Most securities regulation covered in class are derived from the Securities Act of 1933 and the Securities Exchange Act of 1934.

Overview of Raising Capital

Funding a business often means selling parts of the ownership to a third party. Depending on the type of sales, there are

- Public offering
- Private offering

Let's first go over the concept of securities.

Securities

Important

Definition 4.1: Securities

Securities are fungible and tradable **financial instruments** used to raise capital in public and private markets.

Broadly, securities include

- Normal stocks and bonds
- Investment contracts
- **Family resemblance test**: if any of the following is true, then the note is **NOT** a security
  - Consumer financing notes, such as short-term loans
  - Personal financing, such as mortgages

In determining whether if a financial instrument falls under the hood of securities, SEC also relies on what's known as the Howey Test.

Important

Definition 4.2: Howey Test

The Howey Test states that securities are an **investment** of money in a common **enterprise** with **profits** to come **primarily from** the efforts of others.

Note that wording about profits has now changed from "completely" to "primarily".

The key characteristics here are

1. An investment of money
    - That means **NOT** consumption or expenditure
2. Common enterprise
    - To achieve this we need either **horizontal commonality** or **vertical commonality**
        - **Horizontal commonality**: **two or more investors** who **pool** their contributions and receive profits on a pro-rata basis
            - Same risk profile across shareholders
        - **Vertical commonality**: a **common interest** between the **investor** and the **promoter** or third party such that the fortunes of all investors are tied to the expertise of the promoter or third party
            - Commonality with investment
3. With profits
    - Expected profit also suffices
4. Primarily from the efforts of others

The definition of securities is really important because it is **ILLEGAL** to sell **unregistered securities**.

- In which case investors can claim 100% of their investment - no down side and infinite up side

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Private Offering

This is the more common way to raise capitals in corporate America. Only about 1% of exchanges of securities are in fact public offering, and most US companies are **NOT** listed on the public stock exchange.

Important

Definition 4.3: Private Offering

A private placement is a sale of securities to **pre-selected investors** and institutions rather than publicly on the open market.

Most private offerings raise capital under **Rule 506 (b) of Regulation D**. This rule dictates that companies can

- Can sell to an unlimited number of **accredited investors** plus up to 35 non-accredited investors
    - Accredited investors include
        - Any director, executive officer, or partner of the issuer
        - Any individual with at least **$1 million** net worth, excluding primary residence
        - Any individual who earned at least **$200k** each of the last 2 years or joint income with spouse of at least $300k in those years and a reasonable expectation of same in current year
- Must have pre-existing relationship with the investor
- No general solicitation or advertising permitted
    - Combining this with the point above, companies are only allowed selling to pre-existing clients (or their agents)
- Limited disclosure requirements
- No registration required but they must file a form (Form D) with the SEC

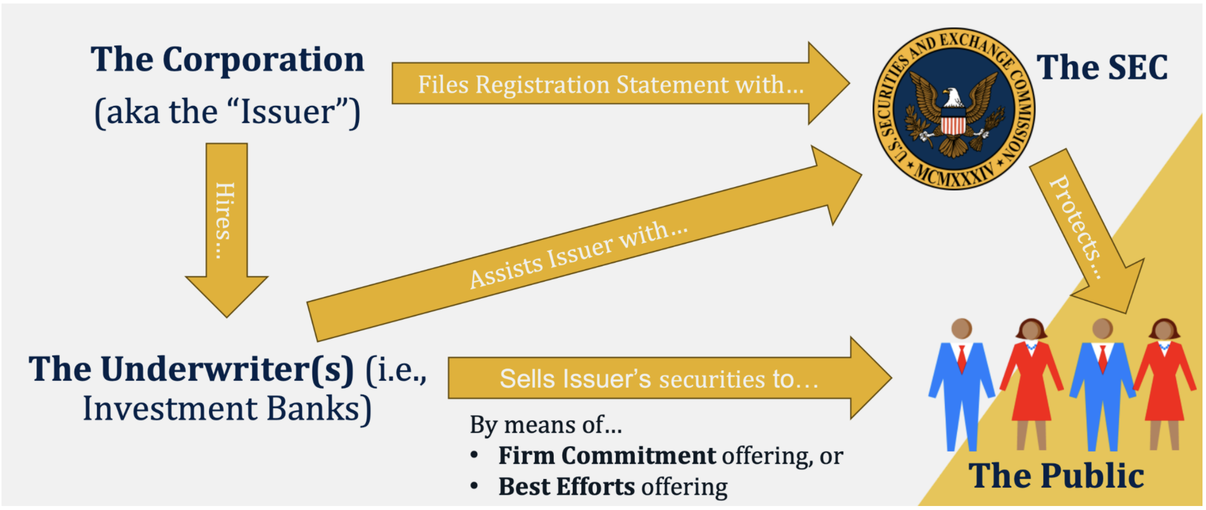
Public Offering

To sell shares to the public, a company needs to go through an **initial public offering**. There are three stages of this process in general.

1. Pre-filing
    - Company hires underwriters (usually IBs)
    - Company/underwriters conduct due diligence
    - Company/underwriters prepare registration statement
2. Filing review
    - Company files Registration Statement with the SEC
    - SEC reviews Registration Statement, provides comments
    - Company maintains quiet period; Underwriters conduct road show
        - Quiet period: to ensure fairness, companies refrain from communicating with investors to **avoid unfairly disclosing material**, non-public information to certain

investors

3. Approval
    - SEC approves Registration Statement
    - Company/Underwriter decided effective date and pricing
    - Underwriters start selling shares on public exchange



Underwriters play a key role in assisting the IPO process especially regarding filing the registration statement. They also sell securities by means of

- **Firm commitment**: Agreement to assume all inventory risk and agreement to purchase all securities for an IPO directly from issuers for public sale
- **Best efforts**: **Does NOT** agree to purchase all of the securities from the issuer but will use their best efforts to act only as an agent to market the securities to investors

Section 11 Claim

This is from the **Securities Act of 1933**. An investor can make a section 11 claim in the scenario where the company screws up its registration statement, such that

- There is **material misrepresentation** or omission in the registration statement
- The purchased shares traced back to the IPO (reliance on the registration statement)

The plaintiff has the right to sue the following parties

- The company
- Underwriters
- Inside directors such as the CEO
- Outside directors
- Officers

A legal tool to help the issuing parties avoid the liability for misstatements in a registration statement is **due diligence**. It is available to directors, officers, underwriters, outside experts, but **NOT** issuers (company).

Use the following chart to determine availability of due diligence.

Defendant	Registration Statement (Non -Expert Portion)	Registration Statement (Expert Portion)
Issuer	Never	Never
Directors & Officers & Underwriters	Defendant must prove: 1. Conducted reasonable investigation, and 2. Reasonably believed statement was true	Defendant must prove: 1. Reasonably believed statement was true
Outside Experts	N/A	Liable for own misstatements

Overview of Securities Enforcement

We have covered the basics of securities in the segments above. Regarding securities enforcements, there are two main branches we will be looking at:

- Raising Capital under the 1933 Act (covered above)
  - Defining a security; selling securities to the public
  - Registration requirements; misstatements and omissions in the **registration statement** by Section 11
  - Only applies to **publicly trade companies** (IPO)
- Obligations of Securities Issuers under the 1934 Act
  - **Rule 10b-5** (i.e. 10b), widely applied **securities fraud** provision that applies to **public and private securities**
  - Prohibitions on insider trading

In general, the **Rule 10b-5** is much broader and covers all kinds of securities, instead of just public companies.

Note

Enforcers of Rule 10b-5

- SEC
- DOJ
- **Shareholders**
  - Usually involves some sort of class action
- Whistle-blower
  - Don't initiate the lawsuit but instead refer it to the government for compensation

For a Section 11 claim, only the investors who purchased their shares through the IPO may file the lawsuit.

Rule 10b-5

Important

Definition 4.4: Elements of a 10-b5 Claim

Private plaintiffs must prove **all** elements:

1. Misstatement or Omission (“M/O”) of a fact
2. M/O must be material
3. M/O made in connection with purchase or sale of security
4. Scienter (M/O was made intentionally or recklessly)
5. Reliance
6. Loss Causation

- (also (7) economic loss and (8) interstate commerce)

Misstatement or Omission (M/O)

Important

Definition 4.5: Misstatement or Omission

Requires the following two elements from the statement of a company:

- Includes any statement made by the company that is **misleading**, even if statement is technically factual

- M/O must be **material**: Would a reasonable investor consider the information important
    - Must be relevant to the investor's decision
    - Statements such as a company's earning and assets are granted material

Puffing (marketing) are usually not viewed as a serious statement.

Companies, however, are usually **NOT required** to make any statements publicly and therefore could avoid misstatements or omission at all.

- Except for public companies who need to disclose financial details
- However, if companies chose **NOT to respond** in the case of a negative rumor, it is deemed essentially helping to spread misleading information

Scienter

This is the equivalent of *mens rea* in criminal laws.

Important

Definition 4.6: Scienter

Requires the following of the statement made:

- Statement was made with **intent** to deceive, manipulate or defraud, **OR**
- Statement was made in reckless disregard of its truth/falsity

Notice that due to the element of **intent**, a negligent yet material statement isn't enough to prove scienter, and nor does a genuine accident.

- However, in these cases, companies have the duty of care to correct the problem when discovered

Reliance, Loss Causation

Important

Definition 4.7: Reliance

There are **TWO** ways to demonstrate reliance:

1. **Direct reliance**
    - Plaintiff directly relies on the misstatement in their decision-making, OR
        - Usually applies to private companies
2. **Fraud on the Market**, for which we would only need:
    - The security is traded in a public market when the statement was made
    - Rationale behind this is the price is the M/O is already reflected in the price

Fraud on the Market turned out to be much easier to prove than direct reliance in most cases.

Important

Definition 4.8: Loss Causations

For which we need to prove **TWO** things:

1. The price of the security **goes up** when the misstatement was published
2. The price of the security **goes down** when the reality was revealed

However, this is usually factually difficult to prove because of the confounding nature of the market.

In short, to bring a security fraud claim if we can prove that the misstatement leads to the actual purchasing/selling of shares.

- This implies that options and futures are excluded from the scope

Rule 10b-5 also sheds lights on the topic of **insider trading**.

Insider Trading

A judge-made law.

Important

Definition 4.9: Insider Trading

A person commits insider trading in violation of Section 10(b) when he/she:

1. Trades on **material, nonpublic information**, and

2. **Breaches a duty** under a theory of insider trading.

That being said, it is **NOT illegal** to trade on private information; it is only illegal in the case that one breaches a duty.

- **Employees** are allowed to trade during a specific **trading window** (usually occurs after the quarterly report)
- **Executives** are allowed to trade, but they'll need to send their trading plan to the SEC at least 60 days in advance
  - Motivation here is to notify the public about this action

There are three main types of insider trading.

Classical Insider Trading

Insider trading that operates as a fraud against the shareholders of the company whose stock was traded.

> **Important**
>
> **Definition 4.10**: Classical Insider Trading
>
> Classical insider trading occurs:
>
> 1. When **an insider of the company** whose stock is being traded
>   - An insider may be “temporary” and not a company employee (e.g., an investment banker, lawyer, etc.)
> 2. Trades while in possession of material, non-public information.

This breaches the **duty of loyalty**.

Misappropriation

Misappropriation insider trading is a fraud, perpetrated by a **non-insider**, against the **source of the trader’s information**.

- Mutually exclusive with the classic insider trading theory

> **Important**

Definition 4.11: Misappropriation

Misappropriation occurs when

1. A trader, who is **NOT an insider** of the company gets material, non-public information
2. From someone to whom the trader owes a **duty not to trade**...
3. And trades anyway

For misappropriation purpose, non-insiders owe the following duties:

- All **applicable fiduciary duties**, plus
- Any duty established by **SEC Rule 10b5-2**

Info

Rule 10b5-2: A trader owes a duty to the source of information in business/personal relations if:

- The trader agrees to maintain confidentiality
- The trader and source have a practice of sharing known confidences, or
- The source of information is the trader's spouse, parent, child, sibling (unless the circumstances indicate that confidentiality is not expected)

Tipping Theory

Important

Definition 4.11: Tipping Theory

Tipping occurs when:

1. A tipper — who is **would've committed classical insider trading or misappropriation** - gives material, nonpublic information
2. In breach of the tipper's duty and for the **direct, or indirect, personal benefit** of the tipper

3. To a tippee, who trades on the information when he or she knows (or should have known) that the information is **material, non-public information** obtained through a **breach of duty**.

Summary

Comparing Security Laws

	Section 11 (1933 Act)	Section 10(b) (1934 Act)
Prohibited Conduct	False or misleading statements or omissions in registration statement	Use of a fraudulent, manipulative, or deceptive device in connection with purchase or sale of securities
Legal Standard	Strict Liability	Scienter
Covered Parties	Issuer; directors; officers; auditors; underwriters	Primary violators; controlling persons; aiders and abettors
Covered Securities	Only registered securities	All securities