which would have enabled the shareholders to sue and prevent the proposed course of action, then that material omission gives rise to a cause of action under §10(b).
2. *Shame Facts:* [has been rejected by Supreme Court] if the company had to disclose to its shareholders its proposed course of action (such as a merger), and it would be ashamed to do it because of negative public relations, the shame facts would prevent the Company from going forward with the proposed course of action.

II. Federal Disclosure Requirements Based on State Law Claims [Sue Facts Doctrine].

A. **G/R:** the Supreme Court has sanctioned a private cause of action under Rule 10b-5 on behalf of sellers to enforce the federal interest in ensuring a proper flow of information between the parties to a securities transaction.

B. **G/R:** Sue Facts: where a minority shareholder in a merger alleges a material misrepresentation or omission by the defendant in connection with the merger that deprived him of a state law injunctive remedy, **a cause of action exists under Rule 10b-5**.

1. For such information to be material, the plaintiff bears the burden of proving that had he received the correct information *he would have a reasonable probability of ultimate success in the state injunctive action*.
    a. This is like a "case within a case" because the plaintiff has to prove: (a) that he had a remedy in state court which was deprived because of a material misrepresentation; *and* (b) that he would have succeeded on that state court action.
2. Materiality: under Rule 10b-5, misinformation by misrepresentation or omission is not by itself sufficient to state a cause of action, the information in question must be material.
    a. **Test:** something is material if there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of a reasonable shareholder.

*****[*Healy v. Catalyst Recovery of Penn.*].

C. **G/R:** where a minority shareholder in a merger alleges a material misrepresentation or omission by the defendant in connection with a merger that deprived him of a state law injunctive remedy, a cause of action exists under Rule 10b-5 if the plaintiff can demonstrate he would have had a reasonable probability of ultimate success in the injunctive action.
*****[*Healy v. Catalyst Recovery of Penn.*].

D. **G/R:** Constructive Deception Concept and Rule 10b-5: as a general rule, corporations are managed by their directors and not by their shareholders, and that management's knowledge may be attributed to the corporation, thus, precluding a finding of deception.

1. Rule 10b-5 claims alleging that a corporation has been deceived requires proof that the corporation was *disabled from availing itself of an informed judgment on the part of its board* regarding the merits of the transaction.

a. EX: a claim of deception based solely on the allegation that shareholders were not informed of management's breaches of state fiduciary duties would be dismissed for legal insufficiency.

2. *Non-Derivative Actions:* In *Healy* the action was a non-derivative where the individual shareholder is the purchaser or seller of securities; hence, a 10b-5 claim only need allege that a shareholder was deceived.

a. The deception requirement is satisfied by alleging that there is a material misrepresentation or non-disclosure in the flow of information between the majority and the individual shareholder that deprived plaintiff of an opportunity under state law to enjoin the merger.

3. *Shareholder Derivative Actions:* [Goldberg Line of Cases]: in actions alleging "deception" the courts have consistently required Rule 10b-5 claims to allege more than a bare availability of state court injunctive relief. In derivative actions, when shareholder approval of a transaction is *not* required, the courts have reasoned that disclosure to a disinterested board of directors is equivalent to disclosure to shareholders.

III. Manipulation

A. **G/R:** Manipulation: manipulation is a term of art in the securities field and it refers to certain practices, such as matched orders, wash sales, or rigged prices, that are designed to mislead investors by artificially affecting market activity, including the price of the subject company's securities.

1. Under §10(b), manipulation of stock prices can cover a wide range of activities, and the SEC pursuant to SEA §21(d)(1) has the power to criminal prosecute stock manipulators.

2. §10(b) covers stock manipulation that is perpetrated in the over-the-counter market as well as on a stock exchange.

3. Market manipulation under §10(b) may be established without proof that the suspect transactions were engaged for the purpose of inducing the purchase or sale of securities by others.

4. *Factors in Proving Manipulation:* market domination is a factor that supports a manipulation charge, the extent to which an investor controls or dominates a market at any given time, however, is not determinative.

a. The percent of domination must be viewed in light of the time period involved and other indicia of manipulation.

b. When domination is extended over such an extended period of time, evidence of manipulation is strong; however, if the percentage of control is measured in terms of minutes or hours, any could find himself labeled a manipulator.

5. Generally, to find manipulation under §10(b) it has to be proven that the defendant engaged in the transactions in questions **with the specific intent to solely affect the market price of the securities at issue.**

*[*U.S. v. Mulheren*].

B. **SEA §(9)(a)(2):** Prohibition Against Manipulation of Security Prices: generally, to prove manipulation under §9(a)(2) [which is more difficult than under §10(b)], the following elements must be shown:

1. that the defendant effect a series of transactions in a security registered on a national securities exchange;
2. creating actual or apparent active trading in such a security, or raising or depressing the price of such security;
3. for the purposes of inducing the purchase or sale of such security by others.

§4.5: CAUSATION AND RELATED REQUIREMENTS

I. <u>Overview</u>

A. **Generally:** proof of reliance normally is required to help prove the causal connection between the defendant's wrongdoing and the complainant's loss.

1. Positive proof of reliance has not been demanded of the plaintiff where unnecessary to show loss causation.
    - a. In such instances, upon demonstrating materiality (e.g. of the nondisclosure), the complainant enjoys a *presumption* of reliance which the defendant can rebut (e.g. by showing that the plaintiff would not have acted differently had he known of the nondisclosure.
2. The general statement of the elements of recovery under Rule 10b-5 requires proof both that the plaintiff relied on the misstatement and that the misstatement was the cause of his loss.

B. **Reliance:** reliance is an issue in all Rule 10b-5 actions, the question is how, and when is it applied:

1. *Presumption of Reliance in Omission Cases:* in a face-to-face transaction between seller and purchaser, where the defendant purchaser omitted to state material facts, the plaintiff's reliance is <u>presumed</u> from the materiality of the omissions [*Affiliated Utes v. US*].
    - a. Thus, upon a finding of materiality, it is then up to the defendant to *rebut* that the plaintiff had not in fact relied on the material omissions.
    - B. Thus, in this instance, proof of non-reliance is an affirmative defense.
    - c. Most courts hold that the presumption of reliance **does not** apply in the case of misstatements (as opposed to omissions).
2. *Proof of Reliance in Misstatement Case:* where a 10b-5 action alleges defendant made positive misrepresentations of material information proof of reliance by the plaintiff upon the misrepresentation is required.
    - a. Upon a failure of proof on the issue the plaintiff loses.
        - i. In other words, the plaintiff must have justifiably relied on the misstatement.
    - b. Thus, in this instance, proof of reliance is a prerequisite to recovery.
3. *Justifiable Reliance:* any reliance by the plaintiff must be justifiable (reasonable reliance requires objective "reasonable man" test).
    - a. The "bespeaks caution" could preclude a finding of reasonable reliance.
    - b. The courts will use an eight factor test in determining whether reliance was justifiable:
        - i. sophistication of plaintiff in financial and securities matters;
        - ii. the existence of a long-standing business or personal relationships;
        - iii. access to relevant information;
        - iv. the existence of a fiduciary relationship;
        - v. concealment of the fraud;
        - vi. the opportunity to defect fraud;
        - vii. whether the plaintiff initiated the stock transaction; and

viii. the generality or specificity of the misrepresentations.

c. The "Fraud on the Market" theory can also be used to establish reliance.

i. Simply, the courts find that the reliance requirement can be satisfied by a showing that the market price was affected by the misstatement or omission and the plaintiff's injury was due to a purchase or sale at the then fraudulently induced market price.

ii. If the plaintiff can prove fraud on the market, he is entitled to a *presumption of reliance*.

C. **Causation:** to be successful in action for damages under Rule 10b-5, in addition to showing the elements of scienter, materiality, and reliance, the plaintiff must also specifically allege (pleading requirements) and prove a sufficient causal connection between his injury and the wrongful conduct that forms the basis of the 10b-5 claim. There are two types of causation (similar to cause in fact and legal cause in tort claims) in securities cases:

1. Transactional Causation: the plaintiff must first prove transactional causation, which means ***but for*** the wrongful conduct, the transaction would not have gone though, at least in the form it eventually took.

a. This is causation in fact, or "but for" causation.

b. Transactional causation requires only that the terms of the transaction have been significantly affected by the material misstatement or omission.

i. It is not necessary to prove that the transaction would not have occurred but for the alleged Rule 10b-5 violation.

c. Transaction causation requires that it be shown that there was a direct causal nexus between the alleged violation and the resulting transaction.

2. Loss Causation: secondly, the plaintiff must prove loss causation; namely, that the plaintiff's injury (generally the diminution in the value of his investment) is directly attributable to both to the wrongful conduct and the form and manner in which the challenged transaction occurred.

a. Loss causation provides the necessary connection between the challenged conduct and the plaintiff's pecuniary loss.

b. Loss causation is defined in terms of a need to identify that portion of the loss which can be traced to the material misrepresentation or omission.

i. The plaintiff has the burden to prove the causal nexus.

ii. This requires the fact finder to place a value on the misrepresentation (i.e. how much would the price have been tat the time of the challenged transaction had there been full disclosure).

c. In a fraudulent inducement case (i.e. where the misrepresentation or omission *induced* the challenged transaction) and the plaintiff has proven transactional causation, the burden shifts to the defendant to prove that the loss was due to wholly independent factors (usually by means of speculation and/or expert testimony).

i. EX: Defendant misstated his earnings in the prospectus, the stock price decreases for 5-reasons one of which was disclosure of the misstatement, D then has to show that the other 4-reasons the stock price dropped were the cause of the plaintiffs loss and not the misstatement.

d. Failure to prove loss causation can result in the dismissal of the suit.

e. **SEA §21D(b)(4)** expressly requires the plaintiff to prove loss causation in any private action arising under the SEA.

II. Plaintiff Due Diligence: Justifiable Reliance

A. **G/R:** Justifiable Reliance: the plaintiff's due diligence requirement generally requires that the plaintiff's reliance be justifiable. The following factors are relevant in determining whether the plaintiff's reliance was justifiable:

1. sophistication and expertise of plaintiff in financial and securities matters;
    a. **Rule 506(b)(2)(ii):** defines a sophisticated person, who is not an accredited investor (which could be an indication of sophistication also—remember the $1-million presumption of sophistication for natural persons) as having knowledge and experience in financial and business matters so that he is capable of evaluating the merits and risks of prospective investments.
    b. The court may also look at age, education, professional status, investment experience, and business background in determining sophistication [*Meyers v. Finkle*].

2.. the existence of a long-standing business or personal relationships;
3.. access to relevant information;
4. the existence of a fiduciary relationship;
5. concealment of the fraud;
6. the opportunity to defect fraud;
7. whether the plaintiff initiated the stock transaction; and
8. the generality or specificity of the misrepresentations.
*[*Litton Industries v. Lehman Brothers Kuhn Loeb inc.*].

B. **G/R:** Justifiable Reliance: is an objective/subject standard looking objectively at the 8-factors listed above and subjective reliance determined by the mental state of the investor [*Huddleston v. Herman & Mclean*].

II(A). Justifiable Reliance: Reliance on Oral Statements Inconsistent with Written Offering Materials

A. **G/R:** Constructive Knowledge: knowledge of information should be imputed to investors who fail to exercise caution when they have in their possession documents apprising them of the risks attendant to the investments.

1. Investors are charged with constructive knowledge of the risks and warnings contained in private memorandum which accompany oral statements of the seller of securities.
2. In evaluating the various factors relevant to justifiable reliance, a person with constructive knowledge of the risks and warnings conduct is examined as if they were aware of the risks and warnings, notwithstanding oral statements to the contrary by the seller of securities.
    a. EX: as in *Finkle*, this situation arises where a broker (or some other seller) tells the buyer, and assures them, that an investment is a good deal and then a prospectus is sent to the buyer which basically contradicts all the oral assurances and statements about the dealing being good.

*[*Meyers v. Finkle*].

B. **G/R:** §10(b) Unsuitability Claim: analytically, an unsuitability claim is a subset of the ordinary §10(b) fraud claim in which a plaintiff must allege, inter alia, (a) material misstatements or omissions; (b) indicating an intent to deceive or defraud; (c) in connection with the purchase or sale of securities.

1. EX: the investor comes in and tells the broker that he wants a low risk capital appreciation investment, and the broker sells him a high risk stock which does not pay dividends, this is an unsuitable investment for the investor.

*[*Brown v. E.F. Hutton*].

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B(1). **G/R:** Elements of an Unsuitability Claim: to succeed on an unsuitability claim the plaintiff must prove:

1. that the securities purchased were unsuited to the buyer's needs;
2. that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs;
3. that the defendant recommended or purchased the unsuitable securities for the buyer anyway;
4. that, with scienter, the defendant made material misrepresentations (or owing a duty to the buyer, failed to disclose material information); AND
    i. Scienter may be inferred by finding that the defendant knew or reasonably believed that the securities were unsuited to the investor's needs, misrepresented or failed to disclose the unsuitability of the securities, and proceeded to recommend the securities anyway.
5. that the buyer justifiably relied to his detriment on the defendant's fraudulent conduct.

*[*Brown v. E.F. Hutton*].

C. **G/R:** Due Diligence in Justifiable Reliance: an investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth.

1. Under this standard, §10(b) liability will not be imposed when an **investor's conduct rises to the level of recklessness.**
    a. To determine whether an investor acted recklessly, and therefore without justifiable reliance, no single factor is dispositive and all relevant factors must be considered and balanced—the relevant factors are in the 8-factor test (above).

*[*Brown v. E.F. Hutton*].

D. **G/R:** Written Words and Oral Statements—Priority: as a matter of law, oral statements do not meet the materiality threshold and a plaintiff's reliance on oral statements is unjustified when they are accompanied by a written document (such as prospectus).

1. Written words *govern* oral statements in order to reward truthful disclosures and facilitate accurate assessment of risk.
2. The written words however must be true, clear, and completed in order to be dispositive.

*[*Acme Propane v. Tenexco*].

II(B). Justifiable Reliance: Bespeaks Caution Doctrine and Related Doctrines

A. **G/R:** Bespeaks Caution Doctrine: the bespeaks caution doctrine may be viewed from both materiality and reliance perspectives. The doctrine provides that where an offering statement, such as a prospectus, accompanies statements of future forecasts, projections and expectations with adequate cautionary language, those statements are not actionable as a securities fraud.

1. Hence, under the doctrine cautionary statements make reliance on the projections or other soft information unjustifiable and renders the statements, when read in conjunction with cautionary language, immaterial.
2. Thus, under the doctrine, a court may determine that the inclusion of sufficient cautionary statements in a prospectus renders misrepresentations and omissions contained therein non-actionable.

3. Application of the doctrine depends upon the specific text of the offering document or other communications at issue, i.e., the courts must assess the communication on a case by case basis.

a. Nevertheless, the courts can state as a general matter, when an offering document's forecasts, opinions, or projections are accompanied by meaningful cautionary statements, the forward looking statements will not form the basis for a securities fraud claim if those statements did not affect the **total mix** of information the document provided investors.

b. In other words, cautionary language, if sufficient, renders the alleged omissions or misstatements immaterial as a matter of law.

4. The doctrine is, as an analytical matter, equally applicable to allegations of both affirmative misrepresentations and omissions containing soft information.

i. Whether plaintiff's allege a document contains an affirmative prediction/opinion, which is misleading or fails to include a forecast or prediction which failure is misleading, cautionary statements in the document may render the challenged opinions immaterial as a matter of law.

5. ***Caveat:*** vague or blanket boilerplate disclaimers which merely warn the reader that the investment has risks will ordinarily be inadequate to prevent misinformation.

a. To suffice, cautionary statements **must be:**

i. substantive; and

ii. tailored to the specific future projections, estimates, or opinions in the prospectus, which the plaintiff's challenge.

*The doctrine really relates to whether a statement can be viewed in isolation or if has to take into account all of the factors and statements in the entire prospectus (which it does).

**[*In Re Trump Securities Litigation*]

B. **G/R:** Soft Information: [usually the MD&A section of the prospectus]: opinions, predictions, and other forward looking statements are not *per se* inactionable under the securities laws; rather, such statements of "soft information" may be actionable misrepresentations if the speaker does not genuinely and reasonably believe them.

1. Soft information refers to statements of subjective analysis or extrapolation, such as opinions, motives, and intentions, or forward looking statements, such as projections, estimates, and forecasts.

*[*In Re Trump Securities Litigation*].

C. **SEA §27A and §21E:** Safe Harbor for Forward Looking Statements: §§27A and 21E provide SEA reporting companies, those acting on their behalf, and underwriters with a safe harbor from liability in *private actions* [not to SEC enforcement actions] for certain forward looking statements, e.g., projections.

1. The safe harbor is applicable to both forward looking **written and oral statements** so long as:

a. the statement is identified as a forward looking statement and is accompanied by meaningful cautionary statements, thus codifying the "bespeaks caution" doctrine;

b. the statement lacks materiality; or

c. the plaintiff fails to prove that the statement was made with actual knowledge of its falsity (irrespective of whether cautionary language is included).

2. The safe harbor also contains specific provisions for oral forward looking statements made by an issuer or those acting on behalf of the issuer.

a. Such forward looking statements are protected if such statements are accompanied by appropriate cautionary language and identify "readily available" information/documentation that sets forth important factors that could cause results to differ materially from those projected.

3. There is **not** a duty to update the forward looking statements [§21E(d)].

4. **SEA §21E(h)(i)(1):** defines a forward looking statement as a statement including:

a. a projection of revenues, income, earnings per share, capital expenditures, dividends, capital structure, or other financial items;

b. a statement of the plans and objective of management for future operations including plans or objectives relating to the products or services of the issuer;

c. any statement of *assumptions* underlying or relating to any statement;

d. any report issued by an outside reviewer.

*Brokers are not covered under this safe harbor protection.

D. **SEA §21E(b)(2)(A)-(F):** Exclusions to the Safe Harbor: to protect unsophisticated purchasers, the safe harbor protection does not apply to certain forward looking statements. The statutory safe harbor does *not* protect forward looking statements:

1. included in financial statements prepared in accordance with GAAP;
2. contained in an initial public offering registration statement;
3. made in connection with a tender offer;
4. made in connection with a partnership, limited liability company or direct participation program offering; or
5. made in beneficial ownership disclosure statements filed with the SEC.

In addition to further protection investors, **§21E(b)(1) makes an exception or "bad boys" who cannot take advantage of the safe-harbor.

E. **G/R:** Two Prong Test for Seeking Protection of the Safe Harbor: a defendant meeting the statutory qualifications, is entitled to summary judgment, even if the forward looking statements are a mixed list of (forward looking statements and ones that are not), if:

1. the list or explanation contains assumptions underlying a forward looking statement; and
2. when the defendant has disclosed the risk factors in a warning accompanying the forward looking statement.

*[*Harris v. Ivax Corp.*].

III. Fraud on the Market Theory

A. **G/R:** Fraud on the Market Theory: deals with the question of reliance. The fraud on the market theory is based on the hypothesis that, in an open and developed securities market (efficient market), the price of a company's stock is determined by the available material information regarding the company and its business.

1. Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.
2. The causal connection between the defendant's fraud and the plaintiff's purchase of stcok in such a case is no less significant than in a case of direct reliance on misrepresentations.

*[*Basic Inc. v. Levinson*].

B. **G/R:** Presumption of Reliance Based on Fraud on the Market Theory: an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most

publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be ***presumed*** for purposes of a Rule 10b-5 action. The market must, however, be **efficient.**

1. *Rebuttable:* the presumption is rebuttal:
    a. if defendant's can:
        i. rebut proof of the elements giving rise to the presumption; or
        ii. show that the misrepresentation in fact did not lead to a distortion of price; or
        iii. that the individual plaintiff traded despite his knowing the information was false.
        iv. Then reliance is not proven.
    b. Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market value, will be sufficient to rebut the presumption of reliance.

C. **G/R:** Reliance Generally: reliance is an element of a Rule 10b-5 cause of action. Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury.

1. There is more than one way to demonstrate the causal connection.
    a. The Supreme Court has previously dispensed with a requirement of positive proof reliance, where a duty to disclose material information had been breached, concluding that the necessary nexus between the plaintiff's injuries and defendant's wrongful conduct had been established [*Affliated Utes*].
    b. In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of the that information by the investor.
    c. With the presence of the market interposed between seller and buyer and ideally transmits information to the investor in the processed from a market price. Thus, the market is performing a substantial part of the valuation process performed by the investor in a fact to face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the values of the stock is worth the market price.

III(A). Fraud on the Market Theory: Defining an Efficient Market

A. **G/R:** Factors in Defining an Efficient Market: there are five factors that need to be considered in order establish an efficient market to support the fraud on the market *presumption* of reliance:

1. large weekly trading volume;
2. the existence of a significant number of reports by security analysts;
3. the existence of market makers and arbitrageurs in the security;
    a. *Market Makers:* are dealers who stand ready to buy or sell a specific stock at quoted prices; the price at which a market maker is willing to sell (the offered price) is somewhat higher than the price at which he is willing to buy (the bid price). The difference is the spread, or the market makes profit.
    b. *Arbitrageurs:* are sophisticated speculators who accumulate shares and plan to tender them to the bidder, or highest bidder. Arbitrageurs enter the market enter the market when announcement of a tender offer is made and buy shares at whatever prices the stocks are offered under the bidders price.
4. the eligibility of the company to file an S-3 Registration Statement; and
    a. Company is eligible to file an S-3 Registration Statement if:
        i. the issuer has a 12-month history of reporting under the SEA; and

ii. the issuer has a public float prior to such an offering of at least $75-million.
5. a history of the immediate movement of the stock price as the result of unexpected corporate events or financial releases.
a. This is the basis for the fraud on the market theory.
*[*Freeman v. Laventhol & Horwath*].
6. In addition, the court may look to the following factors which underlie the fraud on the market theory:
a. An *open market*, that is, one which anyone, or at least a large number of persons, can buy or sell;
b. A *developed market*, that is, one which has a relatively high level of activity and frequency and for which trading information (e.g. price and volume) is widely available; and
c. An *efficient market*, that is, one which rapidly reflects new information in price.
*These terms are cumulative in the sense that a developed market will almost always be an open one and an efficient market will almost invariably be a developed one.
**[*Cammer v. Bloom*].

B. **G/R:** Over the Counter Markets: are unlike organized exchanges (such New York Stock Exchange) because there is no singly place or location for the over the counter market. Rather, it consists of a large number of brokers and dealers who deal with each other by computer or telephone, buying and selling shares for customers or for their own account [many over the counter stocks are traded on NASDAQ's premier "National Market System" a grouping of the largest and most widely followed over the counter stocks, which lends to the theory that the OTC markets are developed and have material information available].
1. *Fraud on the Market Theory and OTCs:* although the Supreme Court adopted the fraud on the market theory in case [Basic Inc.] involving the national exchanges, the lower courts have extended the theory to OTCs.
a. The question is always whether the stock trades in an efficient market, i.e., one in which material information on the company is widely available and accurately reflected in the value of the stock. While some over the counter stocks non doubt trade in a less developed market than some New York Stock Exchange issues, the inquiry in an individual case remains the development of the market for that stock, and not the location where the stock trades.
i. While the location of where the stock trades might be relevant, it is not dispositive of whether the current price reflects all available information.
b. Hence, the fraud on the market theory can be applied to OTCs as long as most of the factors are satisfied.
2. What is being emphasized is that the stocks home (like the national stock exchange) is not dispositive, the courts will apply the above criteria and determine if the market is accounting for such factors; hence, an over the counter market can be efficient, developed, and open.

III(B). Fraud on the Market Theory: Rebutting the Presumption of Reliance

A. **Generally:** Rule 10b-5 makes it unlawful to make any untrue statement of fact or to omit to state a material fact necessary to make the statements made, in light of all the circumstances in which they were made, not misleading.
1. The most obvious example of a false or misleading statement is a misrepresentation of historic fact.

2. Nonetheless, projections and general expressions of optimism may be actionable under the federal securities laws.
3. Ordinarily, omissions by corporate insiders are not rendered immaterial by the fact that the omitted facts are otherwise available to the public. Where a plaintiff alleges actual reliance on a particular statement, it does not matter that the *market* is aware of the facts necessary to make the statement not misleading.
a. The plaintiff must be mislead into believing that the stock has been incorrectly valued by the market.
i. Nonetheless, loss causation also must be proven [SEA §21D(b)(4)].

B. **G/R:** Rebutting the Fraud on the Market Presumption: in the usual claim under §10(b) the plaintiff must show individual reliance on a material misstatement; however, under the fraud on the market theory the plaintiff has the benefit of a **presumption** that the has indirectly relied on the alleged misstatement, by relying on the integrity of the stock price established by the market.
1. In a fraud on the market case, the plaintiff claims that he was induced to trade stock not by any particular representations made by corporate insiders, but by the artificial stock price set by the market in light of statements made by the insiders, as well as other material public information.
2. Rebuttal: the presumption of reliance can be rebutted by a showing that information **sufficient to correct the defendant's alleged misstatements was transmitted through market price in the same fashion as the misstatements themselves.**
a. In *In Re Apple Computer Securities Litigation*, the court found that information transmitted through the press was sufficient to correct the defendants misstatements, and hence, rebut the presumption of reliance (this is probably as far as the rebuttal evidence can be stretched).
i. caveat: the court, however, noted that ordinarily scrutiny by the press will not excuse a material misstatement expressed by directors and officers.
*[*In Re Apple Computer Securities Litigation*].

IV. Fraud to Enter the Market

A. **Generally:** the fraud on the market theory creates a presumption of reliance in an efficient market where the trading in the subject security is liquid and widespread.
1. The *Basic* fraud on the market theory does not apply to inefficient markets, such as those for privately held issuers and for other enterprises where such trading markets are not-liquid and instable.

B. **G/R:** Fraud to Enter the Market: [extension of Fraud on the Market Theory to inefficient markets] the securities laws allow an investor to rely on the integrity of the market to the extent that the market offers to him for purchase securities which are entitled to be in the market place.
1. To be entitled to the fraud on the market presumption of reliance in an undeveloped market, the plaintiff must prove that the securities **would not have been entitled to be marketed**, *but for* the pervasive fraudulent scheme.
a. If the securities otherwise would have been marketed at a lower price, that is not sufficient for application of fraud to enter the market.
b. Hence, the plaintiff must prove that:
i. the defendants knowingly conspired to bring the securities onto the market which were not entitled to be marketed, intending to defraud purchasers;

ii. the plaintiff reasonably relied on the securities availability on the market as an indication of their apparent genuineness, and
iii. as a result to the scheme to defraud, he suffered loss.
c. In other words, if there is scheme to defraud, and the securities are not entitled to be marketed at all, the plaintiff may recover under the fraud on the market theory even in undeveloped markets.
2. **TEST:** Securities Not Entitled to be Marketed: securities meet the test of *not entitled to be marketed* only where the promoters knew the enterprise itself was patently worthless.
a. Expert testimony, however well founded in the experience of securities traders, is noting more than speculation of observers from hindsight.
3. *Shores Holding:* the 5th Circuit basically held that an investor may maintain an action under §10(b) by establishing that the fraud permitted the securities to exist in the market—that *but for* the fraud the securities would have been "unmarketable" and that the investor relied on their existence.
*[*Shores v. Sklar; Abell v. Potomac Ins. Co.*].
**This approach by the 5th Circuit has been rejected by other Circuits [*Eckstein v. Balcor Film Investors*].

§4.6: THE CUMULATIVE REMEDY APPROACH; STANDARD OF PROOF

A. **G/R:** Cumulative Remedies: a party is not barred from invoking the Rule 10b-5 remedy for fraud because the fraudulent conduct would also provide the basis for a damage action under SA §11; that is, the express cause of action [§11] has no preference over the implied cause of action [§10(b)].
1. *Distinction between SA* §11 and *SEA* §10(b):
a. **SA §11:** allows *purchasers* of a registered security to sue certain enumerated parties in a registered offering when false or misleading information is included in a registration statement.
i. The section was designed to assure compliance with the with the disclosure provisions of the SA by imposing a stringent standard of liability on the parties who play a direct role in the registered offering.
ii. If the plaintiff purchased the a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case.
(A) §11 places a relatively minimal burden on a plaintiff.
(B) A §11 action must be brought by a purchaser of a registered security, must be based on misstatements or omissions in the registration statement, and can *only be brought* against certain parties.
b. **SEA §10(b):** is a "catchall" antifraud provision, but it requires a plaintiff to carry a heavier burden to establish a cause of action.
i. In contrast to SA §11, a §10(b) action can be brought by a purchaser or seller of:
(A) any security,
(B) against any person;
(C) who has used any manipulative or deceptive device or contrivance;
(D) in connection with the purchase or sale of securities.
(E) However, §10(b) requires the plaintiff to prove the defendant acted with scienter (whereas §11 has no such requirement).

2. **Rule:** since §11 and §10(b) address different types of wrongdoing, there is no reason to carve out an exception to §10(b) for fraud occurring in a registration statement just because the same conduct may be actionable under §11.
3. **SA §16(a); SEA §28(a):** support this rule by providing parallel clauses that state: that the rights and remedies under the SA or SEA shall be in addition to any and all other rights and remedies that may exist at law or in equity.
*[*Herman & Maclean v. Huddleston*].

A(1). **G/R:** Cumulative Remedies, Applicability to Other Provisions: the availability of an express remedy under SA §11 does not preclude defrauded purchasers of registered securities from maintaining an action under SEA §10(b) [*Herman & Maclean v. Huddleston*].
1. The language of the Court's decision in *Huddleston* strongly supports the position that a cumulative approach between §10(b) and other express rights of action, such as:
a. **SA §12(a)(2);**
b. **SEA §18(a);**
c. **SEA §9** (possibly).
2. In other words, the various procedural restrictions that apply in actions invoking the express remedies (which restrictions are largely absent in suits brought under §10(b)) are counterbalanced by §10(b)'s scienter requirement.

B. **G/R:** Standard of Proof: in a §10(b) action the plaintiff must only establish his case by a preponderance of the evidence (more likely than not), as is typical in any civil suit for money damages.
1. *Policy:* a preponderance standard allows the parties to share the risk of error in roughly equal fashion.
2. The preponderance standard is applied as opposed to the more stringent clear and convincing standard.
*[*Herman & Maclean v. Huddleston*].

§4.7: DAMAGES

A. **G/R:** Actual Damages: the federal securities laws limit recovery to actual damages. Although this measure does not preclude a recovery of damages that exceed mere compensation, punitive damages **may not** be awarded [*Randall v. Loftsgaarden*].

B. **G/R:** Out of Pocket Measure: federal courts have most frequently adopted the out-of-pocket measure of damages to redress violations of §10(b).
1. *Out of Pocket Measure:* this is the traditional Rule 10b-5 measure of recovery and represents the difference between the fair value of all that the plaintiff received and the fair value of what he would have received had thee been no fraudulent conduct.
a. This measure constitutes the disparity between the fair value of the security purchased and the fair value of the consideration paid, generally measured at the time of the transaction.
2. Other measures of damages that have received judicial approbation in select cases include:
a. *benefit of the bargain:* the difference between the represented value of the security purchased or sold and the fair value of the security on the date of the trade.
b. *rescission:* is the judicial act of undoing the transaction.

c. *disgorgement*: returns to the plaintiff the amount of the defendant's unjust enrichment; under this theory, the plaintiff recovers the defendant's profit resulting from the fraud, rather than the plaintiff's losses.
e. *restitution:* restores the party to its pre-transaction condition.
d. certain hybrids of the various measures.

C. **SEA §21D(e):** Limitation on Damages: in general, this provision places a limitation on damages in SEA actions [e.g. Rule 10b-5] where the plaintiff attempts to establish such damages by reference to the market price of a security.

1. In this context, the award of damages is the difference between the purchase or sale price paid or received by the plaintiff and the *mean trading price of the security* during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

a. *Mean Trading Price:* of a security is the average daily trading price of such security, determined as of the close of the market each day during the 90-day period.

§4.8: DEFENSES AND STRATEGIC CONSIDERATIONS

I. Pleading Fraud with Particularity

A. **FRCP 9(b):** in all averments of fraud or mistake, the circumstances constituting the fraud or mistake shall be stated *with particularity*. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

1. Thus, if the plaintiff fails to plead with particularity (at the stage when he has not had the opportunity to conduct discovery), his action will be dismissed.

A(1). Exception**:** [2d Circuit's Approach] despite FRCP 9(b)'s generally rigid requirement that fraud be pleaded with particularity, allegations may be based on information and belief when facts are peculiarly within the opposing party's knowledge.

1. This exception to the general rule must not be mistaken for a license to base claims of fraud on speculation and conclusory allegations.
2. Where pleading is permitted on information or belief, a complaint must adduce specific facts ***supporting a strong inference of fraud***, or it will not satisfy even a relaxed pleading standard. *[*Wexner v. First Manhatten Co.*].

B. **SEA §21D(b)(1):** Requirements for Securities Fraud Actions: §21D(b) generally requires:

1. that a plaintiff in the complaint in any private securities fraud action alleging material misstatements or omissions specify **each statement** alleged to have been misleading; the reasons why the statement is misleading; and if an allegation regarding the statement or omission is made on information or belief, the complaint shall state *with particularity* all factes on which that belief is formed.
2. in any private action under the SEA in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to **each such act or omission** alleged to violate the SEA, state *with particularity* facts giving rise to a strong inference that the defendant acted with the required state of mind.
**This was intended, as evidenced by the legislative history, to be a more stringent pleading requirement than the 2d Circuit's standard set forth in *Wexner*.

C. **G/R:** Status of Pleading Requirements in Federal Courts: three lines of cases have emerged in the federal courts after §21D(b)'s enactment of stringent pleading:

1. One line holds that scienter may still be established by reckless conduct and that the pleading standards under §21D(b) may be satisfied by allegations of the defendant's *motive and opportunity* to commit fraud;
2. A second line rejects the recklessness standard and requires a plaintiff to plead *and prove* that the defendant acted with a deliberate and conscious intent to commit fraud; and
3. A third line holds that while §21D does not alter existing authority permitting the scienter requirement to be met by a showing of recklessness, allegations based solely on the defendant's *motive and opportunity* to commit fraud will not satisfy §21D(b)'s heightened pleading standard.

II. Statute of Limitations

A. **G/R:** Implied Statute of Limitations for §10(b): litigation instituted pursuant to §10(b) and Rule 10b-5 must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation.

1. This is in accord with the general 1-and-3 year periods of limitations contained in the SA and SEA.

*[*Lampf v. Gibertson*].

III. Defense of *In Parli Delicto*

A. **G/R:** In Parli Delicto: at common law, the defense meant that in the case of equal or mutual fault, the position of the defendant party is the better one.

1. The defense is grounded on two premises:
    a. courts should not lend their good efforts to mediating disputes among wrongdoers; and
    b. that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.

*[*Bateman Eichler, Hill Richards, Inc. v. Berner*].

B. **G/R:** Elements *of In Parli Delicto* Defense: the defense of *in parli delicto* applies to implied causes of action [such as §10(b)]; accordingly, in a private cause of action for damages the plaintiff's cause of action may be barred on the grounds of the plaintiff's culpability (equal fault) only where:

1. as a direct result of his own actions, the plaintiff bears **at least substantially equal responsibility** for the violations he seeks to redress; and
2. preclusion of the suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public.

*[*Bateman Eichler, Hill Richards, Inc. v. Berner*].

C. **G/R:** Tippers, Securities Professionals, and Tippees: Relative Degrees of Culpability: notwithstanding the broad reach of §10(b) and Rule 10b-5 there are important distinctions between the relative culpabilities of tippers, securities professionals, and tippees:

1. *Tippees:* a tippee's use of material non-public information does not violate §10(b) and Rule 10b-5 **unless** the tippee owes a corresponding duty to disclose the information.

a. That duty is typically derivative from the insider's duty. In other words, the tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty toward corporate shareholders.

2. In the context of insider trading, a person whose liability is solely derivative cannot be said to be as culpable as one whose breach of duty gave rise to the liability in the first place.

a. Hence, a "Tipper" is more culpable than a "Tippee"

3. Moreover, insiders and broker-dealers who selectively disclose material non-public information commit a potentially broader range of violations than do tippees whos trade on the basis of that information.

a. A tippee trading on inside information will in many circumstances be guilty of fraud against individual shareholders, a violation for which the tipper shares responsibility.

b. But the insider, in disclosing such information, also frequently breaches fiduciary duties toward the issuer itself.

c. And in cases where the tipper intentionally conveys false or materially incomplete information to the tippee, the tipper commits an additional violation: fraud against the tippee.

i. Such conduct is particularly egregious when committed by a **securities professional**, who owes a duty of honesty and fair dealing toward his clients.

4. Hence, absent other culpable actions by a tippee that can fairly be said to outweigh these violations by insiders and broker-dealers, the tippee cannot be properly categorized **as being of substantially equal culpability as his tippers**.

*__NOTE:__ this is important because the defense of *in parli delicto* does not apply if the plaintiff is not of substantially equal responsibility for the violations he seeks to redress; hence, if there is a §10(b)-insider trading problem on the exam where the plaintiff is a tippee, he may still recover.

*[*Bateman Eichler, Hill Richards, Inc. v. Berner*].

§4.9: CONTRIBUTION, PROPORTIONATE LIABILITY, AND RELATED ISSUES

I. <u>Contribution</u>

A. **G/R:** <u>Contribution:</u> defendants based on an implied private right of action under SEA §10(b) and Rule 10b-5 have a right, as a matter of federal law, to seek **contribution** from joint tortfeasors.

1. Thus, those charged with liability in a Rule 10b-5 action have a right to contribution against other parties who have joint responsibility for the violation.

*[*Musick, Peeler & Garrett v. Employers Ins. of Wausau*].

B. **SEA §21D(f)(5):** <u>Contribution:</u> expressly codifies the right to contribution in a §10(b) action.

II. <u>Proportionate Liability</u>

A. **Generally:** the PSLRA amended to the SEA added §21D(f). This section:

1. circumscribes the scope of the current joint and several liability scheme;

2. creates a proportionate liability framework for actions brought against multiple defendants under the SEA or against "outside directors" of the issuer whose securities are the subject of §11 action under the SA; and

3. clarifies several issues relating to partial settlements in federal securities actions.

B. **SEA §21D(f):** Proportionate Liability: §21D(f) provides two major changes in damages awards (and several other changes):

1. The statute limits the application of joint and several liability for damages to apply only if the trier of fact specifically determines that the defendant in question **knowingly committed** a violation of the federal securities laws.
    a. The section provides that the term ***knowingly committed*** requires actual knowledge as the scienter standard and specifically provides that RECKLESSNESS CANNOT constitute a knowing violation.
    b. Under this framework, the legislation provides that the liability of such defendants is to be premised upon findings of percentage of responsibility as to each jointly and severally liable defendant.
2. In all actions where the **knowingly committed** scienter standard may be shown, the statute creates a proportionate liability scheme and (with certain exceptions) restricts liability for damages solely to that portion of judgment that corresponds to the percentage of each individual defendant's responsibility.

§4.10: SPECIAL CONCEPTS OF FRAUD FOR BROKER-DEALERS

A. **G/R:** Shingle Theory: under SEA §10(b), and SA §17(a), a number of principles have been developed to hold broker-dealers to a fairly strict standard of conduct, such as the Shingle Theory, which holds that by hanging out its "shingle," a broker dealer impliedly represents that its conduct and the behavior of its employees will be fair and will comport with professional norms.

1. A securities dealer occupies a special relationship to the buyer of securities in that by his position he impliedly represents that he has an adequate basis for the opinions he renders.
2. A number of implied representations have been recognized as coming within the shingle theory:
    a. an implied representation of fair pricing, including markup or markdown;
    b. an implied representation that the broker-dealer will execute only authorized transactions for its customers;
    c. an implied representation to disclose any special consideration that influences the broker-dealer's recommendation;
    d. an implied representation to execute promptly customer's orders; and
    e. an implied representation that any recommendation made by a broker-dealer to a customer has a reasonable basis.
3. Investors who are defrauded by broker-dealer's attempt to bring a Rule 10b-5 action, based on these implied representations under the theory that: a broker-dealer, by just being a broker-dealer, he is impliedly representing that he will do certain things (see above) and hence, if he does not, it is a material misrepresentation and can be brought under Rule 10b-5.

B. **G/R:** Suitability Theory: there is an implied representation by a broker that it will recommend only those securities suitable for each customer's investment objectives and economic status.

C. **G/R:** Churning: there is an implied cause of action under Rule 10b-5 for churning, which will not likely be done away with. Churning occurs when a broker-dealer enters into a series of transactions just to obtain commissions.

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D. **G/R:** Cognizable Rule 10b-5 Claim: in order to state a cognizable claim for fraud under Rule 10b-5, a plaintiff must allege conduct by the defendant which can fairly be viewed as “manipulative or deceptive” within the meaning of SEA §10(b).

1. Manipulation is virtually a term of art when used in the securities field, and refers narrowly to practices, such as, wash sales, rigged prices, or matched sales which artificially affect market activity in order to mislead investors.
2. In situations not involving a manipulative scheme, the conduct alleged as fraudulent must include deception, misrepresentation, or nondisclosure to violation §10(b) or Rule 10b-5.

*[*Pross v. Baird Patrick & Co.*].

E. **G/R:** Market Making: failure by a broker to disclose that it is “making the market” in a particular security is a material omission, which nondisclosure by itself establishes reliance.

1. However, there is no nondisclosure, and hence reliance, if the broker adequately discloses his market maker status.

*[*Pross v. Baird Patrick & Co.*].

F. **G/R:** a claim for breach of fiduciary duty or breach of contract (or broker agreement), without more, cannot be converted into a fraud claim under §10(b) and Rule 10b-5 .

1. Under this theory, and arguable the Supreme Court’s decision in *Santa Fe* (which seemed to require that deception or manipulation *must be shown*) much of the shingle theory may not be viable under §10(b).
2. *Caveat:* some courts have held that unauthorized trading may constitute “deception” under §10(b) and Rule 10b-5.

§5: ALTERNATIVE PROVISIONS

§5.1: INTRODUCTION

I. Overview

A. **Generally:** if the plaintiff cannot bring an action under SA §11, or SEA §10(b) because of various reasons, then the counsel should focus on the availability of other measures.

1. Commonly, a SA §11 cause of action can be brought because the securities were purchased in the aftermarket, hence, making the express remedy unavailable (unless the tracing requirement is met); or
2. the complainant maybe unable to invoke the §10(b) remedy because the complainant was not a “purchaser or seller” or cannot establish the requisite scienter.

§5.2: IMPLIED RIGHTS OF ACTION—IN GENERAL

A. **G/R:** Four Prong Test for Implying a Federal Cause of Action: there is an a four-prong test that must be satisfied before the court will imply a cause of action:

1. The plaintiff has to be one of the class for whose especial benefit the statute was enacted, that is, does the statute create a federal right in favor of the plaintiff;
2. is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one;
3. is it consistent with the underlying purpose of the legislative scheme to imply such a remedy for the plaintiff; and

4. is the cause of action one traditionally regulated by state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law.
*[*Cort v. Ash*].

A(1). **G/R:** Modified *Cort Test:* in recent years, however, the Supreme Court has restricted the *Cort Test* to basically the second element, that is, is there any indication of legislative intent, explicit or implicit, to create such a remedy or deny one. The conservative Court has not implied any cause of actions under the securities law, under the second element, basically reasoning that there is no Congressional intent to create a cause of action, if it is not contained in the statute [*Virginia Bankshares; Central Bank of Denver*].

1. In other words, if neither the statutory language, nor the legislative history reveal a congressional intent to imply a private cause of action, the inquiry ends with a denial of private rights [*Landry v. All American Assurance*].

B. **G/R:** Recognized Implied Causes of Action: the federal courts have recognized implied cause of actions in the securities field:

1. In the tender offer setting, implied a cause of action under SEA §14(e) on behalf of target corporation shareholders but not a damages remedy on behalf of an offeror; and
2. implied private rights of action under certain provisions of the Investment Company Act, and the Trust Indenture Act.

C. **G/R:** Statutes have been Held NOT to Contain an Implied Cause of Action: the federal courts have refused to recognize an implied cause of action under:

1. SEA §6 against a national securities exchange based on the exchange's failure to enforce its own rules; and under §6 against a broker-dealer, listed corporation, or other subject party based on a violation of exchange rules;
2. SEA §7 for a private damages action on behalf of investors against financial institutions and brokers for violation of the margin requirements.

§5.3: SEA §17(a)

I. General Scope

A. **SA §17:** Fraudulent Interstate Transactions: [general antifraud provision of the SA, only applies to sellers].

(a) It shall be unlawful for any person in the offer or sale of any securities by use [of interstate commerce], directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or
(2) to obtain money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchasers.

A(1). **SA §24:** willful violations of §17(a) are made subject to criminal sanctions SA §24.

B. **Generally:** SA §17(a) is an attractive enforcement weapon for the SEC. The SEC does has to prove scienter under §17(a)(1); however, scienter is **not required** to be shown under §§17(a)(2) or 17(a)(3); hence, under the latter provisions, negligence need only be shown for a violation.

1. §17(a) applies regardless of whether the securities are registered or whether they are exempt from registration.
2. **NOTE:** §17(a) has a severe limitation: its prohibitions apply only to the offer or sale of securities; hence, the provision does not reach fraud committed in the purchase of securities.
3. In addition, the overwhelming majority of courts have held that a private cause of action **does not exist under §17(a).**

C. **G/R:** Scope of §17(a)(1): there are three important principles regarding the scope of §17(a)(1):

1. the protection afforded by §17(a)(1) extends beyond investors to encompass financial intermediaries; that is, §17(a)(1) prohibits fraud against brokers as well as investors, even in criminal cases;
2. the language of §17(a) relating the prohibition of fraud **"in"** an offer or sale of securities is sufficiently inclusive to cover short sellers; and
    a. *Short Selling:* is the sale of a security that the seller does not own or that the seller owns but does not deliver. In order to deliver the security to purchasers, the short-seller borrows the security, typically from a broker-dealer or an institutional investor. The short seller closes out the position by returning the security to the lender, usually by purchasing equivalent securities on the open market.
        i. In general, short selling is used to profit from an expected downward price movement, or to hedge the risk of a long position in the same or related security.
3. §17(a) applies not only in the initial offering context, but also extends to the secondary trading markets.

*[*U.S. v. Naftilin*].

II. State of Mind

A. **G/R:** Scienter Requirements in a §17(a) Action: Scienter is required to be shown in order to establish a violation under §17(a)(1).

1. Scienter is not required to be established under §§17(a)(2) or 17(a)(3).

*[*Aaron v. SEC*].

B. **G/R:** SEC Actions: upon making the proper showing (i.e. a reasonable likelihood that, absent the ordering of the injunction, future violations will occur), the SEC can invoke §§17(a)(2) or 17(a)(3) to obtain injunctive relief based on the defendant's negligent conduct which occurred in the offer or sale of securities in the *secondary trading markets* or primary markets.

1. Thus, §17(a) is a more appealing enforcement weapon to the SEC in the "sale and offer" context than the traditional antifraud provision §10(b).
2. Thus, §17 can be used for:
    a. criminal prosecution;
    b. injunctions; and
    c. cease and desist orders.

III. Implied Right of Action:

A. **G/R:** Implied Cause of Action Under §17(a): a private right of action does not exist under §17(a) because [application of modified *Cort Test*]:

1. the statutory language of §17(a) does not suggest a private cause of action;
2. there is not indication of legislative intent, explicit or implicit, to create such an action.
3. *Caveat:* a small minority of older cases held that a private cause of action does exist under §17(a).

*[*Landry v. All American Assurance Co.*].

B. **G/R:** Express Civil Liabilities for the Protection of Purchasers: §17(a) does not need to contain an implied cause of action for the protection of purchasers because the SA contains two express civil liabilities for the protection of purchasers:

1. **SA §11**, which prohibits falsehoods and omissions in the registration statement; and
2. **SA §12(a)(2)**, which protects purchasers from misstatements or omissions in written or oral communications in public offering.

*Together these sections confer specific private rights upon purchasers, however, before a purchaser may successfully bring suit under either of these two sections strict procedural requirements must be met. §17(a)(2) prohibits the same kind of conduct as §§11 and 12, but has note of the limitations imposed by Congress; hence, the creation of an implied cause of action under §17(a) would effectively frustrate the purpose of the Act.

__NOTE:__ Statutory Construction: the court says by looking at the other sections of the statute, and if Congress gave people express relief in certain cases, then hedged that relief with several procedural restrictions, and then Congress implements a general section without any procedural restrictions, Congress would not have gone to all that trouble in making explicit restrictions on the statutes with express cause of actions. In other words, it would be superfluous to put in express cause causes of action with procedural restrictions, and then give effect to a general statute by implying a cause of action.

1. If needed, use this mode of analysis on the exam.

§5.4: SEA §14(a) and RULE 14a-9

I. Overview

A. **SEA §14(a):** Proxies: it shall be unlawful for any person, by [use of the mails or interstate commerce], to solicit or permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 [registration requirements for the SEA].

B. **Rule 14a-9:** False or Misleading Statements:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any *statement* which, at the time and in the light of the circumstances under which it is made, is *false or misleading* with respect to any *material fact*, or which *omits* to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, …has been flied with or examined by the Commission *shall not be deemed* a finding by the Commission that such material is accurate or complete or not false or misleading,…

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C. **Rule 14a-1:** Definitions:

(f) The term "proxy" includes every proxy, consent or authorization within the meaning of §14(a) of the Act. The consent or authorization may take the from of failure to object or to dissent.

(g) The term "proxy statement" means the statement required by Rule 14a-3(a), whether or not contained in a single document.

II. Elements of §14(a) Cause of Action and Causation Requirements

A. **Elements of §14(a)/Rule 14a-9 Cause of Action**:

1. Policy: §14(a) was intended to promote the free exercise of the voting rights of stockholders by ensuring that proxies solicited with explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.

2. Implied Cause of Action: The Supreme Court has repeatedly recognized an implied remedy for violation of Rule 14a-9's antifraud provisions [*TSC Industries v. Northway; JI Case v. Borak*].

3. Standing: all a private plaintiff need to show in a Rule 14a-9 action is that he or she was injured in connection with a proxy solicitation covered by the SEA regulation regardless of whether there was either a purchase or sale of securities.

4. Materiality: a fact in a proxy solicitation is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote [*TSC Indust. v. Northway*].

5. Degree of Culpability: the majority of federal courts have held that **scienter is not required** in a private Rule 14a-9 cause of action; hence, negligence conduct will suffice to impose liability.

a. This is because §14(a) and Rule 14a-9 do not by their terms require that deceptive or manipulative conduct be shown.

*[*Gould v. American Hawaiian SS Co.*].

6. Reliance: provided that the misstatement or omission is material and thus has a significant propensity to affect the voting process, a plaintiff in a derivative or class action under §14(a) and Rule 14a-9 is not required to show individual reliance on the misleading proxy solicitation (i.e. there will be a *presumption of reliance*) [*Mills v. Electric Auto-Lite Co.*].

7. Causation: there are two types of causation that the plaintiff must prove in a §14(a) claim:

a. *TRANSACTION CAUSATION:* (cause in fact) the misstatements or omissions were causally related to the occurrence of the transaction.

i. **Sue Facts:** (a sue fact is a fact that is material to a decision to sue): the issue of transaction causation is determined by terms of, whether upon full and fair disclosure, the minority shareholder would have had an opportunity to prevent the transaction by seeking an injunction under state law.

ii. **Test:** whether upon full and fair disclosure, a reasonable shareholder's voting decision would have been likely to be affected in deciding whether to take action to prevent the merger, or vote against merger.

2. *LOSS CAUSATION:* (legal cause): the plaintiff's ability to prove actual economic harm resulting from the transaction. This can be divided into two categories:

a. **Essential Link Test:** [used when defendant corporation *does not* control enough shares to assure the number of votes necessary for approval and consummation of the merger]: upon a finding of materiality; a shareholder has

made a sufficient showing of causal relationship between the violation and injury for which he seeks redress if he proves the proxy solicitation itself was an essential link [the link being the needed approval of the shareholders to go forward with the proposed action] in the accomplishment of the transaction [*Mills*].

b. **Vote Not Needed:** [used when the defendant corporation *does* control a majority of shares, and hence votes, necessary to pass the merger, notwithstanding the minority shareholder votes, which were solicited anyhow by proxy]: a private right of action for a violation of the proxy rules will not exist when the transaction in question does not require a shareholder vote in order to be approved.

(A) *Shame Facts:* the court specifically **rejected** this theory of causation (i.e. properly informed shareholders could have caused public relations problems by way of embarrassing or causing ill-will for the corporation (proponent of the merger) that the merger may have been defeated or aborted even by the majority that proposed it.

(B) *Sue Facts:* the court did not specifically address, but, indicated, that shareholder **never** lose their right to sue in state court because immunity from suit is *not* granted if disclosure is improper.

c. **Direct Causal Connection:** If there is no showing that failure to secure the shareholder vote in question would have prevented or in anyway affected the merger, there is absence of a direct causal connection between the proxy solicitation and merger decision, and hence not action can be maintained under §14(a).

*[*Virginia Bankshares*].

III. SEC Proxy Rule Amendments

A. **Securities Litigation Uniform Standards Act [SLUSA]:** with respect to securities class action involving nationally traded securities, the SLUSA generally preempts state law.

B. **Generally:** the SEC amended its proxy rules to facilitate communications between shareholders. There were several changes, however, the two important ones are:

1. **Rule 14a-2(b):** was amended to create an exemption from the proxy statement delivery and disclosure requirements for communications with shareholders, where the person soliciting is not seeking proxy authority and does not have a substantial interest in the matter subject to a vote or is otherwise ineligible for the exemption.
2. **Rule 14a-1:** the definition of "solicitation" was amended to specify that a shareholder can publicly announce how intends to vote and provide the reasons for that decision without having to comply with the proxy rules.

§5.5: SEA §29(b)

A. **SEA §29(b):** Every contract made in violation of any provision of [the SEA] or of any Rule or regulation thereunder, and every contract … made the performance of which involves the violation of, or continuance of any relationship or practice in violation of, any provision of [the SEA] or regulation thereunder **shall be void** … [as regards the rights of the violating party or his successor who takes with knowledge]

B. **G/R:** Right to Rescind: §29(b) implied confers a right to rescind a contract void under the statute [*Transamerica Mortgage Advisors, Inc. v. Lewis*].

C. **G/R:** Rights Protected by §29(b): the language of the section provides that a violating party to a contract, his successor who takes with knowledge, shall have no rights under the contract, even when performance of the contract has been rendered.

1. Conceivably then, §29(b) subjects *every transaction*, from simple purchase or sale of securities, to a complex proxy fight, merger, tender offer reorganization, or other transaction to which the SEA applies, to its voidability provisions.

D. **G/R:** Implied Cause of Action: §29(b) by implication, authorizes a private cause of action for rescission or similar relief [*Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*].

E. **G/R:** Elements of the Cause Action: a person can void a contract under §29(b) if he can show that:

1. the contract involved a prohibited transaction;
    - a. Thus, contracts which are either illegal when made, or in fact performed.
2. his is contractual privity with the defendant; and
3. he is in the class of persons the Act was designed to protect.
    - a. This can be proven by using the policy behind whatever was violated in element (1).
        - Ex: in *Regional Properties* the P and D entered into a K for the sale of securities and D was not registered in violation of §15 of the SEA (prohibited transaction); there were direct parties to the contract (privity); and thus, P was in protected class because Act was designed to protect persons from buying unregistered securities.

*[*Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*].

F. **G/R:** Defenses to a §29(b) Action: in suits of equity, such as to void a contract, equitable defenses apply, such as laches, estoppel, etc…may be raised. Thus, all of the equitable defenses are available to a §29(b) cause of action [*Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*].

§5.6: RICO: RACKETEER INFLUENCED AND CORRUPT PRACTICES ACT

A. **RICO §1964(c):** is generally not available for securities prosecution anymore. The only time a securities fraud can be a predicate act in a civil RICO action is when:

1. any person has been criminally convicted in connection with securities fraud; and
2. in which case the statute of limitations begins to run on the day the conviction becomes final.

§6: INSIDER TRADING

§6.1: INTRODUCTION

I. OVERVIEW

A. **G/R:** Material Non-Public Information: the imposition of §10(b) and Rule 10b-5 for trading on material non-public information must be must be premised on a duty to disclose [*Chiarella v. U.S.*].

B. **G/R:** Tippers and Tippees: the duty of tippers-tippees to disclose or abstain from trading under §10(b) and Rule 10b-5 depends upon whether the insider will personally benefit (e.g. by receipt of pecuniary gain or reputational enhancement that will translate into future earnings), directly or indirectly, from his disclosure.

1. Absent some personal gain, there has been not breach of duty to stockholders.
2. Absent breach by the insider, there is no derivative breach by the tippee.

*[*Dirks v. SEC*].

C. **G/R:** Misappropriation Theory: a person who engages in securities trading, using confidential material information in breach of fiduciary duty owed to the source of the information, violates §10(b) [*U.S. v. O'Hagen*].

D. **Rule 14e-3:** Transactions in Securities on the Basis of Material, Nonpublic, Information in the Context of Tender Offers: generally, the rule seeks to deter insider and tippee trading in the tender offer setting by containing a broad "disclose or abstain" from trading and anti-tipping provisions, with certain exceptions.

1. With certain exemptions, Rule 14e-3, applies the disclose-or-abstain provision where an individual who is in possession of material information relating to a tender offer and knows or has reason to know that such information is nonpublic and was obtained directly or indirectly form the offeror, and subject corporation, any of their affiliate persons, or any person acting on behalf of the company.
2. The Rule was upheld as not exceeding the SEC's authority, as applied to the facts, in *U.S. v. O'Hagan*.

E. **SEA §21(d):** Damages: authorizes the SEC to seek the imposition of a civil monetary penalty amounting to three times the profit received or loss avoided due to violative insider trader transactions. In other words, treble damages.

1. Under certain conditions, broker-dealers, investment advisers, and others are subject to the treble monetary penalty for illegal inside trades effected by those persons who are under their control.

II. THE MEANING OF "MATERIAL" AND "NONPUBLIC" INFORMATION

A. **G/R:** Public Information: trading based on public information does not violate §10(b) or §14(e).

1. *Definition:* information becomes public when disclosed to achieve a braod dissemination to the investing public generally and without favoring any special person or group, or when, although known only by a few persons, their trading on it has caused the information to be fully impounded into the price of the particular stock.

*[*SEC v. Mayhew*].

B. **G/R:** Non Public Information: under certain conditions, the federal securities laws prohibit the trading of securities (or "tipping" related thereto) when such person used *material nonpublic* information.

1. *Definition:* to constitute nonpublic information under the Act, information must be specific and more private than general rumor. Information may also be nonpublic within the meaning of the SEA even though it does not reveal all the details of a particular event or tender offer.
2. A corporate insider's confirmation of information on which the financial press had speculated can satisfy the nonpublic information requirement in the context of §10(b).

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a. This satisfies the nonpublic information requirement of §10(b) because the confirmation by an insider of the merger speculated in the press makes it less likely that nothing will happen.
b. This same reasoning applies to §14(e).
*[*SEC v. Mayhew*].

C. **G/R:** Test for Materiality: information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to invest.
1. To be material the information need not be such that a reasonable investor would necessarily change his investment decision based on the information, as long as a reasonable investor would have viewed it as significant in the **total mix** of information available.
2. Material facts include those which affect the probable future of the company and those which many affect the desire of investors to buy, sell, or hold the company's securities.
a. They include any fact which in reasonable and objective contemplation *might* affect the values of the corporation's stock or securities.
*[*TSC Industries v. Northway*].

C(1). **G/R:** Special Considerations in the Merger Context: materiality, in the merger context, where information can be speculative and tenuous, the materiality standard is difficult to apply. In merger cases, materiality will depend upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.
1. Thus, a violation of the securities laws will NOT be found where the disclosed information is so general that the recipient of the information is still undertaking a substantial economic risk that his tempting target will prove to be speculative.
2. However, because of merger is one of the most important events that can occur for a small company, information regarding a merger can become material at an earlier stage than would be the case as regards lesser transactions.
a. Moreover, where information regarding a merger originates from an insider, the information, even if not detailed, takes on an added charge just because it is inside information and a major factor in determining materiality is the importance attached to it by those who knew about it.
b. In other words, the "total mix of information" depending on the factual situation and whether it will affect the *value of the stock* are important considerations in the merger context.
*[*SEC v. Mayhew*].

§6.2: THE DUTY THEORY

A. **G/R:** Obligations of Insiders: the anti-fraud provisions are phrased in the terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors, and controlling shareholders. These three groups, however, do not exhaust the classes of persons upon whom there is an obligation. Analytically, the obligation rests on two principle elements:
1. the existence of a relationship giving access, directly or indirectly, to information intended to be available for a corporate purpose and not for the personal benefit of anyone; and
2. the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

*Thus, the court's task is to identify those persons who are in a special relationship with a company and privy of internal affairs, and thereby suffer correlative duties in trading its securities.
** [*In the Matter of Cady, Roberts, & Co.*].

B. **G/R:** <u>Disclose or Abstain:</u> [the main insider trading Rule]: anyone in possession of *material* inside information must:

1. disclose the material information to the investing public; or
2. must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed because
    a. he was unable to disclose the material information in order to protect corporate confidence, or
    b. he chooses not to disclose the material information.
3. The SEC took an important step in the development of §10(b) when it held that a broker-dealer and his firm violated §10(b) by selling securities on the basis of undisclosed information obtained from a director of the issuer corporation who was also a registered representative of the brokerage firm.
4. The corporate insider **must abstain from trading in the shares** of his corporation unless he has first **disclosed** all *material* inside information known to him.

*[*Chiarella v. U.S.*].

C. **G/R:** <u>Disclosure Requirements:</u> the courts and the SEC have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to the people with whom they deal, and if known would affect their business judgment.

1. The obligation to disclose or abstain derives from an affirmative duty traditionally been imposed on corporate insiders, particularly officers, directors, or controlling stockholders.
2. The duty to disclose or abstain arises from:
    a. the existence of a relationship affording access to inside information intended to be available only for corporate purposes; and
    b. the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.
3. **g/r:** one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to disclose.
    a. The <u>duty to disclose arises</u> when one party has information that the other party is entitled to know because of a fiduciary or similar relation of trust and confidence between them.
    b. The SEC has recognized a relation of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their positions within the corporation.
    c. This relationship gives rise to a duty to disclose because of the necessity of preventing a corporate insider from taking unfair advantage of the uninformed minority of shareholders.
4. **g/r:** federal courts have found violations of §10(b) where corporate insiders used undisclosed information for their own benefit.
    a. The cases have emphasized in accordance with the common law rule, that the party charged with failing to disclose market information must be under a duty to disclose it.

*[*Chiarella v. US*].

D. **G/R:** No Duty to Disclose: a purchaser of stock who *has no duty to a prospective seller because he is neither an insider or fiduciary* has no obligation to reveal material facts [*Chiarella v. US*].

D(1). **G/R:** Fiduciary Duty: there can be no duty to disclose where the person who has traded on inside information was not the corporation's agent; and hence, was not a fiduciary or was not a person in which the sellers of securities had placed their trust and confidence.

1. Not to require such a fiduciary relationship would depart radically from the established doctrine that duty arises from a specific relationship between two parties and would amount to recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.
2. In other words, a duty to disclose arises from the relationship between parties and not merely from one's ability to acquire information because of his position in the market.

*[*Dirks v. SEC*].

E. **G/R:** Timing of Disclosure: the timing of disclosure is a matter for the business judgment of corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and the SEC.

1. Where a corporate purpose is served by withholding the news of a material fact the person who owe a fiduciary duty to the corporation must no deal personally in the corporation's securities or give outsiders confidential information not generally available to all the corporation's stockholders during the period of non-disclosure.

*[*SEC v. Texas Gulf*].

F. **G/R:** Permissible Insider Investments: an insider can invest in his own company, although he is more familiar with the company's operations than outsiders.

1. *Duty:* an insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if the extraordinary situation is disclosed.
2. An insider is not obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions.

*[*SEC v. Texas Gulf*].

G. **G/R:** Silence as a Manipulative or Deceptive Device: §10(b) does not state whether silence may constitute a manipulative or deceptive device. §10(b) was designed as a catchall clause to prevent fraudulent practices; therefore, when the allegation of fraud is based on nondisclosure there cannot be fraud unless there is a duty to speak. If there is no duty to speak, the duty to disclose under §10(b) does not arise from the mere possession of nonpublic market information [*Chiarella v. US*].

H. **G/R:** Policy and Objectives: the policy of Rule 10B-5 is the implementation of the congressional purpose that all investors should have equal access to the rewards of participation in securities transactions.

1. It was the intent of congress that all members of the investing public should be subject to identical market risks.
2. The only regulatory objection is that access to *material information* be enjoyed equally, but this objective requires nothing more than basic disclosure of fact so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of insiders.

§6.2: TIPPER-TIPEE LIABILITY

A. **G/R:** Tippees: tippees of corporate insiders are liable under §10(b) because they have a duty not to profit form the use of inside information that they know is confidential or know, or should know, came from a corporate insider.

1. The tippees obligation has been viewed as arising from his role as a participant after the fact in the insiders' breach of fiduciary duty.
*[*Chiarella v. US*].

B. **G/R:** Tippee Liability: not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.

1. Similarly, the transaction of those who knowingly participate with the fiduciary in such are *as forbidden* as transactions on behalf of the trustee himself.
2. The tippees obligation has been viewed as arising from his role as a **participant after the fact** in the insider's breach of a fiduciary duty.
*[*Dirks v. SEC*].

C. **G/R:** Derivative Duties of Tippees: some tippees assume an insiders duty to the shareholders, not because they receive inside information, but rather because it was made available to them improperly.

1. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information *only when the insider has breached his fiduciary duties to the shareholders by disclosing the information to the tippee* and the tippee knows, or should know, that the has been a breach.
    a. Relation Back: tippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information.

*[*Dirks v. SEC*].

D. **G/R:** Determining Tippee Liability: in determining whether a tippee is under an obligation to disclose or abstain, it thus in necessary to determine whether the insider "tip" constituted a breach of the insider's fiduciary duty.

1. All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders; however, a corporate insider *does breach his fiduciary duty* when the use of the information is for **personal advantage.**

D(1). **Personal Benefit Test:** the test is whether the insider will personally benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders by the corporate insider.

1. Absent a breach by the insider, there is no derivative breach by the tippee and therefore no liability.
2. *Factors:* scienter in some cases is relevant to determining whether a tipper has violated his corporate fiduciary duty; but it is *not* dispositive. To determine whether the disclosure itself deceives, manipulates, or defrauds shareholders in violation of §10(b) the initial inquiry is

whether there has been a breach of duty by the insider. The requires the courts to focus on **objective criteria**:

a. whether the insider receives a direct or indirect personal benefit from the disclosure, such as:

i. pecuniary gain;
ii. reputational benefit that will translate into future earnings;
iii. selling the information to its recipient for cash, reciprocal information, or other things of benefit to himself;

b. There are objective facts and circumstances that often justify such an inference, e.g., there may be a relationship between the insider and the recipient that suggest a quid pro quo from the latter, or an intention to benefit the particular recipient.
c. The element of fiduciary duty and exploitation of non-public information also exist when an insider makes a gift of confidential information to *a trading relative or friend*.
*[*Dirks v. SEC*].

E. **G/R:** Lawyers (and other fiduciaries) as Temporary Insiders: under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, *lawyer*, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.

1. When such a person breaches his fiduciary duty, and discloses that confidential information, he may be treated more properly as a tipper than a tippee.
2. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information *confidential*, and the relationship must imply such a duty.
*[*Dirks v. SEC*].

F. **G/R:** Improper Purpose Requirement: only when disclosure is made for an *improper purpose* will such a "tip" constitute a breach of the insider's duty, and only when there has been a breach of an insider's duty which the tippee knew, or should have known, constituted such a breach will there be tippee liability sufficient to constitute a violation of §10(b) and Rule 10b-5.

1. A disclosure is made for an improper purpose when an insider personally will benefit, directly or indirectly, from his disclosure.

a. Absent some personal gain, there has been no breach of duty to the stockholders;
b. And absent a breach by the insider to his stockholders there is no derivative breach by the tippee.

*[*SEC v. Switzer*].

G. **G/R:** Eavesdropping: Rule 10b-5 does not bar trading on the basis of information inadvertently revealed by an insider *[*SEC v. Switzer*].

H. **G/R:** Test for Tippee Liability: there is a two prong test for determining whether a tippee has acquired a fiduciary duty:

1. It must be shown that an insider breached a fiduciary duty to the shareholders by disclosing inside information for personal benefit; and
2. it must be shown that the tippee knew, or should have known, that there had been a breach by the insider.
*[*SEC v. Switzer*].

§6.3: THE MISAPPROPRIATION THEORY

A. **G/R:** Classical/Traditional Insider Trading: under the traditional or classical theory of insider trading liability, §10(b) and Rule 10b-5 are violated when a corporate insider trades in securities of his corporation on the basis of *material nonpublic information*.

1. Trading on such information qualifies as a deceptive device under §10(b) because a relationship of trust and confidence exists between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.
    a. The relationship gives rise to a duty to **disclose or to abstain from trading** because of the necessity of preventing a corporate insider from taking unfair advatge of uninformed stockholders.
2. The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorney's accountants, consultants and others who *temporarily* become fiduciaries to the corporation.
3. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts.

*[*US v. O'Hagen*].

B. **G/R:** Misappropriation Theory: the misappropriation theory holds that a person commits fraud "*in connection with*" a securities transaction, and thereby violates §10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.

1. Under this theory, a fiduciary's ***undisclosed*** self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality defrauds the principal of the *exclusive use of the information*.
2. Instead of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned trader's deception of those who entrusted him with access to confidential information.
3. The misappropriation theory outlaws trading o the basis of nonpublic information by a **corporate outsider** in breach of a duty owed not to the trading party, but to the source of information.
    a. The misappropriation theory is thus designed to protect the integrity of the securities markets against abuses by *outsiders* to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's stockholders.
4. *CAVEAT:* because the deception essential to the misappropriation theory involves deceiving the source of information, if the fiduciary *discloses to the source that he plans to trade on the nonpublic information* there is no deceptive device and thus no §10(b) violation—although he still may be liable for breach of the duty of loyalty under state law.
    a. Where however a person trading on the basis of material non-public information owes a duty to two entities or persons—for example a law firm and a client—but makes disclosure to only one, the trader may still be liable under the misappropriation theory.

*[*US v. O'Hagen*].

**Don't forget that under §10(b) the scienter requirement must be satisfied, that is true under the misappropriation theory also.

§6.4: RULE 14e-3

A. **SEA §14(e):** it shall be unlawful for any person to make any untrue statement of material fact or to omit to state any material fact…in connection with a **tender offer** or request or invitation for tenders…The Commission shall…prescribe means reasonable designed to **prevent** such acts and practices as are fraudulent, deceptive, or manipulative.

B. **Rule 14e-3(a):** If any persons has taken a *substantial step or steps* to commence, or has commenced, a **tender offer** (the "offering person"), it shall constitute a **fraudulent, deceptive, or manipulative** act or practice within the meaning of section §14(e) of the [SEA] for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is ***nonpublic*** and which knows or has reason to know has been acquired directly or indirectly from:

> **(1)** the offering person;
> **(2)** the issuer of securities sought or to be sought by such by such tender offer; or
> **(3)** any officer, director, partner or employee of any other person acting on behalf of the offering person or such issuer,

to *purchase or sell*…such securities…*unless* within a reasonable time prior to any purchase or sale such information and its source are publicly **disclosed** by press release or otherwise.

C. **G/R:** Disclose or Abstain from Trading Requirement: §14(e) prohibits fraudulent acts in connection with tender offers. Rule 14e-3(a) is a disclose or abstain from trading requirement.

> 1. One violates Rule 14e-3(a) if he trades on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired directly or indirectly from an insider of the offeror or issuer, or someone working on their behalf.
> 2. Rule 14e-3(a) is disclosure provision—it creates a duty in those traders who fall within its ambit to *disclose or abstain from trading*, without regard to whether the trader owes a preexisting fiduciary duty to respect the confidentiality of the information.
> **[*US v. O'Hagen*].

D. **G/R:** Possession Rule: Rule 14e-3(a) is not analogous to §10(b), but only specifically applied to tender offers; rather, the SEC has more power under Rule 14e-3(a) because §14(e) says that the commission shall have the power to **prevent** such practices.

> 1. Thus, the SEC may prohibit acts, not themselves fraudulent under the common law or §10(b), if the prohibition is *reasonably designed to prevent* acts and practices that are fraudulent.
> *[*US v. O'Hagen*].

E. **G/R:** Rule 14e-3(a) "Substantial Steps Requirement": Rule 14e-3(a) attaches only when a "substantial step" or steps have been taken to accomplish a tender offer; such as:

> 1. retaining a consulting firm;
> 2. signing confidentiality agreements; and
> 3. holding meetings between top officials.
> *These steps and the like satisfy the substantiality requirement of Rule 14e-3.
> **[*SEC v. Mayhew*].

§6.4: CAUSATION

A. **G/R:** Elements of Causation: proof of causation for insider trading under Rule 10b-5 and §10(b) encompasses two related, yet distinct elements—reliance and causation. To satisfy the causation element requires a showing of:

1. *Transaction Causation:* (sometimes called "causation in fact" or "but for causation") the violations caused the plaintiff to engage in the transaction; and
2. *Loss Causation:* (the "proximate/legal" causation of securities law) the violation caused the plaintiff's alleged economic loss.

*[*Litton Industries, Inc. v. Lehman Bros*].

B. **G/R:** Transaction Causation: it two instances, the plaintiff will be entitled to a rebuttal presumption of transaction cause, which will also suffice to satisfy the reliance requirement:

1. If a plaintiff's claim is based on a defendant's failure to disclose material information transactional causation will *be presumed* (this presumption is rebuttable) because in such situations, the plaintiff is unaware of the omitted information and the record generally fails to provide a basis from which a finder of fact may evaluate how the plaintiff would have reacted if he would have been aware of the withheld information [*Affiliated Utes*];
2. A second *rebuttable presumption* arises to establish transaction causation by means of the "fraud on the market" theory, which permits a plaintiff to rely on the integrity of open, well-developed markets rather than requiring proof of direct reliance on the defendant's conduct, which ordinarily would be difficult to come by given the difference between today's market and the face-to-face transactions underlying common law fraud cases [*Basic v. Levinson*].

*A presumption is thus appropriate in at least these two types of situations due to the extreme difficulty in demonstrating transaction causation.

**[*Litton Industries, Inc. v. Lehman Bros*].

C. **G/R:** Loss Causation: the plaintiff, in an insider trading case dealing with tender offers, must establish two things in order to demonstrate loss causation (there are no presumptions):

1. the plaintiff (acquiring/aggressor company) must establish that absent insider trading in the target company's (the company that is sought to be taken over) stock, the plaintiff would have acquired the *target company at a lower price*; AND
2. that the insider trading was a *substantial factor* in the target company's board's assessment of acquiring company's offers.

*[*Litton Industries, Inc. v. Lehman Bros*].

§6.5: DAMAGES

A. **Generally:** in determining the appropriate measure of damages to be awarded to the outside uninformed investor as the result of tippee-trading through use of information that is not equally available to all investors, it must be remembered that investors who trade in a stock on the open market have no absolute right to know inside information. It is the combination of the tip and tippee's trading that possess the evil against which the open market investor must be protected

1. Out of pocket measures of damages, as are typical in normal §10(b) cases are not appropriate in insider trading cases.

*[*Elkind v. Ligget & Meyers*].

B. **G/R:** Insider Liability: insider traders selling on inside information are liable to those who bought on the open market and sustained "substantial losses" during the period of insider trading [*Elkind v. Ligget & Meyers*].

C. **G/R:** Disgorgement Measure of Damages: the disgorgement measure of damages is what is typically used in measuring damages for insider trading violations.

1. The disgorgement measure of damages:
    a. allows any uninformed investor, where a reasonable investor would either have delayed his purchase or not purchased at all if had the benefit of the tipped information, to recover any post-purchase decline in the market value of his shares up to a reasonable time after he learns of the tipped information or after there is a public disclosure of it; ***BUT***
    b. limit his recovery to the amount gained by the tippee or other violator of the insider trading prohibition as a result of his selling at the earlier date rather than delaying his sale until the parties could trade on equal informational basiss.
    c. Should the intervening buyers, because of the volume and price of their purchases, claim more than the tippee's gain, their recovery (limited to that gain) would be *pro rata*.
        i. This is helpful to defendants because it puts a cap on the plaintiff's recovery; namely, the ill-gotten gain of their illegal activity.
2. For a plaintiff to recover, he is simply required to prove:
    a. the time, amount, and price per share of his purchase;
    b. that a reasonable investor would not have paid as high a price or made the purchase at all if he had the information in the tippee's possession; and
    c. the price to which the security has declined by the time he learned the tipped information or at a reasonable time after it became public, whichever event first occurred.

*[*Elkind v. Ligget & Meyers*].

D. **SEA §20A: (a)** provides an express right of action on behalf of "contemporaneous traders" who were trading the same class of securities on the opposite side of the transaction during the time that the allegedly illegal inside trades occurred.

1. Thus, the plaintiff to recover under this express right of action, must be trading contemporaneously with and on the opposite side of the transaction from the insider trader.
2. Moreover, under **§20A(b)** the damages available in an action instituted under §20A on behalf of contemporaneous trades are limited to the profit gained or loss avoided by the defendant's illegal trades (in other words, §20(b) codifies the disgorgement measure of damages.

E. **G/R:** Treble Damages: the SEC has authority under the Insider Trading Sanctions Act of 1984 (ITSA) to seek civil penalties against persons—individuals and firms—who commit insider trading. Violators may be liable for three times the profit gained or loss avoided as a result of their trading whil in possession of material nonpublic information.

F. **Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA):** under ITSFEA Congress again increased the civil and criminal liability for insider traders and it also expanded liability over "controlling persons."

1. **SEA §20(a):** "Controlling Persons" are persons who, directly or indirectly, control any person liable under any provision of the SEA, which may include not only employers, but any person who with power to include or control the direction or management, policies, or activities of another person.

2. Under ITSFEA a court can impose penalties on a controlling person of a primary violator only if:

a. the controlling person knew or acted in reckless disregard of the fact that the controlled person was likely to engage in illegal insider trading; and

b. the controlling person failed to take adequate precautions to prevent the prohibited conduct from taking place.

3. A controlling person has an affirmative duty to take appropriate action once he knows that that the controlled person is engaging in insider trading or tipping.

4. *Compliance Programs:* thus, the board of directors of a corporation must put into effect a compliance program (stating that illegal trading is illegal, possibly erecting Chinese Walls between different divisions in the firm, etc…) because under the Federal Sentencing Statutes is *greatly reduces* the amount of liability (like from a $1-million to a $100K). It is probably negligence for an attorney not to make sure his corporate client has a compliance program in effect.

G. **G/R:** Bounties: Congress also enacted a section which allows the SEC to award payments to persons who provide information concerning insider trading violations—up to 10% of the penalty imposed or settlement reached.

§6.4: SHORT SWING TRADING: SEA §16

A. **SEA §16:** applies to directors, officers, and beneficial owners of more than 10% of of any class of equity security of an issuer (other than exempted security) with such class of equity security being registered under §12(b) or (g). It seeks to deter insider trading based on the use of material nonpublic information by such persons.

(a) Requires that upon becoming an officer, director, or 10% equity shareholder of an issuer, such individual must file with the SEC a report disclosing the number of the corporation's shares beneficially owned, and subsequent reports must be filed thereafter.

(c) Prohibits such insiders from transaction short sales in their issuer's equity securities.

(b) Is designed to permit the corporation or a security holder bringing an action on behalf of the corporation to recover for the benefit of the corporation short-swing profits arising from the purchase and sale (or sale and purchase) by insiders within an **6-month period** of equity securities in the company.

--Under §16(b) an *irrebuttable presumption* is created when "insiders" engage in such short-swing transactions. The profits that the insider gained from the transactions are recoverable by the issuer in a suit initiated by it.

--In other words, it is very mechanical provision, and there is no scienter requirement: if an officer, director, or 10% beneficial owner sells and buys, or buys and sells, during the 6-months, he will have to disgorge the amount made.

§7: <u>ISSUER AFFIRMATIVE DISCLOSURE OBLIGATIONS</u>

§7.1: OVERVIEW

I. <u>INTRODUCTION</u>

A. **Generally:** with certain exceptions, there is no affirmative duty for an issuer to disclose material nonpublic information. Despite the unwillingness of the courts and SEC to recognize such a general mandate, there exist issuer affirmative disclosure requirements in a number of specific circumstances:

1. when SEC rules and regulations require disclosure of specified information;
2. when mandatory disclosure of forward looking statements is called for by Item 303 of Regulation S-K which pertains to MD&A;
3. when the issuer is purchasing or selling its securities in the markets;
4. when the information revealed by the issuer contains a material disclosure deficiency at the time that the statement was made; under such circumstances, there exists a duty to correct;
5. when the issuer previously has made a public statement that, although accurate when made, continues to be "alive" in the market place and ahs become materially false or misleading as a result of subsequent events; under such circumstances, a duty to update may exist; and
6. when material information has been leaked by, or rumors in the marketplace are attributable to the issuer.

B. **Item 303(a):** for reports on Form 10-K, Item 303(a) requires the registrant to discuss the liquidity, capital resources, and results of operations of the registrant and to provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition, and results of operations.

1. **Item 303:** <u>MD&A Release:</u> the MD&A should contain a discussion of all the material impacts upon the registrant's financial condition or results of operations, including those arising from disclosure provided elsewhere in the filing.
    a. The MD&A requirements are intended to provide, in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrants prospects for the future.
        i. In other words, the MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company

B(1). <u>Prospective Information:</u> several specific provisions in Item 303 require disclosure of forward-looking information. The MD&A requires discussions of "known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in an material way.

1. Further, descriptions of known material trends in the registrant's capital resources and expected changes in the mix and cost of such resources are required.
2. Disclosure of known trends or uncertainties that the registrant reasonably expects will have a material impact on net sales, revenues, or income from continuing operations is also required.
3. Finally, the MD&A shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operation results or of future financial condition.
4. **G/R:** The distinction between prospective information that is required to be discussed and voluntary forward-looking disclosure is this:
    a. Both require disclosure regarding (a) the future impact of presently known trends, events or uncertainties and (b) optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required.

i. Required disclosure is based on *currently known trends, events, and uncertainties that are reasonably expected to have material effects.*
ii. Optional forward-looking disclosure involves *anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty.*

5. **G/R:** a disclosure duty exits where a trend, demand, commitment, or event or uncertainty is both presently known to management and *reasonably likely to have material effects* on the registrar's financial condition or results of operation.

C. **G/R:** Test for Determining when Disclosure is Required under the MD&A section of Item 303: where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

1. Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it's not reasonably likely to occur, no disclosure is required;
2. If management cannot make that determination, it must evaluate objectively, the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines a material effect on the registrant's financial condition or results of operations is not likely to occur.

*Where the test for disclosure is met, MD&A disclosure of the effects of such uncertainty quantified to the extent reasonably practicable is required.
**[*In the Matter of Caterpiller, Inc.*].

D. **G/R:** Extent of Disclosure: Regulation S-K requires disclosure of information necessary to understand the registrant's financial statements; that is, management is required to include enough information that investors will have a **complete picture of the company's financial condition through the eyes of management,** and only material information needs to be disclosed [*In the Matter of Caterpiller, Inc.*].

II. DUTY TO DISCLOSE FORWARD LOOKING "SOFT" INFORMATION

A. **Rule 175:** Safe Harbor for Projections: provides a safe harbor from the applicable liability provisions of the federal securities laws fro statements relation to or containing:

1. projections of revenues, income (loss), earnings (loss) per share or other financial items, such as capital expenditures, dividends, or capital structure;
2. management plans and objectives for future company operations; and
3. future economic performance included in management's discussion and analysis of the summary of earnings or quarterly income statements.

A(1). Burden of Proof: the burden of proof is on the plaintiff to establish the absence of reasonable basis and good faith in cases involving the projections of revenues.

1. Rule 175 requires that reasonably based projections be disclosed in good faith.

A(2). Nature of Information Protected by Rule: the scope of the safe harbor rule covers the following types of information:

1. projections of revenues, income (loss), earnings (loss per share);
2. capital expenditures and financing;

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3. dividends and capital structure;
4. statements of management plans and objectives for future operations; and
5. future economic performance included in management's discussion and analysis of the summary of earnings or quarterly income statements.

A(3). Disclosure of Assumptions: the disclosure of assumptions is not mandated under all circumstances; however, under certain circumstances the disclosure of underlying assumptions may be material to an understanding of the projected results.

1. The key assumptions underlying a forward looking statement are of such significance that their disclosure may be necessary in order for such statements to meet the reasonable basis and good faith standards embodied in the Rule.
   a. Because of the potential importance of assumptions to investor understanding and in order to encourage their disclosure, the Rule indicates specifically that disclosed assumptions are also within its scope.

A(4). Persons Covered by the Rule: statements made by or on behalf of an issuer or by an outside reviewer retained by the issuer are covered by the Rule. The existence of relationships between a reviewer and the issuer should also be disclosed.

A(5). Companies Eligible for Protection: the Rule provides protection to:

1. reporting companies under the SEA;
2. non-reporting companies who include forward looking statements in registration statements filed under the SA, such as first time registrants using Form S-1; and
3. non-reporting issuers in Regulation A offerings.

A(6). Duty to Correct: issuers have the responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, where the management knows or has reason to know that its earlier statements non longer have a reasonable basis.

1. Depending on the circumstances, there is a duty to correct statements made in any filing, whether or not the filing is related to specified transaction or event, if the statements either have become inaccurate by virtue of subsequent events, or are later discovered to have been false and misleading from the outset, and the issuer knows or should know that person are continuing to rely on all or any material portion of the statements.

B. **G/R:** Judicial Interpretation of Forward-Looking Statements: forward looking statements need not be correct; it is enough that they have a reasonable basis. Inevitably, inaccuracy in projection does not eliminate the safe harbor; Rule 175 does not say that projections qualify only if firms give ranges and identify the variables that will lead to departure.

1. Rule 175 assumes that readers are sophisticated, can understand the limits of a projection and that if any given reader does not appreciate these limits, the reaction of may professional investors and analysts will lead to prices that reflect the limits of information.
   *[*Wielgos v. Commonwealth Edison*].

III. PUFFING, ATTRIBUTION, AND STATEMENTS OF FACT

A. **G/R:** Statements by Third Parties: The securities laws require a company to speak truthfully to investors; they do not require the company to police statements made by third parties for inaccuracies; even if the third party attributes statements to the Company [*RAAB v. General Physics Corp*.].

B. **G/R:** Sufficient Entanglement Test: there is no liability on a company absent allegations that the company sufficiently entangled itself with the analyst's forecasts to render those predications attributable to it.

1. The converse then, is that if the company sufficiently entangled itself with the analysts predictions, liability will attach.
*[*RAAB v. General Physics Corp*.].

C. **G/R:** Unattributable Statements: statements or reports that are anonymous cannot be held to be attributable to a company for purposes of §10(b) liability; this is because FRCP 9(b) requires fraud to plead with particularity and if the plaintiff does not know the identity of the speaker who made allegedly false and misleading statements they can not be imputed on the corporation [*In Re Time Warner Securities Litigation*].

D. **G/R:** Attributable Statements: statements made by corporate directors, at press conferences and to the media, the statements can provide the basis for liability. Where the disclosure duty arises from the combination of a prior statement and a subsequent event, which, if not disclosed, renders the prior statement false or misleading, the inquires as to duty and materiality coalesce [*In Re Time Warner Securities Litigation*].
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E. **G/R:** Future Earnings: the SEC has adopted a "safe harbor rule" for projections, under which a statement containing a projection of revenues and earning would not be considered to be materially misleading misstatement or omission for purposes of liability under the federal securities laws provided the statement was prepared with a reasonable basis and was disclosed in good faith.

1. Soft information such as asset appraisals and projections must be disclosed only if the reported values are virtually as certain as hard facts.

F. **SEA §23(a):** provides that no liability under the federal securities laws shall be imposed for any act done or omitted in *good faith* conformity with a rule, regulation, or order of the Commission.

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