Module 4: Regulation Part II: Antitrust and Securities

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Lesson 4.1 Antitrust: Unilateral Restraints of Trade

[Antitrust: Unilateral Restraints of Trade]

This lesson is the first in a series of lessons dealing with antitrust laws. To start in this lesson, we'll talk about what is the concept of antitrust, and what are antitrust laws, and we'll also look at some of the ways in which a company can violate these antitrust laws. In this lesson we're going to discuss antitrust laws, and specifically unilateral restraints of trade. But before we get to unilateral restraints of trade, let's talk about what antitrust laws are. Now in this country there's a strong policy in favor of increased competition. The theory is that the more competition in the marketplace, the better for consumers. So instead of having one company that dominates a marketplace you want to have lots of companies that compete with each other because that's good for the consumers. So the United States Congress has adopted a series of laws called antitrust laws that try to promote competition and prohibit companies from dominating markets too much or harming competition. Now two really important antitrust acts are the Sherman Act of 1890 and the Clayton Act of 1914. Now these are really old, right? They're both over 100 years old but they're still very, very important today. There's been a series of acts since the Sherman Act and the Clayton Act, but these still do most of the heavy lifting in terms of antitrust laws in the United States. So one key prohibition in US antitrust laws have to do with restraining trade. There's two ways that trade can be restrained, by one company acting alone, which is what this lesson is about or by multiple companies acting in concert with one another, which is actually what the next lesson is about.

Unilateral Restraints of Trade

Monopolies

Price discrimination

Tying arrangements

So let's talk about unilateral restraints of trade. How can one company harm competition in the marketplace? Well, there's really three primary ways that a unilateral restraint of trade can be undertaken by a company. First by engaging in a monopoly, second by price discrimination, and third through tying arrangements. So let's look at each of these three in turn.

Illegal Monopoly

Innocent and natural monopolies are OK

Three criteria for an illegal monopoly

- Monopoly power
- A defined market
- A willful act of monopolization

First let's talk about monopolies. A monopoly, If you have ever played the game or just know generally, a monopoly is when one company dominates an industry. There are different forms of monopolies, some are actually okay and some are prohibited by antitrust laws. There's something called an innocent monopoly. An innocent monopoly, its perfectly legal and it just happens because you're the best at what you do and nobody can compete with you and that's fine. So for instance Google dominates the search industry, right? Google is for the most part an innocent monopoly as you could make some arguments that they may have taken some anti-competitive steps to dominate that market. But for the most part, especially in its early days, Google dominated the market because it was just better than everybody else. When you type something into Google, you get what you're looking for. And so Google's search for monopoly is probably an innocent monopoly. A second form of monopoly that's ok is what's called a natural monopoly. A natural monopoly is when something about the market just means that it can only support one player. So for instance, before the days of satellite TV your choices were really get the over the air stations or have cable. But to have cable it meant that a company had to actually run some wires to your house and that was expensive. And most markets could only really support one cable company because the investment required to run all those wires would only be undertaken by a company if they knew that they would have a captive audience. So the cable market prior to satellite TV was pretty much a natural monopoly and that was all right. But there are also illegal monopolies. In order for a monopoly to be considered illegal there have to be three elements that are met. Now the first is that a company has monopoly power. Monopoly power just means you have the power to dominate an industry or dominate a market. Now how much of a market share do you have to have in order to dominate? That depends on the industry. You know it could be small and it could be very large. When courts look at monopolies, they generally use the rule that if you own 70 percent of the market share in a market, that's sort of prima facie evidence that you dominate that market. But it could be less, It could be more, it depends on your market. Second element that must be present is what's called a defined market. So do you dominate the market in the entire country for your product or just in a small geographic region. You can have an illegal monopoly that's confined to a smaller geographic region. Then the third, the big big element required to show an illegal monopoly is what's called a willful act of monopolization. This means you take some affirmative action to try and drive out your competitors. Often it comes in the form of predatory pricing which means pricing your products below what it even costs you to manufacture them or to purchase them just for the purpose of driving out your competition.

Price Discrimination

Price discrimination – Different prices charged to similarly situated buyers of goods

What does it mean to be similarly situated?

Okay, the next form of unilateral restraint of trade that is prohibited by antitrust laws is called price discrimination. Price discrimination is when one company charges different prices for the same products to different customers who are similarly situated. So for example, if I go into a coffee shop and order a cup of coffee and they charge me two dollars for it and then the person behind me in line orders the exact same thing and they charge them four dollars for it, that's price discrimination. We are similarly situated. We're both customers coming in to buy the exact same thing at the exact same location of the exact same business. That's illegal price discrimination. Now the customers have to be similarly situated. So for example, a coffee shop can charge a different price to me here in Champaign, Illinois than it does to a customer in New York City because their operating expenses are different. They can charge me two bucks here and four bucks in New York City and that's fine because we're not similarly situated customers in different locations.

Defenses to Price Discrimination Claims

Meeting the competition

Cost justification

Changed conditions

Now when a company is accused of engaging in price discrimination, they actually have some defenses much of the time. One defense to price discrimination claims is when a company changes its price to meet the competition. So for instance I buy a cup of coffee for two dollars and then later that same day they change their price to a dollar fifty because they heard that the coffee shop across the street changed its price to a dollar fifty. That's fine. You can always change your price to meet the competition, even if it results in different prices being charged to consumers. Next defense to price discrimination is what's called cost justification. If I buy one widget for $10 and a company sells the exact same widgets to somebody else, but they buy 10,000 widgets for five dollars each, well, we're similar customers, we're both buying the same product, maybe in the same location from the same manufacturer, but they have a cost justification. They can achieve savings because of the huge scale of a 10,000 widget purchase versus my one widget purchase, so it's okay for them to charge different prices in that case. Then the final defense to price discrimination claims is what's called changing conditions. If a product is perishable or loses value, it's okay for the seller to change the price in response to that. So for instance if I buy a car in December of a year for a certain price, and they sell that same model and make and color and all the options the same to another customer in March of the next year, well, you know what? That's now in a model year older car, It's gone down in value its depreciated, so it's okay for them to charge a different price in that situation.

Tying Arrangements

Tying arrangements – Prohibited unless reasonably required

Now the final type of unilateral restraint of trade is what's called a tying arrangement. Tying arrangements aren't super common but you will occasionally see them. And as a general rule a tying arrangement is not allowed unless you can make some sort of argument that it's reasonably required. So what is a tying arrangement? It's when you buy a product and the seller makes you buy some other products in order to buy the product that you really want. Now sometimes this is not allowed. So for instance if you wanted to buy a new mobile phone and the manufacturer of the mobile phone said, we'll only sell you this phone if you also buy this set of headphones to go along with it. That's an unlawful tying arrangement. You don't have to have the headphones in order for the phone to work right, they just want to sell you the headphones. But an example of a legal tying arrangement might be, if you go to purchase a home, your lender, when you take out a loan to buy that home will make you buy homeowners insurance to protect that home. Now that's reasonably related and reasonably required because your lender wants to make sure that if your house burns down, it will be protected in its loan. So a home lender forcing you to also buy homeowners insurance in order to get the loan that you want, is a reasonable tying arrangement. So those are the three main types of unilateral restraints of trade. In the next lesson we'll look at restraints of trade where more than one company come together to harm competition.

Interview with Venture Capitalist

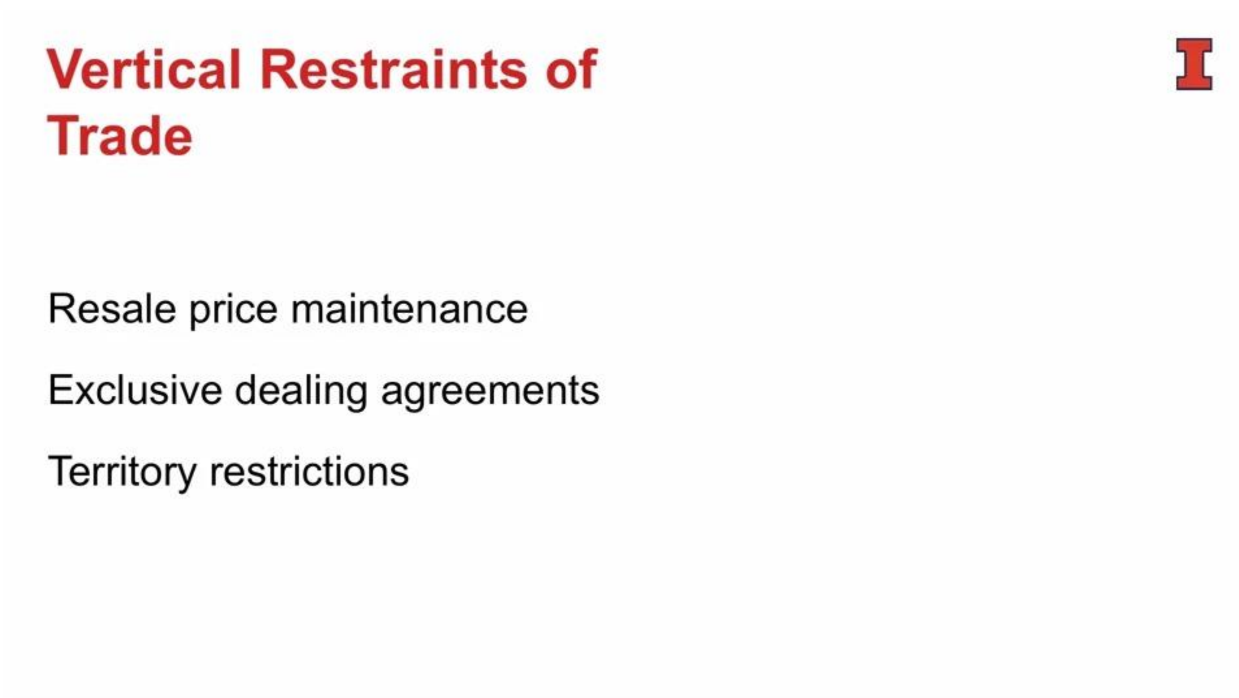
To introduce this module, which deals with antitrust and securities regulation, we have the great privilege to interview Tom Parkinson. Tom Parkinson is a Senior Director of Illinois Ventures, which is a venture capital firm headquartered here in Champagne. Tom is an excellent resource, he's had over 30 years of experience and investments in venture capital. He has his bachelor's and MBA from Northwestern, but he has since made the excellent decision to move down here to Champaign to work with Illinois Ventures. Which works very closely with a lot of firms that have come out of the University of Illinois. So Tom, thank you so much for being here with us today I really appreciate it. >> I'm happy to do it. >> If I could just ask you to start by telling us a little bit about your background, how you chose to become involved with investments and venture capital, that'd be awesome. >> Okay, it's a little bit of a long story, so bear with me. >> Sure. >> So when I was a student in business school, Kellogg, the school I went to, had a program in urban economic development that I was very interested in. And I was lucky enough to get an internship during the summer, working for the city of New Haven, that was building a research park in partnership with Yale University. So I spent the summer working with them to evaluate business plans and opportunities for technology start up companies that were going to be in an incubator as part of that research park and I loved it. And I decided that's what I wanted to do for my career, and then I had the opportunity to operate what started out as a loan fund and then we transitioned in to a very early stage venture capital fund back in Evanstone that North Western was the lead investor in. And that started in the late 80s and so that's when my career in venture capital began. >> Terrific, so now you're here with Illinois Ventures in

Champaign. Could you tell us a little bit about the types of investments Illinois Ventures makes? How you became involved with this firm, and sort of what you most enjoy about investing in small businesses? >> Well, I've been a partner in a traditional venture firm and I've worked at seed capital funds at universities and I really enjoy working with brand new start-ups, students, faculty, new technologies. And so when the opportunity that come to Illinois Ventures became available, I jumped at the opportunity. So Illinois Ventures is the venture capital arm of the university, so we invest only in companies that have a university affiliation. And that might mean that they're commercializing a new invention that some faculty member has come up with at the university, or it may be a start-up company that's being formed by students or recent alumni of the university. But we stay very close to our focus on university affiliated investing, which makes us different from a more traditional venture capital firm. >> Now when Illinois Ventures chooses to invest in a business it obviously, as all venture capital firms do, takes an equity interest in the business most of the time. Can you tell us a little bit about the type of stock that venture capitalists like you usually take and how that transaction works when you invest in a new company? >> Sure, ultimately if a startup company is going to be successful, we want to be an owner of common stock in the business. But it's very risky to purchase common stock at the very outset. So we almost always invest through a convertible security of some sort. Sometimes it's convertible preferred stock or it could be a convertible loan. Or it could be a newer type of convertible security called a safe agreement. But in every case what we want is an investment that will give us some downside protection during the risky early years of the venture. But then give us the opportunity to convert into common stock to participate in the actual real value creation in the company before we exit. >> I know that in your career you've been involved with a few investments that have eventually gone on to have initial public offerings. And I wonder if you couldn't just tell us a little bit about maybe one of those that went public and your involvement with it. However major or minor it might be, and sort of how your firm's investment paid off in that situation? >> Okay, so the thing to keep in mind about venture capital is that initial public stock offerings, while they're usually quite profitable for the investment fund, they're rare and they're few and far between. But when they do happen, you usually have the opportunity to get a very nice return on your investment as an investor in that company. And I've been fortunate enough to be involved in three of those over the course of my career. One of those is Peapod, the computer grocery shopping company that many people have heard of. Another company called Illinois Super Conductor and the most recent one here at Illinois Ventures, that actually happened just before I arrived here, called Mant Quest, which is a bio-technology company. For very early stage investor like Illinois Ventures or the other funds that I've been involved with, most of the time, we're going to be a very small stock holder in the company. By the time the company is advanced to the point and raised enough money and grown enough to the point where it's really ready to be successful with an initial public stock offering. So, I haven't ever had really direct involvement in selecting the bankers or managing the process of the IPO. By that time, there are several other larger venture capital firms that are much bigger investors in the company that are managing that process. >> So if an IPO was somehow of a rare occurrence for a start-up company, as a venture capital firm, what is your more common form of exit strategy? >> Well,most of the time it's going to be an MNA transaction, and there are really two kinds of those that we usually expect to see. One would be a strategic acquisition where if you've got a technology company that's developed an interesting new product or a new innovation. Some large operating company in that industry wants to acquire that technology and bring that technology in house that's a strategic acquisition. And the other would be a financial transaction where you're selling to a private equity firm, another larger financial investor, who is also looking to acquire the company, grow value in that company. But then they'll be looking to sell that company again some number of years into the future. >> Now I know that as your venture firm raises its own capital to make these investments, you have some rules and regulations promulgated by the Securities and Exchange Commission that you have to be aware of. What's your interaction with the SEC when you're raising funds and how do you navigate those rules? >> Well, when you're raising money for a venture capital firm, you have to be very careful to make sure that you're complying with SEC rules. This is the same whether you're raising money for a venture fund, or whether you're raising money from entrepreneurial company. If you run a file of someone of the CES's regulations, you can end up with a lot of legal bills and accounting bills that are involved in trying to fix the problems that you've created, and you can also create problems with your shareholders. For a venture firm, what we have to really be focused on is making sure that we are not conducting what could ever be considered to be a public offering of securities usually limited partnership interest in our venture capital fund. So we have to be very careful in how we solicit money it has to be done privately not publicly. And that means that we can't just like most companies can't just take out an ad in the paper that says we're looking for money, please send your money. That, would get us in trouble with the SEC pretty quickly, so we have to make sure were only soliciting investors that are qualified investors. If they're individuals, they have to be whats called accredited investors, which means they have to meet certain income and net worth guidelines to suggest that they are financially capable of responsibly making a risk investment like an investment in a venture capital fund would be. And we have to limit the number of people that we reach out to so that we don't end up having our offering be treated by the SEC as if it were a public offering, which would mean we'd have to register, and that would be very expensive. >> Terrific, and it sounds to me like you take advantage of the private placement exemption when you are raising funds. >> That's right and there's also what's called a venture capital operating company exemption that we rely on for a lot of things as well. >> Terrific, well, Tom, thank you so much for taking the time to sit down for this interview with me, I really appreciate it. On behalf of my students I thank you for all of the wonderful insight you've shared with us today. >> I'm happy to do it. I've really enjoyed having a career as a early stage venture capitalist working with students, working with faculty, and working with new innovations. It's an exciting way to make a living, and I'm happy to help out in a course like this however I can.

Lesson 4.2 Antitrust: Horizontal & Vertical Restraints of Trade

[Antitrust: Horizontal & Vertical Restraints of Trade]

In this lesson, we continue our discussion of antitrust laws by looking at cases where more than one company come together to harm trade. Specifically, we'll be looking at horizontal and vertical restraints of trade. [MUSIC] In the last lesson, we looked at ways that one company can act alone to violate antitrust laws. In this lesson, we're going to take a look at the ways at which multiple companies can come together to violate antitrust laws. Specifically, we're going to look at horizontal and vertical restraints of trade. So what does that mean? A horizontal restraint of trade is when two competitors in the same industry act together to somehow harm consumers. And there's four main ways that companies do this. The first is what's called price fixing. Price fixing is when two competitors get together and agree to sell their products at a certain price. And this is illegal. So an example of this happening, Apple, the iPhone manufacturer, was actually found liable for price fixing when it released its iBooks app. Because when it created iBooks, it went to all the major publishing companies in the United States and said, we want to publish your books on iBooks, but you have to sell it for the price that we tell you to sell it for. And that was actually illegal price fixing. The publishers, under the law, needed to be free to sell their books on iBooks or whatever they chose to sell them for. The second form of horizontal restraint of trade is called division of markets. So, if Coke and Pepsi decided, we're tired of fighting each other, all this advertising money, it's making us poor. Let's just split up the United States and then we can all get rich. So Coke says we'll take all the markets east of the Mississippi River. Pepsi, you can have all the markets west of the Mississippi River. That's division of markets, and that's an unlawful horizontal restraint of trade. Next, is what's called bid rigging. Bid rigging is when a group of companies that are involved in making bids as a result of a request for proposal, get together to decide who gets the bid each time. So, for instance, say the government puts out a request for proposals for a company to build our next generation fighter jet for the military. Well, if multiple military contractors are thinking of submitting bids, it takes a lot of time and money to submit a bid. So maybe they all get together and they say, okay, for this round, Lockheed Martin, you guys can win, so the rest of us will all submit unrealistic bids so that Lockheed Martin could win. And the next round they all say, okay, Lockheed, you won this time, so this time Raytheon gets to win this government contract. That's an unlawful horizontal restrain of trade. The final form of Horizontal Restraints of Trade is a group boycott. This is when all the competitors or multiple competitors in one level of the market place get together to boycott usually a supplier. So say, for instance, that I own a ice cream company and I think milk is too expensive. So I get together with other ice cream manufacturers, and we all agree to boycott certain milk producers until they lower their prices. That's a group boycott and that is an unlawful horizontal restraint of trade.



So let's talk about Vertical Restraints of Trade. Whereas a Horizontal Restraint of Trade is an agreement between competitors on the same level in the marketplace, a Vertical Restraint of Trade is an agreement between parties on different levels in the chain of production. So, for instance, the first type of Vertical Restraint of Trade is what's called resale price maintenance. If I'm a manufacturer of goods, and I sell those goods to a retail store, I can't tell the retailer how much they have to sell those goods for. So for example, if I'm General Motors and I sell cars to a local Chevrolet dealership, which General Motors does, I can't tell them how much they have to sell those cars to the public for. Now, I can suggest it. And, in fact, car companies do. If you go to the car dealership you see on a car the MSRP. Stands for manufacturer's suggested retail price. That's how much I say the car should sell for, but the dealership is free to sell it for whatever it wants. And, in fact, if you pay MSRP on your car, you're probably getting a bad deal. Most people know that. So the manufacturer cannot control how much a retailer sells the product for. That is called resale price maintenance. Next form of Vertical Restraint of Trade is called exclusive dealing agreement. Now, an exclusive dealing agreement is when I say, you can do business with me, but only if you don't do business with somebody else. And those are generally illegal if they harm competition. So as an example, Intel is a well known manufacturer of computer chips. In the 1990s, they were actually found to have violated antitrust laws by offering big rebates to computer manufacturers who agreed to use only Intel's chips and not buy chips from their competitor, Advanced Micro Devices, or AMD. This is an unlawful exclusive dealing agreement. And then, the final form of Vertical Restraints of Trade are called territory restrictions. Now, territory restrictions are okay if they're reasonable, but if they unreasonable, they violate antitrust laws. So, for example, if I'm a franchisor, and I'm selling a franchise to a local business to operate a franchise. So, I'm McDonald's, headquartered up in the Chicago area, in Illinois. And I'm selling a franchise to somebody to open a McDonald's store, it's reasonable for me to grant them a territory restriction of some small radius around their store so that they don't have to fight with other McDonald's stores. But it would be unreasonable if they demanded a territory restriction of all of the United States, or something outside their reasonable scope of doing business. So those are the forms of Vertical Restraints of Trade. In our next lesson, we'll look at how mergers can sometimes have antitrust implications.

Lesson 4.3 Antitrust: Mergers

Antitrust: Mergers

In this lesson, we will discuss the antitrust implications of mergers. What types of mergers will cause the government to stand up and say, "Hey this might take competition out of the marketplace." Why do we care about mergers and acquisitions from an antitrust perspective? Well, when two companies merge, you're taking competition out of the marketplace, right? We know that the policy of the United States is, the more competition, the better. So, mergers by taking competition out of the marketplace, can often have negative results for consumers. So depending on the type of merger that two companies are undergoing, the government may have more or less interest in scrutinizing the merger and sometimes even blocking the merger. So what are the different types of mergers that the government will look at? Well, the first is called a horizontal merger. This is when two companies that are direct competitors in a marketplace agree to merge with one another, and this gets the highest level of scrutiny and that makes sense, right? You're directly taking competition out of a marketplace in a horizontal merger. Now sometimes it will be allowed and sometimes the government will try to block it. So for example, Office Depot and Office Max were two separate office supply stores they decided to merge. That got a lot of scrutiny from government regulators but it was actually eventually allowed to go through, because of an exception that we'll see here in just a minute. Second type of merger one step down from a horizontal merger, is a vertical merger. This is when two companies on different levels in the same supply chain agree to merge with one another. So for example, if

McDonald's decided to merge with a cattle ranch, this would be a vertical merger, right? McDonald's buys beef from a cow cattle ranch. It doesn't get as much scrutiny as a horizontal merger. You're not directly taking any competition out of the marketplace. The real danger with the vertical merger is if other competitors might be harmed. So if McDonald's merges with the cattle ranch and then says, "Oh this cattle ranch isn't going to sell to other competitors that it used to sell to or it's going to raise its prices for other competitors." That's the real danger with a vertical merger. Now the third type of merger is called a market extension merger, and this again, doesn't get a whole lot of scrutiny, certainly not as much as a horizontal merger. In a market extension merger, two companies have complimentary products or compete in different geographic locations and they decide to merge to gain some economies of scope or economies of scale, things like that. So for example, if I sell a beverage only in a limited geographic market like, I only sell my beverages in the Midwest, and there's another company that sells the same type of beverage in the southeast. We say, "Hey why don't we merge, we can achieve some marketing efficiencies, we can achieve some operational efficiencies." That's a market extension merger. They're usually not heavily scrutinized because again, they're not taking competition out of the marketplace. Then the final form of merger which receives almost no scrutiny is what's called a conglomerate merger. So for example, if I manufacture cars and another business manufactures ice cream and we decide to merge with one another, well those have nothing to do with one another. So, a merger between two companies to form a conglomerate that produces products or services that don't compete in anywhere near the same market is a conglomerate merger and the government usually will allow conglomerate mergers with almost no scrutiny. So, when a company like Berkshire Hathaway buys up a new company for his portfolio Berkshire Hathaway is a giant conglomerate and most of its businesses don't have anything to do with one another. So, they don't get a whole lot of scrutiny when they buy a new business.

Blocking Mergers

Defenses to government attempts to block mergers

- Small company doctrine
- Going out of business

Now, if the government does take notice of a proposed merger and moves to attempt to block it or change it in some way, there are a couple of defenses available to the companies that are trying to merge. The first one is what's called the small company doctrine. Under the small company doctrine, two companies can engage in a horizontal merger which again, takes competition out of the marketplace. But it will be allowed if it allows two companies to better compete against a larger company that dominates the market. So for example, if I own a tiny little hamburger chain and there's another little hamburger chain and we decide to merge, that's a horizontal merger. But if it helps us better compete against McDonald's, the small company doctrine will allow that horizontal merger to proceed. Then the second defense to a government attempt to block a merger is if one of the companies is going out of business any way, then a horizontal merger is allowed because that company's competition will be taken out of the marketplace one way or another. So, allowing a merger or an acquisition of that company by a competitor will at least provide some value instead of just a bankruptcy which takes a lot of value out of the marketplace. So that's the antitrust concerns that arise from mergers and acquisitions.

Lesson 4.4 Antitrust: Enforcement & Exemptions

[Antitrust: Enforcement & Exemptions]

In this lesson we wrap up our discussion of antitrust laws by discussing enforcement mechanisms, consequences for violation, and some exemptions for certain industries to antitrust laws. Generally, antitrust laws can be enforced either by the government or by private individuals. So, when the government enforces antitrust laws, it's usually done by the Federal Trade Commission and the Department of Justice. The FTC has more of a role in civil cases, the Department of Justice prosecutes criminal antitrust violations but they work together a lot. So, what are the consequences if you are found to have violated antitrust laws? That could actually be pretty serious. One big consequence is called treble damages. Now, I don't know why lawyers decided to call it treble damages, they should have just called it triple damages because that's exactly what it is, but it's called treble damages. What it means is that you can be forced to pay up to three times the actual amount of damages that people suffer as a result of your antitrust activities. Other consequences include divestment, the government and courts can force you to sell a business exit or markets, they can force you to terminate contracts and other agreements that violate antitrust laws. So, there are some pretty strong consequences on the government side from antitrust violations. Now on the private side, private individuals and private companies that have been damaged directly as a result of someone else's anti-competitive behavior also have a cause of action and they can sue in court themselves for civil penalties. Those usually include payment of their actual damages, including attorney's fees and court costs and a lot of instances.

Antitrust Exemptions

Statutory exemptions

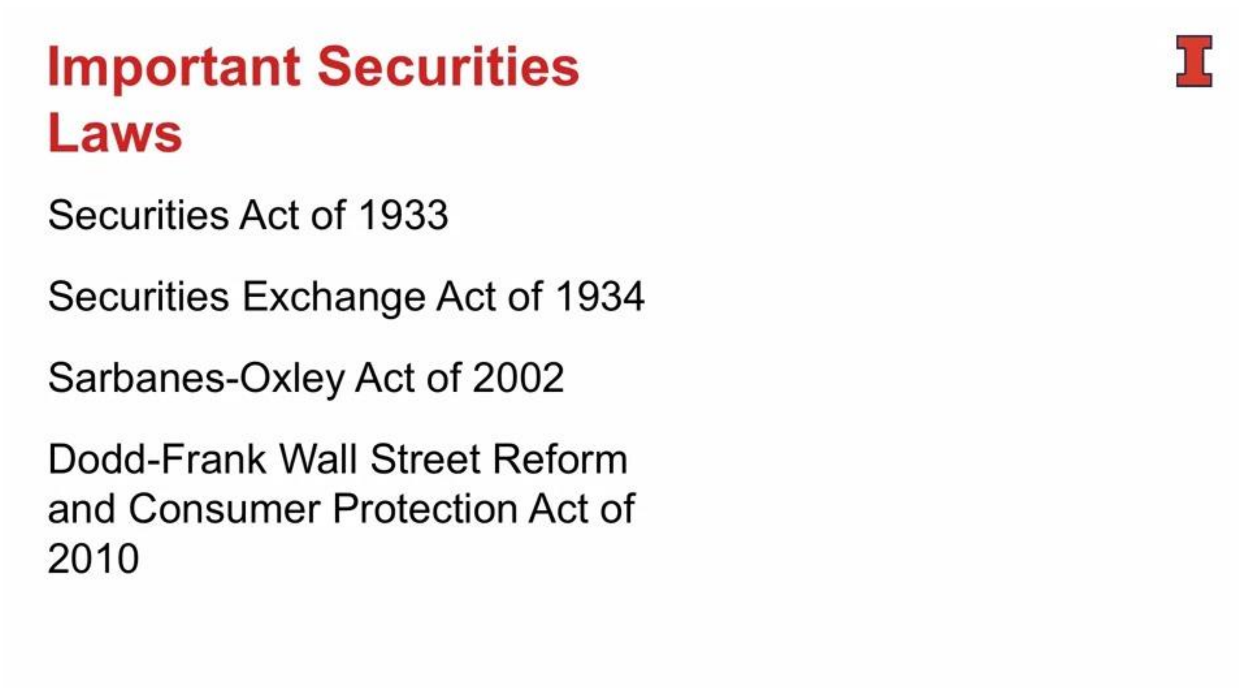
Implied exemptions

State action exemptions

Now, some industries in the US are actually exempt from antitrust laws. So, these industries and companies operating in these industries are allowed to engage in anti-competitive behavior and they will not be held liable for that. There are three main forms of antitrust exemptions. The first is what's called a statutory exemption. This is when Congress has actually passed a law that specifically states this industry is exempt from antitrust laws, an example of this is labor unions. If you think about it in sort of conceptual terms, what is a labor union? It's when a bunch of employees get together to force their employer to pay them a certain amount of money. Well, when you're an employee, what are you selling? You're selling your labor in exchange for some money. So if you and other people all agree to sell your labor for the same price, that's price fixing. But labor unions which engage in price fixing all the time are statutorily exempt from antitrust laws. Next form of the antitrust exemption is called an implied exemption. This happens when Congress hasn't granted a specific statutory exemption, but a court determines that whatever your industry is, it's sort of similar to another industry that does have a statutory exemption, so the court allows you to be exempt also. So, for instance, railroads have a statutory antitrust exemption. Courts have said, "Airlines are kind of like railroads, so we're going to hold that they have an implied exemption also." Then the final type of antitrust exemption is what's called a state action exemption. This is when an industry is basically forced to engage in anti-competitive behavior because of some law in its state. So, for instance, in many states the state government sets utility rates. So the amount that an electric company can charge you for electricity is statutorily set by the state. So, is that price fixing? Yes. Do companies selling electricity have a choice? No, it's the law. So, abiding by that law is an exemption from antitrust enforcement because the state has regulated that industry. So these are three antitrust exemptions, statutory exemptions, implied exemptions and state action exemptions.

Lesson 4.5 Securities Laws & the SEC

[Securities Laws & the SEC]



In this lesson, we introduce the topic of securities. We're going to define, what is a security? We're going to talk about the SEC a little bit and lay some foundations for our future lessons that go more in-depth in terms of security regulations.

Probably the best thing to do would be to start off by defining what is security? You may have heard the term security before and if you think securities are stocks, that's actually not a terrible connotation to make. Let's work with this definition. A security is equity and debt interests in a company. So, stocks are equity interest in a company. Debt interest in a company like bonds are also a form of securities. A much more complicated definition is that some types of investment agreements, some types of purchase agreements are also securities. We're not going to get real in the weeds with those complicated forms of securities. If you want to think in your mind, stocks and bonds or securities, that's totally fine. Now congress regulates securities through a whole series of statutes. There are a few that are much more important than others though and the two big dogs that do the heavy lifting in terms of securities laws are what's called the 33 Act and the 34 Act. Now specifically, these are called the Securities Act of 1933. This regulates the issuance of securities. So if I'm a company, I want to sell some stock to people, I've got to comply with the requirements of the 33 Act. Then the Securities Exchange Act of 1934. This regulates the trading of securities. So, if I'm not an issuing company but I own some stock and I want to sell it to my friend or sell it on stock market, what are the rules? The Securities Act of 34 also called the 34 Act, regulates that. A couple of other important laws, Sarbanes-Oxley Act of 2002. This was passed in the wake of Enron and WorldCom and some other real big disasters in terms of the financial industry. Sarbanes-Oxley added a whole bunch of reporting requirements. So, companies had to be more transparent about their finances and also increased penalties for securities violations. Then more recently, even than Sarbanes-Oxley is the Dodd-Frank Wall Street Reform and Consumer Protection Act which thankfully is usually just known by Dodd Frank, that was passed in 2010. That made even more reporting requirements for publicly traded companies. It closed some loopholes in terms of what they had to report. It reorganized some oversight of the regulatory process. We're not going to go really in-depth on Sarbanes-Oxley or Dodd Frank in this lesson, but it's important to know that they are very important laws that regulate securities. We're mostly going to hone in on the 33 and 34 Act however.

We mentioned the laws that regulate securities in this country but the big governmental agency that is tasked with applying those laws is called the Securities and Exchange Commission or the SEC. You've probably heard of the SEC. It does a lot of stuff. It Investigates possible violations of securities laws. It makes rules that interpret the Acts, especially the 33 and the 34 Act. Because obviously, law passed in 1933 couldn't have taken into account things like electronic trading of stocks. Right? So the SEC actually makes rules that apply the principles of these Acts that were passed, going almost 100 years ago, it applies those principles to modern situations. SEC also has a whistleblower program. It can't monitor everything by itself, so it relies on whistleblowers to report security violations. It actually, has this program where a whistleblower, who reports securities violations, can receive a share of money recovered by the SEC from the company that was violating securities laws. Actually, in 2014, the SEC paid a $30 million whistleblower reward to someone who was actually outside the United States but they reported securities fraud and the SEC recovered north of $100 million from the violator and paid this whistleblower $30 million. Now the SEC keeps whistleblower identities private so no one knows who it was. But that's one strong incentive that the SEC gives for people to come forward and report securities violations. Now one definition we need to pause and talk about before we move on to specifics of the securities laws is the definition of a reporting company. Reporting companies are the companies that the SEC regulates. A reporting company is a company that meets one of three criteria. First criteria is that it's publicly traded. All publicly traded companies are reporting companies. They all are subject to SEC regulation. Second, if a company is not publicly traded but has made what's called a registered offering, it's also a reporting company. In our next lesson, we're going to talk about what register offerings are. But just know that if a company has made a registered offering, it is a reporting company. Finally, if a company has more than $10 million in assets and more than 2,000 shareholders, it's also a reporting company, even if it's not publicly traded and even if it's never made a registered offering.

Lesson 4.6 Initial Public Offerings: Procedures & Liability

[Initial Public Offerings: Procedures & Liability]

Important Terms

Issuer

Initial public offering (IPO)

Underwriter

In this lesson, we continue our discussion of securities laws by specifically focusing on the procedures for a company that engages in an initial public offering and liability for misleading statements. In this lesson, we're going to talk about initial public offerings also known as IPOs. What are the procedures that govern those and then also liability when things go wrong. So let's start with some important terms. Term number one, issuer. An issuer is a company that sells stock to the public. Now they could be selling stock for the very first time or it could be a company that has sold a lot of stock to the public before but they're selling newly created stock to the public. Either way they are an issuer. Second important term, initial public offering. We've already mentioned it also known as an IPO. This is when an issuer sells new stock to the public. It's called an initial public offering. Then the third term we need to define here is called an underwriter. An underwriter is an organization usually an investment bank. So you think like J.P. Morgan's of the world, the Goldman Sachs of the world, they're usually an investment bank and what the underwriter does is it creates a market for the stock. They basically are salespeople. So if I'm a company and I want to engage an initial public offering, the first thing I have to do is find some people who are willing to buy my stock, right? That's when I engage an underwriter, the underwriter goes on what's called a road show and markets my stock to institutional investors, pension funds, retirement funds, that kind of thing. The underwriter doesn't do this for free. They keep a percentage of the stock that they sell to the public and it's exceptionally lucrative. This is why investment banks like Goldman Sachs make a ton of money when it comes to initial public offerings.

IPO Process

Prefilling period

Registration statement filing

Quiet period

Post-effective period

So what's the process if you want to engage in an IPO. There's actually a really stringent process you have to follow and if you break these rules you expose yourself to liability. So, first step in the process. From the first moment you think about engaging in an IPO up until the time that you file your registration statement, this is called the prefiling period. During the prefiling period you're not allowed to sell any securities to anybody. Now during the prefiling period you will be probably engaged in drafting this document called the registration statement. The registration statement is a gargantuan document that contains all the relevant info about your company's management, your finances, risks, all sorts of things and the registration statement gets filed with the Securities and Exchange Commission. It's a public document you can search for it on the SEC's website. Once the registration statement is filed, that begins what's called the quiet period. The quiet period goes from the time of filing of the registration statement until the time the SEC approves the registration statement. During the quiet period your company is actually not allowed to communicate certain information to the public or investors or anyone on the market. Now the company is allowed to market its securities but it can't finalize any sales. So we can say hey we're selling stock and it can actually come to agreements to sell stock to people but it can't finalize the sale until the SEC approves the registration statement which starts the post-effective period. In the post effective period the registration statement has been approved and now the company can actually sell stock to the public or other forms of securities.

IPO Liability

Section 11

Section 12

Criminal liability

Now when a company engages in an IPO, there's always the risk that people will be harmed. Maybe the price of the stock goes down instead of up or other things happen. When that happens people who have suffered damages will try to figure out who's responsible and sue them. Now when individuals or businesses suffer damage as a result of the IPO process, the issuer and also other people involved in the drafting of the registration statement and the selling of the stock can sometimes be exposed to liability. Now specifically in the 33 Act sections 11 and 12 govern the liability to which they might be exposed. Section 11 of the 33 Act creates liability for anybody who makes a false or misleading statement in a registration statement. So if the company includes a false statement in its registration statement, it's liable if people suffer damage as a result of that statement. Section 12 of the 33 Act creates liability for anybody who sells securities and those securities are the subject of a false or misleading registration statement. Now it doesn't matter who wrote the registration statement it matters who sold them. So Section 11 creates liability usually for the issuer, section 12 creates liability usually for the underwriter and other people engage in selling the stock. So if a registration statement is false or misleading, usually the issuer and the underwriter and anybody else involved in the sale of that stock can be held liable. Then finally the 33 Act also imposes criminal liability on anyone who willfully violates the Act. So if you include a false statement on accident there's no criminal liability there but if you purposely try to mislead your investors, that is actually a criminal act under the 33 Act.

Defenses to IPO Claims

Plaintiff knew statement was false/misleading

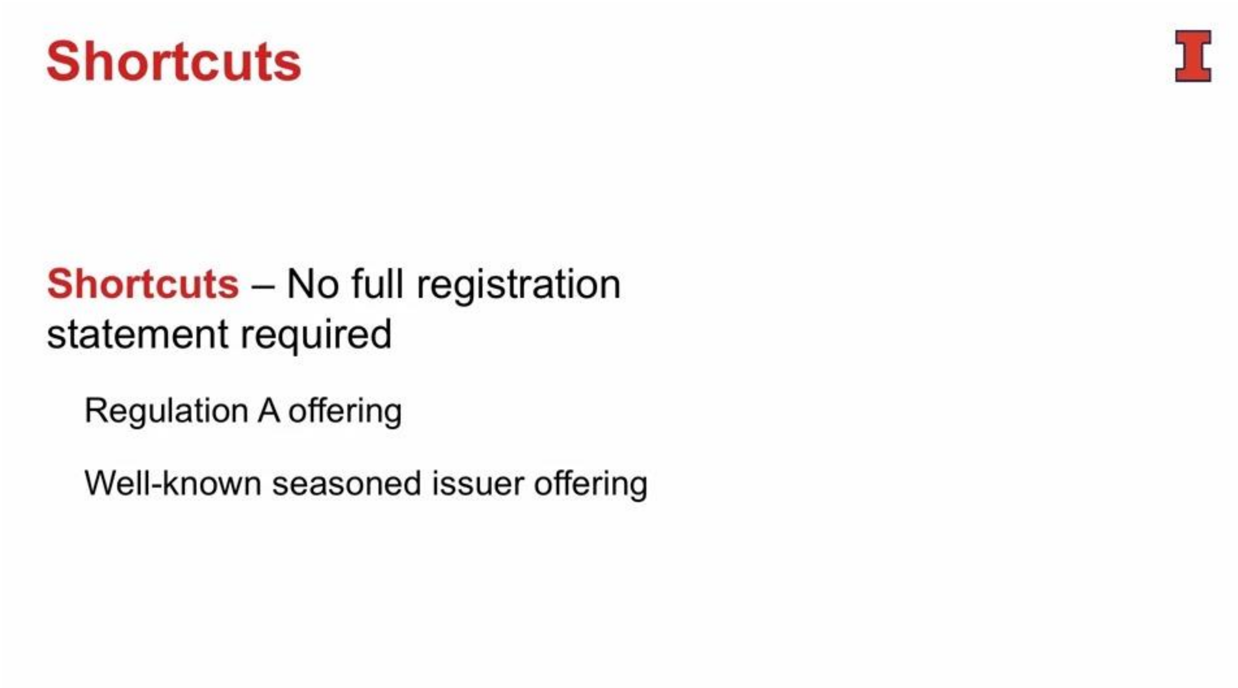
Statement didn’t concern a material fact

Due diligence and reasonable belief of accuracy

Now if a company or individual is subject to a lawsuit for liability pertaining to an IPO, they actually have some defenses in some instances. A first offense that a defendant might raise is that the other party knew the statement was false or misleading and this makes sense right. If I put a false statement in a document and you suffer harm as a result because you didn't know it was false, then that's my fault. But if I put a false statement in a document and you know it's false, then I shouldn't be held responsible for that. So that's one defense to an IPO claim. Second defense is that the statement might have been false or misleading but it didn't concern a material fact. Maybe what the statement was in there maybe the address of our company's headquarters was wrong. That's not a material fact. So even though the registration statement could contain a false statement if it's not a material fact you can't sue me for it. Then the final defense to an IPO claim is if I the defendant who's being sued did my due diligence and I have a reasonable belief that the statement is accurate then I will not be held liable if the statement turns out not to be accurate. Now this defense is only available to parties other than the issuer. The issuer is always liable for its inaccurate statements but if I'm the underwriter or an adviser to the issuer or someone else besides the issuer and I did my due diligence and I tried to ascertain if the statement was true and it turned out not to be true but I reasonably believed it to be true, well in that case I will be held liable for that statement.

Lesson 4.7 Initial Public Offerings: Shortcuts & Exemptions

[Initial Public Offerings: Shortcuts & Exemptions]



Now, I've already discussed IPO process and registration statements, but a company's real goal is to be exempt from that or have some shortcuts to save money and save time. So, in this lesson, we're going to talk about some shortcuts and exemptions that companies can take advantage of to not have to go through the whole IPO process. So, in the last lesson we talked about the IPO process and registration statements, and we mentioned there are these gigantic documents, and you got to pay lawyers a ton of money to draft him and it takes forever and it's this whole big thing. Now, if a company can avoid that full process by any means at all, it's usually a good idea to try and do that. So, in this lesson, we're going to talk about some shortcuts and some exemptions. Shortcuts are processes by which a company can engage in a stock offering or other securities offering, without having to do the full blown registration statement. There's two main types of shortcuts. The first is called a reg A offering, regulation A offering. Now, regulation A is a regulation passed by the Securities and Exchange Commission, and it allows issuers of stock to instead of filing a full blown registration statement, file a document called an offering statement, which is much, much shorter than a registration statement. The one restriction is that in order to engage in a reg A offering, you can sell no more than $50 million worth of stock. Now, $50 million to me is a lot of money. But to the SEC $50 million is not a lot of money. So, their theory is, if you're not really selling a lot of stock, and less than $50 million is not a lot of stock, then we don't need the full blown disclosure, because the risk of harm to the public isn't quite as great, than if you were selling a billion dollars worth of stock where the risk is much higher. Second form of shortcut is called a well-known seasoned issuer offering, abbreviated WKSI offering. This is when a company wants to offer new stock to the public, but it has already sold a bunch of stock to the public. So, the SEC theory is that we already know a lot about you, you don't have to reinvent the wheel here and file a full blown registration statement. In order to qualify for a well-known seasoned issuer offering, you have to either have sold at least one billion dollars in securities in the previous three years, or you have to have at least $700 million in equity securities in the hands of investors who are unaffiliated with your company. If either of those are true, you qualify for the well-known seasoned issuer offering shortcut, and you can file a much shorter statement than the full blown registration statement.

Exemptions

Exemptions – Don't have to file anything at all

Exempt securities

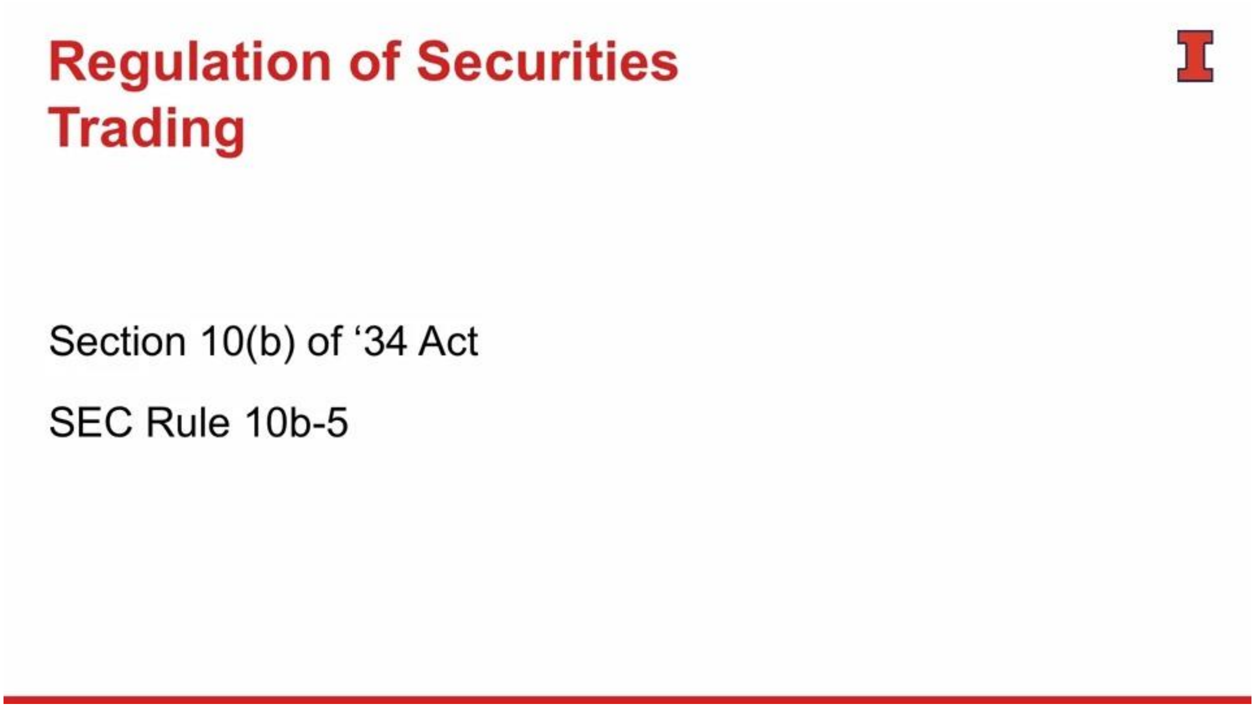
Exempt transactions

- Small offering exemption
- Private placement exemption
- Intrastate offering exemption
- Non-issuer exemption

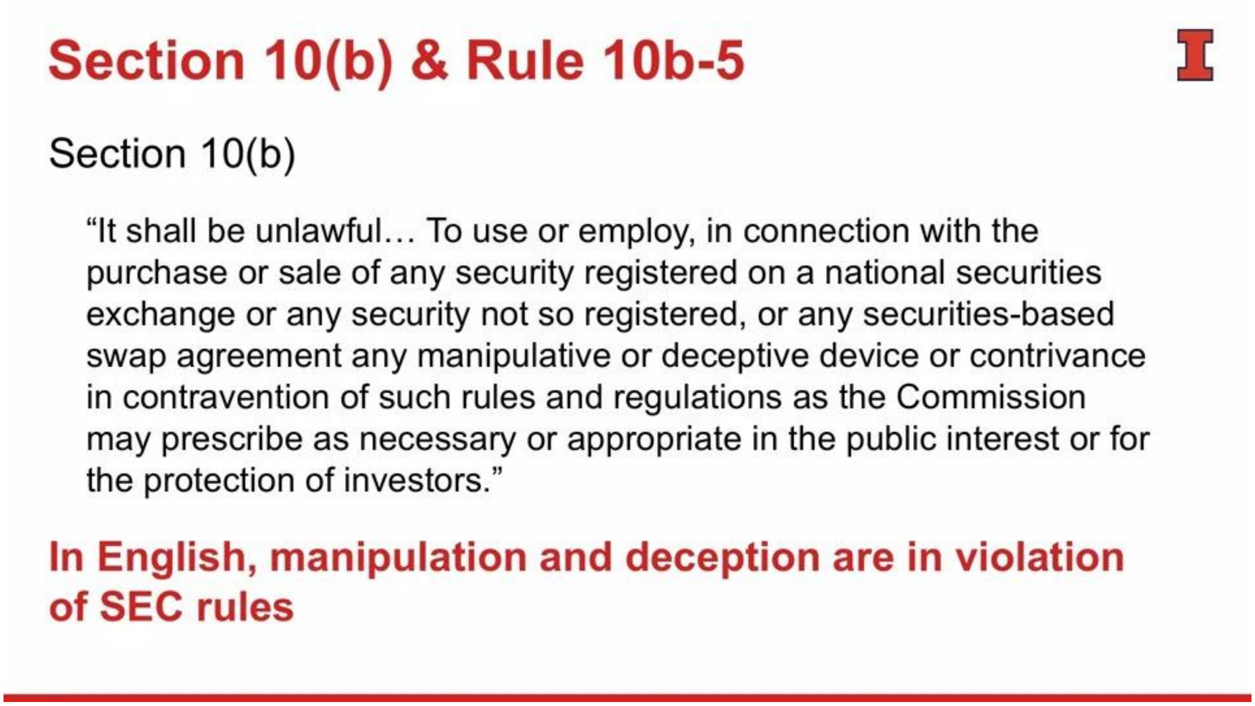
Now, beyond the shortcuts, what's even better than a shortcut is a full blown exemption. If you have an exemption, that means you don't have to file anything with the SEC at all, in order to engage in your securities transaction. Now, when we talk about exemptions, we talk about exempt securities and exempt transactions. So, exempt securities are a type of security that is exempt from registration statements because of the nature of that security. Now, an exempt transaction is regular stock, or bonds, or regular securities, but because of the nature of who you're selling it to or something about the nature of transaction, it's exempt. So, let's start with exempt securities. These are things like securities sold by the governments. Now, you can't buy stock in the government obviously, but you can buy debts issued by the government, but it's exempt, they don't have to file a registration statement. Securities issued by nonprofit organizations are exempt. Any security that's issued but doesn't really transfer any new value is also an exempt securities. For example, if you are a publicly traded company and you undergo a stock split. A stock split doesn't provide any new value to any shareholders. The company is worth the same. It just now has twice as many shares, but they are each worth half as much. So, economically it's the same. That is an exempt security. Now in terms of exempt transactions, some types of transactions are wholly exempt from SEC oversight. The first is what's called a small offering exemption. Now we already mentioned that, offerings up to $50 million can take advantage of a shortcut. But if you're offering is only a million dollars, you're totally exempt up to a million dollars. And the theory is the same; the SEC has bigger fish to fry than you and your tiny little one million dollar offering. Now, to me a million dollars is a lot, but to the SEC a million dollars is virtually nothing, and so, they're not going to require you to file anything for security's offering up to a million dollars. Next form of exempt transaction is what's called a private placement exemption. In a private placement exemption, a company sells securities only to what are called accredited investors. Accredited investors have either a net worth of a million dollars, or an annual income of at least $200,000. So, by selling securities only to accredited investors, the SEC's theory is that, these people are wealthy; they can take care of themselves. We assume that if you have a million dollar net worth, you are sophisticated enough to protect yourself, and the SEC doesn't need to protect you. So, a company selling these securities will be exempt from filing a registration statement because the investors are presumed to be able to do their own due diligence. Next form of exempt transaction is called an intrastate offering exemption. Now, if you know anything about the Constitution, the Constitution grants Congress the authority to regulate commerce between the states. That's called interstate commerce. But if commerce only affects one state, that's called intrastate commerce, and the US Congress actually doesn't have the power to regulate interstate commerce. It's actually showed on its way into a lot of intrastate commerce, but this is one area in which the US Congress actually respects the prohibition on regulating intrastate commerce. So, if a company located in a state only sells stock to other people within that state or other forms of securities, that's the intrastate offering exemption. And it's not subject to SEC regulation, although each state has their own series of securities regulations that it would need to comply with. Then, finally, the non-issuer exemption. If securities are sold by someone other than the original issuer, they are exempt from having to file a registration statement. This makes sense right? If I buy a share of Microsoft stock on the stock market, and then I sell it to somebody else, it would be crazy to make me file a registration statement in order to sell my share of Microsoft to someone else. I don't know anything about Microsoft's financial status, I just bought a share of stock. So, only the issuer, the company that creates the securities is required to file a registration statement.

Lesson 4.8 Trading Securities: Section 10(b) & Rule 10b-5

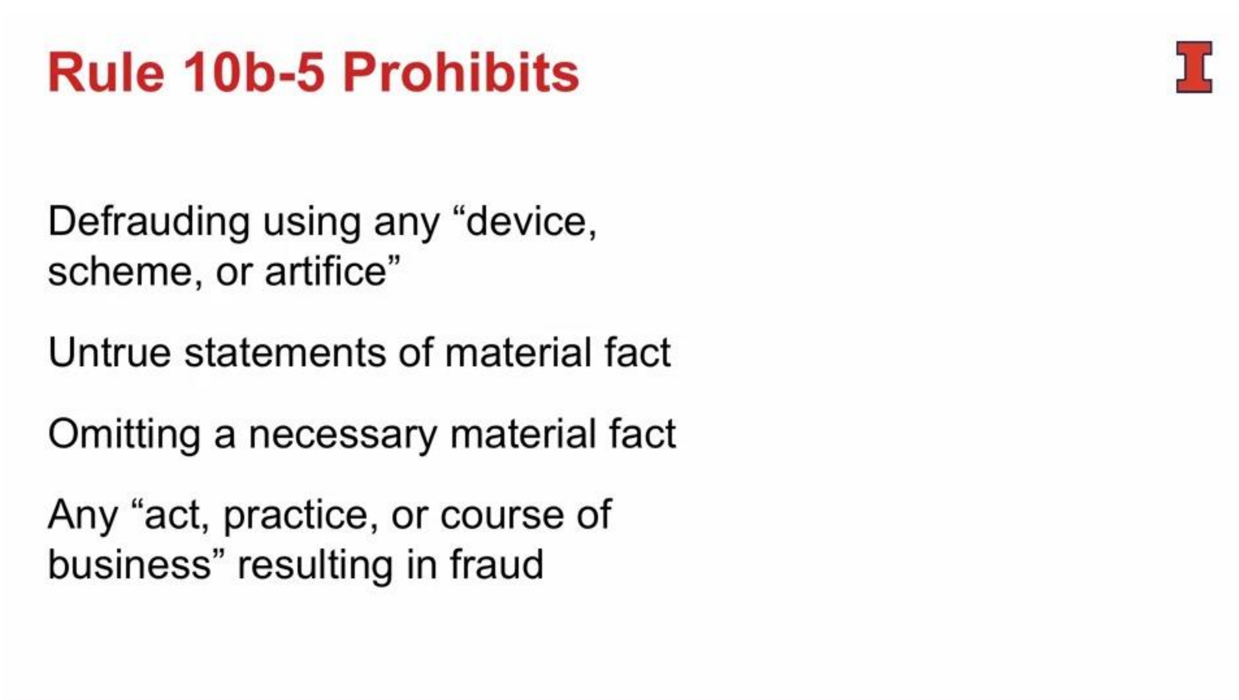
[Trading Securities: Section 10(b) & Rule 10b-5]



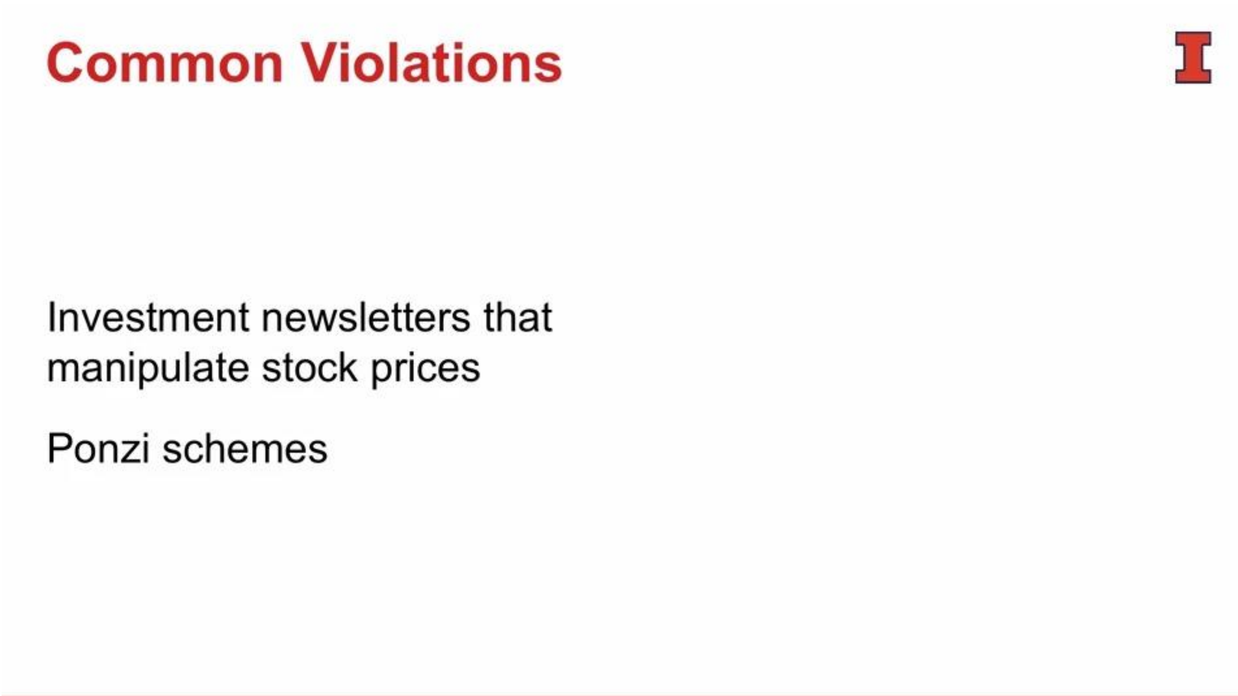
In this lesson, we're going to discuss regulation of securities trading. What are some of the important statutes and regulations that govern the trading of securities between individuals and companies? In this lesson, we shift our focus from the issuance of securities to the trading of securities. So there are a couple of very, very important laws that regulates securities trading. Most important, the 34 Act generally regulates securities trading, but Section 10b of the 34 Act does a ton of heavy lifting when it comes to regulating securities trading. So we're going to talk about some of 10b's requirements and then the Securities and Exchange Commission has adopted rule 10b-5 that also plays a big role in regulating securities trading.



So Section 10b, the text is on the slide, and it is long and hard to understand and seems to follow the general rule for people who draft legislation is that, the longer the run on sentence the better. because then the fewer people can understand it, right?
In English, if you read this paragraph, all it basically says is that, manipulation and deception in the trading of securities, which is in violation of SEC rules, is prohibited.



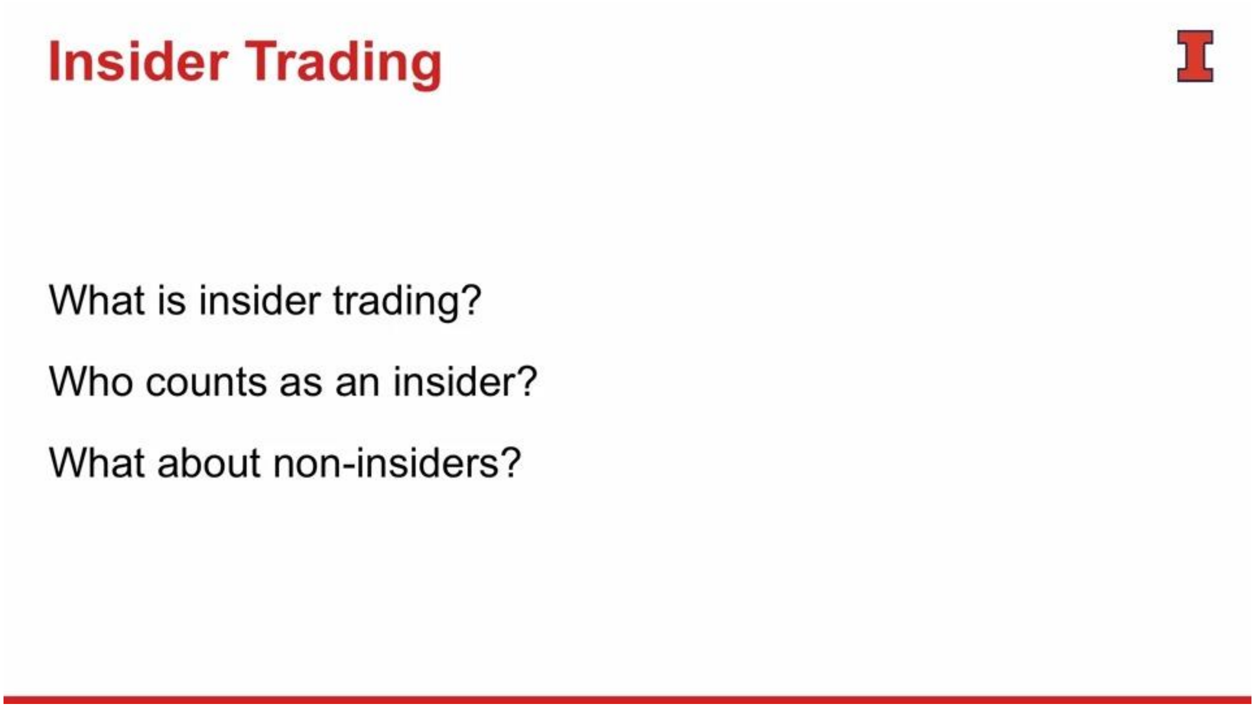
Now, so what you gotta know is what are those SEC rules that you can manipulate and deceive with respect to, well, Rule 10b-5 will tell us. Any communication that defrauds, someone using any quote, device, scheme or artifice is in violation of SEC rules. Also, rule 10b-5 says any untrue statements of material fact, any omission of a material fact, or any act, practice, or course of business resulting in fraud.



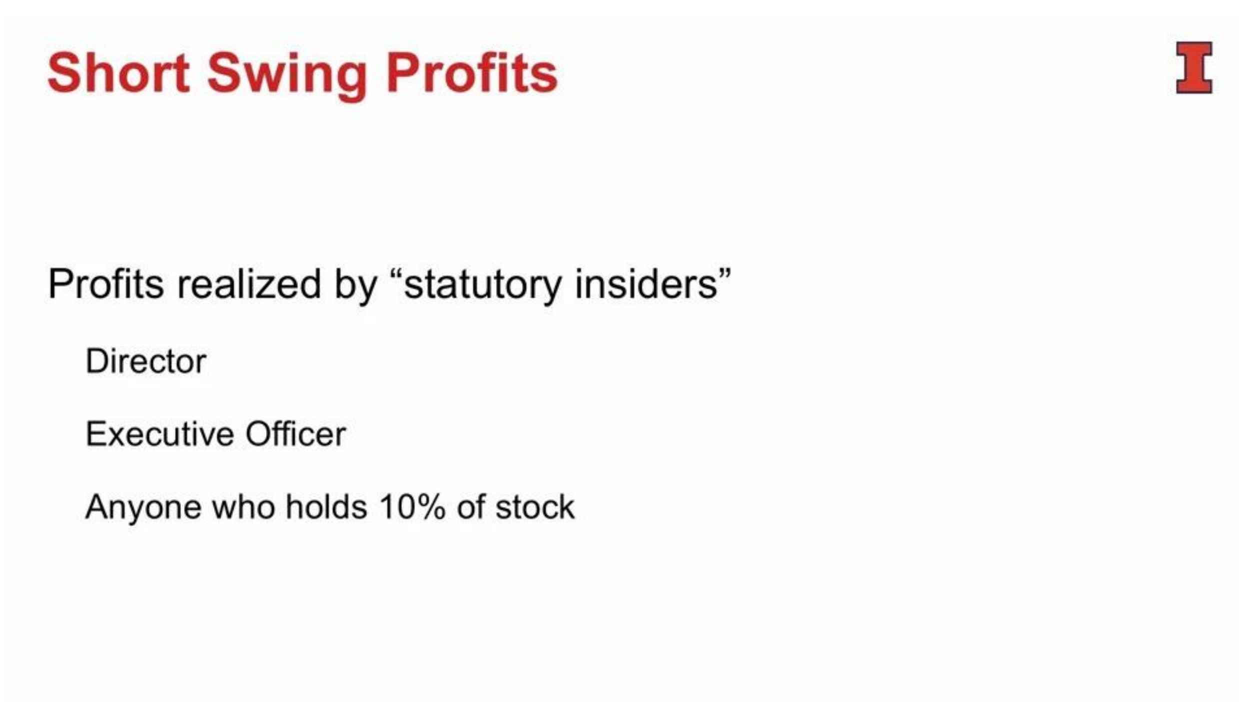
Now, as a general rule, if you could summarize all these things, basically it says, you gotta be honest when you're communicating in a securities transaction. You gotta tell people what's necessary, you can't leave out stuff, you can't tell them any untrue stuff, and you can't actively mislead them. So, when do we see this in real life? A couple of really, really common violations of sections 10b and rule 10b-5, the first is, investment newsletters that manipulate stock prices, these, unfortunately, are pretty common. And if an investment newsletter is sent out to recipients and it says, hey buy this stock, it's a great stock, but it doesn't actually tell you to buy that stock because it really is a great stock. It says buy this stock because the person who writes the newsletter wants to drive up the stock price, and then sell when it's high, before it crashes back down to Earth. That is a violation, because they're misleading you as to the purpose of their stock recommendation. The second common violation of sections 10b and rule 10b-5 are Ponzi schemes. Now Ponzi scheme is when a person or organization takes investment money from its customers, promising them to invest their money in the stock market usually, or in other investment vehicles, and promises them a certain rate of return. But, instead of actually investing their money, it takes their money, and then uses money from new clients to pay the return for existing clients. So, as long as you keep getting a steady stream of new clients, you could pay the returns of your existing clients and it works fine for a while. But eventually, your pool of new clients dries up, and then your existing clients say, where's my money? And you say, I don't have any, time for me to go to jail, or try to escape to some country with no extradition treaty. So by far the most famous Ponzi scheme in history is that of Bernie Madoff who was convicted of running a Ponzi scheme up to 50 billion dollar, now the actual amount is in debate, but Bernie Madoff is now sitting in prison as a result of his Ponzi scheme. So though investment news letters and Ponzi schemes, two very common unfortunately, violations of sections 10b and Rule 10b-5.

Lesson 4.9 Trading Securities: Insider Trading & Short-Swing Profits

[Trading Securities: Insider Trading & Short-Swing Profits]



In this lesson, we wrap up our discussion of securities laws by discussing insider trading in short-swing profits. Alright. In our final lesson on securities laws, we're going to talk about insider trading, something you've probably heard about, and short-swing profits, something you probably haven't. So let's start with insider trading. What is insider trading? Basically, it's whenever non-public information leads to someone to profit on a stock transaction. An insider trading is a crime. So in order to really delve into this thing called insider trading, we need to first understand who is an insider, who counts as an insider for insider trading. Well, under the securities laws, all directors and officers of a corporation are insiders, so are any outside advisers who do business with the companies, like accountants, outside accountants, outside consultants, outside investment bankers, people like that. And basically, anyone who owes any fiduciary duties to the company are insiders. They are prohibited from profiting on stock transactions based on non-public information. But in addition to these insiders, there are also others who are prohibited from engaging in insider trading and this is something called the misappropriation theory. You don't need to know the definition of misappropriation theory, but what you do need to know is that anyone who wrongfully acquires and profits from non-public information, has committed insider trading. Even if you're not an insider, you could be a random jewel on the street, you have no connection with the company. But if you somehow wrongfully acquire non-public information and you profit as a result, then you are guilty of insider trading. Here's an example. You may have heard the story of Martha Stewart's being accused of insider trading. Here's what happened in that case. There's this guy named Sam Waksal. He was the CEO of a company called ImClone. Now ImClone got some bad news. They were developing a drug. They got news that the FDA was not going to approve their drug. So Sam Waksal called his stockbroker and said, "Please stale a bunch of stock before this news becomes public and our stock price drops off a cliff." It just so happened that Sam Waksal's stockbroker was also Martha Stewart's stock broker. And the allegation that was actually not proven, the allegation was that the stockbroker called up his other client Martha Stewart and said, "Hey, you might want to sell your ImClone stock?" And Martha Stewart sold some ImClone stock shortly before the news of this FDA disapproval hit the public. Now actually, Martha Stewart was not convicted of insider trading. But if this was the way that things went down, Martha Stewart would have been guilty of insider trading even though she wasn't in Imclone insider, but she wrongfully acquired this non-public information from the stockbroker who acquired it from ImClone CEO.



Now the next topic in this lesson is short swing profits. This is not commonly known, you may never have heard of short-swing profits. This is when someone called a statutory insider profits on the sale of stock of their own company. Now a statutory insider is not the same as an insider for purposes of insider trading but it's pretty close. So a statutory insider is a director or an executive officer, that's makes sense or anyone who holds at least 10 percent of the stock of a company. Those are what's called statutory insiders and they're prohibited from profiting on the purchase and sale of their own company's stock if that purchase and sale happens within a six month period. So basically, if you purchased stock in your own company, you have to wait at least six months before you sell it. That's the rule on short-swing profits.