Securities Regulation

Quimbee® Outlines

First Edition

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I. The Framework of Securities Regulation

A primary goal of securities regulation is to ensure that investors receive accurate information that allows them to make informed investment decisions.

A. Capital Markets

Securities represent economic claims on issuers. Securities may be bought and sold. The systems that facilitate the buying and selling of securities are the ***capital markets***.

1. The Purpose and Function of Capital Markets

The purpose of capital markets is to facilitate the buying and selling of securities.

2. The Efficient Capital Markets Hypothesis

By analyzing all the information available about an issuer or its securities, investors can make rational predictions about the securities' future value and what that future is worth in today's dollars. These predictions set the securities' market price.

B. Securities Transactions

Securities transactions are the buying and selling of securities. They generally fall into one of two categories: transactions involving issuers (***issuer transactions***) and transactions involving only non-issuer market participants (***market transactions***).

1. Transactions by Issuers

Issuer transactions involve an issuer selling its securities to third-party investors.

2. Transactions by Market Participants

Market transactions do not directly involve the issuer, but rather they take place between an existing holder of securities and a buyer.

C. Federal Securities Law

In the United States, securities regulation is primarily centered around federal law and rules.

1. The Securities Act of 1933

The Securities Act of 1933 was the first federal securities statute.

2. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 regulates the trading of securities after they are distributed.

3. The Investment Advisers Act of 1940 and the Investment Companies Act of 1940

Six years after the adoption of the Exchange Act, Congress enacted the Investment Advisers Act of 1940 and the Investment Companies Act of 1940.

4. The Securities and Exchange Commission

The Exchange Act created the Securities and Exchange Commission (SEC) as the independent agency charged with administering the federal securities laws.

II. The Meanings of Securities and Materiality

The two most important questions in securities regulation are (1) what is a security, and (2) when are securities-related disclosures considered ***material***?

A. The Meaning of Securities

"What is a security?" is an important question because the securities laws regulate only transactions involving securities.

1. The Federal Definition of Securities

Securities include, among other things, notes, stocks, bonds, debentures, investment contracts, fractional undivided interests in mineral rights, puts, calls, and options.

a. Securities Tests

Whether an instrument is or is not a security cannot be determined merely by checking to see if it is labeled with one of the names listed in the Securities Act or Exchange Act.

2. Investment Contracts

Investment contracts have proven to be one of the broadest instruments captured by the federal securities laws' securities definition.

3. Equity Securities

Equity securities are securities that allow investors either directly or indirectly to participate in an issuer's residual value.

a. Stocks

Stocks are the quintessential form of securities.

b. Partnership and Limited Liability Company Interests

Interests in partnerships and limited liability companies (LLCs) require a more fact-specific analysis than for stocks to determine whether they are securities.

4. Notes

Notes, a form of debt instrument, are securities.

5. Derivatives

Derivatives are securities whose values rely on the value of underlying securities.

6. Repackaged Non-Securities as Securities

Financial instruments that are not themselves securities are sometimes pooled and resold as securities.

B. The Meaning of Materiality

In all circumstances, whether information is ***material*** is the general touchstone for whether it should be disclosed.

1. Duty to Disclose

In general, issuers must disclose information only when mandated by law, or when additional information is required to make the mandated disclosures not misleading.

2. Materiality

Whether information is material is a mixed question of law and fact and has long vexed courts and practitioners.

a. The TSC Industries Test

In *TSC Industries*, the U.S. Court held that a fact omitted from a disclosure was ***material*** if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."

b. Speculation and Substantial Likelihood

The *TSC Industries* materiality standard requires that a fact have a ***substantial likelihood*** of changing a reasonable investor's view of the total mix of information available for making a decision.

c. Total Mix of Information

The connection between the total mix of information about a security and the materiality of a fact related to that security rests on an assumption that capital markets have some degree of efficiency.

d. Completeness and Half-Truths

Statements that are literally true may still be misleading if they are half-truths or lack information needed to make them complete.

e. Puffery

Generally, statements that amount to ***puffery*** cannot support a claim that an issuer made a material misstatement.

f. Opinions

Statements of opinion about material facts may be misleading.

g. Buried Information

Disclosures can be misleading when they fail to fairly present material facts in such a way that the information is buried.

h. Silence

Silence, absent a duty to disclose, is not misleading.

3. Forward-Looking Statements

Although forward-looking statements are necessarily about things that have not yet happened, they can nevertheless be misstatements if they were inaccurate at the time they were made.

a. The Bespeaks-Caution Doctrine

Material misstatements made in forward-looking statements are rendered immaterial when accompanied by meaningful cautionary language.

III. Public Offerings

All securities distributions require both registration with the SEC and the delivery of a statutory prospectus to purchasers (unless either the security or the securities transaction is exempt).

A. Public Offerings, Issuers, and Underwriters

Offering securities to the public typically takes place through the ***underwriting*** process, in which a financial intermediary assists an issuer in preparing for, marketing, and administering an offering.

1. Issuers

The securities laws distinguish between issuers that have a substantial connection to the U.S. (***domestic issuers***) and those that are foreign (***foreign issuers***).

a. Domestic versus Foreign Issuers

Issuers are either domestic or foreign. Foreign issuers are further categorized as either foreign-government or foreign-private issuers.

b. Nonreporting and Reporting Issuers

Issuers are further divided into nonreporting and reporting status.

i. Nonreporting Issuers

Nonreporting issuers are issuers for which certain statutory triggers under Section 13 or 15(d) (*e.g.*, going public) of the Exchange Act have not occurred:

ii. Reporting Issuers

Reporting issuers are further divided into three categories: ***unseasoned issuers***, ***seasoned issuers***, and ***well-known seasoned issuers***.

2. Underwriters

An underwriter is any person who has purchased a security either (1) from an issuer or (2) from "any person directly or indirectly controlling or controlled by the issuer" (***control person***) with a view of distributing the security.

B. Registration Requirements

Absent exemption, securities cannot be sold or delivered unless there is a registration statement on file with the SEC that has become ***effective***.

1. Disclosure Requirements

The Securities Act requires issuers to disclose certain information about the offering and the issuer in a registration statement filed with the SEC and a prospectus provided to investors.

a. Integrated Disclosure System

The SEC has created a set of standard information that issuers must disclose when they conduct a public offering under the Securities Act.

b. Regulation S-X

Regulation S-X prescribes the form and content of an issuer's financial statements made in registration statements or other disclosures.

c. Regulation S-K

Regulation S-K prescribes the form and content of an issuer's nonfinancial disclosures, which may be qualitative or quantitative in nature.

d. Registration Forms

Public offerings are registered by filing a registration form with the SEC.

e. Shelf Registrations

Issuers will sometimes register securities for sale but not issue them immediately.

2. Resales by Control Persons and Restricted Securities

In general, ***restricted securities*** may not be offered to the public.

3. Liability and the Due-Diligence Defense

Subject to a due-diligence defense, Section 11 of the Securities Act imposes strict liability for material misstatements or omissions in registration statements.

C. The Public-Offering Process

The public-offering process should be viewed as running through three primary stages: the prefiling period, the waiting period, and the post-effectiveness period.

1. Prefiling Period

The prefiling period is the time between when (1) the issuer and underwriter reach a nonbinding agreement to issue and distribute securities and (2) the issuer files a registration statement.

2. The Waiting Period

The time between the filing of the registration statement and its effectiveness is the ***waiting period***.

a. Effectiveness

The registration becomes effective 20 days after it or its last amendment is filed with the SEC, unless the SEC issues a stop order or accelerates effectiveness.

b. Sales Efforts

After the registration statement is filed, the underwriters may begin sales efforts for the offering.

3. The Post-Effectiveness Period

Once the registration statement has gone effective, the underwriters may sell and deliver the securities.

D. Communications Rules

A goal of the Securities Act is to ensure that investors have adequate information, in the form of a prospectus, about a security and its issuer before making an investment decision.

1. Written Communications

The Securities Act most heavily regulates the use of written communications in connection with offering securities.

2. Prefiling Period

The securities laws take an expansive view of what communications constitute unlawful offers to sell, also known as ***gun-jumping***. There are certain safe harbors for public communications by issuers that do not constitute gun-jumping, including regular releases of factual information.

3. The Waiting Period and Post-Effective Period

Issuers and underwriters make offers to sell and may market the securities through the use of prospectuses and oral communications.

a. Offers to Sell

Offers may be made orally (such as in meetings with prospective investors) or by use of a statutory or ***free-writing prospectus***.

b. Prospectus

Written offers to sell are made by way of a prospectus, which may be either a statutory prospectus or a free-writing prospectus that complements the statutory prospectus.

c. Oral Communications

Oral communications are not included within the definition of prospectus. The most prominent use of oral communications in the offering process are ***road shows*** at which underwriters pitch offerings to prospective investors.

d. Underwriter Research Reports

A research report issued by an investment bank about its issuer client may be considered a prospectus or an unlawful offer to sell.

IV. Exempt Offerings

Every sale of a security be must either (1) be registered or (2) be exempt from registration.

A. Exempt Securities

Securities that are exempt from registration include government and bank securities, securities offered intrastate, insurance policies and annuities, commercial paper, and exchanged securities.

B. Exempt Transactions

Whereas Section 3 of the Securities Act exempts certain securities from registration, Section 4 (in addition to SEC rulemaking under it) exempts certain ***transactions*** from registration.

1. Private Offerings

Private offerings may not be resold unless they become registered or they are resold using a transactional exemption.

a. Section 4 and Safe Harbors

The SEC has adopted a number of ***safe harbors*** that provide clear guidance for private offerings.

b. Restricted Securities

Restricted securities are previously acquired securities that are not freely tradable.

c. Integration

Otherwise exempt transactions may be ***integrated***, or treated as a single transaction.

d. Switching between Private and Public Offerings

Issuers may sometimes begin to raise capital through a private offering only later to determine that the offering should be public, or vice versa.

2. Regulation D

The SEC's Regulation D is a safe harbor for several Section 3 and Section 4 exemptions.

a. Regulation D Generally

The concepts of accredited investor and bad-actor disqualification are important features of Regulation D offerings.

b. Rule 504

Rule 504 of Regulation D exempts offerings from registration in which (1) issuers who are not reporting issuers or investment companies and (2) offer up to $5,000,000 in securities to (3) an unlimited number of purchasers.

c. Rule 506

Rule 506 provides one of the most significant safe harbors for private placements.

i. Rule 506(b)

Rule 506(b) of Regulation D exempts offerings from registration in which issuers sell an unlimited value amount of securities to no more than 35 non-accredited investors.

ii. Rule 506(c)

Rule 506(c) of Regulation D exempts offerings from registration in which issuers sell an unlimited value amount of securities to accredited investors only.

3. Regulation A

Regulation A is an administrative exemption created by the SEC using its authority under Section 3(b) to exempt from registration classes of securities with offerings up to $50,000,000 in a 12-month period.

4. Crowdfunding Offerings

The crowdfunding exemption allows issuers to offer and sell securities in limited amounts to the public.

C. Secondary Distributions

Holders of restricted securities, as well as control persons who hold securities in an issuer (no matter how the securities were acquired) (***control securities***) may resell their securities in non-public offerings under Securities Act Rules 144 and 144A.

V. Continuing Disclosure, Shareholder Voting, and Tender Offers

Federal securities regulation provides rules designed to keep shareholders informed about the condition of the corporation.

A. Continuing Disclosure Obligations

Once a company is public, the Exchange Act imposes continuing reporting obligations on annual, quarterly, and current bases.

1. Issuers Subject to Continuing Disclosure Obligations

Issuers become reporting issuers—subject to continuing disclosure obligations—if they meet either of two triggers: listing on a national securities exchange and reaching certain revenue and shareholder levels.

2. Filer Types

Under Exchange Act Rule 12b-2, the SEC has adopted policies that vary the disclosure requirements of public companies based on factors like their market capitalization.

3. Regulation S-K, Regulation S-X, and Forms

What disclosures must be included on a report, and when reports must be filed, is determined by an issuer's status and Regulations S-K and S-X.

4. Periodic Reporting

Domestic issuers file annual and quarterly reports, as well as current reports between annual and quarterly reports. Foreign private issuers have more modest reporting obligations.

5. Financial Disclosure

Regulation S-X requires detailed, audited financial disclosures.

6. Qualitative Disclosure

Regulation S-K requires detailed qualitative disclosures.

B. Shareholder Voting

State corporate law vests most managerial decisions in a company's board of directors and officers. Shareholders, however, are given certain governance rights.

1. Shareholder Voting

Shareholder voting generally occurs at ***shareholder meetings***. Because most shareholders cannot attend meetings in person, state laws allow them to give another person their ***proxy*** to vote on their behalf.

a. Director Elections

Directors generally hold office for one-year terms.

b. Management Proposals

State law commonly requires shareholder approval for certain extraordinary matters.

c. Shareholder Proposals

Shareholders may sponsor precatory proposals.

2. Proxy Regulation

Regulation 14A regulates proxy solicitation, disclosure, and voting for public issuers.

C. Tender Offers

An acquirer may go directly to the shareholders by offering to buy all or part (but usually at least a majority) of their shares. The Williams Act requires disclosure, equal payments, and at least a twenty business-day offering window for such offers.

VI. Capital Markets Regulation

Federal securities regulation also seeks to ensure that the capital markets allow for securities to be traded efficiently and free from fraud, manipulation, or other abuses.

A. The National Market System

The national market system is a collection of linked securities exchanges and other trading facilities.

1. National Securities Exchanges

A securities exchange is a facility that allows sell and buy orders to be matched at sellers are willing to accept and buyers are willing to pay.

a. Registration

In the U.S., exchanges must be registered with the SEC or exempt from registration.

2. Other Trading Systems

The SEC has authority to exempt a trading facility that meets the definition of a securities exchanges from the requirement to register as an exchange.

3. Over-The-Counter (OTC) Trading

Many securities, including shares of small issuers (***penny stocks***) and bonds, are traded OTC by broker-dealers.

B. Self-Regulatory Organizations (SROs)

Federal securities law looks to securities exchanges and the broker-dealer industry to engage in substantial self-regulation and self-policing under the overall supervision of the SEC.

1. Regulation by Self-Regulatory Organizations

SROs regulate their members by adopting and enforcing rules.

2. National Securities Exchanges as Self-Regulatory Organizations

National securities exchanges are SROs.

3. Financial Industry Regulatory Authority (FINRA)

FINRA licenses and regulates broker-dealer firms and their registered representatives.

C. Market Makers and Specialists

Broker-dealers called market makers or specialists serve to ensure there is always an active market for a security.

D. Broker-Dealers

Broker-dealers are in the business of effecting securities transactions.

1. The Definitions of Broker and Dealer

The terms ***broker*** and ***dealer*** have distinct definitions under the Exchange Act, but institutions typically fill both roles and so common practice is to treat ***broker-dealers*** as a singular concept.

2. Broker-Dealer Regulation

Before entering the securities business, broker-dealers must register with the SEC and state securities regulators.

a. Federal Registration

Section 15 of the Exchange Act makes it unlawful for a broker-dealer to effect securities transactions, or to induce or to attempt to induce the purchase or sale of any security, unless it is first registered with the SEC or it is exempt from registration.

b. Associated Persons

An ***associated person*** is an employee or independent contractor of a broker-dealer.

c. State Jurisdiction

States have concurrent jurisdiction to regulate the entry and conduct of broker-dealers doing business within their borders.

d. Customer Protections

Federal and state courts have failed to reach consensus on when broker-dealers must act as fiduciaries to their customers under state and federal law.

e. Securities Analysts

Broker-dealers often employ securities analysts to research and monitor issuers and their securities.

f. Substantive Regulation

The securities laws also impose substantive regulations on how broker-dealers organize and conduct their businesses, including net-capital requirements, segregation of customer funds, and recordkeeping.

3. Broker-Dealer and Customer Dispute Resolution

Virtually all disputes disputes between broker-dealers and their customers, unless they are settled, are arbitrated before one- or three-arbitrator panels.

VII. Investment Advisers and Investment Companies

In 1940, Congress enacted the Investment Advisers Act and the Investment Companies Act.

A. Investment Advisers

Investment advisers are securities intermediaries that are compensated for providing advice whether to buy or sell securities; they do not themselves execute transactions.

1. The Meaning of Investment Adviser

An investment adviser is any person who (1) for compensation, (2) engages in the business (3) of providing investment advice (4) to others. It also includes those who (1) for compensation (2) as part of a regular business (3) issue reports or analyses about securities.

a. Compensation

Compensation is a broad concept that includes any economic benefit an investment adviser may receive for rendering services.

b. Engaged in the Business

A firm is not ***engaged in the business*** if it provides advice on rare or isolated occasions.

c. Providing Advice about Securities

Providing advice about securities includes giving advice whether to buy or sell specific securities, like stocks, bonds, mutual funds, partnership interests, or notes.

d. Advice to Others

It is clear that a person is providing advice to ***others*** when the persons receiving advice are natural persons. Whether advice provided to artificial persons is ***advice to***

others depends on the potential for conflicts of interest between the adviser and the advisee.

2. Exclusions from the Meaning of Investment Adviser

The statute offers a number of exclusions for persons whose might offer investment advice incidental to another service, including banks and bank-holding companies; lawyers, accountants, engineers, and teachers; broker-dealers; and publishers.

3. Investment-Adviser Registration

Any investment adviser that falls within the definition of investment adviser and is not excluded must register with the SEC unless (1) it is prohibited from registering with the SEC or (2) it is exempt from registration.

a. Prohibition on SEC Registration

The Investment Advisers Act allocates regulatory responsibility between the state and federal governments for investment advisers, with the states generally responsible for regulating smaller advisers. Most smaller advisers are prohibited from registering with the SEC.

b. Exemptions from SEC Registration

Certain investment advisers that would be subject to mandatory SEC registration are exempted from the requirement, although they may register if they so choose.

4. The Duties of Investment Advisers

U.S. securities law does not impose educational or other qualifications on investment advisers, but it instead imposes a set of fiduciary duties on investment advisers' conduct.

B. Investment Companies

Investment companies are in the business of investing, reinvesting, and trading securities. They are regulated under the Investment Company Act.

1. The Meaning of Investment Company

Under Section 3(a)(1)(A) of the Investment Company Act, an ***investment company*** is an issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities.

2. Classifications of Investment Companies

The Investment Company Act classifies investment companies into three categories: management companies, unit investment trusts, and face-amount certificate companies.

3. Registration

An investment company may not offer, sell, deliver, or redeem securities unless it has filed a registration statement with the SEC.

4. Investment-Company Governance

The three primary actors in an investment company's governance are (1) the adviser, the (2) board of directors, and (3) the shareholders.

5. Conflicts of Interest

One goal of the Investment Companies Act is to police conflicts of interest between affiliates (*e.g.*, advisers to investment companies) and investment companies.

6. Distribution

Any investment company will incur expenses as it seeks to market and distribute its shares. Investment companies have several options for how they finance their distribution, including charging purchasers a commission or charging the fund itself.

VIII. Securities Fraud

Securities fraud is prohibited and can lead to private enforcement via civil litigation and public enforcement by the SEC or the U.S. Department of Justice (DOJ).

A. Rule 10b-5

Rule 10b-5 makes unlawful any use of the instrumentalities of interstate commerce or the facilities of a national securities exchange to commit fraud ***in connection with the purchase or sale of any security***.

B. Elements of Securities Fraud

To be fraudulent, conduct must have (1) occurred in connection with the purchase or sale of securities, (2) involve manipulation or deception, (3) been material to an investment decision, and (4) been done with scienter.

1. In Connection with the Purchase or Sale of Securities

The ***in connection with the purchase or sale of securities*** element is also known as the ***transactional-nexus*** element.

2. Manipulation or Deception

Conduct must have been manipulative or deceptive.

3. Materiality

Materiality is whether there is a substantial likelihood that had a reasonable investor received the omitted (or non-misstated) fact, the investor would have made a different investing decision.

4. Scienter

Scienter requires "a mental state embracing intent to deceive, manipulate, or defraud."

C. Insider Trading

Insider trading refers to securities transactions by corporate insiders (or people who receive information from corporate insiders) based on information that is (1) gained through their insider status (or the insider status of the person who ultimately provided the information), (2) material, and (3) nonpublic (***material nonpublic information (MNPI)***).

1. Tipper/Tippee Liability

The prohibition on trading based on misappropriated MNPI applies not only to the person who has a duty not to trade based on the MNPI, but it can also apply to others who learn of the MNPI from the duty-bound person.

2. Rule 10b5-1 Safe Harbor

The SEC has adopted Rule 10b5-1, a safe harbor under which corporate insiders may enter into contracts, instructions, or plans (for example, with a broker-dealer) to execute future transactions.

IX. Private Enforcement

The securities laws allow persons injured by the securities misconduct of others to bring private actions to recover economic damages and to seek other forms of relief.

A. Rights of Action

Congress has provided explicit rights of action for some securities violations, and the courts have found implicit rights of action for others.

1. Section 10(b) of the Exchange Act (Securities Fraud)

Section 10(b) and Exchange Act Rule 10b-5 prohibit fraud in connection with the purchase or sale of securities, making them the most common securities private causes of action.

a. Substantive Elements

To violate Section 10(b) and Rule 10b-5, misstatement or omission must have (1) occurred in connection with the purchase or sale of securities, (2) involve manipulation or deception, (3) been material to an investment decision, and (4) been done with scienter.

b. Private-Action Elements

Private plaintiffs must also prove that (1) they relied on the defendant's misstatement or omission in making an investment decision and (2) the misstatement or omission caused the plaintiffs' loss.

c. Damages

Damages recoverable are limited to an investor's actual damages.

2. Section 11 of the Securities Act (Offering Liability)

Section 11 of the Securities Act creates strict liability for registration statements that contain (1) material misstatements or omissions (2) at the time they become effective, subject to limited good-faith defenses.

3. Section 12(a)(1) of the Securities Act (Unregistered Offerings)

Section 12(a)(1) of the Securities Act provides a right of action for the sale of unregistered securities that are not exempt from registration.

4. Section 12(a)(2) of the Securities Act (Offering Liability)

Section 12(a)(1) of the Securities Act provides a right of action against those who (1) offer or sell securities (2) using the instrumentalities of interstate commerce, (3) by means of a prospectus or oral communication (4) that contains material misstatements or omissions.

5. Section 17(a) of the Securities Act (Securities Offering Fraud)

Section 17(a) of the Securities Act prohibits fraud in connection with the offer or sale of securities.

6. Section 14(a) of the Exchange Act (Proxies)

Section 14(a) provides a right of action in connection with proxy statements and proxy solicitation.

7. Sections 13 and 14 of the Exchange Act (Tender Offers)

Litigation under Section 13 and 14 of the Exchange Act enforces the Williams Act's requirements that certain shareholders disclose their positions and that tender offers that would result in the offeror owning 5 percent or more of a class of an issuer's shares requires filing a Schedule TO with the SEC.

8. Section 16 of the Exchange Act (Short-Swing Profits)

Section 16 of the Exchange Act imposes strict liability for ***short-swing trading*** by corporate insiders, *i.e.*, the purchase **and** sale of issuer securities by an insider within a six-month period.

9. Section 18 of the Exchange Act (False Filings)

Section 18 of the Exchange Act imposes liability for material misstatements and omissions in filings with the SEC.

B. Primary and Secondary Liability

The securities laws impose liability on those who directly violate the law (*e.g.*, by making a material misstatement or omission) (***primary participants***), as well as certain persons who assist them in doing so (***secondary participants***).

C. Procedural Considerations

Beyond proving the substantive elements of securities violations, private securities plaintiffs must also satisfy and complete a number of procedural requirements and steps related to standing, pleading, lead plaintiffs, and discovery stays.

X. Public Enforcement

Violations of federal securities laws and SEC regulations—and, in some cases, the rules of SROs—may subject violators and their employers to civil or even criminal actions by the SEC or DOJ.

A. Liability and Penalties

Liability may arise against employers for employees' misconduct (***respondeat superior liability***), or against third parties who participated in a primary violator's misconduct (***aiding-and-abetting liability***).

B. SEC Enforcement

Courts have traditionally given the SEC broad discretion in investigating potential violations of the securities laws or SEC rules.

1. Investigation

The bulk of SEC enforcement activity occurs during the investigative stage.

a. Informal Investigation

SEC investigations begin with an informal stage of seeking voluntarily document production or interviews.

b. Formal Investigation

If the commission issues a formal order of investigation, enforcement attorneys working on the case have authority to issue subpoenas for documents and testimony.

c. Enforcement Actions

The commission may bring enforcement actions administratively or by filing a civil suit in federal court.

C. Criminal Enforcement

Although most public securities enforcement at the federal level is conducted by the SEC, some cases are handled both civilly and criminally (*i.e.*, by both the SEC and DOJ) or just criminally.

XI. State Blue-Sky Laws

States retain jurisdiction over securities offerings for securities ***except*** when federal law has preempted their jurisdiction.

A. Registration of Securities under State Law

Unless federal law preempts state law, states are free to regulate securities transactions and the players involved in them.

1. Blue-Sky Laws

Each U.S. state and territory (other than the District of Columbia) has a securities statute.

2. State Securities Administrators

States have administrative agencies that are responsible for securities registration, enforcement, and related functions.

3. Securities Defined

The Uniform Act defines "security" and establishes whether transactions are subject to registration or are exempt.

B. Federal Preemption of State Securities Laws

In 1996, Congress adopted the National Securities Markets Improvement Act ("NSMIA"), which ***preempts*** blue-sky laws ***by exempting*** several types of securities from state registration.

C. State Anti-Fraud Laws and Securities Offerings

Although the NSMIA preempted significant parts of state jurisdiction over the registration of securities offerings, it preserved states' ***ex post enforcement authority***.

1. Private Right of Action

The Uniform Securities Act allows securities purchasers who are injured by fraud or other violations of blue-sky laws to bring ***private actions*** against offerors and sellers.

2. Administrative Enforcement

The Uniform Securities Act allows state securities administrators to investigate potential violations of blue-sky laws, including by issuing ***subpoenas***.

3. Criminal Prosecution

In addition to potential private litigation and civil enforcement, states may criminally prosecute individuals or entities that violate their blue-sky laws.

I. The Framework of Securities Regulation

Unlike other financial products such as bank accounts, securities do not hold intrinsic value. Instead, they represent economic claims on their issuers (*e.g.*, companies or government agencies). An issuer's future economic performance, and the value of the securities tied to that performance, are always uncertain. Despite this uncertainty, having information about an issuer, its future prospects, and its market allows prospective investors to predict future performance and thus the present value of the securities linked to that performance. A primary goal of securities regulation is to ensure that investors receive this information accurately, which allows them to make informed investment decisions.

A. Capital Markets

Securities represent economic claims on issuers. For example, the holder of a company's shares might receive a portion of the company's profits in the form of dividends; if the company is ever sold, the shareholder also has a claim on the purchase price, less any payments belonging to superior claimants like lenders. This is called a claim on the company's ***residual value***. Securities may be bought and sold. The systems that facilitate the buying and selling of securities are the ***capital markets***.

1. The Purpose and Function of Capital Markets

The purpose of capital markets is to facilitate the buying and selling of securities. In other words, the transactions that the securities laws regulate take place on capital markets.

a. The Purpose of Capital Markets

Capital markets are places where those who seek to sell a given security and those who seek to buy that security find or are matched with each other. Capital markets are also where these buyers and sellers agree on what prices the buyers are willing to pay and the sellers are willing to accept.

Note: Although capital markets sometimes take the form of physical spaces—such as the floor of a stock exchange—they typically do not. The term ***capital markets*** refers to the overall structure of individual buyers and sellers and is embodied in many discrete markets.

Examples:

(1) An entrepreneur started a new business that required $50,000 in initial capital. To raise this capital, the entrepreneur called 10 friends and sold them shares in the startup in exchange for $5,000 each. The entrepreneur and the investors used email

to complete the necessary paperwork and the investors sent money via wire transfer to purchase their shares. This was a capital-market transaction.

(2) Alto Corporation needed to raise $100 million to fund an expansion. It issued $100 million in bonds at a 7-percent annual interest rate. The bonds were first sold to several large financial institutions, which kept some bonds for their own accounts and sold the rest to their investor customers. This was also a capital-market transaction.

2. The Efficient Capital Markets Hypothesis

An issuer's future economic performance, and thus the value of the securities tied to that performance, are always uncertain. But by analyzing all the information available about an issuer or its securities, investors can make rational predictions about the securities' future value and what that future is worth in today's dollars, also referred to as the security's ***net-present value*** (NPV). These predictions set the securities' market price.

a. Description of the Efficient Capital Markets Hypothesis

A market in which all available information is reflected in the price is said to be an ***efficient market***. In financial research, this insight is called the ***Efficient Capital Markets Hypothesis***.

b. Conditions for Efficient Capital Markets

Under the Efficient Capital Markets Hypothesis, ***at least one*** of three conditions must be satisfied for an efficient market to exist: rationality, independent deviations from rationality, or arbitrage.

i. Rationality

Once investors receive new information about an issuer or its securities, then the market for that security will be efficiently priced if the investors all update their predictions on the security's NPV in a reasonable, objective manner.

Example:

The U.S. Food and Drug Administration (FDA) announced that it approved a new product manufactured by Megarx, a publicly traded pharmaceutical company. The drug treated a condition experienced by millions of people, and Megarx had the exclusive right to manufacture it until the expiration of the patent. The price of Megarx stock went up 15 percent, driven by investors' average prediction of the new profits the drug would earn in the long term. In predicting that the value of

Megarx would go up after the FDA's announcement, market actors behaved rationally.

ii. Independent Deviations from Rationality

If investors do not respond to new information in a reasonable, objective manner, the market for the security will still be efficient so long as irrational responses offset each other. That means that if some investors are irrationally pessimistic about a security's market price and others are irrationally optimistic about it, the resulting irrational under- and over-pricing cancel each other out.

Example:

Rubber Corporation, a publicly traded tire manufacturer, had uneven sales performance over the last three years. It announced that it had fired its CEO. Some investors sold their shares because they believed the firing would lead to disruption and weaker performance in the future. Others bought more shares because they believed a new CEO would improve performance. These trades cancelled each other out and, indeed, Rubber's performance was similar under the new CEO.

iii. Arbitrage

If some investors set the price of a security at irrationally high or low levels, then the market for the security will still be efficient so long as more rational investors can buy or sell the security to take advantage of the under- or over-pricing.

Example:

Rubber Corporation, a publicly traded tire manufacturer, had uneven sales performance over the last three years. That weak performance caused it to have a low stock price compared to other tire manufacturers. Based on its research, however, an investor determined that global demand for tires would increase substantially in the next five years. The market price for Rubber stock did not reflect that information. The investor bought 1,000,000 Rubber shares because it expected all tire manufacturers to benefit from greater demand and because Rubber's shares in particular would increase in value due to their relatively low price. This purchase increased demand for Rubber stock, pushing the price up closer to Rubber's NPV (*i.e.*, after factoring in the future growth in tire demand).

c. Forms of Efficient Capital Markets

Market efficiency is hypothesized as taking three possible forms: weak, semi-strong, and strong. These forms take into account that new information may be absorbed into market prices at different rates.

Note: There is little, if any, empirical evidence that U.S. capital markets are strongly efficient. There is significant open debate, however, as to whether U.S. capital markets are weakly or semi-strongly efficient. [*See* Andrew W. Lo, *Efficient Markets Hypothesis*, *The New Palgrave: A Dictionary of Economics* (2007).]

i. Weak Form Market Efficiency

In a weakly efficient market, the price of a security reflects all information related to the security's prior prices. Weak efficiency means that prior prices cannot be used to predict future prices because future prices are independent of what prior prices were.

Example:

At the end of Monday, Tuesday, and Wednesday's trading days, the prices for Lemon Corporation's shares were $10.00, $10.25, and $9.90. If an investor had only this pricing information about Lemon shares, however, it was not possible to make a rational prediction (*i.e.*, one not based on chance) about the shares' future price.

ii. Semi-Strong Form Market Efficiency

In a semi-strongly efficient market, the price of a security reflects all publicly available information about the security.

Example:

At the end of Wednesday's trading day, the price for Lemon shares was $9.90. Early Thursday morning, Lemon announced that due to safety issues, it would need to recall a substantial portion of its products. The price immediately dropped to $7.95. This nearly 20-percent drop reflected the market's expectation that the recall would cause Lemon (1) to have lower revenue than it previously expected and (2) to incur expenses related to product-liability litigation.

iii. Strong Form Market Efficiency

In a strongly efficient market, the price of a security reflects all information relevant to the security, even if that information is not publicly available.

Example:

At the end of Wednesday's trading day, the price for Lemon shares was $9.90. That evening, Lemon's board of directors determined that due to safety issues, it had to recall a substantial portion of its products. Although Lemon did not publicly announce the recall until Thursday evening, when trading opened on Thursday morning, the price immediately dropped to $7.95. This nearly 20-percent drop implied that the recall information was already known to the market even without a public announcement. [*See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 *Virginia Law Review* 549 (1984).]

B. Securities Transactions

Securities transactions are the buying and selling of securities. They generally fall into one of two categories: transactions involving issuers (***issuer transactions***) and transactions involving only non-issuer market participants (***market transactions***).

1. Transactions by Issuers

Issuer transactions involve an issuer selling its securities to third-party investors. Issuers can include corporations, partnerships, government agencies, or other entities. Investors might be public investors (*e.g.*, individual investors or mutual funds), but they might also be employees (*e.g.*, workers receiving stock options as a form of compensation), inside investors (*e.g.*, founders investing in a new business), or outside investors (*e.g.*, venture capitalists).

a. Private Offerings

Private offerings involve selling securities to a small number of investors. They are negotiated between the issuer and investors. These offerings are generally more streamlined than public offerings because they are subject to less regulation, particularly with respect to disclosure requirements. Examples of private offerings include:

- offering an associate attorney a partnership interest in a law firm,
- raising capital from venture capitalists for a new business,
- a non-public company granting stock options to its employees, and
- a public company issuing new shares or bonds directly to a small group of investors.

b. Public Offerings

Public offerings involve selling securities to a larger number of investors. Issuers may conduct public offerings in order to raise capital to support or expand their business, or to provide existing investors new opportunities to sell their securities (***liquidity***).

Note: Public offerings generally require adherence to more regulatory requirements than private offerings, including greater levels of disclosure about the securities and the issuer. Examples of public offerings include:

- a private company offering its shares to the public for the first time (***going public***);
- a company that has already gone public that later offers new securities to the public; and
- a city government selling bonds to finance new school construction.

2. Transactions by Market Participants

Market transactions do not directly involve the issuer, but rather they take place between an existing holder of securities and a buyer. Just as issuer transactions are either private or public, so too are market transactions.

Note: A securities transaction that does not directly involve the issuer may sometimes nevertheless be a public offering if it involves a significant offering by a shareholder (*e.g.*, when a major shareholder in a non-public company seeks to sell its shares to the public).

a. Public-Market Transactions

In public-market transactions, the seller and buyer transact through an exchange or trading system rather than directly negotiating with each other. These types of transactions generally offer higher liquidity and fewer transaction costs because sellers do not need to search for buyers and then negotiate with them.

Example:

Two years ago, an investor purchased 1,000 shares of Lemon, whose equities traded on the New York Stock Exchange (NYSE), through a stockbroker. Yesterday, the investor sold 500 of those shares by placing a sell order with the stockbroker. One or more buyers bought the investor's 500 shares. The identities of the investor and the buyers(s) of the shares were anonymous to each other. The price the shares were sold at was determined through supply and demand, not direct negotiation.

b. Private-Market Transactions

In private-market transactions, the seller and buyer directly negotiate with each other. In private-market transactions, sellers and buyers must first find each other and then negotiate a transaction, including what the price for the securities will be.

Example:

Alpha Bank held 100,000 bonds issued by the Public Hospital Finance Agency (PHFA), which were not traded on a public exchange. Alpha Bank decided to sell all of its PHFA bonds. It did so by calling mutual funds and other banks and offering to sell the bonds to them. The mutual funds and other banks agreed to buy the bonds, and Alpha Bank negotiated with each of them how many bonds they would buy and what price they would pay.

C. Federal Securities Law

In the United States, securities regulation is primarily centered around federal law and rules. These laws and rules are primarily enforced by federal agencies and in federal courts.

1. Securities Law Prior to 1933

The federal government has regulated securities transactions for less than a century. In the aftermath of World War I and the Great Depression, however, the federal government enacted its first securities laws. Since then, securities regulation has steadily shifted toward greater and greater federal responsibility.

a. State Responsibility for Securities Regulation

Prior to 1933, securities regulation in the United States was the responsibility of the states. Although securities regulation is highly federalized today, states continue to exercise some jurisdiction over securities-related transactions and activities. In the aftermath of World War I and the Great Depression, however, there was growing concern about fraudulent securities offerings. In particular, there were concerns that investors were not receiving accurate, complete information that they needed to make informed investment decisions. [*See* Thomas Lee Hazen, 1 *Law of Securities Regulation* § 1:13–15 (May 2019); *see also* State Blue Sky Laws, *infra*.]

b. Beginnings of Federal Securities Regulation

Since Congress enacted the first federal securities statute in 1933, U.S. securities law has frequently changed and expanded in scope as the result of statutory enactments and rulemaking by the Securities and Exchange Commission (SEC). However, four statutes passed during a seven-year span—the Securities Act of 1933, the Securities

Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Companies Act of 1940—formed, and continue to serve as, the foundation of federal securities law.

2. The Securities Act of 1933

The Securities Act of 1933 (the Securities Act, or the '33 Act) was the first federal securities statute.

a. Disclosure-Based Securities Regulation

The Securities Act focused on ensuring that before securities are distributed, investors have sufficient information about the issuer and the securities to make informed decisions whether to purchase. The Securities Act thus focused on ***disclosure***, rather than the merits of a securities offering. In other words, through the Securities Act, the federal government would require only that investors receive adequate information, but it would not pass judgement on whether securities were good or bad investments. This policy is often justified on the grounds that "sunlight is the best disinfectant." [*See* Thomas Lee Hazen, 1 *Law of Securities Regulation* § 1:16 (May 2019).]

b. Requirements of the Securities Act

Under the Securities Act, prior to distributing securities, an issuer must file a registration statement with the SEC. The registration statement must contain certain information, including:

- information about the issuer's business, property, and management;
- audited financial statements for the current and prior years, sometimes broken down by major business lines;
- risk factors that could affect the issuer's performance or the securities' value;
- management's discussion and analysis of the issuer's future needs and performance prospects; and
- detailed descriptions of the voting and other rights associated with the securities, as well as disclosures about the issuer's governance.

c. Registration Required to Distribute Securities

This registration statement is subject to review by the SEC's Division of Corporation Finance and revision by the issuer. The issuer is prohibited from distributing securities until the registration statement becomes ***effective***. [*See* Public Offerings, *infra*.]

d. Application of the Securities Act

The Securities Act does not apply to all securities, however. It carves out transactions in securities issued by governments (*e.g.*, state governments, municipal authorities), banks, and insurance companies, as well as securities sold in certain private transactions. [*See* 15 U.S.C. § 77a, *et seq.*; *see also* Exempt Offerings, *infra*.]The Securities Exchange Act of 1934

The Securities Act ensures that investors receive adequate information to make investment decisions about an initial distribution of securities, and the Securities Exchange Act of 1934 (the Exchange Act, or the '34 Act) regulates the trading of those securities after they are distributed. The Exchange Act was intended to curb unsafe, abusive, or manipulative practices in the securities markets that could harm individual investors or the markets as a whole. Among the Exchange Act's features are:

- requirements that public issuers make continuous disclosures to investors (*i.e.*, not just at the time they are required to make offering disclosures under the Securities Act);
- general prohibition of fraud in connection with securities transactions; and
- regulation of securities trading, stock exchanges, and broker-dealers.

[*See* 15 U.S.C. § 78a, *et seq.; see also* Corporate Governance, Takeovers, and Tenders, *infra;* Capital Markets Regulation, *infra;* Securities Fraud, *infra*; Private Enforcement, *infra;* Public Enforcement, *infra*.]

3. The Investment Advisers Act of 1940 and the Investment Companies Act of 1940

Six years after the adoption of the Exchange Act, Congress enacted the Investment Advisers Act of 1940 (the Investment Advisers Act) and the Investment Companies Act of 1940 (the Investment Companies Act, or the '40 Act).

a. Investment Advisers

The Securities Act protects investors by ensuring that they receive adequate information before deciding to participate in the offering of new securities, and the Exchange Act protects investors in part by ensuring that they receive continuously updated information about issuers and their securities. Investors may not evaluate this information or make investment decisions themselves, however. They may instead turn to ***investment advisers***, professionals who are compensated to provide investment advice to, or manage investments for, others.

i. What the Investment Advisers Act Does

Because there are potential conflicts between investment advisers and their clients, especially around how the investment adviser is compensated, the Investment Advisers Act, as amended, requires that advisers register with the SEC or a state securities regulator. It also imposes substantive requirements on advisers, including to retain certain records, adopt compliance policies, and refrain from certain compensation practices. [*See* 15 U.S.C. § 80b-1, *et seq.*; *see also* Investment Advisers and Companies, *infra*.]

b. Investment Companies

Investors often seek to pool their investment capital into funds managed by professional investors. These pooled funds take a variety of forms and are regulated under an umbrella regulatory framework as ***investment companies***. A characteristic of investment companies is that they are vehicles for investing in the securities of other issuers. ***Mutual funds*** are the most common type of investment company. The Investment Companies Act imposes a number of rules on investment companies, including:

- financial, governance, and other disclosures that must be made to investors;
- governance standards;
- pricing, marketing, and distribution requirements; and
- compensation regulations for affiliated investment managers.

[*See* 15 U.S.C. § 80b-1, *et seq.*; *see also* Investment Advisers and Investment Companies, *infra*.]

4. The Securities and Exchange Commission

The Exchange Act created the SEC as the independent agency charged with administering the federal securities laws and adopting rules to carry out their mandates and purposes.

a. The Commission

At the top of the SEC are its commissioners, but its day-to-day work is carried out by over 4,000 civil servants.

i. The Organization of the Commission

The SEC is led by five commissioners appointed by the president and confirmed by the U.S. Senate to six-year terms. These terms are staggered, and each June one commissioner's term expires. One commissioner is designated by the president as chair. No more than three commissioners may be members of the same political party. [*See* 15 U.S.C. § 78d.]

ii. The Delegation of Authority in the SEC

The commissioners delegate much of their authority to senior staff within the SEC's various divisions and offices. Four of the most important offices within the SEC are the Division of Corporation Finance, the Division of Trading and Markets, the Division of Investment Management, and the Division of Enforcement.

1) The Division of Corporation Finance

The Division of Corporation Finance administers the securities laws' disclosure requirements in the context of offerings, continuous disclosure (*e.g*., annual, quarterly, and periodic reports), proxy solicitation, tender offers, and other circumstances. [*See* Public Offerings, *infra;* Exempt Offerings, *infra;* Continuing Disclosure, Shareholder Voting, and Tender Offer, *infra.*]

2) The Division of Trading and Markets

The Division of Trading and Markets administers the securities laws in the context of secondary trading markets (*e.g*., national stock exchanges) and the regulation of broker-dealers. [*See* Capital Markets Regulation, *infra.*]

3) The Division of Investment Management

The Division of Investment Management administers the securities laws in the context of disclosures by and substantive regulation of investment advisers and investment companies. [*See* Investment Advisers and Investment Companies, *infra.*]

4) The Division of Enforcement

The Division of Enforcement, operating through several regional offices, is responsible for the civil public enforcement of the securities laws. The division investigates potential securities violations, which may result in the SEC bringing charges against issuers, broker-dealers, investment advisers, and other market participants. These charges are heard administratively before the SEC's Office of Administrative Law Judges or the commissioners, or they may be brought as civil litigation in federal district courts. (Criminal prosecution for violations of the securities laws is the responsibility of the U.S. Department of Justice.) [*See* SEC, *What We Do*, https://www.sec.gov/Article/whatwedo.html (November 18, 2019); *see also* Public Enforcement, *infra.*]

II. The Meanings of Securities and Materiality

This chapter considers perhaps the two most important questions in securities regulation: (1) what is a security, and (2) when are securities-related disclosures considered ***material***?

A. The Meaning of Securities

"What is a security?" is a foundational question of securities regulation. This question is important because the securities laws regulate only transactions involving securities. That means that if a transaction does not involve a security, then securities laws, and their protections, do not apply.

Example:

An investor was told by a real estate broker that a tract of undeveloped land would be valuable in a few years after a new highway was built in the area. The investor paid a premium price for the land on the expectation that it would be valuable when the highway was built nearby. In fact, the broker knew that the state had decided to locate the highway in a different area. The broker's misrepresentation was not a violation of the anti-fraud protections of the securities laws, however, because the land was not a security. (The broker might have violated other laws against fraud, however.)

1. The Federal Definition of Securities

The Securities Act and the Exchange Act do not provide a functional or conceptual definition of a security. Instead, they provide that a long list of financial instruments presumptively will be considered securities, unless the "context otherwise requires." [15 U.S.C. §§ 77b(a)(1) (Securities Act § 2(a)(1)), 78c(a)(10) (Exchange Act § 3(a)(10).] These instruments include, among other things, notes, stocks, bonds, debentures, investment contracts, fractional undivided interests in mineral rights, puts, calls, and options.

a. Congress's Purpose

Congress's purpose in enacting the securities laws was to regulate investments broadly, without regard to the form they take or what they are called. As a result, Congress's Securities Act and Exchange Act definitions of security were meant to be broad and to "to encompass virtually any instrument that might be sold as an investment." [*Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).]

b. Securities Tests

Whether an instrument is or is not a security cannot be determined merely by checking to see if it is labeled with one of the names listed in the Securities Act or Exchange Act. Otherwise, by calling an instrument a convenient name, promoters could evade the substantive regulation of transactions that Congress intended to regulate. Instead, courts follow a functional approach for making that determination. In other words, the question is whether an instrument that has been transacted is the sort of instrument that Congress intended to include when it adopted the federal securities laws. Courts have adopted several tests for conducting that analysis.

i. The *Howey* Test

In an early landmark securities case, the United States Supreme Court considered whether a sale-leaseback arrangement for Florida citrus groves qualified as an investment contract under the Securities Act. Under the arrangement, investors purchased strips of Florida citrus trees and then leased the land back to an affiliate of the seller. The seller had sole possession of the strips and was responsible for managing the citrus trees and marketing the produce they grew. In holding that this arrangement was an investment contract under the Securities Act, the Court stated what is known as the *Howey* test. Under that test, a transaction involves securities if it is (1) "a contract, transaction, or scheme" in which (2) a person invests money in (3) "a common enterprise" and is (4) "led to expect profits solely from the efforts of the promoter or a third party." [*SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–299 (1946).]

ii. Other Uses of the *Howey* Test

Howey provided a test for determining whether an instrument is an investment contract. The test has long been used, however, for determining whether other types of instruments qualify as securities. The SEC, for example, has used a *Howey* analysis to determine that digital assets, like cryptocurrency tokes, are securities. However, the *Howey* test is not appropriate when assessing whether an instrument whose label appears in the securities laws' laundry list has the characteristics typical of instruments with that label. For example, when an instrument is labeled "stock," the proper analysis is whether that instrument has the characteristics typical of stock. [SEC, *Framework for "Investment Contract" Analysis of Digital Assets* (Apr. 3, 2019); *see also Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691 (1985).]

Example:

An art dealer told a group of patrons that if they would each invest $50,000 into a fund, then the dealer would use the money to purchase works from up-and-coming artists. The dealer explained that in a few years when those purchased works were more valuable, they would be sold and the patrons would receive their money back plus a profit. Under the *Howey* test, the dealer proposed a security transaction, because there would be (1) transactions in which (2) patrons invested money (3) in common and in which (4) their profit relied on the dealer's success at buying art that would appreciate in a few years' time.

iii. *Howey*'s Investment Prong

To qualify as a securities transaction, a transaction must satisfy each of the *Howey* prongs, which include that the money paid was for ***investment***, rather than for ***consumption***. That means that if a person purchases an instrument that is labeled with one of the federal securities laws' laundry-list terms, like stock, that label does not always mean the instrument fits the federal definition of a security. For example, if a person purchases housing-cooperative stock that merely entitles the purchaser to live in a unit within the cooperative, that purchase is not a securities transaction even though stock is listed in the statutes as a security. That is because the purchaser bought the stock for consumption purposes (*i.e.*, to have a place to live), rather than for investment. [*United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 858 (1975).]

Example:

A developer sold tracts of Florida citrus groves to restaurants, hotels, and supermarkets. The purchasers leased their tracts back to the developer, who was responsible for managing the groves. The produce was periodically harvested. It was then pooled and distributed to the tract owners in proportion with the number of tracts they owned. Because the tract owners consumed the produce (*i.e.*, they used the fruit in their businesses), these sale-leaseback transactions were not made for purposes of investment and thus not securities transactions.

iv. *Howey*'s Common-Enterprise Prong

Federal courts are split in how they assess *Howey*'s common-enterprise prong. The approaches they follow are to look for ***horizontal commonality*** or ***vertical commonality***.

Note: The SEC does not regard common enterprise to be a distinct element of an investment contract, and so it does not subscribe either to horizontal or vertical commonality. [*In re Barkate*, 57 S.E.C. 488, 496 n.13 (Apr. 8, 2004).]

1) Horizontal Commonality

Under horizontal commonality, investors' fortunes are tied together in a common fund or through pooling of their assets, typically with profits distributed ratably among the investors according to their share of the common fund. [*Revak v. SEC Realty Corp.*, 18 F.3d. 81, 87–88 (2nd Cir. 1994).]

Example:

An art dealer persuaded a group of patrons to invest $50,000 each into a fund. The fund would allow the dealer to purchase works from up-and-coming artists. The dealer would then sell the works years later after the artists became famous. After the works were sold, the dealer would distribute the profits pro rata to the patrons. Because the patron's investments were pooled, the investments exemplified horizontal commonality.

2) Vertical Commonality

There are two approaches to vertical commonality. Under a loose approach, ***broad vertical commonality***, the common-enterprise element will be satisfied if there is a connection between investors' profits and losses and the efforts of the promoter. Under a tighter approach, ***strict vertical commonality***, the promoter and investors must share in the risk of an enterprise whose success depends on the promoter. [*Revak v. SEC Realty Corp.*, 18 F.3d. 81, 87–88 (2nd Cir. 1994).]

Example:

An art dealer persuaded a group of patrons to invest $50,000 each that the dealer would use to purchase works from up-and-coming artists. The dealer would then sell the works years later after the artists became famous. Each work was purchased for an individual patron, and so the potential earnings of the patrons varied based on demand for a given artist's work. Because there was some connection between each patron's investment and the dealer's efforts, the investments exemplified ***broad vertical commonality***.

Compare:

An art dealer persuaded a group of patrons to invest $50,000 each that the dealer would use to purchase works from up-and-coming artists. The dealer would then sell the works years later after the artists became famous. Each individual work was purchased for an individual patron, and so the potential earnings of the patrons varied based on demand for a given artist's work. The dealer also invested in each purchase and so would participate in any profits alongside the patrons. Because the dealer shared risk with the investors, and because the outcome of the investments depended on the dealer's managerial success, these investments exemplified the ***strict-vertical-commonality*** approach.

v. *Howey*'s Efforts-of-Others Prong

Under *Howey*, transactions qualify as securities transactions if their expected profits derive "solely from the efforts of the promoter or a third party." [*SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–299 (1946).] Despite the apparent strictness of the "solely" modifier, federal courts do not treat this part of the test literally but rather consider the efforts-of-others prong to be satisfied when expected profits are substantially or predominantly driven by efforts of persons other than the investor. [*see SEC v. International Loan Network, Inc.*, 968 F.2d 1304 (D.C. Cir. 1992).]

Example:

A real estate developer sold a condominium to an investor who hoped to profit by renting it out to vacationers. The developer explained that many units were rented up to 300 nights a year and agreed to post a listing for the unit to the building's rentals bulletin board. The investor marketed the unit on vacation websites and personally managed bookings. This transaction ***was not*** a securities transaction because it did not satisfy *Howey*'s efforts-of-others prong. Although the developer sold the unit to the investor for investment purposes and made representations about potential profits, neither the developer nor its affiliates were involved in the operation of the unit. More, the marketing the developer did (*i.e.*, posting a listing to a bulletin board) was insubstantial compared to the investor's efforts.

Compare:

A real estate developer sold a condominium to an investor who hoped to profit by renting it out to vacationers. The developer explained that many units were rented up to 300 nights a year. Like the other investors, the investor also entered into a service contract under which the developer's affiliate would handle all the marketing and bookings and remit the rental income to the investor. Under the contract, the investor was free to block off dates for personal use of the unit. Personal use, of course, would reduce the unit's potential rental income. This transaction ***was*** a securities transaction in part because it satisfied *Howey*'s efforts-of-others prong. The investor purchased real estate and the expected profits were substantially based on the efforts of the developer's affiliate, despite the fact that the investor could affect the profits through personal use of the unit.

vi. Other Regulatory Regimes

Courts sometimes decline to treat instruments as securities despite their presumptively falling under the Securities Act or Exchange Act definitions. This treatment arises when the instruments are regulated under another regulatory regime that protects investors. For example, even though "certificate of deposit" is listed as a type of security in the acts, the Supreme Court has held that bank-issued certificates of deposit are not securities because banking regulations are adequate to protect investors. Similarly, the Court has held that pension plans are not securities because their beneficiaries are protected by the Employee Retirement Income Security Act of 1974 (ERISA). [*Marine Bank v. Weaver*, 455 U.S. 551, 558 (1982); see also *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 570 (1979).]

Examples:

(1) Alpha Bank offered its customers one-year certificates of deposit paying 2-percent annual interest. The bank's customer deposits (including certificates of deposit) were insured by the Federal Deposit Insurance Corporation and the bank was subject to safety-and-soundness supervision by its banking regulator. The certificates of deposits would not be treated as securities because investors were protected by deposit insurance and the supervision of Alpha Bank.

(2) Natural Industries offered its employees a pension plan. Under the plan, if employees contributed 5 percent of their wages and worked at the company for at least 25 years, they would receive lifetime retirement income. Natural Industries matched each employee's 5-percent contribution and invested the contributions made to the plan so that it could meet its obligations to retirees. Employees' interests in the pension plan would not be treated as securities because they were already regulated under ERISA.

2. Investment Contracts

Investment contracts have proven to be one of the broadest instruments captured by the federal securities laws' securities definition. Whether an instrument is an investment contract is evaluated under the *Howey* test.

Example:

GameRay, a startup gaming company, sold digital tokens that could be used to play games. Token sales helped fund GameRay's expenses. Its marketing materials for the tokens focused on their potential appreciation as the company's games grew in popularity: early purchasers would be able to sell their tokens for a profit once demand for them went up. The popularity of the company's games would depend on its management's ability to build and market games that would attract many players. The digital tokens would meet *Howey*'s test for being investment contracts because they would be purchased for investment in a common enterprise and their expected profitability would depend on GameRay's efforts in growing player demand. [*See* SEC, *Framework for "Investment Contract" Analysis of Digital Assets* (Apr. 3, 2019).]

3. Equity Securities

Equity securities are securities that allow investors either directly or indirectly to participate in an issuer's residual value. An example of an equity security is a share of common stock in a public company, which entitles the holder to dividends (if the company decides to issue them), voting rights, and a share of the purchase price if the company is ever acquired.

a. Stocks

Stocks are the quintessential form of securities. Despite the *Howey* test's efforts-of-others prong, the securities laws apply to their sale without regard to what role the purchaser plays in connection with the issuer. In other words, shares held by a shareholder are still securities even if the shareholder is principally responsible for the company's performance. [*Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).]

Example:

GameRay, an online gaming company, received an acquisition offer from its competitor, Mega Game. GameRay's senior managers represented to Mega Game that it would soon close a big licensing deal with a major sports league. Mega Game acquired all of GameRay's stock for a purchase price that was based partly on the expected profits from the sports-licensing deal. After Mega Game took control of the acquired company, it discovered that the licensing deal was not only nowhere near being closed, but in fact the sports league had withdrawn after preliminary discussions. Because the transaction involved the purchase of stock, the acquisition was a securities transaction, despite the fact that GameRay's performance after it was acquired depended solely on the managerial efforts of its new owner, Mega Game.

b. Partnership and Limited Liability Company Interests

In contrast with corporation stock, interests in partnerships and limited liability companies (LLCs) require more fact-specific analysis to determine whether they qualify as securities. The most important factor in this analysis is whether the investor is passive, or whether the investor takes an active role in the partnership or LLC's management. As a general matter, interests in general partnerships have not been treated as securities, whereas interests in limited partnerships have been. [*see* Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, 25 *Journal of Corporation Law* 307, 335 (2000).]

Examples:

The partners at a law firm offered a partnership interest to their associate. The new partner was required to pay $100,000 for the interest and was provided with financial disclosures before doing so. The new partner received a share of the firm's profits and was expected to help manage the firm through voting at partners' meetings and serving in firm leadership roles and committees. The sale of this partnership interest would not be a securities transaction because the new partner was actively involved in the firm's day-to-day management.

Compare:

The developer of a natural-gas pipeline organized the pipeline as a limited partnership, appointing itself as the general partner. It sold limited-partner interests to hundreds of investors. Although limited partners would have no say in the day-to-day management of the company, they would be able to elect an executive committee to supervise the general partner and to vote on extraordinary transactions like selling the company. Given the narrow involvement of the limited partners in the company's management, the sale of the partnership interests ***would be*** a securities transaction.

4. Notes

Notes, a form of debt instrument, are included in the laundry list in the Securities Act and Exchange Act's security definitions. However, the acts exclude notes with maturities falling within nine months of issuance. That nine-month limitation, among other things, excludes transactions in commercial paper (short-term lending between large companies and financial institutions). Although the definition of security presumptively includes all notes with greater-than-nine-month maturities, in practice courts have construed "note" to exclude commercial (as opposed to investment) transactions. Examples of these commercial transactions include consumer loans, mortgage notes, business loans secured by receivables, personal loans, and other notes bearing a family resemblance to those examples. The Supreme Court has articulated a four-factor test for making this determination:

- whether the note is intended to finance minor assets, consumer goods, or to address cash-flow or commercial concerns (less likely a security), or to finance general business purposes or substantial investments (more likely a security);

- whether the note is available for common trading or investment (more likely a security);
- whether the public has an expectation that the note is a security; and
- whether there is another regulatory regime that makes securities regulation unnecessary with respect to the note.

[15 U.S.C. §§ 77b(a)(1), 77c(a)(3) (Securities Act §§ 2(a)(1), 3(a)(3)), 78c(a)(10) (Exchange Act § 3(a)(10)); *see also Reves v. Ernst & Young*, 494 U.S. 56 (1990).]

Examples:

Natural Industries needed a loan to pay for raw materials. It obtained a $10,000,000 loan from Alpha Bank. The loan note was secured by a lien on $10,000,000 in accounts receivable and was payable a year after issuance. This note was not a security because it represented a commercial transaction between the borrower and a bank and was subject to banking regulation.

Compare:

Natural Industries needed cash to fund its expansion plans. It decided to obtain this cash through a $100,000,000 debt offering. It sold five-year notes to dozens of banks and institutional investors. These notes were securities because they were intended to finance major investment activity, were made broadly available to investors, investors likely considered the notes to be securities, and there was no other regulatory regime in place to protect investors.

5. Derivatives

Derivatives are securities whose values rely on the value of underlying securities. They include options to buy (***call***) or sell (***put***) a stock or bond, as well as more exotic instruments such as swaps. [15 U.S.C. §§ 77b(a)(1) (Securities Act § 2(a)(1)), 78c(a)(10) (Exchange Act § 3(a)(10)).]

Example:

GameRay, a gaming company, compensated its new software engineer with salary and an option to purchase 10,000 shares of the company at $10 per share. These options were derivatives of the company's stock and their issuance was a securities transaction.

6. Repackaged Non-Securities as Securities

Financial instruments that are not themselves securities are sometimes pooled and resold as securities. For example, individual home-mortgage notes are not securities. However, if a promoter pools numerous mortgages together and then sells bonds tied to the performance of the pool (***securitization***), the bonds issued by the pool would be securities. [*see Zolfaghari v. Sheikholeslami*, 943 F.2d 451, 455 (4th Cir. 1991).]

B. The Meaning of Materiality

The U.S. securities-regulation system is built around disclosure. This policy choice follows an assumption that full and fair disclosure is investors' best protection in making investment decisions. In some circumstances, issuers are affirmatively mandated to make specific disclosures. These circumstances include when securities are being offered for the first time. In other instances, issuers must make judgments about what to disclose. In all circumstances, however, whether information is ***material*** is the general touchstone for whether it should be disclosed.

Example:

GameRay, a gaming company, sought to raise $25,000,000 from a venture capitalist. As part of its due diligence, the venture capitalist asked GameRay to disclose any "material litigation or threatened litigation" involving GameRay. At that point, GameRay was involved in two potential lawsuits. In the first, the former employer of GameRay's star designer accused the designer of stealing intellectual property that became key elements in GameRay's most popular game. In the second case, a driver sought reimbursement for mechanic's bills after GameRay employees hit her bumper while driving to an industry conference. GameRay's management determined that the first case was material because it could lead to an injunction against the distribution of a major product or the need for GameRay to pay a significant settlement to the former employer; GameRay disclosed that case to the venture capitalist.

1. Duty to Disclose

In general, issuers must disclose information only when mandated by law, or when additional information is required to make the mandated disclosures not misleading. [17 C.F.R. §§ 230.408, 240.12b-20; *see also* Public Offerings, *infra;* Exempt Offerings, *infra;* Continuing Disclosure, Shareholder Voting, and Tender Offers, *infra*.]

2. Materiality

Whether information is material is a mixed question of law and fact and has long vexed courts and practitioners. Courts have, however, provided some guidance for making the determination. [*SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963); *see also* Public Offering, *infra*; Exempt Offerings, *infra*; Continuing Disclosure, Shareholder Voting, and Tender Offers, *infra*; Securities Fraud, *infra*.]

a. The TSC Industries Test

The leading case for understanding materiality is the Supreme Court's decision in *TSC Industries, Inc. v. Northway, Inc.* In *TSC Industries*, the Court held that a fact omitted from a disclosure is ***material*** if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." [*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).] That does not mean that there must have been a substantial likelihood that had a reasonable investor received the omitted fact, the investor would have made a different decision. Rather, there needs to have been a substantial likelihood that a reasonable investor would have viewed the omitted fact as significantly altering the ***total mix*** of available information.

Note: *TSC Industries* addressed facts related to proxy solicitation and was decided in that context. In *Basic Inc. v. Levinson*, however, the Supreme Court expressly extended the *TSC Industries* standard to other contexts covered by the anti-fraud provisions of the Exchange Act. [*Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).]

b. Speculation and Substantial Likelihood

The *TSC Industries* materiality standard requires that a fact have a ***substantial likelihood*** of changing a reasonable investor's view of the total mix of information available for making a decision. In *Basic Inc. v. Levinson*, the Supreme Court held that applying this standard requires a fact-specific assessment weighing the probability of a factual event occurring multiplied by how important the information would be to a reasonable investor. That ***probability/magnitude*** test means that facts that are certain (*i.e.*, they have happened) or are near certain (*i.e.*, all indications are that they will happen) must be weighed more heavily in a materiality analysis than speculative facts (*i.e.*, that might happen but that are not certain). [*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).]

Example:

GameRay, a gaming company, sought to raise $25,000,000 in capital from a venture capitalist. GameRay told the venture capitalist that PlayStore, the sole distributor of its games, charged a 20-percent commission of all customer revenues in exchange for marketing and distributing GameRay's games. Days earlier, PlayStore had privately informed all the game developers it worked with that in two months it would raise the commission to 40 percent. This increase would cut GameRay's net revenues by a fourth. Because this fact was reasonably certain to occur (*i.e.*, PlayStore definitively said it would raise the commission) and because it would have a significant impact on GameRay (*i.e.*, reducing its net revenues by a fourth), the information was material.

Compare:

GameRay sought to raise capital from a venture capitalist. GameRay told the venture capitalist that PlayStore, its sole distributor, charged a 20-percent commission of all customer revenues for marketing and distribution. At the time of that disclosure, GameRay and PlayStore were negotiating an extension of their distribution agreement. A PlayStore executive mentioned that PlayStore would “like to talk about a small increase in our commission share,” but the parties had not discussed specific numbers. It was also unclear how serious PlayStore was about the new split. The fact that PlayStore wanted a “small increase” in its commission was immaterial because whether it would occur was highly uncertain and, even if it did, it would not cause a significant decrease in GameRay’s revenues. Considering the level of uncertainty in the context of a relatively minor increase in expense, the potential increase in PlayStore commissions would be immaterial to GameRay’s prospective investors.

c. Reasonable Investors

Just who is a reasonable investor has proven an elusive question since the Supreme Court set forth the *TSC Industries* test. Courts, practitioners, and scholars have largely failed to come to a consensus, but the leading paradigm imagines reasonable investors as “the idealized, perfectly rational actor of neoclassical economics.” [Tom C.W. Lin, *Reasonable Investor(s)*, 95 *Boston University Law Review* 461, 466–67 (2015).] In *Basic*, the Supreme Court cautioned, however, that investors are not to be treated paternalistically as “nitwits” who cannot appreciate the speculative or probabilistic nature of disclosures. [*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).]

Example:

Sash & Company, a publicly traded consulting firm, had an office in one of New York’s most prestigious office buildings. Its consultants rarely met with clients at its New York office; they usually traveled to clients. Sash decided to move its New York office to a less expensive, and less prestigious, office building. A reasonable investor would be unlikely to view investing in Sash in a new light if given information about this move, because there was no reason to believe that having a less prestigious office location would affect client relationships.

d. Total Mix of Information

The connection between the total mix of information about a security and the materiality of a fact related to that security rests on an assumption that capital markets have some degree of efficiency. Given that market-efficiency assumption, the total mix of information can sometimes include information that is already broadly in the public domain and thus should be known to investors. By assuming market efficiency, courts can look to market reactions to disclosed information as signals of information's materiality. Issuers accused of failing to disclose material information may thus defend against the claims by pointing to the information already in the public domain, the so-called ***truth-on-the-market*** defense. [*Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989); *see also* The Framework of Securities Regulation, *supra*.]

Example:

The largest expense for Pizza Universe, a publicly traded pizza chain, was the wages it paid its 10,000 hourly employees, the vast majority of whom were paid minimum wage. Citizen activists in the state of Franklin, by far Pizza Universe's largest market, succeeded in placing a proposition on the ballot to increase the state's minimum wage by 20 percent. The proposition led steadily in the polls and was approved by the voters. Pizza Universe's labor expenses went up 12 percent as a direct result. If Pizza Universe were sued for failing to disclose the risk related to the Franklin proposition, it would have a truth-on-the-market defense, because investors had ample public information about the proposition, its likely impacts, and its chances for success to assess its risks to Pizza Universe.

e. Completeness and Half-Truths

Statements that are literally true may still be misleading if they are half-truths or lack information needed to make them complete. In addition to the disclosures mandated by federal securities laws, the Securities Act's Rule 408 and the Exchange Act's Rule 12b-20 require companies to disclose "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." [17 C.F.R. §§ 230.408 (Securities Act Rule 408), 240.12b-20 (Exchange Act Rule 12b-20).]

Example:

At a year-end investor conference, the CEO of Pizza Universe announced that the company sold 30 percent more pies that year than in the year prior. "This was a record year for us, and we expect to continue the momentum next year!" the CEO told investors. The CEO omitted however, that the company achieved higher sales largely by deeply discounting its pies, a strategy it had long resisted and that it had not told investors about. When Pizza Universe filed its annual report, investors saw both a substantial increase in the number of pies sold but also a decrease in revenue from the year before. The CEO's statement was true but misleading, because without disclosing the discounting strategy, the statement gave the false impression that Pizza Universe would also see a substantial increase in revenue.

f. Puffery

Generally, statements that amount to ***puffery*** cannot support a claim that an issuer made a material misstatement. Such statements are viewed as too general to cause a reasonable investor to rely on them. [*see City of Pontiac Policemen's & Firemen's Retirement System v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014).]

Example:

Pizza Universe experienced years of declining sales as consumer tastes shifted from pizza to burgers and sandwiches. When asked about this decline, the CEO proclaimed, "I believe Pizza Universe has a bright future and its best days are still ahead!" That generic statement was an example of puffery that a reasonable investor would not rely on.

g. Opinions

Statements of opinion about material facts may be misleading. They are actionable under the securities laws' anti-fraud rules, provided there is objective evidence to show the opinion itself (rather than the speaker's belief in it) was false. [*See Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991).]

Example:

Pizza Universe received a takeover bid from Burger Galaxy for $25 a share. Burger Galaxy also promised that after the merger, Pizza Universe's CEO would lead the combined company. Sub Hut made a topping bid for Pizza Universe of $32 a share, but it gave no guarantee about future jobs for Pizza Universe's senior executives. The Pizza Universe CEO and board of directors accepted the Burger Galaxy bid and told shareholders that they should vote to approve the transaction because "this offer is uniquely attractive." Regardless of what the CEO and board personally believed, the "uniquely attractive" statement of opinion was objectively false because the company had received a superior bid from Sub Hut.

h. Buried Information

Disclosures can be misleading when they fail to fairly present material facts in such a way that the information is buried. [*See Kohn v. American Metal Climax, Inc.*, 322 F.Supp. 1331 (E.D. Pa. 1970).]

Example:

In its earnings release, Pizza Universe announced in the first paragraph that it had sold 30 percent more pies in the just-completed year than it had the year prior. Five pages later, in a discussion of its marketing efforts during the prior year, the release mentioned "our marketing efforts included our new pizza discounts." Pizza Universe had long eschewed discounting as a sales strategy. By burying the fact that it had begun discounting, Pizza Universe rendered misleading its truthful announcement about an increase in pies sold because that announcement gave the false impression that the new sales were undiscounted.

i. Silence

Silence, absent a duty to disclose, is not misleading. "No comment" is the equivalent of silence. [*See Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).]

Example:

After Pizza Universe received a takeover bid from Burger Galaxy, rumors of merger negotiations made their way to the press. Pizza Universe's management did not want to hurt negotiations with Burger Galaxy by acknowledging the talks, but it also did not want to falsely state that there were no negotiations. Instead, it responded to press inquiries by saying, "It is our policy not to comment on transactions the company may or may not be considering."

3. Forward-Looking Statements

Forward-looking statements, or soft information, are issuer communications that express management expectations, estimates, projections, or assumptions about the future performance of the company as a whole or some aspect of it. Although forward-looking statements are necessarily about things that have not yet happened, they can nevertheless be misstatements if they were inaccurate at the time they were made. Two protections have arisen to protect issuers from claims that their forward-looking statements were misleading: the judicial ***bespeaks-caution doctrine*** and the statutory ***safe harbors*** of the Private Securities Litigation Reform Act of 1995 (PSLRA).

a. The Bespeaks-Caution Doctrine

Under the bespeaks-caution doctrine, material misstatements made in forward-looking statements are rendered immaterial when the statements are accompanied by meaningful cautionary language. To be meaningful, that cautionary language must be specific enough to allow a reasonable investor to discount the forward-looking statement when that investor considers the total mix of information available. Blanket or vague cautionary statements that the securities are risky, or that the forward-looking statements may later prove inaccurate, are not sufficient to give the issuer the protection of the bespeaks-caution doctrine.

Example:

Fixtures City, a chain specializing in kitchen and bathroom fixtures, stated in a press release that it intended to open 100 new stores a year over the next five years. The press release included the cautionary language that "Our ability to meet this expansion goal could be limited by factors both within and outside our control, including our ability to identify suitable store sites and to receive necessary operating permits, our ability to recruit new store and regional employees in areas with competitive labor markets, and economic conditions that may reduce consumer demand for kitchen and bathroom fixtures." This cautionary language was specific and meaningful enough to satisfy the bespeaks-caution doctrine.

b. The Statutory Safe Harbor for Forward-Looking Statements

In the mid-1990s, Congress set out to reform what it saw as abuses in private securities litigation. One of the problems it sought to address was that issuers were overly reluctant to make forward-looking statements out of fear that they would be sued if their projections or expectations did not come to fruition. Congress addressed this concern in the PSLRA, which included two statutory safe harbors for forward-looking statements. The first safe harbor shields issuers from private liability for misstatements that are accompanied by meaningful cautionary language. In other words, it essentially codifies the bespeaks-caution doctrine. The second safe harbor requires plaintiffs to prove that a forward-looking statement was made with actual knowledge that it was misleading. [15 U.S.C. §§ 77z-2 (Securities Act § 27A), 78u-5 (Exchange Act § 21E).]

Note: The PSLRA's safe harbors for forward-looking statements apply only to private litigation. Public enforcement agencies (the SEC, federal prosecutors, or state securities regulators) may still bring enforcement actions for misleading forward-looking statements that would otherwise fall under the safe harbors. More, the safe harbors do not apply when forward-looking statements are made in connection with initial public offerings, going-private transactions, or tender offers. [Public Enforcement, *infra*.]

III. Public Offerings

This chapter explains the major regulatory concepts, as well as the mechanical steps, involved in public securities offerings. Under Section 5 of the Securities Act, all securities distributions require both registration with the SEC and the delivery of a statutory prospectus to purchasers (unless either the security or the securities transaction is exempt from those requirements). The goals of Section 5 are to ensure that investors receive adequate disclosure about securities before making investment decisions, as well as to prevent fraud in the offering process. To achieve those goals, federal securities laws and SEC rules impose elaborate requirements for disclosures and the conduct of an offering. [Exempt Offerings, *infra*.]

A. Public Offerings, Issuers, and Underwriters

Issuers may decide to sell securities to the public in order to raise capital or to provide liquidity (*i.e.*, the opportunity to sell) to existing holders of their securities. Offering securities to the public typically takes place through the ***underwriting*** process, in which a financial intermediary, or syndicate of intermediaries, assists an issuer in preparing for, marketing, and administering an offering.

1. Underwritten Offerings

The underwriting process takes two principal approaches, ***firm commitment*** and ***best efforts***. The first approach places greater risk for the offering's success with underwriters, whereas the second approach places more risk with the issuer.

a. Firm Commitment

In firm-commitment underwriting, an underwriter (*i.e.*, an investment bank) commits to purchase and sell all the shares being issued. It thus assumes financial risk for any unsold shares (*i.e.*, it must tie up its own capital until it can sell the shares). Issuers often favor firm-commitment underwriting because it ensures that they will receive a guaranteed amount of capital while the underwriter bears the financial risk for the offering's success.

b. Best Efforts

In best-efforts underwriting, an underwriter undertakes to sell as many shares being offered as possible, with any unsold shares being return to the issuer.

Example:

An underwriter agreed to purchase 5,000,000 shares from an issuer for $20 per share. It undertook to sell the shares to the public. Because the underwriter purchased a fixed number of shares and assumed the financial risk of shares going unsold, this was a firm-commitment underwriting.

Compare:

An underwriter agreed to sell up to 5,000,000 shares on behalf of an issuer at $20 per share. The underwriter would receive a percentage of the proceeds as its commission. Because the underwriter did not purchase a fixed number of shares nor assumed the risk of shares going unsold, this was a best-efforts underwriting.

2. Issuers

Under Section 2(a)(4) of the Securities Act, an issuer is any person who issues or proposes to issue a security. The securities laws distinguish between issuers that have a substantial connection to the U.S. (***domestic issuers***) and those that are foreign (***foreign issuers***). These distinctions affect what disclosures issuers must make under the Securities Act and Exchange Act. It further categorizes issuers based on factors such as the value of their common stock and their compliance with their reporting obligations under the Exchange Act. This latter set of categories also affects what disclosures issuers must make and what rules they must follow when they offer securities. [15 U.S.C. § 77b(a)(4).]

a. Domestic versus Foreign Issuers

Rule 405 of the Securities Act and Rule 3b-4 of the Exchange Act categorize issuers as either domestic or foreign. Foreign issuers are further categorized as either foreign-government or foreign-private issuers.

i. Domestic Issuers

Domestic issuers are issuers for which (1) more than 50 percent of their outstanding voting securities are directly or indirectly held by U.S. residents (*e.g.*, natural persons, U.S. business entities, or other U.S. persons) ***and*** for which any of the following is true:

- a majority of the issuer's directors or executive officers are U.S. citizens or residents,
- a majority of the issuer's assets are located in the U.S., or
- the issuer is principally managed from the U.S.

[17 C.F.R. §§ 230.405 (Securities Act Rule 405), 240.3b-4 (Exchange Act Rule 3b-4).]

ii. Foreign Issuers

Foreign issuers are issuers (1) that are a foreign government, a resident of a foreign country, or an issuer organized under the laws of a foreign country ***and*** (2) that do not satisfy the definition of a domestic issuer. Registration statements filed with the SEC by foreign issuers follow the F-series (*i.e.*, F-1, F-3, and so on), which corresponds to the S-series (*i.e.*, S-1, S-3, and so on) forms used by domestic issuers.

1) Foreign-Government Issuers

Foreign-government issuers are foreign issuers that are either a national government or the government of a political subdivision. [17 C.F.R. §§ 230.405 (Securities Act Rule 405), 240.3b-4 (Exchange Act Rule 3b-4).]

2) Foreign-Private Issuers

Foreign-private issuers are any foreign issuers that are not foreign-government issuers, provided that they do not satisfy the definition of a domestic issuer. [17 C.F.R. §§ 230.405 (Securities Act Rule 405), 240.3b-4 (Exchange Act Rule 3b-4).]

Examples:

Rockette S.A. was a Paris, France-based provider of e-commerce services for the French market. It went public on the NYSE last year. After going public, a majority of its shares were owned by U.S. venture-capital firms that had invested in the company early on. However, because a majority of Rockette's executive officers and directors were French, most of its assets were in France, and it was managed entirely from Paris, it was a foreign-private issuer.

Compare:

Galaxy Burger, Inc. relocated its corporate headquarters to an offshore island for tax-planning purposes. It also reincorporated on the island after having previously been incorporated in Delaware. It kept the same directors and executive officers, however, all of whom were U.S. citizens. Its shares also continued to be owned almost entirely by U.S. investors. Given this majority U.S. shareholding and exclusively U.S. senior management, Galaxy Burger continued to be a domestic issuer.

b. Nonreporting and Reporting Issuers

Apart from domestic- or foreign-issuer status, issuers are further divided into nonreporting and reporting status. Issuers in the former status are obligated to file continuous public disclosures with the SEC, whereas the latter are not.

i. Nonreporting Issuers

Nonreporting issuers are issuers for which none of the following statutory triggers under Section 13 or 15(d) of the Exchange Act have occurred:

- the issuer elects to list a class of securities on a national securities exchange (*e.g.*, the NYSE);
- the issuer has a class of nonexempt equity securities that is (1) held by either 2,000 or more persons ***or*** 500 or more persons who are not ***accredited investors*** and (2) on the last day of the issuer's fiscal year its total assets were $10,000,000 or more; or
- the issuer has filed a registration that has become effective.

[15 U.S.C. §§ 78l, 78o; *see also* Exempt Offerings, *infra.]*

ii. Reporting Issuers

All issuers other than nonreporting issuers are ***reporting issuers***. Reporting issuers are further divided into three categories: ***unseasoned issuers***, ***seasoned issuers***, and ***well-known seasoned issuers***.

1) Unseasoned Issuers

Unseasoned issuers are reporting issuers that have not met the eligibility requirements to file registration statements on Forms S-3 or F-3. [*See* SEC, Form S-3, General Instructions (May 2019); SEC, Form F-3, General Instructions (May 2019).]

2) Seasoned Issuers

Seasoned issuers are reporting issuers that have met the eligibility requirements to file registration statements on Forms S-3 or F-3. The principal requirements for eligibility to use Forms S-3 or F-3 are:

- the issuer must have at least one class of registered securities;
- the issuer must have timely filed for the prior 12 months all reports required under the Exchange Act;
- neither the issuer nor any of its subsidiaries since the last fiscal year will have materially defaulted on payment of preferred-stock dividends, long-term lease payments, or other debt repayments; and
- the aggregate market value of the issuer's voting and nonvoting common equity that is held by nonaffiliates is $75,000,000 or more.

[*See* SEC, Form S-3, General Instructions (May 2019); SEC, Form S-3, General Instructions (May 2019); *see also* Continuing Disclosure, Shareholder Voting, and Tender Offers, *infra*.]

Example:

Trident Systems, Inc. was a major producer of nautical equipment that had been publicly traded for nearly a decade. It realized right before filing its annual report on Form 10-K that it had significantly miscalculated certain figures in its draft financial statements. Because it had to investigate what went wrong and determine the right numbers, Trident did not file its Form 10-K by the deadline. Because Trident failed to timely file all its Exchange Act reports over the prior 12 months, it lost its seasoned-issuer status until it was able to satisfy Form S-3's eligibility requirements once again.

3) Well-Known Seasoned Issuers (WKSI)

Well-known seasoned issuers, or WKSIs (pronounced ***wick-sees***), are issuers that have met the eligibility requirements to file registration statements on Forms S-3 or F-3 and that meet at least one of the following requirements on at least one date within 60 days of being determined to be a WKSI:

- have had a worldwide $700 million or more in market value of outstanding voting and nonvoting common equity held by nonaffiliates; or
- have issued in the last three years at least $1 billion aggregate principal amount of nonconvertible securities, other than common equity, in primary offerings for cash.

Note: To be a WKSI, an issuer must also not be ineligible to be a WSKI. Causes of WKSI ineligibility include: failure to timely file all required Exchange Act reports within the prior 12 months; being a blank-check or shell company or offering penny stock; being a limited partnership unless the offering is a firm-commitment offering; having had a registration statement be subjected to a stop or refusal order by the SEC within the prior three years; having been the subject of a bankruptcy petition within the prior three years; having been convicted of certain crimes within the prior three years; or being the subject of an enforcement action in connection with a securities offering. The SEC may waive WKSI ineligibility however, upon a showing of good cause. [17 C.F.R. § 230.405 (Securities Act Rule 405).]

3. Underwriters

Under Section 2(a)(11) of the Securities Act, an underwriter is any person who has purchased a security either (1) from an issuer or (2) from "any person directly or indirectly controlling or controlled by the issuer" (***control person***) with a view of distributing the security. Underwriters also include any person who "offers or sells for an issuer in connection with the distribution of a security" and or who "directly or indirectly participates in any such undertaking or the underwriting of such an undertaking." [15 U.S.C. § 77b(a)(11).] Broker-dealers are not underwriters if they merely sell securities for the underwriter in return for a usual and customary sales commission from the underwriter.

a. Underwriter Roles

An underwritten offering usually involves more than one underwriter. By having a syndicate of underwriters, issuers are able to benefit from multiple sales-and-marketing networks, and for their parts underwriters can share risk. Each offering will have a ***managing underwriter***, and particularly large or complex offerings may have ***co-managers***. The managing underwriter has a coordinating role and is responsible for determining each underwriter's ***allocation***, *i.e.*, how much of the offering the underwriter will be responsible for. Managing underwriters receive compensation for serving in that role.

b. Underwriter Compensation

Underwriters are compensated through several different approaches. In firm-commitment offerings, they purchase the issued securities from the issuer for less than the selling price, with the difference being the underwriting commission. In best-efforts offerings, underwriters receive a portion of the sales proceeds as their commission.

c. Underwriting Agreements

Before an offering, issuers and underwriters enter into a nonbinding letter of intent that describes the basic contours of the offering and the terms of the underwriting relationship. Prior to an offering, issuers and underwriters will enter into a binding underwriting agreement that specifies, among other terms, the size of the offering and how the underwriters will be compensated, in addition to provisions for indemnification and overallotment rights (the right to purchase additional shares from the issuer). The underwriters also enter an agreement among themselves that includes the allotment of each underwriter and provisions to prevent flipping (purchasers quickly selling securities for a short-term profit, which puts downward pressure on the security's price), along with contribution and indemnification provisions.

B. Registration Requirements

Section 5 of the Securities Act requires that, absent exemption, securities cannot be sold or delivered unless there is a registration statement on file with the SEC that has become ***effective***. Section 5 also prohibits the offering of securities (a logical first step before they are sold and then delivered) until a registration statement has been filed with the SEC. [15 U.S.C. § 77e*; see also* Exempt Offerings, *infra*; Public Enforcement, *infra*.]

1. Disclosure Requirements

The Securities Act requires issuers to disclose certain information about the offering and the issuer in a registration statement filed with the SEC and a prospectus provided to investors.

a. Integrated Disclosure System

The SEC has created a set of standard information that issuers must disclose, in whole or in part, when they conduct a public offering under the Securities Act or in connection with their continuous disclosure obligations under the Exchange Act. The disclosures required by this ***integrated disclosure system*** are described in Regulation S-K and Regulation S-X. These regulations serve effectively as menus of disclosures. In turn, various SEC forms, such as registration-statement forms, specify which items from those two regulations must be included on the forms. Filings under this system are freely available to the public on the SEC's EDGAR website, a database for reviewing documents filed by issuers with the SEC. In some circumstances, an issuer can satisfy a disclosure obligation by incorporating by reference an earlier disclosure.

b. Regulation S-X

Regulation S-X prescribes the form and content of an issuer's financial statements made in registration statements or other disclosures. [17 C.F.R. § 210.1-01.]

c. Regulation S-K

Regulation S-K prescribes the form and content of an issuer's nonfinancial disclosures, which may be qualitative or quantitative in nature. Although Regulation S-K covers a variety of information, major categories required under it include disclosures about (1) the issuer's business, (2) the issuer's securities, (3) certain financial information, and (4) the issuer's management (including executive compensation) and major security holders. In the case of registration statements, Regulation S-K also requires a prospectus summary and additional disclosure, including information about (1) the use of proceeds from the offering, (2) the determination of the offering price, (3) the sellers, (4) the plan of distribution, and (5) underwriter compensation. [17 C.F.R. § 210.1-01.]

d. Registration Forms

Public offerings are registered by filing a registration form with the SEC. The SEC has prescribed a number of forms, and the correct form to use will be based upon the characteristics of the issuer and the offering. Domestic issuers commonly use Forms S-1 and S-3, and foreign issuers commonly use the corresponding Forms F-1 and F-3.

i. Forms S-1 and F-1

Form S-1 and F-1 require complete disclosure. They must be used by nonreporting or unseasoned issuers. They may also be used by other issuers if there is not another appropriate form to use in an offering. [*See* SEC, Form S-1 (May 2019); SEC, Form F-1 (May 2019).]

Note: In general, Forms S-1 and F-1 do not permit incorporation by reference. However, seasoned issuers may incorporate prior Exchange Act reports by reference. Allowing seasoned issuers to incorporate by reference allows them to avoid repeating prior disclosures.

ii. Forms S-3 and F-3

Forms S-3 and F-3 require disclosure about the prospective offering, but they allow information about the issuer to be incorporated by reference from its Exchange Act reports. These forms permit a simplified registration process because they assume investors will incorporate prior disclosures by the issuer in their evaluation of a new offering, a concept that relies on the efficient-markets hypothesis. [*See* SEC, Form S-3 (May 2019); SEC, Form F-3 (May 2019).]

Example:

Rockette was a privately held French startup company that decided to go public in the U.S. Because Rockette was classified as a foreign-private issuer, it used the F-series of registration forms to register. Because Rockette had not been a reporting company (it was private, after all), it was not eligible to use Form F-3. Thus, Rockette was required to use Form F-1 to register its securities.

e. Shelf Registrations

Issuers will sometimes register securities for sale but not issue them immediately. These reservations for the shelf, or ***shelf registrations***, provide issuers with flexibility to sell securities at opportune times, for example to finance an acquisition or to take advantage of favorable changes in interest rates. Under Rule 415 of the Securities Act, issuers may register securities that will be offered or sold on a “continuous or delayed basis in the future." Shelf registrations expire three years after the registration statement's effective date, although unsold securities may be carried over into a new shelf registration. Shelf registrations usually use Form S-3 or F-3, which allow forward incorporation by reference, *i.e.*, the issuer's future Exchange Act reports are deemed incorporated into the previously filed registration statement.

i. Automatic Shelf Registration

WKSIs may take advantage of ***automatic shelf registrations***, or ASRs. Registration statements for ASRs become effective immediately upon filing without review by the SEC Division of Corporation Finance staff.

2. Resales by Control Persons and Restricted Securities

In general, holders of ***restricted securities*** (securities falling under a number of conditions specified by Securities Act Rule 144(a)(3)) or by control persons may not be offered to the public except through (1) a registered offering, (2) certain private placements, or (3) an offering relying on Rule 144's safe harbors. [17 C.F.R. § 230.144; *see also* Exempt Offerings, *infra*.]

3. Liability and the Due-Diligence Defense

Section 11 of the Securities Act imposes strict liability for material misstatements or omissions in registration statements on (1) the issuer, (2) every person who signs a registration statement, (3) every director at the time of the statement's filing (or anyone who has consented to being named as a future director), and (4) experts such as accountants who consent to being named as experts, and underwriters. Section 11(c) of the Securities Act, however, provides a due-diligence defense against liability for any exposed party, other than the issuer itself. This defense requires that the party have done reasonable investigation to give it reasonable belief that at the time a registration statement was filed, it contained no material misstatements or omissions. [15 U.S.C. § 77k.]

Note: Much of the offering process is driven by parties seeking to conduct sufficient investigation so that they will have the due-diligence defense available to them if they are sued in connection with the offering. [*See* Private Enforcement, *infra*.]

C. The Public-Offering Process

The public-offering process should be viewed as running through three primary stages: the prefiling period, the waiting period, and the post-effectiveness period.

1. Prefiling Period

The prefiling period is the time between when (1) the issuer and underwriter reach a nonbinding agreement to issue and distribute securities and (2) the issuer files a registration statement. During this time the issuer and underwriters may not offer to sell securities, whether through the use of a prospectus or otherwise. [15 U.S.C. § 77e(c).]

2. The Waiting Period

Once the issuer files the registration statement, it and its underwriters may begin selling efforts, but securities may not actually be sold or delivered until the registration statement becomes ***effective***. The time between the filing of the registration statement and its effectiveness is the ***waiting period***.

a. Effectiveness

Under Section 8(a) of the Securities Act, the registration becomes effective 20 days after it or its last amendment is filed with the SEC, unless the SEC issues a stop order or refusal to prevent the statement from going effective. [15 U.S.C. § 77h(a).]

b. Review by SEC Staff and Amendments

Despite Section 8(a)'s default timing for effectiveness, in practice the SEC Division of Corporation Finance's staff reviews the registration statement and issues comment letters to the issuer. The issuer then amends the registration statement to respond to these comment letters. This informal review process emerged as an alternative to the use of stop orders and refusals for policing disclosures in registration statements.

c. Acceleration

Once the SEC staff is satisfied with the disclosures in the registration statement, the issuer will request ***acceleration*** of the registration statement's effectiveness. Section 8(a) of the Securities Act allows the SEC to set effectiveness dates earlier than the default rule of 20 days after the last amendment. [15 U.S.C. § 77h(a).]

d. Sales Efforts

After the registration statement is filed, the underwriters may begin sales efforts for the offering. Sales efforts may include the delivery of statutory and free-writing prospectuses, as well as oral communications. Underwriters may not actually sell or deliver securities, however, until the registration statements become effective. [15 U.S.C. § 77e(c).]

3. The Post-Effectiveness Period

Once the registration statement has gone effective, the underwriters may sell and deliver the securities. In the case of ***initial public offerings*** (IPOs), when an issuer offers its equity securities to the public for the first time, the securities will then be ***listed*** for trading on an exchange like the NYSE (although securities do not have to be listed to be publicly offered). [*see* Capital Markets Regulation, *infra*.]

a. Pricing Amendment

Issuers do not set an exact offering price for shares when they file the registration statement. This practice is partly to give underwriters the opportunity during the waiting period to determine what price investors are willing to pay. Under Securities Act Rule 430A, a registration statement for a cash offering may become effective even without pricing information. This rule gives issuers and underwriters flexibility to price the offering by amending the registration statement shortly before the securities are sold. [17 C.F.R. § 230.430A.]

b. Distributing the Offering

After the registration statement becomes effective, the underwriters may begin selling and delivering securities to investors who previously indicated an interest in buying the securities. Broker-dealers may distribute the securities to individual retail investors. Under Section 5(b)(2) of the Securities Act, securities may not be delivered unless they are accompanied by a final statutory prospectus. Securities Act Rule 172 provides an exception to this delivery requirement, however. If the statutory prospectus is filed with the SEC and certain other conditions are met, delivered securities need not be delivered with a prospectus (on the ***access equals delivery*** theory that an investor can look up the prospectus on the SEC's EDGAR website). [15 U.S.C. § 77e(b)(2); *see also* 17 C.F.R. § 230.172.]

D. Communications Rules

A goal of the Securities Act is to ensure that investors have adequate information, in the form of a prospectus, about a security and its issuer before making an investment decision. Section 5(c) of the Securities Act prohibits securities from being offered for sale prior to the filing of a registration statement for them, whereas Section 5(b) requires that all written offers of sale be done in connection with a prospectus. The prospectus in turn must satisfy the content requirements of Section 10 of the Securities Act. To enforce these rules, issuers and underwriters are subject to a number of restrictions on their communications with potential investors (and thus, indirectly, with the public). [15 U.S.C. §§ 77e (Securities Act § 5), 77j (Securities Act § 10).]

1. Written Communications

The Securities Act most heavily polices the use of written communications in connection with offering securities. Written communications fall into two buckets: (1) written and broadcast communications and (2) graphic communications.

a. Written and Broadcast Communications

Written communications include all communications that are written, printed, or broadcasted on television or radio. [17 C.F.R. § 230.405.]

Examples:

(1) The CEO of a startup operated a personal blog website and published a post about the startup's successes. Because this communication was written, it would qualify as a written communication under the Securities Act.

(2) The CEO of a startup appeared as a guest on a cable business network to discuss the startup's successes. Because this communication was broadcast on television, it would qualify as a written communication under the Securities Act.

b. Graphic Communication

Written communications include ***graphic communications***, which the SEC broadly defines to include "all forms of electronic media." [17 C.F.R. § 230.405.]

Example:

The CEO of a startup appeared on a panel at a university to discuss the startup's successes. The panel discussion was recorded and posted to the university's website. Because this communication was electronically recorded and disseminated, it would qualify as a graphic communication, thus making it a written communication under the Securities Act.

2. Prefiling Period

The Securities Act envisions an active policing role for the SEC, especially in connection with the review of registration statements. During the prefiling period, however, the offering has not yet come under the SEC's direct regulatory control. Given the risks of misstatements at the prefiling stage, the securities laws take an expansive view of what communications constitute unlawful offers to sell, also known as ***gun-jumping***. The SEC has provided several safe harbors for certain communications during that stage.

Examples:

(1) The CEO of a startup operated a personal blog website and published a post about the startup's successes. The startup planned to file a registration statement to go public a few weeks after the post. Because the startup was in the quiet period, the CEO's post was an unlawful offer to sell.

(2) The CEO of a startup appeared as a guest on a cable business network to discuss the startup's successes. The startup planned to file a registration statement to go public a few weeks after the appearance. Because the startup was in the quiet period, the CEO's broadcasted interview was an unlawful offer to sell.

a. Prefiling Public Announcements

Under Securities Act Rule 135, issuers may issue a press release or other written communication announcing the offering without that announcement itself being considered an unlawful offer. This safe harbor allows reporting issuers to disseminate material nonpublic information (which an offering might be) and it allows all issuers to put rumors to rest. A Rule 135 announcement must state that an offering will only be made by prospectus and may contain no more than the following information:

- issuer's name;
- title, amount, and terms of the securities;
- amount of securities to be offered by selling holders;
- anticipated timing of the offering;
- a brief statement about the purpose of the offering; or
- information specific to certain rights or special offerings.

Note: A Rule 135 announcement may not contain the names of any underwriters (on the theory that prospective investors might seek the underwriters out, thereby leading to unlawful offers to sell or purchase). [17 C.F.R. § 230.135.]

b. Issuer Websites

Information on the issuer's website can be considered either an offer to sell or merely historical information about the issuer (*i.e.*, not an offer). Whether information on an issuer website constitutes an offer requires a case-by-case evaluation. The SEC, however, has created a safe harbor for historical information. Under Securities Act Rule 433(e), website information will be considered historical information if it is (1) labeled as historical information and (2) located on a part of the website dedicated solely to historical information. [17 C.F.R. § 230.433.]

c. Preliminary Underwriting Negotiations

Preliminary negotiations or agreements between an issuer and underwriter (or a control person and an underwriter), or among underwriters, are not offers to sell. [15 U.S.C. § 77b(a)(3) (Securities Act § 2(a)(3).]

d. Communications 30 Days before Filing

Securities Act Rule 163A provides a safe harbor for issuers (but not underwriters) for communications made more 30 days prior to filing the registration statement. Under the rule, issuer communications made more than 30 days before filing are not considered offers to sell, provided that (1) the communications do not reference the securities offering and (2) the issuer takes steps to prevent the communication's redistribution ***within*** the 30 days prior to filing a registration statement. [17 C.F.R. § 230.163A.]

e. Regular Disclosure of Factual Information

Securities Act Rules 168 and 169 provide additional safe harbors. Under these rules, it is not an offer to sell if an issuer releases factual information about its business, provided it already does so in the ordinary course of business. [17 C.F.R. §§ 230.168, 230.169.]

3. The Waiting Period and Post-Effective Period

During the waiting period and post-effective period, issuers and underwriters may make offers to sell and may market the securities through the use of prospectuses and oral communications.

a. Offers to Sell

Section 5 of the Securities Act permits offers to sell once a registration statement has been filed. Offers may be made orally (such as in meetings with prospective investors) or by use of a statutory or ***free-writing prospectus***.

b. Prospectus

Written offers to sell are made by way of a prospectus, which may be either a statutory prospectus, the content of which is prescribed by the Securities Act, or a free-writing prospectus that complements the statutory prospectus.

i. Statutory Prospectus

Section 5 of the Securities Act requires that any prospectus used in connection with securities marketing comply with the content requirements of Section 10 of the Securities Act. A prospectus is any "prospectus, notice, circular, advertisement, letter, or communication, ***written or by radio or television***, which offers any security for sale or confirms the sale of any security . . . .". [15 U.S.C. § 77b(a)(10) (emphasis added).] The definition of prospectus excludes ***free-writing material***, which is any communication sent or given after the registration becomes effective, so long as it can be proved that a prospectus that complies with Section 10 of the Securities Act was given to the recipient at or before the time the free-writing material was given. [15 U.S.C. § 77b(a)(10).]

Note: Despite their similar names, free-writing materials and free-writing prospectuses are distinct communications. The key distinction is whether the communication is made before (free-writing prospectus) or after (free-writing material) the registration statement becomes effective.

ii. Free-Writing Prospectus

Issuers and underwriters may communicate in writing about an offering using written material other than the statutory prospectus. These ***free-writing prospectuses*** may go beyond the statutory prospectus in terms of content, but may not conflict with it. Issuers must file free-writing prospectuses with the SEC, although underwriters generally are not required to do so. Any free-writing prospectus must also contain a legend stating that it relates to an offering and directing the reader to where the registration statement and statutory prospectus may be obtained. [17 C.F.R. § 230.164 (Securities Act Rule 164).]

Example:

A startup pharmaceutical company filed a registration statement. During the waiting period, the company issued a technical report on the therapeutic products it was developing. Because this report was a written communication other than the statutory prospectus, it was a free-writing prospectus that the company was required to add a Rule 164 legend to and to file with the SEC.

c. Oral Communications

Oral communications are not included within the definition of prospectus. The most prominent use of oral communications in the offering process are ***road shows*** at which underwriters pitch offerings to prospective investors. Road shows can be transmitted live (*i.e.*, so that potential investors in separate locations may observe) without that transmission be considered a broadcast (and thus a free-writing prospectus). [17 C.F.R. § 230.405 (defining "graphic communication").]

Example:

A startup's underwriters conducted a road show in which prospective investors were hand-selected and invited to presentations about the offering. Because this communication was entirely oral, it was not a free-writing prospectus. However, if the company posted a transcript of the presentation to its website, the transcript, as a written communication, would be a free-writing prospectus.

d. Underwriter Research Reports

Investment banks typically have research departments that issue reports on issuers and industries. A research report issued by an investment bank about its issuer client may be considered a prospectus or an unlawful offer to sell. Securities Act Rules 137, 138, and 139 provide limited safe harbors for underwriters' research reports. [17 C.F.R. §§ 230.137, 230.138, 230.139.]

IV. Exempt Offerings

Section 5 of the Securities Act requires that every sale of a security either (1) be registered or (2) be exempt from registration. Congress and the SEC have established exemptions from registration for several reasons, including the adequacy of other regulatory systems (*e.g.*, banking regulation) to protect investors, the interests of efficient capital formation, and political considerations. Those exemptions take two forms. ***Exempt securities*** are categories of securities that Congress has determined should never be required to be registered prior to sale. ***Exempt transactions***, on the other hand, occur when nonexempt securities are sold under circumstances that do not require registration. In addition to exempt securities and transactions, this chapter also covers ***secondary distributions*** as transactions that closely interplay with the exempt-offering rules. [*See* 15 U.S.C. §§ 77c (Securities Act § 3) (exempt securities), 77d (Securities Act § 4) (exempt transactions); *see also* Public Offerings, *supra*.]

A. Exempt Securities

In general, securities listed under Section 3 of the Securities Act are exempt from registration, meaning that they may be sold and resold without the need for registration or a transactional exemption to registration. Congress included securities under Section 3 based on its judgment that the need for registration's investor-protection function was low with respect to them, or for political reasons such as respect for state autonomy to issue governmental securities. Issuers that have issued ***only*** exempt securities are also not subject to continuous reporting obligations under the Exchange Act. Exempt securities remain largely subject to the securities laws' antifraud provisions, thus allowing for *ex post* enforcement by public authorities and private investors. [*See* 15 U.S.C. § 77c (Securities Act § 3); *see also* Private Enforcement, *infra*; Public Enforcement, *infra*.]

Note: For certain exemptions under Section 3 of the Securities Act, the acquirer of the securities is not free to resell the securities without registration or an exemption. Although these securities are categorized as exempt securities, they are ***exempt transactions*** in character.

1. Government Securities

The most significant group of exempt securities in terms of total issue value is government securities. Under Section 3(a)(2) of the Securities Act, this category includes debt securities issued or guaranteed by (1) the federal government or its agencies or (2) by state or local governments (***municipal securities***). This exemption is premised on the idea that government issuers are unlikely (compared to private issuers) to deceive investors or to default on their debts, and thus the need for the protections of the registration is not present. As it relates to municipal securities, the exemption also respects states' prerogatives to raise revenue free of federal regulation. [*See* 15 U.S.C. § 77c(a)(2) (Securities Act § 3(a)(2)).]

a. U.S. Government Securities

The Section 3(a)(2) exemption is perhaps most justified in the case of U.S. government or government-agency securities. Those securities are considered ***risk free*** because they are backed by the full faith and credit of the U.S. government; investors are assured of receiving their principal back with guaranteed interest. [*See* 15 U.S.C. § 77c(a)(2) (Securities Act § 3(a)(2)).]

Example:

An investor purchased a 10-year debenture issued by the Federal Housing Administration (FHA). Because the FHA is a federal agency, its debentures were exempt from registration and the investor was free to resell the debentures without registering them or relying on a transactional exemption.

b. Municipal Securities Regulation

States and localities issue debt for a number of reasons, including to meet revenue shortfalls and to build long-term infrastructure. Municipal issuers sometimes default on payments or even make material misstatements in the offering process. Although the securities laws do not regulate municipal issuers directly, the SEC and the Municipal Securities Rulemaking Board (MSRB) (a ***self-regulatory organization (SRO)*** subject to SEC oversight) do indirectly regulate the municipal market by regulating the broker-dealers and banks that assist municipal issuers. For example, Exchange Act Rule 15c2-12 requires a broker-dealer to obtain an ***official statement*** from the municipal issuer if it serves as underwriter on certain primary offerings. The MSRB's

pay-to-play rule restricts broker-dealers and their affiliates from contributing to the campaigns of political candidates who could influence awards of municipal-securities underwriting business. [*See* 17 C.F.R. § 240.15c2-12 (Exchange Act Rule 15c2-12); MSRB Rule G-37.]

Example:

A candidate for city council asked a longtime friend for a campaign contribution. The friend was a municipal finance professional with an investment bank that did municipal underwriting for localities in the candidate's state. The friend told the candidate, "You know I would love to help, but the pay-to-play rules don't allow me to contribute because if you're elected, you'll have influence on underwriter selection."

c. Municipal Securities and Private Financing

One controversial use of municipal securities is their use in financing private or semi-private activities. A classic example of this use is a locality issuing bonds to build a sports stadium on the promise that the professional team that plays in the stadium will pay rent and royalties to cover the debt payments.

Example:

The River City Jackals, a professional sports team, was privately owned by a local businessperson and needed a new stadium. To fund the new stadium, the team issued bonds to cover the costs of acquiring land and building the stadium. Because bonds issued by a private sports team were not exempt securities, the Jackals were required by the Securities Act to register the bond offering or use a transactional exemption from registration.

Compare:

The River City Jackals, a professional sports team, was privately owned by a local businessperson and needed a new stadium. To fund the new stadium, the River City Industrial Authority, a political subdivision of the city, issued revenue bonds backed by a long-term lease and royalty agreement with the Jackals. Because bonds issued by the city were exempt securities under Section 3(a)(2) of the Securities Act, the new sports stadium was funded without any need to register the bond offering or to rely on a transactional exemption.

2. Bank Securities

Sections 3(a)(2) and 3(a)(5) of the Securities Act also exempt securities issued by banks and certain other depositary institutions (*e.g.*, savings and loans and cooperative banks) (whether chartered by the federal or a state government), but not bank-holding companies. A rationale behind this exemption is that banking regulation is sufficient to protect investors. [*See* 15 U.S.C. §§ 77c(a)(2), (5) (Securities Act § 3(a)(2), (5)).]

Example:

A group of businesspeople in River City organized to charter a new bank. The state banking regulator approved their application for a new bank. To finance the bank, the organizing group sold shares to local investors. As a standalone institution, the bank did not have a holding company. Because shares issued by the bank were exempt securities under Section 3(a)(2) of the Securities Act, the shares were sold without any need to register the offering or to rely on a transactional exemption.

Compare:

Mega Bancorp was a bank holding company whose wholly owned subsidiaries included Mega Bank, N.A. (a federally chartered bank), Mega Investments, LLC (a broker-dealer), and Mega Insurance, Inc. (an insurance carrier). Mega Bancorp sought to raise new capital by issuing shares. If it sold shares in itself as a bank-holding company, the shares would not be exempt securities under Section 3 of the Securities Act. It would thus be required either to register the shares or to identify a transactional exemption from registration.

3. Intrastate Offerings

Securities that are part of an issue offered and sold only to residents of a given state and in which the issuer is resident (*i.e.*, if it is a corporation, it is incorporated in that state) and does its business, are exempt securities under Section 3(a)(11) of the Securities Act. The premise behind this exemption is that state securities regulators stand able to police these purely intrastate offerings and so federal registration is not needed to protect investors. [*See* 15 U.S.C. § 77c(a)(11).]

Note: Once securities under this exemption have ***come to rest*** in the hands of the in-state purchasers, those purchasers may resell the securities to out-of-state purchasers without the issuer being at risk of losing the intrastate exemption for the offering. Securities Act Rule 147 provides a safe harbor for avoiding this risk, including a clearer definition of which purchasers are in-state residents and how much in-state business an issuer must do. It also provides safe harbors for ensuring that purchases have investment intent (rather than intent to immediately resell). [17 C.F.R. § 230.147.]

Example:

Big Boat Tours, Inc. was a provider of riverboat tours on the Green River, which formed part of the border between the states of Franklin and Monroe. Big Boat Tours was incorporated in Franklin and its headquarters and primary tour facility were in River City, Franklin. The company's boat tours went back and forth between River City, Franklin and Rapidsville, Monroe (where it had a landing dock and a small gift shop). It raised $500,000 to refurbish its boat fleet by selling bonds to River City residents. The clerk who ran the Rapidsville gift shop, a Monroe resident, also purchased $1,000 in bonds. Because it sold part of the issue to a person who was not resident in Franklin, Big Boat Tours was not able to rely on the intrastate exemption. [*see* State Blue Sky Laws, *infra*.]

4. Insurance Policies and Annuities

In addition to casualty coverage (*e.g.*, home or automobile insurance), insurance carriers also offer quasi-investment products (*e.g.*, life-insurance policies that may be sold for cash, and annuity contracts). Section 3(a)(8) of the Securities Act excludes insurance policies and annuity contracts issued by insurers or banks that are regulated by state insurance or banking regulators. The premise behind this exception is that (1) state insurance regulation is sufficient to protect investors and (2) the insurer or bank carries the financial risk of the policy or contract's performance. [See 15 U.S.C. § 77c(a)(8).]

Note: There is debate whether insurance policies and annuities are securities at all (exempt or otherwise), or whether Congress merely included them in Section 3 of the Securities Act for the avoidance of doubt. Insurance is typically thought of as a product for managing risk, not investing, which suggests that insurance policies and annuities are not securities. At the same time, insurance products like ***variable annuities*** (whose payouts partly depend on factors like stock-market performance) have quasi-investment uses, suggesting they are securities.

Example:

Mega Bancorp was a bank-holding company whose wholly owned subsidiaries included Mega Insurance, Inc. (an insurance carrier). Mega Insurance sold a Franklin resident an annuity contract. Under the contract, the resident would receive lifetime monthly payments starting at age 55. Because the product sold was an annuity contract, and because Mega Insurance was regulated by the Franklin State Insurance Commission, the contract was an exempt security (or not a security at all, according to one legal view).

5. Commercial Paper

Under Section 3(a)(3) of the Securities Act, notes with maturities under nine months are exempt securities, provided they are issued to cover ***current transactions*** (*i.e.*, current expenses, not long-term or special capital needs) (***commercial paper***). [*See* 15 U.S.C. § 77c(a)(3); *see also* The Meanings of Securities and Materiality, *supra*.]

Example:

A major manufacturer of aluminum products issued $6,000,000 in three-month notes to a group of large financial institutions. The proceeds of the notes were used to finance the manufacturer's day-to-day expenses until its customers paid invoices. Because the notes had a maturity under nine months and because they were used to pay for regular expenses, they were exempt securities.

Compare:

A major manufacturer of aluminum products issued $60,000,000 in eight-month notes to a group of large financial institutions. The proceeds of the notes were to be used to build a new plant and would be paid back once the manufacturer finished its divestiture of several assets. Although the notes had a maturity under eight months, because the proceeds were used for a long-term investment in a new plant, they were not exempt securities.

6. Exchanged Securities

Under Section 3(a)(9) or the Securities Act, if an issuer exchanges one set of securities for another with its existing shareholders, the new securities are exempt provided that no commission or other payment was paid for soliciting the exchange. [*See* 15 U.S.C. § 77c(a)(9).]

Note: Despite being included under Section 3, exchange transactions under Section 3(a)(9) are in reality exempted transactions. To be resold, securities received in such an exchange must be registered or sold in a transaction exempt from registration.

Example:

An investor held 1,000 convertible notes in an issuer. The notes entitled the investor to convert the notes to 10,000 shares of common stock. If the investor exercised that right, the shares issued by the issuer in exchange for the notes would be exempt securities under Section 3(a)(9) of the Securities Act. That result follows in part because the investor did not pay additional consideration at the time of the conversion, *i.e.*, the investment decision was made when the convertible debt was bought, not when the conversion right was exercised.

Compare:

An investor held a warrant in an issuer. The warrant entitled the investor to purchase 10,000 shares of common stock at $1 per share. If the investor exercised that right, the shares issued by the issuer in exchange for the notes would ***not be*** exempt securities under Section 3(a)(9) of the Securities Act. That result follows in part because the investor paid an additional $10,000 in consideration to acquire the shares, *i.e.*, exercising the warrant rights required making a new investment decision.

7. Other Exempt Securities

Section 3 of the Securities Act includes a number of other, less prominent, categories of exempt securities, including:

- common trust funds operated by a bank in its capacity as a fiduciary trustee, executor, administrator, or guardian;
- interests in railroad-equipment trusts;
- certificates issued by a receiver or by a trustee or debtor in possession in a case brought under the Bankruptcy Code, provided there was approval of a court; and
- securities distributed after being approved in a fairness hearing by a court.

[*See* 15 U.S.C. § 77c(a).]

B. Exempt Transactions

Whereas Section 3 of the Securities Act exempts certain securities from registration, Section 4 (in addition to SEC rulemaking under it) exempts certain ***transactions*** from registration. The policy rationale for transactional exemptions includes the need to allow businesses to raise capital without going through the expense of registered offerings. To protect investors, rules around transactional exemptions do impose a number of restrictions on the offer and sale of securities sold under them. They also create incentives for issuers to sell to investors who have the resources and sophistication to bear the risk of an unregistered offering. Unlike the general case for exempt securities, if securities are acquired through exempt transactions, they cannot be resold unless they are first registered, or they are resold in an exempt transaction. This section describes the major exempt transactions in U.S. capital markets and their applications.

Example:

Scoot365 was a startup founded to help workers commute on electric scooters. To develop its scooters and deploy them in major cities around the U.S., Scoot365 needed to raise significant capital. However, as an early-stage company with little traction, it could not expect to raise money in a public offering, nor would a bank provide a loan to get it off the ground.

Scoot365 was able to obtain funding, however, by selling preferred shares to venture-capital firms through exempt transactions.

1. Private Offerings

Private offerings differ from public offerings in that they are exempt from Section 5's registration requirement. Unlike exempt securities, however, securities obtained in private offerings may not be resold unless they become registered or they are resold using a transactional exemption.

a. Section 4 and Safe Harbors

Section 4 of the Securities Act provides market actors with a set of transactional exemptions from Section 5's registration requirement. Because the text of some exemptions is unclear on what actors must do to satisfy the exemption, the SEC has adopted a number of ***safe harbors*** that provide clearer guidance for doing so.

i. The Role of Safe Harbors

The securities statutes as passed by Congress are often vague or open to differing interpretations. Market actors—especially issuers, underwriters, and dealers—are understandably reluctant to engage in transactions that might give rise to liability through public-enforcement or private-plaintiff actions. In these circumstances, the SEC has stepped in to provide greater clarity and certainty by crafting regulatory safe harbors. Safe harbors give market actors more precise rules for how they can act within the bounds of the securities laws. Not following the rules in a safe harbor does not necessarily mean an actor is violating the law, but staying within the safe harbor ensures that it is not doing so (at least with respect to the law the safe harbor relates to). Safe harbors abound throughout securities regulation, and perhaps the most famous and important examples—like Regulation D—are the safe harbors under Section 4 of the Securities Act. Because they literally provide their users with safety, securities practice frequently strives to follow them.

ii. Section 4(a)(1)

Section 4(a)(1) exempts transactions from Section 5's registration requirements if they are undertaken by any person other than an issuer, underwriter, or dealer. This exemption allows most categories of securities holders to resell securities. [*See* 15 U.S.C. § 77d(a)(1).]

Example:

A pension plan decided to reallocate part of its portfolio. To do so, it sold to an insurance company some of the unregistered limited-partnership interests it held in an oil pipeline. Because neither the pension plan nor the insurance company was an issuer, underwriter, or dealer with respect to the limited partnership, their transaction was exempt.

1) Issuers, Underwriters, and Dealers

The securities laws and the SEC broadly define and construe who is an underwriter. Under Section 2(a)(11) of the Securities Act, an ***underwriter*** is any person who: (1) purchased a security from an issuer with a view to distributing it, or (2) offers or sells for the issuer in connection with a distribution, or (3) participates or has direct or indirect participation in the activities in items (1) or (2), or participates or has a participation in the direct or indirect underwriting of any such undertaking. Under Section 2(a)(12) of the Securities Act, a ***dealer*** is any person who engages directly or indirectly in the business of offering, buying, selling, or otherwise dealing in securities issued by another person. [*See* 15 U.S.C. §§ 77b(a)(11) (underwriter), (12) (dealer).]

Examples:

(1) Mega Investments, LLC was an investment bank retained to help Omni underwrite a public offering. Mega in turn retained Financial Associates, a financial consulting firm, to help it conduct due diligence into Omni's offering. Omni had no involvement with Financial Associates and did not even know that Mega had retained the firm. Because Financial Associates participated in Mega's underwriting efforts, it too was an underwriter in the offering.

(2) An individual received an offer to purchase shares from a prominent startup company. The individual did not usually invest in startups but knew that the shares in that company were hard to get and in high demand. The individual purchased the shares intending to quickly resell them at a premium. Because the individual purchased the shares for distribution to others (and not personal investment), the individual was a dealer under the Securities Act.

iii. Section 4(a)(2)

Section 4(a)(2) of the Securities Act exempts transactions by issuers that do not involve a public offering. Transactions under this exemption are often referred to as ***private placements***. The United States Supreme Court has offered some guidance regarding what conditions must exist for transactions to fall under this exemption. Importantly, the securities must be offered only to a limited number of qualified purchasers, and those purchasers must agree to resale restrictions. Issuers must not engage in ***general solicitation*** (a solicitation of purchasers accessible generally to the public). The touchstone requirement of a private placement, the Court reasoned, was that investors receive or have access to the pertinent information they need to make an intelligent investing decision. [*See* 15 U.S.C. § 77d(a)(2); *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).]

Note: Despite the prohibition on general solicitation, Securities Act Rule 135 does allow issuers to make a public announcement that they are conducting a private placement, just as it allows them to do in connection with public offerings. [*See* 17 C.F.R. § 230.135 (Securities Act Rule 135); *see also* Public Offerings, *supra*.]

Example:

Omni, a publicly traded corporation, faced financial turmoil and needed a significant injection of capital to restructure its debt. Its financial advisers held confidential conversations with existing business contacts to identify two investment funds that would provide Omni with $50,000,000 in capital in exchange for preferred shares. Because this transaction would be conducted by an issuer and a limited number of sophisticated purchasers, and because the financial advisers did not engage in general solicitation to find the two purchasers, this transaction would likely qualify for a Section 4(a)(2) private-placement exemption.

Compare:

Omni, a publicly traded corporation, faced financial turmoil and needed a significant injection of capital to restructure its debt. Its financial advisers posted a message on their website and social-media accounts that they were representing a public company that was seeking $50,000,000 in financing in exchange for preferred shares. The website and social-media posts were freely accessible to anyone with an internet connection, rendering them general solicitations for the placement. Because the financial advisers engaged in general solicitation, this transaction would ***not*** qualify for a Section 4(a)(2) exemption.

iv. Section 4(a)(1)(½)

Section 4(a)(1)(**½**) is not actually part of the Securities Act. Rather the Section 4(a)(1)(**½**) exemption relies on the combined effects of Sections 4(a)(1) and 4(a)(2). It allows investors that have received restricted securities under a Section 4(a)(2) exempted transaction to resell the securities to others in a private placement in reliance on the Section 4(a)(1) exemption. The seller relies on Section 4(a)(1) because Section 4(a)(2) only applies to private placements by issuers.

Example:

An investment fund purchased restricted preferred shares from Omni, a publicly traded corporation, in a private placement. After the price of Omni shares went up, the investment fund sought to realize profits by reselling the restricted preferred shares to an insurance company. Because it was a non-issuer selling to a person other than an issuer, underwriter, or dealer, it used the so-called Section 4(a)(1)(½) exemption.

v. Section 4(a)(3)

Section 4(a)(3) of the Securities Act exempts dealer transactions provided that the transaction does not: (1) involve unsold allotments from a public offering (*i.e.*, securities still held by an underwriter with a view for distribution and not investment) or (2) the transaction occurs, depending on certain factors, within 25 or 90 days following an initial public offering. Securities Act Rule 174 provides further rules for reliance on the Section 4(a)(3) exemption. [*See* 15 U.S.C. § 77d(a)(3); 17 C.F.R. § 230.174.]

vi. Section 4(a)(4)

Section 4(a)(4) of the Securities Act is used by brokers transacting on customer orders. It cannot be used by customers themselves, however. To avail themselves of the exemption, brokers must make reasonable inquiries to ensure that customers' ordered transactions are themselves exempt; a reasonable inquiry must look beyond potentially self-serving representations by the customer or its counsel. [*See* 15 U.S.C. § 77d(a)(4); *see also* SEC, *Responses to Frequently Asked Questions re Section 4(a)(4) Exemption* (Oct. 9, 2014).]

Example:

A pension plan decided to reallocate part of its portfolio. To do so, it instructed its broker to sell unregistered securities and to use the proceeds to purchase other securities. The broker inquired into the facts and circumstances of the unregistered securities and determined that the customer had an exemption from registration available to consummate the transaction. The broker was thus able to fulfill the order and itself rely on the Section 4(a)(4) exemption.

vii. Section 4(a)(5)

Section 4(a)(4) of the Securities Act exempts private placements with ***accredited investors*** for amounts under $5,000,000. Accredited investors are defined by Section 1(15) of the Securities Act to include banks, insurance companies, investment companies, small-business development companies, employee benefit plans, financially sophisticated persons, or other persons with qualifying amounts of assets under management (as determined by SEC rules). [*See* 15 U.S.C. §§ 77b(15) (definition), 77d(a)(5) (Section 4(a)(5).]

viii. Section 4(a)(6)

Section 4(a)(6) was added to the Securities Act as part of the Jumpstart Our Business Startups (JOBS) Act. This section creates the ***crowdfunding*** exemption in which small aggregate amounts of securities may be sold via brokers or ***funding portals*** to individuals who invest relatively small amounts. [*See* 15 U.S.C. § 77d(a)(6).]

b. Restricted Securities

The concept of ***restricted securities*** is important for applying several transactional exemptions. In short, restricted securities are previously acquired securities that are not freely tradable. Securities Act Rule 144(a)(3) defines restricted securities. Among the most prominent examples of restricted securities are securities that were acquired:

- directly or indirectly from the issuer or its affiliate in a private placement, or a chain of private placements, under the Section 4(a)(2) exemption;
- from an issuer, subject to the resale restrictions of Regulation D or Securities Act Rule 701(c) (relating to employee-benefit plans);
- in a Securities Act Rule 144 transaction, or a chain of Rule 144 transactions; or
- from an issuer in a transaction under the Section 4(a)(5) exemption.

c. Integration

The Securities Act and SEC regulations provide a number of transactional exemptions intended to satisfy capital-formation needs against a broader policy goal of investor protection. One problem that can arise with the availability of different exemptions is that issuers might use multiple exemptions to effect an aggregate offering that would itself not be exempt from registration. To respond to this problem, otherwise exempt transactions may be ***integrated***, or treated as a single transaction. When private offerings are integrated, the consequence is that they would often be deemed an unregistered public offering that violates Section 5 of the Securities Act.

i. Factors for Determining Integration

Securities Act Release 33-4522 announced five factors for determining whether to integrate two or more ostensibly private exempt offerings: whether the offerings

(1) were part of a single plan of financing, (2) involved issuance of the same class of security, (3) were made at or around the same time, (4) were made for the same type of consideration, and (5) were made for the same general purpose. [*See* Securities Act Release No. 33-4522 (Nov. 6, 1962).]

Example:

A builder sought to build a housing development that straddled the Franklin/Monroe state border. To raise funds for the project, it sought to rely on the intrastate exemption. It organized a Franklin subsidiary and a Monroe subsidiary, with each subsidiary being responsible for construction in its state. It sold common shares in the subsidiaries exclusively to residents of their respective states. Because these sales were part of a single plan of financing and were made for the same general purpose (*i.e.*, to build one cross-border housing development), involved the same class of securities (common shares in the builder's subsidiaries), and were made around the same time, they would be integrated and would thus constitute an ***interstate*** public offering. Assuming that this interstate offering was not registered or otherwise exempt, it violated Section 5 of the Securities Act.

ii. Integration Safe Harbors

Just as the exemptions in Section 4 of the Securities Act may be uncertain from the statutory text, the five integration factors announced in Securities Act Release 33-4522 are also potentially uncertain. The SEC includes rules within its exempt-transaction safe harbors that allow issuers to avoid transactions being integrated.

d. Switching between Private and Public Offerings

Issuers may sometimes begin to raise capital through a private offering only later to determine that the offering should be public, or vice versa. For example, if there is limited interest in a private offering, the issuer may wish to switch to a registered offering.

i. Barriers to Switching

If a private offering is abandoned in favor of a public offering, or vice versa, the two transactions would be integrated under the Securities Release 33-4522 factors. Integration, however, would cause the issuer to violate Section 5 or to lose the availability of the Section 4(a)(2) exemption. Offers made in connection with an initial Section 4(a)(2) private offering would be gun-jumping in the context of a subsequent Section 5 offering. And filing (and then withdrawing) a registration statement as part of a public offering would constitute a general solicitation under a subsequent Section 4(a)(2) private place. The SEC has, however, adopted safe harbors that permit issuers to switch between private and public offerings without the two transactions being integrated. [*Compare* 15 U.S.C. § 77e (Securities Act § 5) *with* 15 U.S.C. § 77d(a)(2) (Securities Act § 4(a)(2).]

ii. Switching from Private Offering to Public Offering

Securities Act Rule 152 provides that a transaction relying on the Section 4(a)(2) exemption will satisfy the exemption's requirements if, after the offering begins, the issuer decides to make a public offering and/or files a registration statement. This rule allows issuers to abandon a private offering in favor of a public offering. Securities Act Rule 155(b) provides another safe harbor for this switch, provided that: (1) no securities are sold in the private offering, (2) all offering activity stops prior to the filing of a registration statement, (3) the prospectus includes certain disclosures about the abandoned private offering, and (4) the registration statement is filed at least 30 days after the private offering has ended (a waiting period that does not apply if the private offering was made only to accredited or sophisticated investors). [*See* 17 C.F.R. §§ 230.152 (Securities Act Rule 152), 230.155(b) (Securities Act Rule 155(b).]

Example:

An airline sought to raise capital for new planes by selling $200,000,000 in notes via a Section 4(a)(2) private placement. It did not find sufficient interest on the private market to sell all the notes, and so it decided instead to issue the notes via a registered public offering. The airline would be able to use Rule 152 to avoid the failed private placement from being integrated with the public notes offering.

iii. Switching from Public Offering to Private Offering

Securities Act Rule 155(c) provides a safe harbor for switching from a registered offering to a private placement, provided that: (1) no securities are sold in the registered offering, (2) the registration statement is withdrawn, (3) the private offering does not begin until 30 days after the registration is withdrawn, and (4) the issuer makes certain disclosures to purchasers (including that the purchased securities are restricted securities). [*See* 17 C.F.R. § 230.155(c).]

Example:

A startup software company filed to go public and needed to raise $500,000,000 in its public offering to meet short-term cash needs. Given uncertainty around the company's long-term profitability, however, there was tepid interest from investors during the underwriter's road show. The company decided not to follow through with its public offering, withdrew its registration statement, and 30 days later completed a $500,000,000 private placement with one of its existing investors. Because the startup did not sell any shares in the public offering, withdrew its registration statement, waited 30 days, and (presumably) made required disclosures to its investor, under Rule 155(c), the private transaction would not be integrated with the abandoned public offering.

2. Regulation D

The SEC's Regulation D is a safe harbor for several Section 3 and Section 4 exemptions. Its Rule 504 provides exemptions for limited offerings by issuers for amounts not exceeding $5,000,000. Its Rule 506 provides a safe harbor under Section 4(a)(2) of the Securities Act for (1) securities offerings up to $5,000,000 to up to 35 nonaccredited investors or (2) in unlimited amounts to ***accredited investors***. General solicitation is prohibited in Regulation D offerings, except for offerings under Rule 506(c).

a. Regulation D Generally

The concepts of accredited investor, bad-actor disqualification, and integration safe harbor are important features of Regulation D offerings.

i. Accredited Investors

Accredited investors are assumed to have the financial means and sophistication to fend for themselves, and thus the Securities Act provides them with the least affirmative protection in the offering process. Under Regulation D, accredited investors are:

- banks, insurance companies, investment companies under the Investment Company Act, business development companies, and small business investment companies;
- employee benefit plans if (1) banks, insurance companies, or investment advisers under the Investment Advisers Act make investment decisions for them or (2) if they have over $5,000,000 in assets;
- charitable organizations with over $5,000,000 in assets;
- directors, executive officers, or general partners of issuers;
- enterprises in which all equity owners are themselves accredited investors;
- individuals with either (1) income exceeding $200,000 in each of the two most recent calendar years or (2) joint income with a spouse exceeding $300,000 for those years, provided the investor has a reasonable expectation of the same income level in the current year; or

- trusts with assets of at least $5,000,000.

[*See* 17 C.F.R. §§ 230.501(a).]

ii. Bad-Actor Disqualification

Issuers that experienced certain ***bad-actor*** events (or whose affiliates did) prior to January 20, 2017 are not eligible to use Regulation D exemptions; this disqualification is also known as ***bad-boy disqualification***. Disqualifying events prior to January 20, 2017 must be disclosed to purchasers. Events that give rise to this disqualification include:

- certain instances of criminal convictions;
- certain judicial injunctions and restraining orders;
- certain state and federal agency final orders;
- certain SEC disciplinary and cease-and-desist orders, as well as stop orders and orders suspending the issuer's Regulation A exemption;
- suspension or expulsion from an SRO (*e.g.*, FINRA); or
- U.S. Postal Service false-representation orders.

Note: The SEC may waive bad-actor disqualifications and frequently does. [*See* 17 C.F.R. § 230.506(d).]

iii. Integration

Rule 502(a) of Regulation D provides that an offering under the regulation will not be integrated with other offers and sales made more than six months before the start, or six months after the end, of the Regulation D offering. This integration safe harbor only applies if during those six-month periods, there are no offers or sales of securities by the issuer that are of the same or a similar class as those offered and sold under the Regulation D offering (subject to limited exceptions). [*See* 17 C.F.R. § 230.502(a).]

b. Rule 504

Rule 504 of Regulation D exempts offerings from registration in which (1) issuers who are not reporting issuers or investment companies (*i.e.*, investment companies under the Investment Company Act) (2) offer up to $5,000,000 in securities to (3) an unlimited number of purchasers. Securities sold in reliance on Rule 504 are restricted securities and must bear a legend disclosing that resale is restricted. Issuers have affirmative disclosure obligations for a Rule 504 offering only if there are nonaccredited purchasers. [*See* 17 C.F.R. §§ 230.502, 230.504.]

Example:

A group of amateur brewers in River City decided to start manufacturing their beer and selling it commercially. They needed to raise $1,500,000 for professional brewing equipment, rent of commercial space, raw ingredients, and legal and licensing fees. They raised this capital by selling shares to a number of local businesspeople (who were all accredited investors), as well as personal friends and family members (who were mostly nonaccredited investors). They decided to call the new company River City Brewery. The offering relied on Regulation D's Rule 504 and, because some investors were nonaccredited, the brewers were required to provide a disclosure document.

c. Rule 506

Rule 506 provides one of the most significant safe harbors for private placements, particularly for startup companies in the technology and other high-growth industries.

i. Rule 506(b)

Rule 506(b) of Regulation D exempts offerings from registration in which issuers sell an unlimited value amount of securities to no more than 35 persons. Accredited investors are not included in the 35-investor cap. Nonaccredited investors, either alone or with the assistance of a representative, must meet sophistication standards; nonaccredited investors must also be provided with extensive disclosures. Securities sold in reliance on Rule 506(b) are restricted securities and must bear a legend disclosing that resale is restricted. [*See* 17 C.F.R. § 230.506(b).]

ii. Rule 506(c)

Rule 506(c) of Regulation D exempts offerings from registration in which issuers sell an unlimited value amount of securities to accredited investors only. Issuers must undertake diligence to verify that investors are in fact accredited investors, such as reviewing tax returns. Securities sold in reliance on Rule 506(c) are restricted securities and must bear a legend disclosing that resale is restricted. Unlike other Regulation D offerings, however, issuers using Rule 506(c) ***may*** engage in general solicitation. [*See* 17 C.F.R. § 230.506(c).]

Example:

> Three years after its founding, River City Brewery was a commercial success and needed to expand into a large new facility to keep up with growing demand. River City's CEO remarked to one industry publication, "We're working to raise $20,000,000 for a major expansion." Given the public circulation of the publication, this remark was a general solicitation. Sure enough, a venture capitalist focused on the beverage industry saw the interview and contacted the CEO. The $20,000,000 offering was closed two months later. River City Brewery engaged in general solicitation to sell securities, but because the securities were purchased solely by an accredited investor, under Regulation D's Rule 506(c) the offering was an exempt transaction.

3. Regulation A

Regulation A is an administrative exemption created by the SEC using its authority under Section 3(b) to exempt from registration classes of securities with offerings up to $50,000,000 in a 12-month period. Regulation A offerings are often referred to as ***mini-registration*** because they require issuers to file an offering statement on Form 1-A. The offering circular, which is part of the offering statement, must be furnished to purchasers; the issuer cannot accept payment for sales until the SEC's Division of Corporation Finance Staff ***qualify*** the Form 1-A. Purchasers must either be accredited investors, or, if they are nonaccredited investors, their purchase must not exceed 10 percent of the greater of the purchaser's annual income or net worth (excluding the value of the purchaser's primary residence). [*See* 17 C.F.R. §§ 230.251–230.263.]

Note: Unlike those sold in Regulation D offerings, securities sold in connection with Regulation A offerings are not restricted and so they can be immediately resold by their purchasers. Like Regulation D offerings, Regulation A offerings are subject to the bad-actor disqualifications.

4. Crowdfunding Offerings

In response to the JOBS Act, the SEC promulgated Regulation Crowdfunding. This exemption allows issuers to offer and sell securities in limited amounts to the public. Issues made in reliance on this exemption must meet four primary conditions:

- all transactions under Regulation Crowdfunding must take place online through an SEC-registered intermediary, either a broker-dealer or a funding portal;
- issuers may raise no more than $1,070,000 through crowdfunding during a 12-month period;
- investments by individual investors across all crowdfunding offerings in a 12-month period are limited to (1) $2,200 or 5 percent of the lesser of the investors annual income or net worth if either amount is less than $107,000 or (2) 10 percent of the lesser of the investor's

annual income or net worth if both amounts are more than $107,000, subject to a $107,000 total cap; and

- issuers must disclose certain information to the SEC, investors, and facilitating intermediaries.

Note: Crowdfunding is not available for foreign or reporting issuers, investment companies under the Investment Companies Act, or issuers subject to bad-actor disqualification. [*See* 17 C.F.R. § 227.100–227.503.]

C. Secondary Distributions

Holders of restricted securities, as well as control persons who hold securities in an issuer (no matter how the securities were acquired) (***control securities***) have several options for reselling their securities, including (1) a registered offering, (2) a Section 4(a)(1)(½) private placement, (3) a resell to the public in a transaction in reliance on Securities Act Rule 144, and (4) a resell in reliance on Securities Act Rule 144A to a ***qualified institutional buyer*** (QIB) for its own or another QIB's account. This section addresses the second two options: Rule 144 and Rule 144A offerings.

1. Rule 144

Securities Act Rule 144 provides conditions under which a holder of restricted securities or control securities may resell the securities to the public without being deemed to be engaged in a securities distribution. In other words, the selling securities holder would not be deemed to be an underwriter. To resell securities in reliance on Rule 144, sellers must satisfy four types of conditions related to: (1) holding period, (2) current public information, (3) volume limitations, and (4) manner of sale.

a. Holding Period

Holders of reporting-issuer securities must wait six months before reselling. Holders of nonreporting issuer securities must wait 12 months. [*See* 17 C.F.R. § 230.144(d).]

b. Current Public Information

If the issuer has been a reporting issuer for at least 90 days, it must have filed all required annual and quarterly reports for the prior 12 months or, if it has been public less than a year, then for the whole time it has been public. But if the issuer is not a reporting issuer, certain prescribed information must be available to the public. [*See* 17 C.F.R. § 230.144(c).]

c. Volume Limitations

Affiliates of the issuer (*e.g.*, an executive officer) during a three-month period may not sell more than (1) 1 percent of the shares or units outstanding or (2) the average weekly trading volume during the preceding four weeks. [*See* 17 C.F.R. § 230.144(e).]

d. Manner of Sale

Equity securities may be sold only through a broker transaction, directly to a market maker, or through a riskless principal transaction. [*See* 17 C.F.R. § 230.144(f).]

Example:

The cofounder and CEO of River City Brewery owned restricted shares in the company before it went public. After the brewery went public, the CEO wanted to sell shares in order to buy a new house. Under Rule 144, the CEO could do so (1) after waiting six months after the company went public, (2) ensuring that the company was current on its public disclosures, and (3) conducting the resale through a broker or other permissible transaction.

2. Rule 144A

Securities Act Rule 144A provides conditions under which privately placed securities may be resold to QIBs. Rule 144A is an important mechanism for facilitating a market among institutional investors for unregistered securities. High-yield bonds are a leading example of unregistered securities that are commonly sold in the institutional market in reliance on Rule 144A. Securities sold under Rule 144A must meet four key conditions: (1) QIB buyers only, (2) seller notice, (3) nonfungibility, and (4) disclosure. Resales under Rule 144A may occur at any time: unlike Rule 144 sales, there is no waiting period.

a. QIBs Only

The reseller must sell only to a QIB, or an investor the reseller reasonably believes is a QIB. QIBs include: (1) business entities (including insurance companies, employee benefit plans, and other entities) that hold $100,000,000 or more in securities of nonaffiliates, (2) registered dealers that hold or invest $10,000,000 or more of nonaffiliate securities or that are engaged in certain transactions on behalf of QIBs, (3) an investment company that is part of a group of investment companies that holds $100,000,000 or more of nonaffiliate securities, or (4) U.S. and foreign banks that hold $100,000,000 or more in nonaffiliate securities and that have a net worth of at least $25,000,000. [*See* 17 C.F.R. § 230.144A(d)(3)(i).]

Note: Rule 144A was amended as a result of the JOBS Act. Offers may be made to non-QIBs so long as the purchasers are, or are reasonably believed to be, QIBs.

b. Seller Notice

The seller must notify the purchasers that the seller may rely on Rule 144A in reselling the securities. [*See* 17 C.F.R. § 230.144(d)(2).]

c. Nonfungibility

The securities must not be of the same class as securities listed on a national securities exchange or quoted through an interdealer quotation system. [*See* 17 C.F.R. § 230.144(d)(3).]

d. Disclosure

If the issuer is not a reporting issuer, the seller and prospective QIB purchaser must be entitled to obtain from the issuer certain limited disclosures, including the issuer's financial statements for the most recent period and the two prior years. [*See* 17 C.F.R. § 230.144(d)(4).]

Example:

After going public, River City Brewery issued notes in a private offering to finance the acquisition of River City Vineyards, a large wine producer. This was the only debt security it had issued. Mega Bank, N.A. purchased all of the notes and, after closing, sold them to a number of other banks, insurance companies, and investment companies, all of which qualified as QIBs. Because Mega Bank sold the notes only to QIBs, the notes were nonfungible, River City Brewery was a reporting issuer, and (presumably) provided a seller's notice to the purchasers, under Rule 144A the resale of the River City Brewery notes was an exempt transaction.

V. Continuing Disclosure, Shareholder Voting, and Tender Offers

Federal securities regulation is a set of statutes and rules regulating the distribution of securities. Many securities, like notes or investment contracts, are largely instruments governed by contracts between the issuer and holders. But one class of securities—stock—represents residual claims on entities formed under state law, *i.e.*, corporations. Stock usually comes with a right to vote on important corporate matters, like the election of directors (who are chiefly in charge of managing the corporation), voting on extraordinary transactions (like whether to approve a merger or charter amendment), or voting on nonbinding proposals submitted by shareholders. Federal securities law, however, does not seek just to protect investors by ensuring that they are fully informed when they make investment decisions during public or private offerings. It also provides rules designed to keep shareholders informed about the condition of the corporation, about their options in terms of voting, and about certain public offers to buy their shares. This chapter discusses the role of federal securities regulation on each of these topics. [*See* Public Offerings, *supra*.]

A. Continuing Disclosure Obligations

When a company goes public for the first time, Sections 5 and 10 of the Securities Act require it to make a broad set of financial and qualitative disclosures to prospective shareholders. Once a company is public, Sections 13 and 15 of the Exchange Act impose continuing reporting obligations on annual, quarterly, and current bases. [*See* Public Offerings, *supra*.]

1. Issuers Subject to Continuing Disclosure Obligations

Under Section 13(a) of the Exchange Act, issuers become reporting issuers—subject to continuing disclosure obligations—if they meet either of two triggers. First, issuers that list securities on a national securities exchange (*e.g.*, NYSE) become reporting issuers. Second, issuers with $10,000,000 or more in assets (on the last day of the prior fiscal year) become reporting issuers if they have a class of equity securities, like common or preferred stock, held by either (1) 2,000 or more persons or (2) 500 or more persons who are not ***accredited investors***. [*See* 15 U.S.C. § 78l(a), (g) (Exchange Act § 12(a), (g)).]

Example:

Radical Speakers was a startup speaker manufacturer that raised initial funds via exempt offerings. A total of 2,500 individuals purchased shares. At the end of its last fiscal year, it valued its assets—including cash on hand, receivables, intellectual property, inventory, and other assets—at $15,000,000. Because Radical Speakers had both over $10,000,000 in assets and over 2,000 shareholders, it became a reporting issuer subject to continuing disclosure obligations. [*See* Exempt Offerings, *supra*.]

a. Securities Types and Continuing Disclosure Requirements

Not all securities are equity securities, but it is equity securities that trigger continuing disclosure requirements under the Exchange Act. This focus on equity securities is justified because equity holders hold claims on the residual value of a going concern. Other types of securities, like notes, often have definite lifespans and investors can protect themselves through contractual terms (*e.g.*, covenants in debt securities that protect investors' interests). Equity, holders, however, face much higher uncertainty and risk with their investments. They primarily protect their own interests through selling shares, voting shares, or sometimes even filing lawsuits. The securities laws thus provide them additional informational and sometimes substantive protections.

2. File versus Furnish

An important distinction in securities practice is whether a document is ***filed*** with the SEC or ***furnished*** to it. Although these words appear to have equivalent meanings, they differ significantly in terms of associated liability. Section 18 of the Exchange Act imposes liability for material misstatements or omissions in documents ***filed*** with the SEC. Although ***furnished*** documents do not carry Section 18 liability, they may still give rise to liability for misstatements or omissions under Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. [*See* 15 U.S.C. § 78r(a) (Exchange Act § 18(a)); *see also* Private Enforcement, *infra*; Public Enforcement, *infra*.]

3. Books and Records

It is not helpful to shareholders, of course, if they receive mandatory disclosures from issuers, yet those disclosures are based on inaccurate records. Section 13(b) of the Exchange Act addresses this risk by mandating that reporting issuers meet two requirements. These books-and-records requirements are an important way that investors receive accurate disclosures from issuers, and issuers are subject to enforcement if they fail to maintain complete, accurate books and records.

a. Accurate and Fair Records

Issuers must make and keep financial books and business records in reasonable detail to accurately and fairly reflect their financial and business transactions. [*See* 15 U.S.C. § 78m(b) (Exchange Act § 13(b)).]

b. Internal Accounting Controls

Issuers must maintain a system for internal accounting controls that gives assurance that, among other things, (1) transactions are done only when authorized and (2) the accounting records are sufficient to allow financial statements to be prepared that align with generally accepted accounting principles (GAAP). [*See* 15 U.S.C. § 78m(b) (Exchange Act § 13(b)).]

4. Filer Types

Under Exchange Act Rule 12b-2, the SEC has adopted policies that vary the disclosure requirements of public companies based on factors like their market capitalization (*i.e.*, the number of shares they have outstanding multiplied by the current share price). In general, these rules allow smaller companies to disclose less information in their public disclosures and to take more time in making their disclosures, which is helpful to those issuers given the expense of making the disclosures required of larger companies. The five categories of public filers are emerging growth companies, smaller reporting companies, nonaccelerated filers, accelerated filers, and larger accelerated filers.

a. Emerging Growth Companies

In general, an emerging growth company is one that had less than $1,070,000,000 in gross revenue during its most recently completed fiscal year. [17 C.F.R. § 240.12-2.]

b. Smaller Reporting Companies

In general, a smaller reporting company must not be an investment company under the Investment Companies Act, as asset-backed issuer (*e.g.*, a corporation created to bundle and sell mortgages), or a majority-owned subsidiary of a parent company that is not itself a smaller reporting company. In addition, a smaller reporting company must meet one of the following conditions: (1) have a public float (*i.e.*, the value of publicly held shares in the corporation, other than shares held by affiliates, such as executive officers or directors) of less than $250,000,000 or (2) have annual revenues less than $100,000,000 ***and*** a public float of less than $700,000,00 (or no public float). [17 C.F.R. § 240.12-2.]

c. Nonaccelerated Filers

In general, nonaccelerated filers are companies that have a public float of less than $75,000,000. Based on these rules, nonaccelerated filers are smaller reporting companies, but the reverse is not always true. [*Cf*. 17 C.F.R. § 240.12-2.]

Example:

North Labs was a pharmaceutical company that in its most recently completed second fiscal quarter had $80,000,000 in revenue and a public float of $200,000,000. Because it satisfied the first of two alternative conditions for smaller reporting company status—a public float under $250,000,000—it was a smaller reporting company. However, because North Labs's public float was over $75,000,000, it was ***not*** a nonaccelerated filer.

d. Accelerated Filers

In general, accelerated filers are companies that have (1) a public float of less than $700,000,000 ***and*** (2) more than $75,000,000 in public float as of the last business day of the issuer's most recently completed second fiscal quarter. They must also be current on their public-reporting obligations. Based on these rules, smaller reporting companies are sometimes (but not always) also accelerated filers. [*Cf.* 17 C.F.R. § 240.12-2.]

Example:

North Labs was a pharmaceutical company that in its most recently completed second fiscal quarter had $80,000,000 in revenue and a public float of $200,000,000. Because North Labs's public float was over $75,000,000, it ***was*** an accelerated filer.

e. Large Accelerated Filers

Accelerated filers are companies that have a public float of $700,000,000 or more as of the last business day of the issuer's most recently completed second fiscal quarter. They must also be current on their public-reporting obligations. (Large accelerated filers and smaller reporting companies are mutually exclusive categories.) [17 C.F.R. § 240.12-2.]

Example:

South Labs was an established pharmaceutical company with a public float of $5,000,000,000 on the last business day of its most recently completed second fiscal quarter. Because South Labs's public float was above the $700,000,000 threshold, it was a large accelerated filer.

5. Regulation S-K, Regulation S-X, and Forms

What disclosures must be included on a report, and when reports must be filed, is determined by an issuer's status (*e.g.*, domestic or foreign private, or smaller reporting company; nonaccelerated filer; accelerated filer; or large accelerated filer) and the requirements of the report forms that are promulgated, and amended, by the SEC. Regulation S-K provides a menu of qualitative disclosures, whereas Regulation S-X provides a menu of quantitative disclosures. In turn, report forms like Form 10-K or Form 8-K identify which ***items*** from the Regulation S-K or Regulation S-X menus must be included. [*See* 15 U.S.C. § 783 (Exchange Act § 13); 17 C.F.R. pts. 210 (Regulation S-X), 229 (Regulation S-K).]

6. Periodic Reporting

The Exchange Act's basic scheme for continuing mandatory disclosures is for domestic reporting issuers to file annual and quarterly reports, as well as current reports between annual and quarterly reports. Foreign private issuers have more modest reporting obligations than domestic issuers.

a. Annual and Quarterly Reports

Domestic issuers must file an Annual Report on Form 10-K for each fiscal year and a Quarterly Report on Form 10-Q for each fiscal quarter. In other words, they must file three Form 10-Qs throughout the year, plus a Form 10-K that will contain both annual and fourth-quarter disclosures. [*See* SEC, Annual Report on Form 10-K (May 2019); SEC, Quarterly Report on Form 10-Q (May 2019).]

b. Current Reports

Certain triggering events in the life of a reporting issuer are significant enough that shareholders should not be required to wait until the next annual or quarterly report to learn of them. The SEC has identified those events on the Current Report on Form 8-K. Examples of those events that must be disclosed on a Form 8-K include: (1) the issuer has entered into, amended, or terminated a material agreement; (2) the issuer has entered bankruptcy or receivership; (3) the issuer has undertaken certain obligations or material debts; (4) there have been changes in personnel among the issuer's board of directors or executive officers; (5) the issuer has withdrawn reliance on its publicly disclosed financial statements; (6) the announcement of the results of shareholder voting; and (7) other triggers. [*See* SEC, Current Report on Form 8-K (May 2019).]

Example:

Radical Speakers was a reporting company facing business turmoil as its senior executive team and founder/CEO clashed and rival companies moved into its high-end speaker market. Radical negotiated a sale to a major competitor. As part of the agreement, Radical's controversial founder and CEO resigned from the company effective immediately and was replaced in the interim by the COO. Because Radical had entered into a material definitive agreement (*i.e.*, it signed a merger agreement with its competitor) and its CEO resigned and was replaced, Radical would be required to file a Current Report on Form 8-K to disclose these events.

c. Foreign Private Issuers

Foreign private issuers that are reporting issuers are subject to less extensive continuous obligations than domestic issuers. These rules are designed to strike a balance. On the one hand, the U.S. does not want to discourage foreign private issuers from entering the U.S. capital markets out of fear of needing to comply with substantial U.S. disclosure requirements on top of the requirements of their home countries. On the other hand, if foreign private issuers are to enter the U.S. capital markets, U.S.-based investors deserve a level of protection in the form of adequate disclosures. As a result, foreign private issuers are required to file an Annual Report on

Form 20-F, whose financial statements may be prepared under International Financial Reporting Standards (IFRS), the primary body of accounting standards outside the U.S. They are not required to file quarterly reports. However, they must ***furnish*** current reports on Form 6-K when certain triggers occur, including the filing of mandatory reports with their home-country securities regulators or stock exchanges. [*See* SEC, *Accessing the U.S. Capital Markets — A Brief Overview for Foreign Private Issuers* (Feb. 13, 2013).]

7. Financial Disclosure

Regulation S-X requires detailed, audited financial disclosures in the Annual Report on Form 10-K, as well as unaudited financial disclosures in Quarterly Reports on Form 10-Q. Major categories of disclosures under Regulation S-X include: (1) a report and attestation by the accounting firm that audited the financial statements, (2) a balance sheet, (3) an income statement, (4) a statement of cash flows, (5) and other disclosures. [*See* 17 C.F.R. pt. 210 (Regulation S-X).]

Note: The financial statements of all domestic issuers must be prepared in accordance with GAAP, a body of accounting principles designed to provide uniformity across all public companies in the U.S. This uniformity, in turn, allows investors to compare issuers in an apples-to-apples context. Although the SEC has authority to adopt accounting rules, it generally delegates this role to the Financial Standards Accounting Board (FASB), a private accounting standards-setting body that governs GAAP.

8. Qualitative Disclosure

Regulation S-K requires detailed qualitative disclosures in either the Annual Report on Form 10-K, the Quarterly Reports on Form 10-Q, or both. Major categories in these disclosures include:

- information about the business of the issuer (Items 101–03);
- information about the securities of the issuer (Items 201–02);
- selected financial information, management's discussion and analysis of the issuer's financial condition and results, information about the issuer's disclosure controls and procedures, and information about the issuer's internal control over financial reporting (Items 301–08);
- information about the directors and executive officers of the issuer, its corporate governance, and certain major shareholders (Items 401–07); and
- any exhibits required by disclosure forms (Item 601);

[*See* 17 C.F.R. pt. 229 (Regulation S-K).]

B. Shareholder Voting

State corporate law vests most managerial decisions in a company's board of directors and officers. Shareholders, however, are given certain governance rights. These rights include electing directors, voting on shareholder proposals (*i.e.*, requests that the board of directors consider or adopt certain corporate policies), and voting on extraordinary matters. Although these voting powers are created and governed by state corporate law, for public companies, the federal securities laws impose regulations designed to ensure that shareholders have adequate information before making voting decisions.

1. Shareholder Voting

Shareholder voting generally occurs at ***shareholder meetings***, which state corporate laws require to be held at least annually. Because most shareholders cannot attend meetings in person, state laws allow them to give another person their ***proxy*** to vote on their behalf. In most instances, proxies are given to management. Management also sets the agenda for shareholder meetings and most voting outcomes are consistent with management's recommendations. Major voting items include director elections, management proposals, and shareholder proposals.

a. Director Elections

Directors generally hold office for one-year terms, although some companies have staggered boards in which directors hold multi-year terms and a portion of the director seats come up for election each year. In general, management nominates directors for election (who may be incumbents or new nominees). State law also allows shareholders to nominate directors.

b. Management Proposals

Apart from director elections, state law commonly requires shareholder approval for certain extraordinary matters, including the sale of the company or substantially all of its assets or making amendments to the charter. These proposals are made by management.

c. Shareholder Proposals

Although managerial decisions are vested by state law in the board of directors and officers, shareholders may sponsor precatory proposals. These proposals ask the board of directors to consider or adopt policy changes for the company and its business. Although these proposals are nonbinding, they do pressure boards of directors to act (*e.g.*, directors who ignore shareholder wishes might be at risk of losing votes for reelection). Exchange Act Rule 14a-8 requires issuers to include shareholder proposals as voting items at shareholder meetings and in proxy materials (which shareholders use to vote if they cannot attend the meeting). This requirement is subject to certain eligibility requirements for the shareholder proponent, as well as certain exceptions that allow issuers to exclude proposals.

i. Eligibility to Submit a Shareholder Proposal

Shareholders are eligible to submit a shareholder proposal if for at least one year prior to the submission they have held voting securities in the company that (1) have a market value of $2,000 or more or (2) represent 1 percent or more of the company's voting securities. Shareholders may submit no more than one proposal for each shareholder meeting, and proposals and accompanying supporting statements are limited to 500 words. [17 C.F.R. § 240.14a-8(b)–(d) (Exchange Act Rule 14a-8(b)–(d)).]

ii. Exclusions of Shareholder Proposals

Issuers are not required to include all shareholder proposals in their proxy materials, however. The SEC has articulated certain categories that may be excluded. Companies may seek guidance from the SEC's Division of Corporation Finance as to whether certain proposals fall under one of Rule 14a-8's exclusions. However, shareholder proponents may sue the company if a nonexcludable proposal is excluded. These exclusions are:

- if implemented, the proposal would violate a law to which the company is subject;
- the proposal or its supporting statement violate the proxy rules (*e.g.*, they are misleading);
- the proposal relates to a personal grievance or personal interest not shared by shareholders generally;
- the proposal relates to operations that relate to 5 percent or less of the company's net assets, net earnings, or gross sales, and it is not otherwise significantly related to the company's business;
- the proposal could not be implemented because the company would lack authority to do so;
- the proposal relates to the company's ordinary business operations (whereas day-to-day management is committed to the board of directors and officers);
- the proposal would interfere with or affect director elections; or
- the proposal would conflict with a management proposal.

Example:

A shareholder of an airline held $5,000 in voting shares for several years. The shareholder believed the airline was missing a big opportunity by not offering direct flights between River City and other cities. The shareholder submitted a proposal that the airline do so. Because this proposal related to the airline's ordinary business operations (*i.e.*, making decisions about what routes to serve), the airline was allowed to exclude the proposal from its proxy materials.

Compare:

A shareholder of an airline held $5,000 in voting shares for several years. The shareholder flew on the airline several times a year, but on two occasions it lost the shareholder's luggage and refused to offer compensation. The shareholder learned that many other passengers had similar experiences. The shareholder submitted a proposal that the airline offer just compensation for lost luggage. Because this proposal related to a personal grievance (*i.e.*, the shareholder's lost luggage), the airline was allowed to exclude the proposal from its proxy materials. Even though this problem affected ***customers*** generally, it was not a general concern of shareholders (who may or may not also have been the airline's customers). [17 C.F.R. § 240.14a-8(b) (Exchange Act Rule 14a-8(b)); *see also* Roosevelt v. E.I. DuPont de Nemours & Co., 958 F.2d 416 (D.C. Cir. 1992) (recognizing a private right of action for improperly excluded shareholder proposals).]

2. Proxy Regulation

Regulation 14A under the Exchange Act regulates proxy solicitation and voting for public issuers. Just as the securities laws seek to ensure that investors received materially accurate and complete information before making investment decisions, it also seeks to ensure that they receive materially accurate and complete information before making voting decisions. Regulation 14A approaches this goal by mandating that certain disclosures be made by persons soliciting proxies from shareholders and that proxy materials not contain materially false or misleading statements.

a. Proxy Solicitation

In protecting investors when they make voting decisions, Regulation 14A primarily regulates proxy solicitation. Proxy solicitation is a central part of modern corporate governance because few shareholders actually attend shareholder meetings where matters are voted on; instead, they exercise their voting rights by giving a proxy for voting matters.

i. The Definition of Solicitation

Regulation 14A's definition of ***solicitation*** is analogously as broad as the Securities Act's definition of ***offering***. This broad definition of solicitation is intended to prevent those who seek to influence shareholder voting from avoiding the proxy-solicitation rules. Under Exchange Act Rule 14a-1(l), a solicitation includes:

- any request to a shareholder for a proxy;
- any request to a shareholder to execute or not execute a proxy; or
- furnishing a proxy or any other communication to a shareholder under circumstances reasonably calculated to influence the shareholder to give, withhold, or revoke a proxy.

Example:

A major shareholder of an airline was dissatisfied with the direction of its business. It identified three directors as negative influences on the airline's future. In the run-up to the annual shareholder meeting, the major shareholder wrote an open letter to its fellow shareholders urging them to ***withhold*** their votes for the three identified directors. Because this open letter was intended by the major shareholder to influence other shareholders to withhold a proxy vote, the letter would be a proxy solicitation.

Compare:

A major shareholder of an airline was dissatisfied with the direction of its business. It identified three directors as negative influences on the airline's future. In the run-up to the annual shareholder meeting, the major shareholder wrote an open letter in a financial publication announcing that it would vote to ***withhold*** its proxy votes for the three directors, but that it would vote ***for*** the other director nominees. Because this open letter merely stated how the major shareholder intended to vote, it would ***not*** be a proxy solicitation. [17 C.F.R. § 240.14a-1(l) (Exchange Act Rule 14a-1(l)); *see also* Public Offerings, *supra*.]

ii. Exemptions from the Definition of Solicitation

Certain acts are carved out of the definition of solicitation. These acts include: (1) providing a proxy form to a shareholder after the shareholder's unsolicited request for one; (2) an issuer's mandatory distribution of proxy materials on behalf of another proxy solicitor (or its furnishing a list of shareholders to the other solicitor); (3) communications by shareholders about how they intend to vote (provided that certain conditions are met, such as making the announcement through press releases or bona fide media outlets). [*See* 17 C.F.R. § 240.14a-2(b) (exemptions).]

b. Proxy Statements

Unless the solicitation is exempt from this requirement under Exchange Act Rule 14a-2(b), anyone engaging in proxy solicitation must furnish a ***proxy statement*** to the person being solicited. The proxy statement must contain disclosures prescribed by Schedule 14A, including information related to: (1) who the solicitor is (*e.g.*, the issuer's management); (2) shareholder meetings and director elections; (2) the functions and operations of the board (including director compensation); (3) voting items (*e.g.*, management proposals, advisory votes on executive compensation, or shareholder proposals); and (4) other disclosures. Disclosures may also be incorporated by reference to disclosures in previously filed reports. Preliminary and definitive proxy statements must be filed with the SEC.

i. Materiality in the Context of Proxy Solicitation

Exchange Act Rule 14a-9 prohibits any proxy statement, notice of meeting, or other written or oral communication that contains any materially false or misleading fact, or omits any material fact needed to make any statement not false or misleading. Materiality in the context of proxy solicitation follows the *TSC Industries v. Northway, Inc.* standard. In that case, the Court held that a fact omitted from a disclosure was material if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." [*TSC Industries v. Northway, Inc*, 426 U.S. 438, 449 (1976); 17 C.F.R. § 240.14a-9 (Exchange Act Rule 14a-9.]

Example:

A proxy statement included disclosures about a nominee for the board of directors. This nominee had not previously served on the company's board, and it noted that the nominee had previously been "a highly successful CEO of a major public corporation, overseeing record growth in revenue." The proxy statement did not disclose that the CEO had been fired from that previous company after accounting irregularities arose there. Because this discharge from recent employment, especially for accounting issues, would be considered important in a reasonable shareholder's decision whether to vote for the nominee, its omission rendered the proxy statement materially misleading.

ii. Bundling

Exchange Act Rule 14a-1 requires that proxy statements clearly and impartially list each separate voting item, including any voting items that are conditioned on the approval of other items. This antibundling rule prevents management from giving shareholders a take-it-or-leave-it choice to either vote ***yes*** on all management's recommendations or ***no*** on all of them. [17 C.F.R. § 240.14a-4 (Exchange Act Rule 14a-4).]

Examples:

(1) An airline's proxy statement included as a voting item "Item A. To approve the reelection of all nominated incumbent directors and to approve the company's executive-compensation plan for this fiscal year." Because the proxy statement required shareholders to vote on director reelections and executive compensation as a single package, it violated the proxy rules' antibundling provision.

(2) An airline intended to purchase a rival; part of its acquisition strategy included reincorporating to Bermuda, which would allow it to realize tax savings. Its proxy statement included as voting items "Item A. To approve the acquisition of Global Airlines" and "Item B. To approve the reincorporation of the company to Bermuda, provided that such reincorporation will occur only if the acquisition of Global Airlines was approved." Even though the reincorporation was conditioned on the merger being approved, the two voting items were separate and thus there was no violation of the antibundling provision.

c. Delivery of Proxy Statements

In the U.S., most voting securities of public companies are held in ***street name***, *i.e.*, they are held by nominees (banks, broker-dealers, or other agents) on behalf of their ***beneficial owners***. Because of this system, issuers do not have complete lists of who beneficially owns their voting shares, a gap in data that could prevent them from mailing proxy materials to shareholders. Traditionally this gap was overcome by issuers sending proxy materials (including proxy statements and proxy cards) to nominees. Now, however, issuers may provide the materials electronically on a website, although beneficial owners remain entitled to request paper copies. [17 C.F.R. § 240.14a-16 (Exchange Act Rule 14a-16).]

d. Proxy Contests

Although management is most frequently the proxy solicitor, others may also solicit proxies. One prominent example of non-management solicitation is proxy contests waged by dissident shareholders who seek to influence the direction of the company by, *e.g.*, nominating one or more director candidates (as opposed to voting for or against nominees of the board of directors). (Proxy contests may also be waged by a potential acquirer of the company, which hopes to install directors who will be receptive to an acquisition offer.) Those who wage proxy contests are at a disadvantage compared to management, which can use corporate resources to fund its proxy campaign. Management is required by Exchange Act Rule 14a-7, however, to supply the organizer of a proxy contest with a list of shareholders (so the organizer can mail a proxy solicitation to them) or to mail the materials to the shareholders itself; in either case, the organizer must itself pay the considerable expenses of the solicitation. [*See* 17 C.F.R. § 240.14a-7 (Exchange Act Rule 14a-7).]

C. Tender Offers

Corporate takeovers represent a tool for efficiently allocating capital. If a company's assets could be more valuable if owned and controlled by another firm, it might expect to be the target of a takeover. Companies that are acquired are generally bought for a premium over the current value, which allows equity holders in the selling company to enjoy some of the gains the transaction is expected to achieve. If the board of directors of a target company refuses to negotiate or approve a transaction, an acquirer may go directly to the shareholders by offering to buy all or part (but usually at least a majority) of their shares. In order to protect shareholders in connection with tender offers, Congress adopted the Williams Act, a set of amendments to the Exchange Act. [*See* 82 Stat. 455 (1968) (The Williams Act).]

1. Shareholding Disclosure

The Williams Act amended the Exchange Act to include Section 13(d), which requires anyone who becomes the beneficial owner of 5 percent or more of any class of a public company's equity securities to file a notice with the SEC. This notice allows the company's management and shareholders to know that there is a new major shareholder that might attempt to exert influence over the issuer, including potentially launching a tender offer. These notices, which are filed on Schedule 13D, among other things require the acquiring shareholder to disclose the source of its funding for the shares (which could shed light on its intentions), a statement of why it purchased the shares, and a statement about any intentions it has to exercise control over the company. [*See* 15 U.S.C. § 78m(d) (Exchange Act § 13(d); 17 C.F.R. § 240.13d-1(a) (Exchange Act Rule 13d-1(a).]

Note: Certain types of investors, including broker-dealers and investment companies under the Investment Companies Act, may alternatively file a Schedule 13G when they acquire 5 percent or more of securities. In order to qualify to file a Schedule 13G, they must have acquired the securities in the ordinary course of business and not for the purpose of changing or influencing control of the issuer. For passive investors, like mutual funds, it is preferable to file a Schedule 13G because it requires less information and does not need to be updated as frequently as Schedule 13D. [*See* 17 C.F.R. § 240.13d-1(b)(1) (Exchange Act Rule 13d-1(b)(1).]

Example:

An investment fund identified Picky's, a publicly traded restaurant chain, as poorly managed. It determined that if several of its partners, who had expertise in restaurants, joined Picky's board of directors, they could push strategic initiatives to improve performance. The fund acquired shares on the open market over several weeks, eventually hitting the 5-percent threshold. It was therefore required by Section 13(d) of the Exchange Act to file a Schedule 13D, including disclosing its intention to continue acquiring shares and of nominating its partners to the Picky's board at the next annual shareholder meeting.

Compare:

A mutual fund was designed to replicate an index of hospitality-industry stocks, which included Picky's, a publicly traded restaurant chain. As the mutual fund grew, it bought shares in all the stocks in the hospitality-industry index in proportion to their allocation in the index. Eventually, it came to hold 6 percent of Picky's stock. Because the mutual fund was a passive investor in Picky's, after crossing the 5-percent threshold it was permitted to file a Schedule 13G instead of a Schedule 13D.

2. Definition of a Tender Offer

The Williams Act leaves the term ***tender offer*** undefined. The leading test for whether a transaction is a tender offer is supplied by *Wellman v. Dickinson*. The *Wellman* test looks for the presence of eight factors (not all of which must be present for the transaction to be deemed a tender offer):

- there is active and widespread solicitation of shareholders for the issuer's shares;
- the solicitation is for a substantial portion of the issuer's shares;
- the offering price is at a premium to the prevailing market price;
- the offering terms are firm (*i.e.*, they are not negotiable);
- the offer is contingent on the tender of a fixed number of shares, often subject to a minimum as well;
- the offer is open for a limited period of time;
- shareholders are under pressure to sell their shares; and

- public announcements of share purchasing precede or accompany rapid accumulation of large amounts of the target issuer's securities.

[*Wellman v. Dickinson* 475 F. Supp. 783 (S.D.N.Y. 1979).]

Example:

A venture-capital fund owned 15 percent of a company that recently went public. It was approached by a private-equity fund with an offer to buy all of its shares in the company. The two parties negotiated a price but kept the transaction confidential until it was consummated. The private-equity fund paid the venture-capital fund a 10-percent premium over the market price of the company's shares. Because there was no public solicitation for shares, the transaction was negotiated, and the shares were all bought in a block, this transaction was ***not*** a tender offer under the *Wellman* test. The transaction was not a tender offer even though some of the *Wellman* factors were present, including a substantial percentage of the company's shares being purchased at a premium price.

3. Basic Tender-Offer Rules

Tender offers are publicly announced offers for shareholders to sell their stock, typically announced in a widely circulated newspaper or other press outlet. The Williams Act and Regulation 14D are designed to ensure that shareholders have adequate information to make an investment decision whether to tender their shares, and also to ensure that shareholders are not pressured by a short offering period to make a hasty decision.

a. Tender-Offer Disclosure

Bidders must file a Schedule TO with the SEC that contains disclosures for shareholders to consider in deciding whether to tender their shares. [17 C.F.R. §§ 240.14d-2, 240.14d-100 (Exchange Act Rules §§ 14d-2, 14d-100).]

b. Full versus Partial Tender Offers

A tender offer may be for all or part of a target company's shares, although usually the bidder will set a minimum number of shares that must be tendered (otherwise all tendered shares will be returned). If a partial tender offer is oversubscribed (*i.e.*, more shares are tendered than the bidder announced it would accept), then it must pro rate the number of shares it accepts from each tendering shareholder. [*See* 15 U.S.C. § 78n(d)(6) (Exchange Act § 14(d)(6)); 17 C.F.R. § 240.14d-8 (Exchange Act Rule § 14d-8).]

Example:

A tender offer was commenced for a maximum of 55 percent of a publicly traded company's shares. A shareholder held 1,000 shares and decided to tender them all to the bidder. A total of 65 percent of the company's shares were tendered, meaning the offer was oversubscribed. Because 55 percent was 84.6 percent of the total number of tendered shares, 84.6 percent of each tendering shareholder's shares would be accepted. As a result, for the shareholder who tendered 1,000 shares, 846 would be accepted and paid for, and the remaining 154 shares would be returned.

c. Consideration for and Pricing of Tender Offers

Shareholders must receive the same price (which may be paid in cash, securities, or a combination of cash and securities) for their shares. If the bidder increases the price during the period the offer is open, it must pay that same price to shareholders who had already tendered their shares. [17 C.F.R. § 240.14d-10 (Exchange Act Rule § 14d-10).]

d. Timing of Tender Offers

Tender offers must generally be kept open for 20 business days from the date they are announced. The purpose of this requirement is to give shareholders time to make a decision whether to tender their shares. It also keeps the tender offer open long enough for competing acquirers to make topping bids, thereby allowing shareholders to receive the highest price possible. Because shareholders may withdraw their tendered shares at any time during the offer period, if a superior tender offer is commenced, they would be expected to withdraw any shares tendered to the original bidder and then tender the shares to the superior bidder. [*See* 17 C.F.R. § 240.14e-1 (Exchange Act Rule § 14e-1).]

4. Mini-Tender Offers

Section 14(d) of the Exchange Act applies only to tender offers that would lead to the bidder becoming the holder of more than 5 percent of a class of equity securities of an issuer. Bidders may thus engage in ***mini-tender offers*** (*i.e.*, acquiring no more than 5 percent of any class of equity securities) without following the offering procedures of Regulation 14D, including filing a Schedule TO. The antifraud provisions of Section 14(e) of the Exchange Act still apply to mini-tender offers, however. [*See* 15 U.S.C. §§ 78n(d)–(e) (Exchange Act §§ 14(d)–(e)).]

5. Self-Tender Offers

Tender offers are not always conducted by outside bidders. Issuers may conduct self-tender offers in which they solicit their shareholders to sell shares back to the company. Self-tender offers may be conducted to thwart outsider bidders; in these cases, if the issuer commences a self-tender offer during another offer, it must meet certain disclosure requirements under Exchange Act Rule 13e-1. Otherwise, although self-tender offers are not directly subject to Section 14(d) of the Exchange Act, Exchange Act Rule 13e-4 subjects self-tender offers to substantially the same rules as offers by outside bidders. [17 C.F.R. §§ 240.13e-1 (Exchange Act Rule § 13e-1), 240.13e-4 (Exchange Act Rule § 13e-4)).]

VI. Capital Markets Regulation

Federal securities regulation does more than regulate the disclosure-based conduct of securities issuers and related parties like underwriters. It also seeks to ensure that the capital markets allow for securities to be traded efficiently and free from fraud, manipulation, or other abuses. Although capital-markets regulation relies in part on the power of disclosure to allow investors to make informed decisions, it also imposes substantive rules on how the markets and its participants operate. [*See* Public Offerings, *supra*.]

A. The National Market System

The national market system is a collection of linked securities exchanges and other trading facilities. Exchange Act Regulation NMS regulates the national market system and seeks to ensure uniform dissemination of securities prices (***quotations***) and orderly transactional functions such as trades and clearing. [*See* 17 C.F.R. § 242.600 (Regulation NMS); *see also* The Structure of Securities Regulation, *supra*.]

1. National Securities Exchanges

A securities exchange is a facility that allows sell orders by securities sellers and buy orders by securities buyers to be matched at prices the former are willing to accept and the latter are willing to pay. The two largest and most prominent national securities exchanges are the NYSE and the Nasdaq Stock Market (Nasdaq).

a. Registration

In the U.S., exchanges must be registered with the SEC or exempt from registration, and it is unlawful for broker-dealers to execute transactions on unregistered or non-exempt exchanges. Among the requirements a prospective exchange must satisfy to become registered is to propose rules for regulating its members, for preventing fraudulent and manipulative acts and practices, and for promoting just and equitable principles of trade. [*See* 15 U.S.C §§ 78e (Exchange Act § 5), 78f (Exchange Act § 6).]

2. Other Trading Systems

The SEC has authority to exempt a trading facility that meets the definition of a securities exchanges from the requirement to register as an exchange. Under Exchange Act Rule 3a1-1(a) and Regulation ATS, a facility can qualify for this exemption by registering as a broker-dealer, filing an initial operation report with the SEC, and abiding by other rules and regulations. These facilities are called ***alternative-trading systems*** (ATS). One type of ATS is the ***electronic-communication network*** (ECN), which displays buy and sell orders on a consolidated quotation stream. [*See* 17 C.F.R. § 240.3a1-1 (Exchange Act Rule 3a1-1), § 242.301 (Regulation ATS).]

3. Over-The-Counter (OTC) Trading

Not all secondary trading happens on a national securities exchange or ATS. Many securities, including shares of small issuers (***penny stocks***) and bonds are traded ***OTC*** by broker-dealers. Although in OTC trading there is no trading facility to regulate broker-dealers' conduct (as there is with national securities exchanges), broker-dealers nevertheless are members of the Financial Industry Regulatory Authority and are subject to its regulation. [*See* 15 U.S.C. § 78o (Exchange Act § 15).]

B. Self-Regulatory Organizations

Federal securities law does not leave sole responsibility for capital-markets regulation with the SEC. Instead, it also looks to securities exchanges and the broker-dealer industry to engage in substantial self-regulation and self-policing under the overall supervision of the SEC. In their capacity as regulators, the national securities exchanges and the Financial Industry Regulatory Authority are known as ***SROs***. [*See* 15 U.S.C. § 78s (Exchange Act § 19).]

Note: SROs are often for-profit institution or industry-led bodies, which raises questions about whether they are the proper organizations to police the capital markets. On the other hand, market participants bring day-to-day technical expertise to capital-markets regulation, which the SEC (an organization primarily led by lawyers) might lack.

1. Regulation by Self-Regulatory Organizations

SROs regulate their members by adopting rules and enforcing them (such as through examinations of member broker-dealers and levying fines or other sanctions for rule violations). All SRO rules are subject to being approved by the SEC before they may go into effect, and the SEC has authority to amend or add to an SRO's rules. [15 U.S.C. § 78s(c) (Exchange Act §19(c)).]

2. National Securities Exchanges as Self-Regulatory Organizations

National securities exchanges are SROs. In this role, they are responsible for making and enforcing rules designed to prevent fraud and manipulation and to promote equitable conduct on their exchanges. They also set minimum financial, corporate-governance, and other standards for issuers that seek to list their securities (or to continue listing their securities) on the exchanges (***listing standards***). [*See* NYSE, *Listed Company Manual*.]

3. Financial Industry Regulatory Authority (FINRA)

Section 15A of the Exchange Act provides for ***registered securities associations***, SROs composed of broker-dealers that would regulate broker-dealer conduct and the securities industry. The National Association of Securities Dealers was formed in 1939 as a registered securities association and it was succeeded in 2007 by FINRA. FINRA licenses and regulates broker-dealer firms and their registered representatives (*i.e.*, individual stockbrokers). It also manages the FINRA arbitration system for settling disputes between broker-dealers and their customers. [*See* 15 U.S.C. § 78o-3 (Exchange Act § 15A).]

C. Market Makers and Specialists

Two goals of national securities exchanges and the national securities market are to provide both ***liquidity*** and competitive national prices. Liquidity is a measure of how quickly a securities holder can sell securities. Exchanges function in part by matching sellers and buyers at prices that will ***clear*** the market (*i.e.*, ensure that all willing buyers and sellers are matched). However, an exchange does not always have sufficient orders to meet the demand of buyers or sellers. To prevent these mismatches in demand, broker-dealers called market makers or specialists serve to ensure there is always an active market for a security.

Example:

An investor purchased shares in SiliconRiver, a nonpublic technology startup. Two years later, SiliconRiver was still not public and the investor decided it wanted to sell its shares. It took the investor's broker several weeks to find someone to buy the SiliconRiver shares. Given that it took a considerable amount of time to sell the SiliconRiver shares, they would be said to be ***illiquid***, or not liquid.

1. Market Makers and Specialists

Market makers are broker-dealers that will buy or sell the securities of a given issuer on a regular and continuous basis; they commonly operate on the Nasdaq.

2. Specialists

Specialists are similar to market makers, but they have additional obligations under exchange rules to ensure a fair and orderly market for the securities they specialize in; specialists commonly operate on the NYSE. These actors are valuable to capital markets because they ensure that securities can always be sold, even when there is limited demand from third-party purchasers, *i.e.*, they provide liquidity.

3. Bid-Ask Spread

Market makers and specialists, as well as other financial intermediaries, are compensated through the ***bid-ask spread***. The bid-ask spread is the difference between the price at which buyers want to buy securities (***bid***) and the price at which sellers want to sell securities (***ask***). After a market maker, specialist, or other intermediary completes a transaction with a third-party, it keeps the spread, which compensates it for taking on the risk of providing liquidity to other market participants.

Example:

A specialist in General Airlines announced a bid price of $10.02 for General Airlines shares and an ask price of $10.05, meaning that the bid-ask spread was $0.03. An investor sold 10,000 shares of General Airlines shares to the specialist for $100,200. Minutes later, the ask price had not changed and a different investor bought 10,000 shares of General Airlines for $100,500. The $300 difference reflected the $0.03 bid-ask spread and was the specialist's compensation for providing liquidity to the seller and an inventory of purchasable shares to the buyer.

D. Broker-Dealers

Broker-dealers are in the business of effecting securities transactions. They may do so, for example, in connection with registered public offerings, exempt offerings, or secondary-market transactions. [*See* Public Offerings, *supra*; Exempt Offerings, *supra*.]

1. The Definitions of Broker and Dealer

The terms ***broker*** and ***dealer*** have distinct definitions under the Exchange Act, but institutions typically fill both roles and so common practice is to treat ***broker-dealers*** as a singular concept.

a. Brokers

Under Section 3 of the Exchange Act, ***brokers*** are engaged in the business of effecting transactions in securities for the accounts of others. Importantly, those who effect transactions for their own accounts, or those who effect transactions for others but are not in the business of doing so, are not brokers. [15 U.S.C. § 78c(a)(4), Exchange Act § 3(a)(4).]

Example:

An attorney was appointed as trustee of a family trust that held securities. From time to time, the attorney bought and sold securities in the trust to meet its distribution requirements. Although the attorney effected securities transactions for another's account (*i.e.*, the trust's), the attorney was not a broker because the transactions were incidental to providing trust services. In other words, the attorney was in the trustee business, not the business of effecting securities transactions.

b. Dealers

Under Section 3 of the Exchange Act, ***dealers*** are engaged in the business of buying and selling securities for their own accounts, including through brokers. Brokers are often dealers too, because they typically hold their own inventory of securities for sale, rather than strictly effecting transactions between their customers and third parties. [15 U.S.C. § 78c(a)(5), Exchange Act § 3(a)(5).]

Note: Dealers are those who hold securities as *sales inventory* for their own accounts, rather than those who buy and sell securities as ***investments***. The line between sales inventory and investment can blur in some cases, however, as in the case of frequent traders.

Example:

A hedge fund purchased and sold securities on a regular basis consistent with its predictions about the long-term value of the securities. Although the hedge fund purchased and sold securities for its own account, it was not a dealer under the Exchange Act because it transacted in securities as investments.

2. Broker-Dealer Regulation

Before entering the securities business, broker-dealers must register with the SEC and state securities regulators.

a. Federal Registration

Section 15 of the Exchange Act makes it unlawful for a broker-dealer to effect securities transactions, or to induce or to attempt to induce the purchase of sale of any security, unless it is first registered with the SEC or it is exempt from registration. [15 U.S.C. § 78o (Exchange Act § 15).]

Note: The most common exemption from the federal registration requirement is for broker-dealers that only do business in one state (***intrastate exemption***). State law may still require the intrastate broker to register with that state's securities regulator.

b. Associated Persons

An ***associated person*** is an employee or independent contractor of a broker-dealer. An associated person may also be called a stockbroker or registered representative. Associated persons do not need to themselves register with the SEC, but they must be supervised by a registered broker-dealer and they must themselves register with FINRA. Before engaging in certain securities-related activities, they must also take and pass licensing exams, such as the Series 7 exam administered by FINRA. [*See* 15 U.S.C. § 78o(a)(18) (Exchange Act § 3(a)(18); 17 C.F.R. § 240.15b7-1 (Exchange Act Rule 15b7-1).]

c. State Jurisdiction

Although broker-dealer regulation is most prominently conducted by the SEC and FINRA, states have concurrent jurisdiction to regulate the entry and conduct of broker-dealers doing business within their borders. [*See* State Blue Sky Laws, *infra.*]

d. Customer Protections

Federal and state courts have failed to reach consensus on when broker-dealers are fiduciaries to their customers under state and federal law. However, Sections 9(a), 10(b), and 15(c) of the Exchange Act provide customers of broker-dealers with a number of antifraud protections that partly substitute for fiduciary duties. FINRA's rules also impose customer-protection requirements on broker-dealers, which FINRA can discipline them for violating. [*See* 15 U.S.C § 78i(a) (Exchange Act § 9(a)), § 78j(b) (Exchange Act § 10(b)), § 78o(c) (Exchange Act § 15(c)).]

Note: The customer protections owed by a broker-dealer to its customers are also owed by its associated persons to the customers.

i. Fair Dealing

Under the ***shingle theory*** developed through caselaw and SEC interpretations and enforcement actions, by going into the securities business, a broker-dealer represents to its customers that it will treat them fairly in accordance with industry standards. Fair dealing includes (1) promptly executing orders, (2) disclosing information material to the investor, (3) fully disclosing any conflicts of interest on the broker-dealers' part, and (4) charging prices reasonably in line with prevailing market prices. FINRA rules concurrently impose fair-dealing duties on broker-dealers. [*See* FINRA Rules 2010, 2020.]

Examples:

(1) A broker received an order on Monday during trading hours to sell 1,000 shares of General Airlines. At the time the order was received, the share price was $54.80. The broker executed the trade on Wednesday, when the share price was $49.50. Had the broker sold the shares promptly, the customer would have received $54,800 for the shares, but instead received only $49,500 due to the tardy execution. The broker violated the fair-dealing duty to promptly execute orders and cost the customer $5,300 by doing so.

(2) A broker recommended to an institutional investor that it purchase a significant number of shares of General Airlines. The broker did not tell the investor, however, that the broker's spouse was the chief financial officer of General Airlines and that part of the spouse's compensation was based on the company's stock performance. The broker violated the fair-dealing duty to disclose conflicts of interest because the broker had an interest in the spouse receiving higher compensation via a higher stock price.

ii. Best Execution

When broker-dealers execute a customer order, they must do so at the best bid (highest price, for sell orders) or best offer (lowest price, for buy orders). Exchange Act Regulation NMS requires broker-dealers to locate the best bid or best offer available on the national market system and to trade at those prices, the ***national best bid and best offer*** (NBBO). [*See* 17 C.F.R. § 242.600(b)(43) (Regulation NMS § 600(b)(43)).]

Example:

A broker received an order to sell 1,000 shares of General Airlines. The highest bid on the NYSE was $54.80, while the highest bid on an ATS called Good ATS was $54.90. The broker sold the shares on the NYSE for $54,800. Because the shares could have been sold on Good ATS for $54,900, however, the broker failed to execute the order at the best price.

iii. Suitability

The antifraud provisions of the Exchange Act, as well as FINRA Rule 2111, require that a broker-dealer recommend only ***suitable*** transactions to their customers. To be suitable, broker-dealers must have a reasonable basis to believe—*i.e.*, based on reasonably diligent efforts to learn the customer's investment profile—that a recommended securities transaction or strategy is suitable for that customer. Factors for this suitability analysis include the customer's age, other investments (portfolio size and allocation), financial situation and needs, tax considerations, investment objectives and experience, time horizon, liquidity needs, and risk tolerance. [*See* FINRA Rule 2111.]

Example:

A broker recommended that a customer purchase ***$100,000*** in shares of SpaceTomorrow, a startup company designing a next generation of payload space rocket, in a private-placement transaction. The customer was 70 years old, had $500,000 in retirement savings, and relied on dividends to supplement living expenses not covered by a pension. Given that the customer was in retirement, the recommended transaction was 20 percent of the customer's portfolio, the company was risky and any payoff would be years away, and the securities of the company were illiquid, this recommendation ***was not*** a suitable transaction for that customer.

Compare:

A broker recommended that a customer purchase ***$10,000,000*** in shares of SpaceTomorrow, a startup company designing a next generation of payload space rocket, in a private-placement transaction. The customer was an investment fund started by several engineers who had made their fortunes when they sold a company they founded. Given that the customer was a fund backed by wealthy individuals with technical and financial sophistication and long-term investment horizons, this recommendation ***was*** a suitable transaction for that customer.

iv. Insider Trading

Section 10(b) of the Exchange Act and Exchange Rule 10b-5 prohibit insider trading. In the broker-dealer/customer context, that prohibition means that a broker-dealer must not convert customer information to its own use, such as by purchasing securities for its own account before executing a customer's order for those securities (***front-running***). [*See* 15 U.S.C. § 77j(b) (Exchange Act § 10(b); 17 C.F.R. § 240.10b-5 (Exchange Act Rule 10b-5); *see also* Securities Fraud, *infra*.]

Example:

A broker received an order from a hedge fund to purchase 200,000 shares of General Airlines at the best national offer price. Knowing that there would be a large, guaranteed order for General Airlines shares, the broker purchased 200,000 for its own account, paying $50.10 per share. That order pushed the price up to $50.15 per share, and the broker then sold its shares at that price and filled the hedge fund's order at $50.15 per share. By trading in advance of executing the customer's order, the broker-dealer made a $10,000 trading profit while causing its customer to pay $10,000 more than it otherwise would have.

v. Credit Terms

Broker-dealers often extend credit to their customers to buy securities with borrowed funds, a practice called ***margin trading***. Exchange Act Rule 10b-16 requires broker-dealers to make disclosures to their customers at account opening and quarterly about the credit terms for margin trading. [*See* 17 C.F.R. § 240.10b-16 (Exchange Act Rule 10b-16).]

e. Securities Analysts

Broker-dealers often employ securities analysts to research and monitor issuers and their securities. This research is disseminated through research reports, which often contain a recommendation—based on the analyst's views of the securities' long-term outlook—to buy, to sell, or to hold (*i.e.*, do nothing if an investor already holds the securities). To prevent conflicts of interest from entering into research reports (including other divisions within a broker-dealer pushing positive coverage of their clients), Exchange Act Regulation AC requires reports to certify that the contents reflect the analyst's personal views and to disclose certain information about conflicts of interest. [17 C.F.R. § 242.501 (Regulation AC).]

f. Penny Stocks

In general, penny stocks are shares in small issuers that trade for under $5 per share. Penny stocks are believed to represent greater fraud risk than higher-priced shares issued by larger issuers. One example of penny-stock fraud is high-pressure cold calling by broker-dealers that receive substantial commissions to induce customers to purchase shares of dubious value (***boiler rooms***). Under Exchange Act Rules 15g-2 through 15g-9, broker-dealers may effect a penny-stock transaction that they have solicited from a customer only once certain risk and other disclosures have been made to the customer and the customer has returned written acknowledgments. These rules are intended not only to improve disclosures around penny-stock risks, but also to reduce pressure on potential customers to make quick decisions. [*See* 17 C.F.R. §§ 240.15g-2–9 (Exchange Act Rules 15g-2–9).]

g. Substantive Regulation

In addition to regulating how broker-dealers interact with customers, the securities laws also impose substantive regulations on how broker-dealers organize and conduct their businesses. Major areas of regulation include net-capital requirements, segregation of customer funds, and recordkeeping requirements.

i. Net-Capital Requirements

Exchange Act Rule 15c3-1 requires broker-dealers to maintain enough capital to satisfy customer claims should they go out of business. Broker-dealers that clear and carry customer accounts must maintain net capital of the greater of $250,000 or 2 percent of aggregate customer net balances. [*See* 17 C.F.R. § 240.15c3-1 (Exchange Act Rule 15c3-1).]

ii. Segregation of Customer Balance

Exchange Act Rule 15c3-3 requires broker-dealers to deposit excess customer balances into a special reserve banking account, thereby preventing them from using customers' funds in their businesses. [*See* 17 C.F.R. § 240.15c3-3 (Exchange Act Rule 15c3-3).]

iii. Books and Records

Exchange Act Rules 17a-3, 17a-4, 17a-5, and 17a-11 require extensive recordkeeping by broker-dealers. Having adequate records allows the SEC, state securities regulators, and others to monitor broker-dealers' conduct and to hold them responsible for violations. [*See* 17 C.F.R. §§ 240.17a-3 (Exchange Act Rule 17a-3), 240.17a-4 (Exchange Act Rule 17a-4), 240.17a-5 (Exchange Act Rule 17a-5), 240.17a-11 (Exchange Act Rule 17a-11).]

3. Broker-Dealer and Customer Dispute Resolution

Disputes sometimes arise between broker-dealers and their customers, including disputes arising under federal and state securities laws. Virtually all such disputes, unless they are settled, are arbitrated before one- or three-arbitrator panels. These arbitrations are administered by FINRA. Disputes between broker-dealers and their associated persons, or between two or more broker-dealers, are arbitrated under FINRA's auspices.

a. Broker-Dealers, Customers, and Pre-Dispute Arbitration

Prior to the Supreme Court's decision in *Rodriguez de Quijas v. Shearson/American Express Inc.*, arbitration agreements in broker-dealers' customer agreements were considered to be invalid under the securities laws' provisions against waivers of private-litigation rights. Disputes between broker-dealers and their customers, which often arose out of federal securities laws, were thus most commonly heard in courts. In *Rodriguez*, however, the Court held that pre-dispute arbitration agreements did not effect a waiver of substantive rights and further that the Federal Arbitration Act protected the right to arbitrate, including by using pre-dispute provisions in broker-dealer customer agreements. [*See Rodriguez de Quijas v. Shearson/American Express Inc.*, 490 U.S. 477 (1989).]

VII. Investment Advisers and Investment Companies

Congress passed the first two major federal securities acts—the Securities Act and the Securities Exchange Act—in 1933 and 1934, respectively. During the 1930s, it also tasked the SEC with studying the role of investment advisers and investment companies (*e.g.*, mutual funds) in causing the financial crisis that led to the Great Depression. The findings of that study prompted Congress to pass two new related, but separate, securities statutes in 1940: the Investment Advisers Act and the Investment Companies Act (also known as the ***'40 Act***). [*See* The Framework of Securities Regulation, *supra*.]

Note: Investment advisers are generally organized as firms, and the individuals who provide direct services to clients are representatives of those firms. Although colloquially these individual representatives are often referred to as investment advisers, that term as used in this chapter refers to firms.

A. Investment Advisers

Broker-dealers are securities intermediaries that are compensated for executing transactions for customers. Investment advisers, in contrast, are securities intermediaries that are compensated for providing advice whether to buy or sell securities, although they do not themselves execute transactions. The Investment Advisers Act is focused on requiring persons acting as investment advisers to register with the SEC (or to be exempt from registration or subject to state registration), ensuring that those advisers make appropriate disclosures to their clients, and policing potential conflicts between advisers and their clients.

1. The Meaning of Investment Adviser

Under Section 202(a)(11) of the Investment Advisers Act, an investment adviser is any person who (1) for compensation, (2) engages in the business (3) of providing investment advice (4) to others. It also includes those who (1) for compensation (2) as part of a regular business (3) issue reports or analyses about securities. This definition is subject to certain exclusions. [15 U.S.C. § 80b–2(a)(11) (Investment Advisers Act § 202(a)(11).]

a. Compensation

Compensation is a broad concept that includes any economic benefit an investment adviser may receive for rendering services. It can include advisory fees or commissions paid by the client or another person. [*See* Investment Advisers Act Release No. 1092 (Oct. 8, 1987).]

Example:

A financial planner received a flat fee from a company to hold one-on-one meetings with the company's employees about their personal finances. The fee paid by the company was compensation under the definition of ***investment adviser***.

b. Engaged in the Business

To fall under the investment-adviser definition, a firm must be in the business of providing investment advice. Although providing investment advice need not be the sole or primary focus of the business for a firm to be ***engaged in the business***, providing advice on rare or isolated occasions does not mean a firm is engaged in the investment-adviser business. Factors that help determine whether someone is engaged in the business include (1) affirmative representations of being an investment adviser, (2) receipt of compensation directly attributable to giving investment advice, and (3) the frequency and specificity with which advice is given. [*See* Investment Advisers Act Release No. 1092 (Oct. 8, 1987).]

Example:

A financial planner received a flat fee from a company to hold one-on-one meetings with the company's employees about their personal finances. Among the personal matters the planner talked with employees about were saving for a home or a child's college education, family budgeting, and retirement planning. For retirement planning, the adviser recommended different portfolios of mutual funds based on the employee's risk tolerance. Because the planner was regularly giving investment advice (*i.e.*, it would be hard to plan employees' finances without considering their investments), gave specific investment recommendations, and was paid by the employer to provide advice that included investment advice, the financial planner was engaged in the business of investment advising.

c. Providing Advice about Securities

Providing advice about securities includes giving advice whether to buy or sell specific securities, like stocks, bonds, mutual funds, partnership interests, or notes. It does ***not*** include advice about non-securities investments, like real estate, precious metals, or other commodities. Beyond advice about specific securities, providing advice about securities also includes broader advice, such as how to respond to securities-market trends or how to allocate a portfolio based on risk tolerance and other goals. [*See* Robert R. Champion, SEC Staff No-Action Letter (Sept. 22, 1986); Maratta Advisory, Inc., SEC Staff No-Action Letter (July 16, 1981).]

Example:

A financial planner received a flat fee from a company to hold one-on-one meetings with the company's employees about their personal finances. In talking to employees about their retirement plans, the planner demonstrated how to build a well-diversified portfolio of mutual funds based on an employee's risk tolerance and retirement date. Because the planner was providing advice on allocating investments in securities, the information was advice about securities.

d. Advice to Others

It is clear that a person is providing advice to ***others*** when the persons receiving advice are natural persons. Whether advice provided to artificial persons is ***advice to others*** depends on the potential for conflicts of interest between the adviser and the advisee. The general partner of an investment fund, for example, advises the limited partners in terms of investments made and has interests that potentially diverge from the limited partners. The general partner thus provides advice to others, *i.e.*, the limited partners. [*Abrahamson v. Fleschner*, 566 F.2d 862, 870 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).]

Example:

Marquess University had an endowment valued at over a billion dollars. The endowment was managed by Marquess Management, an investment firm wholly owned and controlled by Marquess University. Marquess Management only managed endowment money for the university. Because there was no conflict of interest between the university and its investment firm, the firm's services ***were not*** advice to others.

Compare:

Marquess University had an endowment valued at over a billion dollars. The endowment was managed by Marquess Management, an investment firm wholly owned and controlled by Marquess University. Marquess Management managed the endowment of both the university and the Marquess Foundation, a separate entity that the founder of Marquess University had established to support the university. Although the foundation was aligned with the university's mission, it was a separate entity with its own investment goals, and thus services it received from Marquess Management ***were*** advice to others.

2. Exclusions from the Meaning of Investment Adviser

Not everyone who meets the definitions of Section 202(a)(11) of the Investment Advisers Act is an investment adviser, however. The statute offers a number of exclusions for persons whose business might literally include investment advice, whose advice is incidental to another service or is adequately regulated by another regulatory regime.

a. Banks and Bank Holding Companies

Banks and bank holding companies are excluded from the definition of investment adviser; other financial institutions like credit unions and non-U.S. banks are not, however. In addition, a subsidiary of a bank holding company that provides investment advice is not excluded. [*See* 15 U.S.C. § 80b–2(a)(11)(A) (Investment Advisers Act § 202(a)(11)(A).]

Example:

Metro Bancorp was a bank holding company whose subsidiaries included Metro Bank, N.A. (a national bank), Metro Mortgage, Inc. (a mortgage-servicing company), and Metro Investments, Inc. Metro Investments provided investment services to Metro customers, including investment advice. Because Metro Investments provided advice to others regarding securities, it was required to register as an investment adviser, even though its parent company, Metro Bancorp, was excluded from the definition of investment adviser.

b. Lawyers, Accountants, Engineers, and Teachers

Professionals in the fields of law, accounting, engineering, and teaching are excluded from the definition of investment adviser when they provide investment advice incidental to the practice of their professions. Factors that guide whether investment advice is incidental to professional practice include (1) whether there is a representation that the professional is an investment adviser, (2) whether the advice is reasonable related to professional services, and (3) whether the compensation for investment advice is based on the same factors used by the professional for charging for professional services. [*See* 15 U.S.C. § 80b–2(a)(11)(B) (Investment Advisers Act § 202(a)(11)(B); Investment Advisers Act Release No. 1092 (Oct. 8, 1987)).]

Example:

A lawyer represented a severely injured person in a lawsuit and recovered a $5,000,000 settlement for the client, which the client would rely on for living expenses and medical care for life. The lawyer advised the client to invest the money in a well-diversified portfolio of low-cost mutual funds, including keeping 10 percent of the portfolio in money-market mutual funds in case the client had immediate cash needs. The lawyer charged a standard hourly rate to discuss the client's investment and money-management strategy. Because this investment advice was incidental to the lawyer's representation of the client in connection with the client's injury, the lawyer was not an investment adviser.

c. Broker-Dealers

A broker or dealer that is registered with the SEC under the Exchange Act is not an investment adviser if any investment advice it provides to clients is "solely incidental" to brokerage services. To be solely incidental to brokerage services, the advice must be provided in connection with and be reasonably related to the brokerage services. Broker-dealers must not receive ***special compensation*** for investment advice, meaning their compensation must limited to compensation received for brokerage services (*e.g.*, trading commissions). [*See* 15 U.S.C. § 80b–2(a)(11)(C) (Investment Advisers Act § 202(a)(11)(C)).]

d. Publishers

Publishers, such as newspapers or investment magazines or websites, are excluded from the definition of investment adviser. This exclusion only applies, however, if the publication (1) provides only non-personalized advice, (2) is ***bona fide*** (*i.e.*, its analysis and commentary are disinterested rather than being intended to promote or tout securities), and (3) is of general and regular circulations (*i.e.*, not published in response to one-off market trends or other activity). [*See* 15 U.S.C. § 80b–2(a)(11)(D) (Investment Advisers Act § 202(a)(11)(D); *see also Lowe v. SEC*, 472 U.S. 181 (1985).]

Example:

The Daily Trade was a website featuring articles and commentary on the securities markets, including investment reports and advice columns written by experts in various industries. Writers for the website were required to accept no compensation for this writing other than from the publisher of The Daily Trade and were required to disclose in their reports and columns any conflicts of interests (*e.g.*, the writer had a position in a security mentioned in a column). The Daily Trade in turn made money from ads sold by its advertising department, which it kept separate from the editorial function. Because The Daily Trade provided non-personalized advice, was a bona fide publication, and was in general and regular circulation, it was excluded from the definition of investment adviser.

Compare:

RoboMoney was a website that allowed users to input information about their finances, their retirement or other financial goals, and their risk preferences. Based on these inputs, the RoboMoney algorithms generated investment portfolios that matched the users' investment styles and goals. RoboMoney did not charge users directly for this service, but rather made money by anonymizing user submissions and selling the data to the securities industry, which gave the industry insight into new investment products. Because RoboMoney provided personalized investment advice, it did not satisfy the publisher exclusion from the definition of investment adviser.

e. Other Exclusions

Other less-common exclusions include those for (1) firms whose advice is limited to securities issued or guaranteed by the U.S. government; (2) credit-rating agencies; (3) family investment offices that are wholly owned and exclusively controlled by members of the same family; (4) federal, state, and local governments; and (5) non-U.S. advisers. [15 U.S.C. § 80b–2(a)(11) (Investment Advisers Act § 202(a)(11); 17 C.F.R. § 275.202(a)(11)(G)-1 (Investment Advisers Act Rule 202(a)11)(G)).]

3. Investment-Adviser Registration

Any investment adviser that falls within the definition of investment adviser and is not excluded must register with the SEC unless (1) it is prohibited from registering with the SEC or (2) it is exempt from registration.

a. Prohibition on SEC Registration

Amendments to the Investment Advisers Act allocated regulatory responsibility between the state and federal governments for investment advisers, with the states generally responsible for regulating smaller advisers.

i. Small Advisers

Investment advisers with less than $25,000,000 in assets under management are prohibited from registering with the SEC unless the states of their principal offices or business locations do not have a statute for the registration of investment advisers. (Wyoming is the only such state.) [*See* 15 U.S.C. § 80b–3(a)(1) (Investment Advisers Act § 203A(a)(1)).]

ii. Mid-Sized Advisers

Investment advisers with more than $25,000,000 but less than $100,000,000 in assets under management are prohibited from registering with the SEC unless the states of their principal offices or business locations do not subject registered investment advisers to examination by the state securities regulator. (New York and Wyoming.) [*See* 15 U.S.C. § 80b–3(a)(1) (Investment Advisers Act § 203A(a)(1)).]

iii. Larger Advisers

Investment advisers with more than $100,000,000 in assets under management may register with the SEC and thus become subject to SEC examination, and they must do so once they have $110,000,000 in assets under management. [17 C.F.R. § 275.203A-1 (Investment Advisers Act Rule 203A-1(a)(1)).]

b. Exemptions from SEC Registration

Certain investment advisers that would be subject to mandatory SEC registration are exempted from the requirement, although they may register if they so choose. These exempted investment advisers include:

- an intrastate adviser whose clients are residents of the adviser's state and who does not give advice on securities listed on national securities exchanges;
- an adviser whose only clients are insurance companies;
- a foreign adviser who has no place of business in the U.S. and who abides by certain limits on the number of U.S. clients and U.S.-client assets under management;
- an adviser that is a charitable organization or a charitable organization's employee benefit plan, or certain affiliates of the organization (*e.g.*, employees of the organization);
- commodity trading advisors registered with the Commodity Futures Trading Commission;
- an adviser to private funds that have less than $150,000,000 in assets under management in the U.S.; and
- advisers to certain venture-capital funds.

[*See* 15 U.S.C. § 80b–3(b), (l) (Investment Advisers Act § 203(b), (l)).]

4. The Duties of Investment Advisers

U.S. securities law does not impose educational or other qualifications on investment advisers, but instead imposes a set of duties on investment advisers' conduct. These duties include (1) fiduciary duties to clients, (2) substantive requirements and restrictions, (3) contractual requirements, (4) recordkeeping requirements, (5) and administrative requirements (*e.g.*, to submit to SEC examinations).

a. Fiduciary Duties to Clients

Investment advisers have fiduciary obligations to their clients. That means that they must avoid conflicts of interest with clients and put their clients' interests ahead of their own. These duties include (1) full and fair disclosure of material facts, including conflicts of interest and whether the adviser has been subject to disciplinary action; (2) providing only suitable advice based on the client's overall investment profile; (3) having a factually reasonable basis for advice; (4) seeking best execution when the adviser has responsibility for the client's brokerage; (5) voting proxies when the adviser has the authority to do so. [*See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 190–192 (1963).]

Example:

An investment adviser was given discretionary trading authority over an elderly client's account. After a broker-dealer offered the adviser large commissions to do so, the adviser placed half the client's portfolio in illiquid private offerings that the broker-dealer was selling. The adviser did not disclose the commissions it received from the broker-dealer. Because the adviser engaged in a conflicted transaction (using its discretionary powers to generate compensation for itself) and made an unsuitable trade (in terms of the concentration in high-risk investments and the low-risk profile of an elderly customer), the adviser violated the fiduciary duties owed to the client.

b. Substantive Requirements and Restrictions

Apart from an investment adviser's fiduciary duties, the SEC has adopted certain substantive requirements and restrictions for adviser conduct. These requirements and restrictions include restrictions or requirements related to (1) the adviser selling its own securities to a client absent client consent; (2) the adviser acting as broker for its advisory client and a third party absent client consent; (3) advertising to current and prospective clients; (4) safekeeping of client assets; (5) pay-to-play in connection with public pension contracts; (6) proxy voting; (7) and supervision, compliance, and ethics. [*See* 15 U.S.C. § 80b–6(3) (Investment Advisers Act § 206(3); 17 C.F.R. §§ 275.206(3)-1 – 275.206(3)-8 (Investment Advisers Act Rules 206(3)(1) – 206(3)-(8)).]

c. Contractual Requirements

The Investment Advisers Act does not require investment advisers to enter into written agreements with their clients. Advisory agreements, however, must contain certain provisions related to (1) advisory fees, (2) assignment of the advisory contract, (3) notification of partnership changes if the adviser is a partnership, (4) anti-waiver of the securities laws, and (5) termination penalties. [15 U.S.C. § 80b–5 (Investment Advisers Act § 205).]

d. Recordkeeping Requirements

Investment advisers must maintain two types of books and records. The first type is financial and legal documents that would typically be kept by any business (*e.g.*, bank and financial records and legal contracts). The second type is documents the SEC has required investment advisers to keep that are specific to the services they provide. This second category includes records (1) on personal securities holdings of the adviser's employees, (2) relating to securities transactions, (3) of correspondence related to securities recommendations or transactions, (4) of advertisements or other marketing materials, (5) of investment performance, (6) of internal discipline, and (7) of political contributions. [17 C.F.R. § 275.204-2 (Investment Advisers Act Rule 204-2).]

e. Administrative Requirements

All records maintained by investment advisers are subject to examination by the SEC's Office of Inspections and Compliance. The SEC uses examinations to ensure that investment advisers are adhering to their client and regulatory duties. For investment advisers that are prohibited from registering with the SEC, examinations by state securities regulators fill a similar role. 15 U.S.C. § 80b–4(6) (Investment Advisers Act § 204(6)).]

B. Investment Companies

Like any other company that sells shares to investors, investment companies do not exist to provide a product or service to the marketplace. Rather, they are in the business of investing, reinvesting, and trading securities for their own account. In a sense, investors—instead of making their own decisions about individual securities investments or seeking out recommendations from investment advisers—can outsource their investing activity by buying shares in an investment company that is in turn managed by professional investors. Given this difference from ordinary services-or-products companies, investment companies are regulated separately under the Investment Company Act, a highly technical statute that imposes substantive requirements and restrictions on their management.

1. The Meaning of Investment Company

Under Section 3(a)(1)(A) of the Investment Company Act, an ***investment company*** is an issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities. [15 U.S.C. § 80a–3 (Investment Companies Act § 3(a)(1)(A)).]

Example:

A healthcare-industry analyst announced the formation of a fund that would invest in healthcare-company securities. The fund would sell shares to the general public, which would allow the general public to benefit from the expertise of the analyst in choosing which healthcare investments would have the greatest long-term value. Because the fund was proposed to be primarily in the business of investing in securities, it was an investment company under the Investment Company Act.

a. Exceptions

The Investment Company Act contains a number of exceptions from the definition of investment company. The most important exception is for ***private investment companies***, funds that have a limited number of investors and that do not intend to make a public offering of securities. Common, and important, examples of private investment companies are venture-capital, private-equity, and hedge funds. [*See* 15 U.S.C. §§ 80a–3(c)(1), (7) (Investment Companies Act §§ 3(c)(1), (7)).]

i. Venture-Capital, Private-Equity, and Hedge Funds

Venture-capital, private-equity, and hedge funds are private investment companies that are funded by limited partners (*i.e.*, typically wealthy individuals and institutional investors) and managed by a general partner (which is usually a business entity run by one or more investment professionals). Venture-capital funds specialize in investing in startup business, often in the technology industry. Private-equity funds specialize in acquiring all or a significant share of existing businesses. Hedge funds specialize in making profits from investing and trading in securities.

2. Classifications of Investment Companies

The Investment Company Act classifies investment companies into three categories: management companies, unit investment trusts, and face-amount certificate companies.

a. Management Companies

Management companies are business entities (often a corporation or statutory trust) that are organized under state law, have a governing board (*e.g.*, a board of directors), and are managed by an outside registered investment adviser (who receives fees from the company for its services). Management companies in turn take one of two forms: closed-end companies and open-end companies. [15 U.S.C. § 80a–4 (Investment Companies Act § 4).]

i. Closed-End Companies

Closed-end companies sell a fixed number of shares in an initial public offering and periodically thereafter. Investors may trade their shares on the secondary market, and thus closed-end company shares may be traded on exchange to facilitate this secondary market. [15 U.S.C. § 80a–5(a) (Investment Companies Act § 5(a)).]

ii. Open-End Companies

Open-end companies continuously offer shares and will themselves ***redeem*** any share held by an investor. Redemption prices are set daily by the open-end company based on the total value of the securities and other assets it holds, less expenses and debts (***net asset value***). Most mutual funds are open-end companies, making them one of the largest asset classes in the financial markets. [15 U.S.C. § 80a–5(a) (Investment Companies Act § 5(a)).]

b. Unit Investment Trusts

Unit investment trusts (***UITs***) are organized as trust indentures, custody contracts, or similar instruments, rather than as corporations or statutory trusts. They do not have governing boards or investment advisers. Rather, they are typically a fixed basket of securities that will be redeemed at a fixed time in the short- to mid-term. Unit investment trusts are a relatively small asset class in the financial markets. [15 U.S.C. § 80a–5 (Investment Companies Act § 4.]

c. Face-Amount Certificate Companies

Face-amount certificate companies issue face-amount certificates of the installment type. They are rare in the contemporary financial markets. [15 U.S.C. § 80a–5 (Investment Companies Act § 4.]

3. Styles of Open-End Companies

Open-end companies are by far the most common form of investment company and they represent the vast majority of assets held in investment companies. These companies exist in a wide variety of organizational forms and investment styles. Common organizational forms include:

a. Mutual Funds

Mutual funds are investment companies in which an adviser chooses securities based on a disclosed investment objective. The adviser can be active (*i.e.*, it monitors the market and makes investment decisions based on its analysis, judgment, and the fund's investment objectives) or passive (*i.e.*, securities are bought and sold to replicate an index of securities, such as the Standard and Poor's 500 (S&P 500)). Although mutual funds can be closed-end funds, most are open-end funds.

b. Money-Market Mutual Funds

Money-market mutual funds differ from traditional mutual funds in that they typically hold only short-term, high-quality fixed-income investments, such as government bonds and short-term notes. Money-market mutual funds are often used as a substitute for deposit accounts (although they do not have deposit insurance), and so their investment objective is to maintain $1.00 net asset value.

c. Exchange-Traded Funds

Exchange-traded funds (ETFs) are open-end funds that are similar to mutual funds in their use as investments, but that trade freely on securities exchanges and are priced constantly, rather than being redeemed by the issuer at a price set once a day.

4. Registration

Section 7 of the Investment Company Act prohibits the offer, sale, delivery, or redemption of investment-company securities unless the company has filed a registration statement with the SEC. This registration statement requires disclosures unique to investment companies, as well as disclosures that would be required in a registration statement under the Securities or Exchange Acts. [15 U.S.C. §§ 80a–7–8 (Investment Companies Act § 7–8).]

5. Investment-Company Governance

The governance of investment companies is controlled by the Investment Company Act, SEC rules, and state corporate law. The three primary actors in an investment company's governance are (1) the adviser, the (2) board of directors, and (3) the shareholders.

Note: These governance structures are not applicable to unit investment trusts or face-amount certificate companies.

a. Adviser

The adviser is a registered investment adviser that receives compensation in the form of fees for managing the investment company's investments. Fees are typically expressed as a percentage of total assets under management (*e.g.*, 0.5 percent). One or more individual employees of the adviser might manage the company's day-to-day operations (***manager***). Advisers are typically the firm that originally sponsored and marketed the fund. Advisers often have a ***family*** of related funds. Prominent examples include Vanguard Group, Fidelity Investments, Pimco, Franklin Templeton, BlackRock, and State Street Global Advisors. [*See* Investment Companies Act Release No. 24,082 (Oct. 14, 1999).]

b. Boards of Directors

Investment companies are formed under state corporate law. Boards of directors of investment companies have the same duties and role as any other board of directors under state law, in addition to duties prescribed by the Investment Companies Act or SEC rules.

i. The Role of the Board of Directors

The Investment Companies Act imposes duties on directors in addition to their duties under state law, including (1) evaluating and approving the advisor's contract (and any assignment of that contract); (2) approving the company's principal underwriting agreement; (3) selecting the company's independent auditor; (4) valuing the company's securities; (5) evaluating the reasonableness of advisory and distributions fees; and (6) managing certain conflicts of interest, especially between the adviser and the company.

ii. Independent Directors

At least 40 percent of directors must be independent, which the Investment Companies Act defines as directors who are not ***interested persons***. Section 2(a)(19) provides numerous instances in which a director will become an interested person, including when the director or the director's immediate family are (1) affiliated with the investment company, (2) affiliated with legal counsel to the investment company, (3) engaged in certain transactions with the investment company, or (4) affiliated with the investment company's adviser or underwriter. [15 U.S.C. §§ 80a–2(a)(19), 80a–10(a) (Investment Companies Act §§ 2(a)(19), 10(a)).]

c. Shareholders

As with any corporation, shareholders in investment companies vote on director elections and other voting matters, and the SEC regulates the solicitation of investment-company proxies. [15 U.S.C. § 80a–20 (Investment Companies Act § 20).]

6. Conflicts of Interest

One goal of the Investment Companies Act is to police conflicts of interest between affiliates (*e.g.*, advisers to investment companies) and investment companies. Subject to the SEC's exemptive power, the Investment Companies Act prohibits two major categories of conflicted transactions: (1) transactions involving the investment company as a principal and (2) loan transactions. These prohibited conflicts cannot be waived by the investment company's board of directors, but the SEC may on a case-by-case basis exempt transactions from the prohibitions. [15 U.S.C. § 80a–17(b) (Investment Companies Act § 17(b)).]

a. Principal Transactions

Section 17 of the Investment Companies Act prohibits any affiliate, promoter, or principal underwriter of an investment company from buying or selling any security or other property to or from the investment company, or to or from any company controlled by the investment company. Exceptions to this prohibition include the sale of the investment company's shares back to it and the investment company's purchase of shares that are part of a general public offering. [15 U.S.C. § 80a–17(a)(1)–(2) (Investment Companies Act § 17(a)(1)–(2)).]

b. Loan Transactions

Section 17 of the Investment Companies Act also prohibits any affiliate, promoter, or principal underwriter of an investment company from borrowing from or lending to the investment company. [15 U.S.C. § 80a–17(a)(3)–(4) (Investment Companies Act § 17(a)(3)–(4)).]

7. Distribution

In addition to compensation paid to the adviser, any investment company will incur expenses as it seeks to market and distribute its shares. In theory, by having more assets under management, the investment company can achieve economies of scale that in turn benefit its shareholders. Investment companies have several options for how they finance their distribution: (1) charge purchasers for distribution costs, (2) charge sellers for distribution costs, or (3) finance distribution costs as part of the company's internal expenses.

a. Sales Load

A minority of investment companies are ***load funds***, in which a purchaser is charged a percentage of the purchase price of the investment company's shares. This charge in turn is used to compensate underwriters or broker-dealers involved in selling the shares. Instead of charging an up-front fee, a fund might charge a ***redemption fee*** at the time a shareholder sells shares back to the investment company.

b. No-Load Funds and 12(b)(1) Plans

Investment companies that do not have loads are termed ***no-load funds***. They cover distribution and marketing expenses as internal expenses of the fund (*i.e.*, these expenses are spread among all shareholders in proportion to their shareholding). If an investment company intends to have shareholders themselves finance distribution and marketing expenses, Rule 12(b)(1) requires it to detail that financing plan and receive approval. This 12(b)(1) plan must be approved annually by a majority of the directors ***and*** the disinterested directors, and it must also be approved by shareholders representing a majority of the company's voting securities. The purpose of this requirement is to manage the conflict of interest that may emerge in which an adviser uses shareholders' funds to increase assets under management. This use of funds could to lead to an increase in the adviser's compensation (because it is compensated as a percentage of assets under management), but it might not have a compensating benefit for existing shareholders in terms of achieving greater economies of scale. [*See* 17 C.F.R. § 270.12b-1 (Investment Company Act Rule 12(b)(1)).

VIII. Securities Fraud

Much of securities regulation entails technical rules for what issuers and other market participants may do, must do, and must not do, as well as exceptions to and exemptions from those rules. A constant backdrop of securities regulation, however, is that fraud is prohibited and can lead to private enforcement via civil litigation and public enforcement by the SEC or the U.S. Department of Justice (DOJ). [*See* Private Enforcement; Public Enforcement, *infra*.]

A. Rule 10b-5

Section 10(b) of the Exchange Act establishes a broad prohibition on fraud in connection with interstate securities transactions. It also delegates authority to the SEC to create rules and regulations to prevent fraud. Exchange Act Rule 10b-5 uses that delegation. Rule 10b-5 makes unlawful any use of the instrumentalities of interstate commerce or the facilities of a national securities exchange ***in connection with the purchase or sale of any security*** to do any of the following:

- "to employ a device, scheme, or artifice to defraud;

- to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
- to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."

[15 U.S.C. § 78j(b)) (Exchange Act § 10(b); 17 C.F.R. § 240.10b-5 (Exchange Act Rule § 10b-5).]

B. Elements of Securities Fraud

Rule 10b-5 is written in broad terms. Since it was adopted by the SEC in 1942, the courts and the SEC have clarified what conduct the rule prohibits and what elements must be satisfied for liability to arise under it. In short, the conduct must have (1) occurred in connection with the purchase or sale of securities, (2) involve manipulation or deception, (3) been material to an investment decision, and (4) been done with scienter.

Note: Federal jurisdiction must also be satisfied to establish liability under Rule 10b-5. Because it is unlikely that a securities transaction does not use some instrumentality of interstate commerce (*e.g.*, the use of the mails, telephone, or Internet communications), the discussion in this chapter will assume that federal jurisdiction is satisfied.

1. In Connection with the Purchase or Sale of Securities

The ***in connection with the purchase or sale of securities*** element is also known as the ***transactional-nexus*** element. As an initial matter, fraud arising directly from the purchase or sale of a security easily satisfies the transactional-nexus element. In those cases, there is ***privity*** between purchasers and sellers. In the landmark *Texas Gulf Sulphur* case, however, the Second Circuit held that fraudulent conduct need not involve transactions in which there is privity between two parties. In that case, the court held that Rule 10b-5 is violated when a speaker makes a statement that (1) is false, misleading, or so incomplete as to be misleading and (2) that is "reasonably calculated to influence the investing public." [*SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 862 (2nd Cir. 1968), cert. denied, 404 U.S. 1005 (1971).] Those statements violate Rule 10b-5 even if they are made for reasons other than to mislead investors.

Examples:

(1) Poptime was a publicly traded, online subscription-based streaming service for original television shows and films. Poptime competed with other streaming providers to attract creators of new shows and films, who were motivated in part by having large audiences for their programs. To improve its competitiveness with potential creators, Poptime's

chief creative officer stated in an interview that Poptime had 25 million daily viewers, even though the true number was 18 million. Although the goal of this misstatement was to induce creators to sign with Poptime, it was still reasonably calculated to influence investors (*i.e.*, to imply greater subscriber engagement than reality) and it thus satisfied Rule 10b-5's transactional-nexus element.

(2) A broker-dealer engaged in its own proprietary securities trades. To fund these trades, it used uninvested customer funds, despite the fact that borrowing customer funds was prohibited by its customer agreement and federal regulations. The broker-dealer returned all customer funds within 48 hours of borrowing them. Despite the fact that the customers were neither purchasers nor sellers of securities, because their funds were fraudulently used in securities transactions, they were victims of a Rule 10b-5 violation (assuming the other elements of the violation were satisfied). [*See* 17 C.F.R. § 240.15c3-3 (Exchange Act Rule 15c3-3) (requiring segregation of customer funds).]

2. Manipulation or Deception

To be fraudulent under Rule 10b-5, conduct must have been manipulative or deceptive. Deceptive conduct is the more straightforward of the two: making an untrue statement of a material fact or omitting 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. The other type of conduct, manipulation, can take many forms in the capital markets, including wash sales, front-running, bear raiding, cornering the market, and churning. Common to these forms of manipulation, however, is the use of facially legitimate acts (*e.g.*, buying and selling stocks) in manners intended to move the market, not to express an expectation on the value of a security. [*Cf. United States v. Mulheren*, 938 F.2d 364 (2nd Cir. 1991).]

Example:

An investor had two brokerage accounts. One account contained 10,000 shares of Poptime, an online content-streaming service. Poptime's stock price was $10. The investor used the second brokerage account to place orders for Poptime stock at $11, more than anyone else was offering for Poptime stock. Immediately after bidding, however, the investor cancelled the bid before it could be filled. The investor continued to place $11 bids for Poptime stock, creating the impression that there was increased demand for the stock at the higher price. Eventually, the price reached $10.90 and the investor sold all 10,000 shares at that inflated price. Once other investors realized that there was no new information to justify the $10.90 price, the price fell back to $10. The investor's bidding strategy was manipulative because it was merely intended to affect Poptime's stock price.

3. Materiality

The United States Supreme Court's decision in *TSC Industries* provides the leading standard for materiality: whether there is a substantial likelihood that had a reasonable investor received the omitted (or misstated) fact, the investor would have made a different investing decision, *i.e.*, whether an omitted fact would have significantly altered the ***total mix*** of available information. Although *TSC Industries* related to proxy solicitation, in *Basic Inc. v. Levinson* the Supreme Court expressly extended the *TSC Industries* standard to the antifraud provisions of the Exchange Act, including Rule 10b-5. [*See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988); *see also* The Meaning of Securities and Materiality, *supra*.]

Example:

Poptime was a publicly traded, online subscription-based streaming service for original television shows and films. The company's chief revenue officer announced via social media that the company's year-over-year new subscriptions had increased from 10 million new accounts two years ago to 15 million accounts in the just-completed year. The announcement omitted that cancellations also rose from one million account cancellations two years ago to four million in the just-completed year. Because the increase in cancellations was omitted from the announcement, the total mix of information about the company's subscription growth was altered and thus the omission ***was*** material.

Compare:

Poptime was a publicly traded, online subscription-based streaming service for original television shows and films. The head of the company's public-relations department announced on Poptime's social-media accounts that its original television shows and films had received "50 nominations for major awards in last year's awards season." In truth, the number of nominations for major awards was 42. Because awards nominations were of limited importance to investors' decisions (because to the extent they mattered, their impacts were captured in subscription revenue and other financial metrics), this minor discrepancy in awards nominations was ***not*** material.

4. Scienter

The Supreme Court has observed that Section 10(b) prohibits manipulation and deception, words whose meanings imply a level of intent or knowledge on the part of the party engaging in the manipulation or deception. In making this observation, the Court imposed a ***scienter*** requirement for violations of Rule 10b-5. The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." [15 U.S.C.

§ 78j(b) (Exchange Act § 10(b)).] In other words, merely negligent statements or omissions are insufficient to give rule to liability under Rule 10b-5.

Note: Rule 10b-5's scienter requirement contrasts with the strict liability that Section 11 of the Securities Act imposes on certain participants in securities offerings for material misstatements or omissions. [15 U.S.C. § 77k (Securities Act § 11).]

Example:

Poptime was a publicly traded, online subscription-based streaming service for original television shows and films. Investors paid close attention to Poptime's expenses for licensing content from rightsholders. Poptime's chief creative officer told a financial journal that the company expected at most a 5-percent increase in licensing costs in the coming year. At the time of this statement, the chief creative officer had not spoken for a week with the company's licensing team, which was negotiating with the owner of a major content catalog. Poptime eventually agreed to high fees in the next year for that catalog, causing its licensing expenses to go up 10 percent. Although the chief creative officer was negligent in not being apprised on the status of negotiations before announcing that expense increases would be limited to 5 percent, that negligence was insufficient to satisfy the scienter element for Rule 10b-5 liability.

Compare:

Poptime was a publicly traded, online subscription-based streaming service for original television shows and films. Investors paid close attention to Poptime's expenses for licensing content from rightsholders. Poptime's chief creative officer told a financial journal that the company expected at most a 5-percent increase in licensing costs in the coming year. At the time of this statement, the company was negotiating with the owner of a major content catalog. The company's negotiator predicted to the chief content officer that "we'll have to pay a big increase in licensing fees to keep this catalog. That'll increase licensing expenses close to 10 percent." This prediction came true and licensing fees increased 10 percent. Because the chief creative officer knew that it was likely that licensing expenses would go up 10 percent, the misstatement that they would go up by no more than 5 percent was made with scienter.

C. Additional Pleading Burdens for Private Plaintiffs

Private plaintiffs who are injured by Rule 10b-5 violations must meet additional pleading requirements in addition to showing that the transactional-nexus, manipulation/deception, materiality, and scienter requirements have been satisfied. These additional requirements include proving that the plaintiffs (1) have standing as purchasers or sellers, (2) acted in reliance on defendants' misstatements or omissions, (3) have losses caused by defendants' misstatements or omissions, and (4) have damages as a result of (2) and (3). Public enforcers, the SEC and DOJ, need not meet these additional requirements in order to bring a civil enforcement action or criminal prosecution for violations of Rule 10b-5. [*See* Private Enforcement; Public Enforcement, *infra*.]

D. Insider Trading

Insider trading refers to securities transactions by corporate insiders (or people who receive information from corporate insiders) based on information that is (1) gained through their insider status (or the insider status of the person who ultimately provided the information), (2) material, and (3) nonpublic (***material nonpublic information (MNPI)***). The law of insider trading has largely arisen through enforcement, with insider trading representing a form of securities fraud under Rule 10b-5. Although Congress has never directly enacted a substantive statute on insider trading, it has filled in gaps around enforcement, including through the Insider Trading Sanctions Act of 1984 and the Stop Trading on Congressional Knowledge Act of 2012. [*See* The Framework of Securities Regulation, *supra*.]

1. The Classical Theory of Insider Trading

The earliest insider-trading cases revolved around the ***classical theory***. Under the classical theory of insider trading, it is fraudulent for a corporate fiduciary—someone who owes a duty to the corporation's shareholders—to trade based on MNPI obtained from being a corporate insider. Corporate fiduciaries include directors, officers, and employees, as well as, in some circumstances, outside underwriters, accountants, lawyers, or consultants who do work for the company. [*See Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).]

Example:

A senior human resources (HR) manager at Poptime, a publicly traded online streaming service, received an urgent summons on a Saturday morning. After arriving at the office, the HR manager was instructed to print lists of all Poptime employees, as well as a summary of their compensation and benefits. The HR manager knew from prior experience that this request probably meant the company was about to be sold and indeed, the chief HR officer remarked, "it's too sensitive to talk about, but a big transaction is brewing." That Monday, the HR manager bought 1,000 shares in Poptime, expecting that if the company was sold that there would be a significant premium on the current stock price. Because the employee obtained MNPI (*i.e.*, that a big transaction was in the works) through employment with Poptime, the trade ***was*** unlawful insider trading.

Compare:

A senior HR manager at Poptime, a publicly traded online streaming service, read a story in a financial publication about competition in the industry. The story speculated that Poptime would be acquired by one of its competitors, and the HR manager bought 1,000 shares in Poptime in the hope that the company would be acquired at a premium price. Two weeks later, the HR manager was summoned by the chief HR officer and told "this is highly confidential, but we've been in acquisition discussions the last three weeks and I need your help with due diligence." The HR manager did not engage in any other purchases or sales of Poptime stock until the acquisition by the competitor was announced. Because the HR manager was not aware of the potential acquisition at the time of the 1,000-share purchase, the purchase was ***not*** unlawful insider trading.

2. The Misappropriation Theory of Insider Trading

Under the classical theory, a corporate insider commits fraud against the corporation to which he or she owes a fiduciary duty by transacting in its securities while in possession of MNPI. The current law of insider trading, however, follows the ***misappropriation theory***, in which an insider who owes a fiduciary duty to a source of information commits fraud by using the information to trade securities in ***any*** company's stock, not just the stock of the company to which a duty is owed. [*See United States v. O'Hagan*, 521 U.S. 642 (1997).]

Example:

A journalist at *The Economic News*, a newspaper dedicated to financial news, regularly received tips that big corporate deals were in the works, which the journalist wrote about in the newspaper's *Listening on the Street* column. Before publishing the stories, however, the journalist sometimes traded the securities of companies that were the subject of the tips. Because the tips were the property of the journalist's employer, the newspaper, the journalist misappropriated MNPI and committed unlawful insider trading by using that MNPI to engage in securities transactions. [*See United States v. Carpenter*, 791 F.2d 1024 (2nd Cir. 1986), aff'd by equal div., *Carpenter v. United States*, 484 U.S. 19 (1987).]

Compare:

A journalist at *The Economic News*, a newspaper dedicated to financial news, covered and wrote exclusively about the airline and hotel industries. One night, the journalist went to dinner with friends; one table over was the CEO of Yven, a famous fashion company. The CEO spoke loudly, mentioning that Yven would soon buy Tolla, a popular new shoemaker that had recently gone public. After dinner, the journalist called a broker and put in an order to buy 10,000 shares of Tolla. Because the journalist did not learn of Yven's acquisition from Tolla through any employment or fiduciary relationship, purchasing the Tolla shares, even though it was based on MNPI, was not unlawful insider trading.

3. Tipper/Tippee Liability

The prohibition on trading based on misappropriated MNPI applies not only to the person who has a duty not to trade based on the MNPI, but it can also apply to others who learn of the MNPI from the duty-bound person. Under tipper/tippee liability, a person receiving MNPI (the ***tippee***) from an insider (the ***tipper***) is liable for insider trading if the tippee participates in a breach of the tipper's fiduciary duty (*i.e.*, the tippee knows that the tipper breached a fiduciary duty and received a ***personal benefit*** in doing so). A classic example of tipper/tippee liability is when the tipper provides MNPI to the tippee, who trades based on the MNPI and kicks back part of the trading profits to the tipper. Kickbacks are not always required, however, to establish the tipper's personal benefit. The Supreme Court held in *Salman v. United States*, for example, that outright ***gifts*** of MNPI to family members produce personal benefits for tippers. [*See Dirks v. SEC*, 463 U.S. 646 (1983); *Salman v. United States*, 137 S. Ct. 420 (2016).]

Example:

Two riders on a train, who had never met before, began chatting while waiting for their respective stops. One rider mentioned being a physician and the other mentioned being "on Wall Street." "Well," the physician said, "do you have any investment ideas for me?" "You can't go wrong buying Tolla, the shoemaker, these days, it's going to be acquired," the other rider answered. Little did the physician know, but the other rider was an investment banker working on a deal whereby Tolla would be bought by Yven, a fashion company, at a considerable premium. The physician purchased 10,000 shares of Tolla and realized a hefty trading profit weeks later when the acquisition was announced. Because the physician did not know that the other rider had breached a duty in disclosing the forthcoming acquisition and did not confer a personal benefit on the banker, the physician ***did not*** commit unlawful insider trading.

Compare:

Two riders on a train, who had never met before, began chatting while waiting for their respective stops. One rider mentioned being a physician and the other mentioned being "on Wall Street." "Well," the physician said, "do you have any investment ideas for me?" "I've been working on a hush-hush deal for Tolla, the shoemaker, really exciting," the rider answered. The physician bought 10,000 shares of Tolla and realized a hefty trading profit weeks later when it was announced that fashion company Yven even was buying the shoemaker. The physician handed the banker a watch as a thank-you gift the next time they ran into each other. Because the physician should have known that the banker breached a confidence in providing the tip, and because the banker received a personal benefit for doing so (*i.e.*, a watch), the physician ***did*** commit unlawful insider trading.

4. Rule 10b5-1 Safe Harbor

Corporate insiders typically hold common stock, stock options, and other securities in the companies they work for. This practice is considered beneficial because it aligns the economic interest of directors, officers, and employees with the shareholders (because they too are shareholders). Corporate insiders, especially those whose jobs frequently involve MNPI, face a tension, however, between being able to sell company securities (*e.g.*, to diversify a portfolio or to pay for a child's college tuition) and not violating Rule 10b-5. To address this tension, the SEC has adopted Rule 10b5-1, a safe harbor under which corporate insiders may enter into contracts, instructions, or plans (for example, with a broker-dealer) to execute future transactions. Those future transactions, in turn, do not violate Rule 10b-5 even if the insider was in possession of MNPI at the time of the (pre-planned) transaction. [*See* 17 C.F.R § 240.10b5-1(c) (Exchange Act Rule 10b5-1(c)).]

Example:

Two executives at Yven, a fashion company, received 100,000 shares of stock each year in incentive compensation, with a fourth of the shares vesting each quarter. To fund personal expenses and balance their portfolios, they each created 10b5-1 plans in which they instructed their broker-dealers to sell half the shares they received in a given quarter at the one-year anniversary after receipt. The broker-dealers were instructed to sell the shares at whatever the opening price was on that anniversary date.

IX. Private Enforcement

Federal securities laws and regulations impose numerous requirements and prohibitions—and exceptions and exemptions from those requirements and prohibitions—on participants in the securities markets. The SEC and DOJ have the authority to enforce those requirements and prohibitions by bringing civil and criminal enforcement actions. *Ex post* enforcement, in turn, is expected to deter issuers and other market participants from violating the law in the first place. Neither agency, however, has sufficient resources to effectively detect and police securities-related misconduct. Given this constraint on public enforcement, the securities laws allow persons injured by the securities misconduct of others to bring private actions to recover economic damages and to seek other forms of relief. [*See* Securities Offerings, *supra*; Exempt Securities Offerings, *supra*; Continuing Disclosure, Shareholder Voting, and Tender Offers, *supra*; Capital Markets Regulation, *supra*; Securities Fraud, *supra*; Public Enforcement, *infra*.]

A. Rights of Action

Not all violations of the securities laws and regulations permit private enforcement. In some cases, especially those involving offering-related violations under the Securities Act, Congress has explicitly provided for private rights of actions. In others, such as Section 10(b) and Rule 10b-5 actions, the courts have held that the law provides an implicit private right of action. This subchapter discusses the private rights of action under the federal securities laws and regulations, including noting places in which they overlap and in which there are open questions whether a provision is enforceable by private plaintiffs, or only by public enforcers.

1. Section 10(b) of the Exchange Act (Securities Fraud)

Section 10(b), and Exchange Act Rule 10b-5 promulgated under it, prohibit fraud in connection with the purchase or sale of securities, making them the most common securities private causes of action. In fact, an analysis by Cornerstone Research found that 84 percent of private securities litigation filed in 2015 had Section 10(b)/Rule 10b-5 claims. [15 U.S.C. § 78j(b) (Exchange Act § 10(b)); 17 C.F.R. § 240.10b-5 (Exchange Act Rule § 10b-5); Cornerstone Research, *Securities Class Action Filings: 2015 Year in Review* at 8 (2016); *see also* Securities Fraud, *supra*.]

a. Substantive Elements

To violate Section 10(b) and Rule 10b-5, a person's misstatement or omission must have (1) occurred in connection with the purchase or sale of securities, (2) involve manipulation or deception, (3) been material to an investment decision, and (4) been done with scienter. These elements must be proved both by private plaintiffs bringing suit, as well as by the SEC or DOJ when they bring civil or criminal actions. [*See* Securities Fraud, *supra*.]

b. Private-Action Elements

In addition to proving the substantive elements of securities-fraud violations, private plaintiffs must also prove that (1) they relied on the defendant's misstatement or omission in making an investment decision and (2) the misstatement or omission caused the plaintiffs' loss.

i. Reliance

Reliance, also known as ***transaction causation***, is a causal element that is satisfied when frauds by defendants cause investors to buy or sell securities. The most common pleading theory to support this element is the ***fraud-on-the-market*** theory. The fraud-on-the-market theory was articulated in the United States Supreme Court's *Basic Inc. v. Levinson* decision. It follows that in an efficient market for a security, material misstatements or omissions will be priced into the value of the security, meaning that in considering price when deciding to buy or sell, investors will have relied on the fraudulent statements or omissions. A fraud-on-the-market theory can be rebutted, however. For example, a plaintiff who in fact did not rely on, or was aware of, a defendant's misstatements and omissions cannot satisfy the reliance element for a civil Section 10(b) action. [*Basic Inc. v. Levinson*, 484 U.S. 224 (1988); *see also Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).]

Example:

An investor bought $50,000 in a technology company's shares. After the purchase, a newspaper article revealed a whistleblower report that the company had inflated its sales by nearly 8 percent over the prior three years. The price of the company's shares fell significantly, leaving the investor's stake valued at $42,000. Because the investor purchased shares at the pre-whistleblower price, and because that price reflected the company's material misstatements about its sales in the prior three years, the investor ***would*** be able to establish reliance by using a fraud-on-the-market theory.

Compare:

An investor's due diligence revealed that a technology company claimed to have sold more units in the prior three years than it had held in inventory, suggesting that it was inflating its sales numbers. Despite this information, the investor purchased $50,000 in the company's shares. After the purchase, a newspaper article revealed a whistleblower report that the company had inflated its sales by nearly 8 percent over the prior three years. The price of the company's shares fell significantly, leaving the investor's stake valued at $42,000. Because the investor knew of the inflated sales numbers, the investor ***would not*** be able to establish reliance on them.

ii. Loss Causation

Loss causation is a causal element related to, but distinct from, reliance. Proving loss causation requires showing a causal connection between a defendants' culpable actions and the losses suffered by the plaintiffs. It is insufficient to plead loss causation by pointing to differing prices in a security before and after a material misstatement or omission was corrected. Instead, the change in a security's price must be shown to be directly caused by the culpable conduct. [*See Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. 336 (2005).]

Example:

A newspaper story featured a whistleblower report that a technology company had inflated its sales by nearly 8 percent. After the report, the price of the company's shares fell significantly. To prove that that the misstated sales numbers caused the technology company's stock to be priced artificially high and that the correction of that material misstatement caused the price to drop, securities plaintiffs hired financial economists to conduct a statistical analysis to isolate the effect of the misstatement and correction on the stock price.

c. Damages

Section 28(a) of the Exchange Act limits damages recoverable under Exchange Act claims to an investor's actual damages. In other words, punitive damages are not available for Rule 10b-5 claims, or other claims brought under the Exchange Act. This damages limitation expresses a congressional judgment that securities litigation should primarily have a compensatory role. [15 U.S.C. § 78bb(a) (Exchange Act § 28(a)).]

i. Deterrence

The limitation does, however, reduce the deterrent effect on bad actors given that (1) many frauds may go undiscovered and (2) many of those that are discovered do not result in a successful litigation. Thus, because many frauds are not subject to successful litigation and because at most defendants recover the costs of the fraud, bad actors have, at least in the Rule 10b-5 context, a positive expected value from making fraudulent misstatements or omissions.

2. Section 11 of the Securities Act (Offering Liability)

Section 11 of the Securities Act creates strict liability for registration statements that contain (1) material misstatements or omissions (2) at the time they become effective. Section 11's strict liability means that plaintiffs ***do not*** need to prove reliance, loss causation, or scienter. Non-issuer defendants, however, may assert a good-faith defense that they believed, and had reasonable grounds to believe, that the registration statement contained no material misstatements or omissions. Common-law and statutory defenses may also insulate forward-looking statements with appropriate cautionary language from giving rise to Section 11 liability. [15 U.S.C. § 77k (Securities Act § 11); *see also* The Meaning of Securities and Materiality, *supra*.]

Example:

Hearth Homes, a large homebuilder, was preparing an initial public offering. The company hired a public accounting firm to conduct an independent audit of its financial statements for inclusion in the registration statement and prospectus. The board of directors met with the auditor on several occasions and relied on the auditor's expert assurances that the financial statements were materially accurate. After the offering, it was discovered that the financial statements contained material misstatements. Assuming the directors did not know about the misstatements, their supervision of the auditor and reliance on the auditor's expert findings would provide a due-diligence defense to individual liability under Section 11.

3. Section 12(a)(1) of the Securities Act (Unregistered Offerings)

Section 12(a)(1) of the Securities Act provides a right of action for the sale of unregistered securities that are not otherwise exempt from registration. Defendants are strictly liable for violating the registration requirements, and successful plaintiffs are entitled either to damages (*i.e.*, if they no longer own the securities) or rescission. A plaintiff must prove three elements for a Section 12(a)(1) claim: (1) the securities were sold by the defendant to the plaintiff, (2) the offering used the instrumentalities of interstate commerce (*e.g.*, a mailed letter, phone call, or email), and (3) the defendant did not comply with the registration requirements of Section 5 of the Securities Act. Strict liability is intended to give issuers a strong incentive to comply with the Securities Act's requirement that all securities either be registered or exempt from registration before being issued. [15 U.S.C. § 77l(a)(1) (Securities Act § 12(a)(1)).]

Example:

A startup company sold shares in a transaction its attorneys opined was exempt from the Securities Act's registration requirements. An investor bought shares. Months later, a major competitor replicated the startup's product, leading to a substantial loss of customers and revenues. The investor did further investigation into the offering and found, despite the attorneys' legal opinion, the offering was not exempt from registration, nor was it registered. Despite the fact that no material misstatements or omissions in the offering were identified (other than that the transaction was exempt from registration), under Section 12(a)(1), the investor would be entitled to a rescission of the purchase, *i.e.*, the startup must repurchase the shares from the investor for the price paid.

4. Section 12(a)(2) of the Securities Act (Offering Liability)

In addition to Section 11, Section 12(a)(1) of the Securities Act provides a right of action against those who (1) offer or sell securities (2) using the instrumentalities of interstate commerce, (3) by means of a prospectus or oral communication (4) that contains material misstatements or omissions (provided that the purchaser is unaware of the true or omitted fact). [15 U.S.C. § 77l(a)(2) (Securities Act § 12(a)(2)).]

a. Burden Shifting and Defenses

Once plaintiffs establish a prima facie case under Section 12(a)(2), the burden shifts to defendants to present a defense. One such defense is due diligence, which defendants may use if they "did not know, and in the exercise of reasonable care could not have known" of the material misstatement or omission. [15 U.S.C. § 77l(a)(2), (b) (Securities Act § 12(a)(2), (b)).] A lack of reliance or loss causation may also be raised as affirmative defenses.

Example:

Hearth Homes, a large homebuilder, was preparing an initial public offering. The company hired a public accounting firm to conduct an independent audit of its financial statements for inclusion in the registration statement and prospectus. A broker who was part of the selling group sold shares to customers. After the offering, it was discovered that the financial statements contained material misstatements. Assuming the broker did not know about the misstatements and exercised reasonable care in reviewing the prospectus (*e.g.*, reading the auditor's report), it would be able to assert a successful due-diligence defense to Section 12(a)(2) liability.

5. Section 17(a) of the Securities Act (Securities Offering Fraud)

Section 17(a) of the Securities Act prohibits fraud in connection with the offer or sale of securities. In that sense, it serves as a Securities Act analog of the Exchange Act's Section 10(b) and Rule 10b-5. [15 U.S.C. § 77q(a) (Securities Act § 17(a)); *see also Aaron v. SEC*, 446 U.S. 680 (1980).]

Note: Courts have generally found that Section 17(a) does not give rise to a private right of action and thus may be enforced only by public authorities. It differs from Exchange Act Section 10(b) and Rule 10b-5 cases in that it does not require a showing of scienter, and thus mere negligence may give rise to liability under this section.

6. Section 14(a) of the Exchange Act (Proxies)

Section 14(a) provides a right of action in connection with proxy statements and proxy solicitation. To state a claim under Section 14(a), a plaintiff must allege (1) material misstatement or omission that was (2) at least negligent and (3) that the proxy solicitation, and not a representation made within the proxy statement, was an ***essential link*** for achieving the subject of the solicitation (*e.g.*, approval of a merger). [15 U.S.C. § 78n(a) (Exchange Act § 14(a)); *see also Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).]

Example:

A shareholder of TopCar, a car retailer, submitted a proposal to include a shareholder vote in the company's annual proxy asking the company to disclose information about its political spending. The company excluded the proposal from the proxy statement, although the shareholder met and complied with the requirements of Exchange Act Rule 14a-8 for shareholder proposals. The shareholder sued, seeking injunctive relief under Section 14(a) to compel the company to amend the proxy statement to include the omitted proposal.

7. Sections 13 and 14 of the Exchange Act (Tender Offers)

Litigation under Section 13 and 14 of the Exchange Act enforces the Williams Act's requirements that certain shareholders disclose their positions (Section 13(d)) and that tender offers that would result in the offeror owning 5 percent or more of a class of an issuer's shares file a Schedule TO with the SEC. Litigation under the Williams Act is relatively rare and is typically brought by companies asserting their shareholders' interests. [15 U.S.C. §§ 78m–n (Exchange Act §§ 13 and 14).]

8. Section 16 of the Exchange Act (Short-Swing Profits)

Section 16 of the Exchange Act imposes strict liability for ***short-swing trading*** by corporate insiders, *i.e.*, the purchase ***and*** sale of issuer securities by an insider within a six-month period. Section 16 is intended to prevent short-term insider trading, and issuers may sue under it to recover short-swing profits. [15 U.S.C. § 78r (Exchange Act § 18).]

Example:

The chief operating officer of Storage, Inc., a publicly traded mini-storage operator, believed strongly in the company's future and bought 1,000 shares with each month's paycheck. When the COO's eldest child was about to start college, the COO sold 1,000 shares of Storage, Inc. stock—then priced at $40 per share—to pay for the child's tuition and expenses. A month earlier, the CEO had bought 1,000 shares at $37 per share. Because the COO bought and sold shares within a six-month period and enjoyed a $3,000 profit between the $37 and $40 prices, the COO violated Section 16's prohibition on short-swing trading. The COO was strictly liable for this violation even though the purchase was part of a consistent pattern and the sale was for personal cash needs, *i.e.*, not trading on inside information.

9. Section 18 of the Exchange Act (False Filings)

Section 18 of the Exchange Act imposes liability for material misstatements and omissions in filings with the SEC. Litigation under Section 18 is rare, however, because it requires plaintiffs to plead reliance with personal particularity, rather than relying on the fraud-on the-market theory. Given that Section 10(b) and Rule 10b-5 also create liability for misstatements and omissions in documents filed with the SEC, 10(b) litigation is generally an easier vehicle for such claims. [15 U.S.C. §§ 78r (Exchange Act § 18).]

B. Primary and Secondary Liability

The securities laws impose liability on those who directly violate the law (*e.g.*, by making a material misstatement or omission) (***primary participants***), as well as certain persons who assist them in doing so (***secondary participants***).

Example:

Rumors began circulating among investors that the longtime CEO of Truefilm Studios, a publicly traded production company, was ill and participating little in Truefilm's day-to-day creative direction and operations. Truefilm's general counsel, despite knowing that the rumors were true, prepared a press release that opened, "Despite the rumors we've heard, our CEO has never been in better health or more active in the company's management." The general counsel asked the company's main outside counsel to "do a proofread" before the statement was released. The outside counsel did not perform due diligence on the statement's claims, but did note several grammatical errors. In making this false statement, only the general counsel would be a primary participant because the outside counsel was not substantially involved in drafting the press release.

Compare:

Rumors began circulating among investors that the longtime CEO of Truefilm Studios, a publicly traded production company, was ill and participating little in Truefilm's day-to-day creative direction and operations. Truefilm's general counsel, despite knowing that the rumors were true, asked the company's main outside counsel to prepare a statement denying them. The outside counsel prepared a press release that opened, "Despite the rumors we've heard, our CEO has never been in better health or more active in the company's management." The outside counsel did not know whether this statement was true but had noticed that the CEO had not joined conference calls as usual for several months; the outside counsel inquired no further. Both the general counsel and the outside counsel were primary participants in the misstatement: the general counsel directed the general content of the misstatement and the outside counsel crafted the misleading press release.

1. Primary-Participant Liability

The SEC has resisted the drawing of a bright line between who is and who is not a primary participant on a material misstatement or omissions for liability purposes. Courts have also varied in how they identify primary participants, but the ***substantial participant*** test has been commonly used. Under this test, an actor is a primary participant for liability purposes if the actor was a substantial participant in making a material misstatement or omission. [*See, e.g.*, *In re Software Toolworks Inc.*, 50 F.3d 615 (9th Cir. 1994).]

2. Aiding-and-Abetting Liability

Congress has authorized public securities enforcers to bring actions against those who aid and abet securities violations, who are secondary participants. The United States Supreme Court has held that there is no private right of action against aiders and abettors, however. Given this limitation, there is significant focus on whether a given actor is or is not a primary participant for liability purposes. [*Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).]

3. Control-Person Liability

The Securities Act and Exchange Act both provide for liability for control persons who are not direct securities violators. For control liability to emerge, there must be a control relationship between the control person and the primary violator (*e.g.*, an employee or business entity). Although neither statute defines ***control***, courts generally look to whether a defendant has the power to control the primary violator, whether in a specific instance or in general. Defendants facing control-person liability may offer a good-faith affirmative defense. [15 U.S.C. §§ 77o(b) (Securities Act § 15(b)), 78t(e) (Exchange Act § 20(e).]

Example:

Best Brokers was a registered broker-dealer. It specialized in cold-calling individuals and pressuring them to purchase shares in small, thinly traded companies. Representatives at this broker-dealer, an example of a ***boiler room***, frequently misstated the risks of the securities in order to make a sale. The CEO of the broker-dealer did not personally make sales calls, but did coach the firm's representatives "to never hang up that phone until you have a sale, but be sure not to do anything illegal." In a Rule 10b-5 action against the firm for its deceptive sales practices, the CEO would have control-person liability for the conduct of the firm's representatives, despite the admonition that representatives not break the law in the sales process.

4. Respondeat Superior Liability

Conceptually related to control-person liability is the common-law doctrine of ***respondeat superior*** liability. Under this theory, an employer is responsible for violations of law committed by an employee within the scope of that person's employment. Defendants facing suit under a respondeat superior theory may offer good faith as an affirmative defense. [*See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990).]

Example:

Decent Brokers was a registered broker-dealer. The firm received customer complaints that a representative had made unauthorized trades in their accounts, generating sales commissions for both the representative and the firm. The firm had no system in place to require representatives to document customer trading instructions before making a trade, and it bore respondeat superior liability for the representative's unauthorized activity.

Compare:

Decent Brokers was a registered broker-dealer. The firm received customer complaints that a representative had made unauthorized trades in their accounts, generating sales commissions for both the representative and the firm. The firm had a system in place requiring representatives to document trading instructions and receive approval from a supervisor before executing a trade. An investigation revealed that the representative had bypassed this system by creating sophisticated forged emails from customers with trade instructions. Given the reasonable trading-authorization compliance system it had in place, the firm had a colorable argument that the representative's circumvention of the system was unforeseeable and that it should prevail on a good-faith defense. [See *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980).]

C. Procedural Considerations

Beyond proving the substantive elements of securities violations, private securities plaintiffs must also satisfy and complete a number of procedural requirements and steps. This section reviews the rules of civil procedure as they uniquely apply to securities litigation.

1. Standing

Although a variety of persons can suffer harm in connection with violations of the securities laws, standing to assert a private claim under them requires an individual to be either a purchaser or seller of securities. Claims brought under the Securities Act require that the plaintiff and defendant be in privity with each other (*i.e.*, there must be a direct transactional relationship between the two). [*See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).]

Examples:

(1) Garden Stores was a retailer of home-and-garden supplies. Although it advertised and stated in its public disclosures that its products were "all green, all safe, all natural," a news report and whistleblower identified numerous products it sold that were made of toxic chemicals. Its sales, and its stock price, dropped. Retire Funds 500, a mutual fund, owned 1,000,000 Garden Stores shares and frequently bought and sold shares. Franklin State Employee Pension Fund (FSEPF) owned 3 percent of Retire Funds 500's shares. Retire Funds 500 would have standing to bring a Rule 10b-5 claim against Garden Stores. FSEPF, however, was neither a purchaser nor seller of Garden Stores shares and thus would lack standing, even though the value of its Retire Funds 500 shares was affected by the retailer's misstatements.

(2) FSEPF bought shares of Garden Stores, a home-and-garden retailer, from an underwriter during the retailer's initial public offering. Within an hour of buying the shares, FSEPF sold half of the shares to its sister fund, Franklin State Police Pension Fund. Months later, it was discovered that Garden Stores's registration statement contained material misstatements about the safety of its products. The employee fund, as a direct purchaser, had standing to bring a claim under Section 11 of the Securities Act; the police fund, as a secondary purchaser, did not have standing under Section 11.

2. Heightened Pleading Standards

Actions alleging some form of fraud must satisfy Federal Rule of Civil Procedure 9(b)'s heightened pleading standard by stating "with particularity the circumstances constituting fraud . . . ." [Fed. R. Civ. P. 9(b).] This standard requires enough specificity—such as identifying the exact misstatements or omissions that are alleged to give rise to a claim—at the pleading stage to allow defendants to prepare a response. The PSLRA also requires that plaintiffs plead the state of mind necessary to establish a defendant's liability. When doing so requires pleading scienter, plaintiffs must plead facts sufficient to create a "strong inference" of scienter. [15 U.S.C. § 78u-4(b)(2).]

Example:

A pension fund filed a putative class action against Garden Stores, a publicly traded retailer of home-and-garden supplies. The pension fund alleged that Garden Stores made material misstatements that its products were "all green, all safe, and all natural," when in fact a news report and whistleblower revealed that they were made with toxic chemicals. The key Rule 10b-5 allegation in the fund's complaint stated: "Garden Stores lied about the nature of its products, causing the stock price to fall." Because this statement alleged fraud and did not satisfy the heightened pleading standard of Rule 9(b), and because it alleged scienter by alleging the retailer lied but provided no other factual allegations to draw that inference, it failed to meet its pleading standards and would be expected to be dismissed.

Compare:

A pension fund filed a putative class action against Garden Stores, a publicly traded retailer of home-and-garden supplies. The key Rule 10b-5 allegation in the fund's complaint stated: "Garden Stores's CEO said on the April 17 analyst call that its products are 'all green, all safe, and all natural.' The company repeated this claim on page 30 of its second quarter 10-Q. In fact, on March 15, the CEO received an email from a senior VP warning 'We got the test results back—dangerously high levels of toxic chemicals in many of the products.' The CEO replied to the email, 'Let's discuss soon.'" Because this language pointed to specific alleged misstatements and specific facts giving a strong inference of scienter on the CEO's part, it met the heightened pleading standards of Rule 9(b) and the PSRLA.

3. Private Securities Litigation Reform Act of 1995

Congress has established a number of procedural requirements specific to securities claims, including through the PSLRA. Securities claims are frequently brought as class actions, and Congress has legislated with the belief that many securities class actions are driven by lawyers who hope to obtain quick settlements, versus those who bring truly meritorious cases. Whatever the merits of this view, it has profoundly shaped the process and nature of private securities litigation in the United States.

a. Lead Plaintiffs and Counsel

The PSLRA established new procedures for the appointment of lead plaintiffs and lead counsel for securities class actions. Under these procedures, there is a rebuttable presumption that courts will appoint the plaintiff with the largest economic stake, *i.e.*, the plaintiff that lost the most due to alleged securities violations, as lead plaintiff. The procedure also requires prospective lead plaintiffs to provide certain disclosures to other members of the putative class. These procedures are intended to reduce the influence of plaintiffs' attorneys in generating and driving securities litigation. [15 U.S.C. § 77z–1(a)(3) (Securities Act § 27(a)(3), 78u-4(a)(3) (Exchange Act § 21D(a)(3)).]

b. Stay of Discovery and Motions to Dismiss

In civil litigation, discovery generally proceeds while motions to dismiss are pending. The PSLRA provides for an automatic stay of discovery while a motion to dismiss is pending. This stay allows defendants to avoid the considerable costs of complying with plaintiffs' discovery requests. The provision is intended to avoid forcing defendants to incur these costs, which could be for naught if they are victorious in their motions to dismiss. [15 U.S.C. § 78u-4(b)(3)(B) (Exchange Act § 21D(b)(3)(B).]

c. Contribution

Securities plaintiffs are likely to file suit against multiple defendants in order to optimize their ability to recover losses. In litigation surrounding a security offering, for example, the issuer, its officers and directors, and underwriters might be named. In a case involving broker-dealer misconduct, a representative and the representative's firm would be named. Although traditionally codefendants face joint and several liability, the PSLRA uses a comparative-liability rule in which defendants are liable for damages in proportion with their contribution to the securities violation. Comparative liability prevents deep-pocketed defendants (*e.g.*, broker-dealers) from being forced to pay a full award when there are more culpable, but less wealthy, defendants (*e.g.*, broker-dealer representatives who defraud customers). Defendants are not entitled to comparative liability, however, if they knowingly violate the securities laws. [15 U.S.C. § 78u-4(f)(7)(A) (Exchange Act § 21D(f)(7)(A)).]

4. Securities Litigation Uniform Standards Act of 1998 (SLUSA)

After the passage of the PSLRA, there was a significant uptick in private securities litigation filed in state courts under state securities laws. Concerned that this uptick represented an end run around the PSLRA's reform provisions, Congress enacted SLUSA. Among SLUSA's most important effects was essentially to prohibit ***covered class actions***, cases which (1) involve 50 or more class members, (2) are brought under state law, and (3) relate to ***covered securities*** (*e.g.*, securities traded on national securities exchanges and shares of registered investment companies). [15 U.S.C. § 77p(f)(2)(A)(ii); *see also* State Jurisdiction, *infra*.]

5. Time Limitations

The securities laws impose statutes of limitations on when actions must be brought. Under Section 13 of the Securities Act, for example, actions under Section 11 or Section 12(a)(2) must be brought within one year of a material misstatement or omission being discovered, or one year from when it should have been discovered. Actions also must not be filed more than three years after a bona fide offering or sale of a security to the public. Actions under Section 10(b) of the Exchange Act or Rule 10b-5 must be brought within the shorter of two years from discovery of actionable conduct or five years from the date of the conduct. [15 U.S.C. § 77m (Securities Act § 13), 28 U.S.C. § 1658(b).]

Note: There is a general consensus that statutes of limitations apply only to private actions and not by actions brought by the SEC. [*See* In re *Exxon Mobil Corp. Sec. Litig.*, 500 F.3d 189, 197 (3d Cir. 2007).]

X. Public Enforcement

Violations of federal securities laws and SEC regulations—and, in some cases, the rules of SROs—may subject violators and their employers to civil or even criminal actions by the SEC or DOJ. This chapter summarizes key concepts and processes in the public-enforcement process. [*See* Securities Offerings, *supra*; Exempt Securities Offerings, *supra*; Continuing Disclosure, Shareholder Voting, and Tender Offers; Capital Markets Regulation, *supra*;; Securities Fraud, *supra*; Private Enforcement, *supra*.]

A. Liability and Penalties

Not everyone who is liable for a securities violation has directly committed a violation. Frequently, liability arises against employers for employees' misconduct (***respondeat superior liability***), or against third parties who participated in a primary violator's misconduct (***aiding-and-abetting liability***).

1. Respondeat Superior Liability

A unique feature of American law is that employers have strict liability for unlawful conduct committed by their employees (1) in the course of their employment that (2) are intended to benefit the employer. Respondeat superior liability is also called ***vicarious*** liability. The second requirement for respondeat superior liability—benefit to the employer—can be satisfied by any act or omission that might confer some benefit on the employer, even if the employee's conduct is mostly self-serving or in fact harms the employer. Vicarious liability applies in both civil and criminal enforcement. [*See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc).]

Example:

A senior sales manager at a pharmaceutical company was under pressure to achieve sales targets for the year. The sales manager instructed subordinate salespeople to offer discounts to customers in exchange for taking inventory a quarter early, from Q1 of next year to Q4 of the current year. This offer had the effect of moving sales from one quarter to another, but at a reduced total revenue. This act caused the company to overstate its revenue in Q4, but to lose revenue overall. The pharmaceutical company would be vicariously liable because the sales manager's misconduct was partly meant to benefit the company (*i.e.*, by increasing its reported sales in Q4), even though (1) its net effect harmed the company by reducing its revenue and (2) it was primarily intended to benefit the sales manager personally (*i.e.*, by reducing risk of being fired for poor sales numbers).

Compare:

A senior sales manager at a pharmaceutical company created a fake customer account purporting to belong to a chain of New England drugstores. The manager had authority to authorize customer-loyalty rebates and submitted an authorization that the chain receive a $1,000,000 rebate, which was deposited into an account controlled by the manager. This rebate caused the company to understate its revenue in its financial statements. The company would not be vicariously liable for this theft because the sales manager embezzled the money solely for personal purposes and did not provide any benefit to the company in doing so.

a. Mitigating Respondeat Superior Liability

Respondeat superior liability applies in both the civil and criminal enforcement contexts for securities violations. Its applications can be potentially harsh in holding firms responsible for the misconduct of their employees. The federal sentencing guidelines, DOJ, and SEC have all implemented policies, however, to allow firms to mitigate or even escape liability for employee wrongdoing if they have effective compliance programs in place, self-report employee wrongdoing, and cooperate with investigations. [*See* U.S. Sentencing Comm'n, 2018 Guidelines Manual § 8B2.1 (effective compliance and ethics programs); DOJ, Principles of Federal Prosecution of Business Organizations 9-28.300 (factors to be considered in corporate charging); SEC, Report of Investigations, Exchange Act Release No. 44969 (Oct. 23, 2001) (establishing SEC policy for determining how much self-policing, self-reporting, remediation, and cooperation credit a corporate defendant may receive).]

2. Aiding-and-Abetting Liability

A person has aiding-and-abetting liability if (1) there was a primary violation of the securities laws, or SEC and SRO rules, by another person; (2) the aider-and-abettor had knowledge of the violations; and (3) the aider-and-abettor provided substantial assistance in the achievement of the primary violation. [*See SEC v. Apuzzo*, 689 F.3d 204 (2nd Cir. 2012); *see also* Securities Fraud, *supra*; Private Enforcement, *supra*.]

Example:

The chief compliance officer at Vexture, a broker-dealer, identified a team of representatives that had executed trades without customer authorization. The team leader explained that the customers had high confidence in their representatives and convinced the chief commercial officer (CCO) not to say anything. After the team leader assured the CCO that unauthorized trades would not happen again, the CCO agreed not to document this violation in the firm's compliance report. An SEC examination, however, identified not only the original unauthorized trades, but continued unauthorized activity. The CCO aided and abetted the unauthorized trades because he knew of the trades and provided substantial assistance after the fact (*i.e.*, by covering up their existence).

Compare:

A registered representative at Bad Securities, a broker-dealer, marketed the firm's private hedge funds to clients, bringing in tens of millions of dollars in invested assets. The representative made all required disclosures about the placements. Little did she know, however, that the hedge funds were not legitimate but that in fact the owner of the firm and a small group of employees were operating a Ponzi scheme with the investors' money. Although the representative did provide substantial assistance to the scheme by raising money for it, she would not have aiding-and-abetting liability due to a lack of knowledge about the primary violation.

3. Civil Penalties

The SEC and courts may impose a number of civil penalties on persons who violate the securities laws or SEC or SRO rules. These penalties include:

- civil-money penalties (*i.e.*, fines);
- disgorgement (*i.e.*, repaying unlawful gains);
- restitution (*i.e.*, return of losses to victims);
- remediation undertakings;
- injunctions;
- suspensions and revocations of licenses; and
- collateral consequences (*e.g.*, duty to disclose penalties to investors, loss of certain offering exemptions).

B. SEC Enforcement

Section 21(a) of the Exchange Act gives the SEC authority to "in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision" of the Exchange Act or rules issued under it. [15 U.S.C. § 78u(a) (Exchange Act § 21(a)).] Courts have traditionally given the SEC broad discretion in investigating potential violations of the securities laws or SEC rules.

Enforcement investigations and actions are governed by the SEC's Rules of Practice. [*See generally* SEC, Rules of Practice.]

1. Investigation

The bulk of SEC enforcement activity occurs during the investigative stage, in which enforcement attorneys gather substantial amounts of evidence—sometimes requiring review of millions of documents—to assess whether a violation of the federal securities laws or SEC rules have occurred and to prepare an enforcement case. All SEC enforcement is conducted by its Division of Enforcement and generally proceeds through several stages of investigation to the institution of an enforcement proceeding. The vast majority of enforcement actions the SEC brings are settled, rather than being litigated in court or an administrative proceeding.

a. SEC Division of Enforcement

The SEC Division of Enforcement is responsible for conducting investigations of and, when appropriate, bringing enforcement actions for suspected violations of the federal securities laws or SEC or SRO rules. The Division of Enforcement is staffed by attorneys, accountants, and other staff who are located at the SEC's headquarters in Washington, D.C., or in one of the SEC's 11 regional offices. It is led by a director or co-directors appointed by the chair of the SEC. [*See* SEC, Division of Enforcement, https://www.sec.gov/page/enforcement-section-landing.]

b. Investigation Sources

The SEC obtains information about potential violations of the securities laws or SEC rules from a wide variety of sources. Among the most common sources are:

- referrals from other divisions within the SEC, particularly the Division of Corporation Finance, Division of Investment Company, Division of Trading and Markets, and the Office of Compliance and Inspections;
- referrals from federal agencies (*e.g.*, the Food and Drug Administration) or federal criminal prosecutors;
- referrals from state securities regulators, as well as state and local law enforcement and criminal prosecutors;
- referrals from SROs (*e.g.*, FINRA);
- press reports;
- investor or public complaints;
- reviewing publicly available securities settlement agreements;

- whistleblower tips (*i.e.*, from insiders who witness wrongdoing); and
- self-sourced investigations.

c. Informal Investigation

SEC investigations begin with an informal stage. At this stage, enforcement attorneys ask potential targets and third parties to voluntarily produce documents or sit for interviews. At this stage of the investigation, SEC enforcement attorneys do not have the ability to issue compulsory subpoenas. Targets and others often cooperate with these voluntary requests in order to avoid the issuance of a subpoena in the future, as well as to receive cooperation credit in the event that an enforcement action is later brought against them. Informal investigations may also include review of public documents, such as filings with the SEC. If the Division of Enforcement determines from its informal investigation that there has been no violation, it will close the case.

d. Formal Investigation

If the Division of Enforcement determines that there is sufficient evidence of violations, or if its efforts to obtain voluntary production or interviews has been unsuccessful, it may present the evidence of suspected violations and request that the commission issue a ***formal order of investigation***. If the commission issues a formal order of investigation (*i.e.*, if a majority of the five commissioners approve), the enforcement attorneys working on the case will have authority to subpoena documents and require that individuals submit to on-the-record sworn testimony. The commission has also delegated to the director of the Division of Enforcement the authority to issue formal orders of investigation. [17 C.F.R. § 200.30-4(a)(1).]

i. Enforcing Subpoenas

If the recipient of a subpoena refuses to comply, the SEC may seek an order from a federal court compelling compliance, which the court may in turn enforce via its contempt powers. Courts will generally enforce SEC subpoenas provided that they (1) are not issued for an improper purpose, (2) seek only relevant information, (3) the SEC does not currently possess the information it seeks, and (4) all administrative procedures for issuing a subpoena have been followed. [15 U.S.C. § 78u(c) (Exchange Act § 21(c)); *see also SEC v. Blackfoot Bituminous, Inc.*, 622 F.2d 512, 514 (10th Cir. 1980).]

ii. Privilege

SEC subpoenas may not compel document production or testimony that is protected by privilege. All recipients, including natural persons and business entities, are protected from producing documents or information that is protected by attorney-client privilege or work-product doctrine. Natural persons and sole proprietorships may also assert a Fifth Amendment privilege against self-incrimination. Other privileges may also apply (*e.g.*, bank-examiner privilege in connection with banks). [*But see Braswell v. United States*, 487 U.S. 99 (1988) (holding that an officer of a subpoena recipient is not permitted to assert Fifth Amendment privilege against producing corporate records even if doing so would incriminate him or herself).]

e. Enforcement Actions

Just as enforcement attorneys require a formal order of investigation before they may issue subpoenas, they may present a case to the commission and request that it either issue an ***order instituting proceedings*** (for cases that will be brought as administrative proceedings) or authorize the filing of a civil lawsuit in federal district court. The commission must also approve settlements.

i. Wells Submissions

Prior to bringing charges to the commission, the SEC's Rules of Practice permit potential targets of enforcement actions to submit a white paper commonly known as a ***Wells submission***. The Wells submission is an opportunity for a target to make an argument to the enforcement staff as to why charges should not be brought or why some charges should be brought, rather than others. To facilitate these submissions, the SEC requires enforcement staff to notify individuals and entities through what is known as a ***Wells notice*** that the staff is preparing to recommend charges. [SEC, Rules of Practice § 202.5(c).]

ii. Settlements

The vast majority of enforcement actions settle, and often enforcement staff submits to the commission both a request to bring an enforcement action and a proposed settlement. Settlements to cases that have been filed in federal court must also receive the approval of the court. Some ***settlement agreements***, ***non-prosecution agreements*** and ***deferred-prosecution agreements*** require the defendant (typically a firm) to undertake remediation efforts and to avoid subsequent violations for a certain amount of time, otherwise the defendant will lose the benefits it obtained in the settlement agreement (*e.g.*, lower penalties, avoiding charges with severe collateral consequences). [*See* SEC OIG, Controls of Negotiated Settlements, Audit. No. 218 (1995) (describing settlement procedures).]

iii. Administrative Actions

The SEC does not need to go to federal court to prosecute an enforcement action. The securities laws also allow it to bring a range of actions administratively. Although the Division of Enforcement staff are required to make certain disclosures to the respondent, the rules of discovery and evidence are relaxed as compared to court. After a hearing before an administrative-law judge (ALJ), the ALJ reaches findings of fact and law. The decisions of an ALJ may be appealed to the commission itself. Further appeal is allowed via a petition for review to the D.C. Circuit or the court of appeals for the circuit in which the respondent is located. The Supreme Court may also grant a writ of certiorari from a court of appeals decision. [15 U.S. Code § 78y (Exchange Act § 25); *see also* SEC, Rules of Practice, §§ 201.200–201.490.]

Note: Although the SEC may impose stop orders, cease-and-desist orders, disciplinary sanctions against registered persons, and civil-money penalties, it lacks the authority to impose injunctions or bars on individuals who have violated the antifraud rules from serving as an officer or director of a public company. [15 U.S.C. § 78u–2 (Exchange Act § 21B).]

iv. Federal Court

In addition to administrative remedies, the SEC may bring an action in an appropriate federal district court for violations of the federal securities laws or SEC rules, or the rules of self-regulatory organizations. Litigation in court is subject to the same evidentiary and civil-procedure rules as any civil action. If courts find that defendants have violated the securities laws, they have authority to impose injunctions, civil-money penalties, and bars on individuals from serving as officers or directors of public companies. [15 U.S.C. § 78u(d) (Exchange Act § 21(d).]

C. Criminal Enforcement

Although most public securities enforcement at the federal level is conducted by the SEC, some cases are handled both civilly and criminally (*i.e.*, by both the SEC and DOJ) or just criminally. Examples of commonly prosecuted securities violations include significant intentional accounting fraud, large thefts (*e.g.*, by Ponzi schemes or thefts of customer funds by broker-dealers), or insider trading. Criminal securities prosecutions are managed by U.S. attorneys' offices located in each federal district. Federal prosecutors obtain case leads from the SEC, as well as from the sources the SEC uses (*e.g.*, press reports, referrals from other agencies). The non-prosecution agreement and deferred-prosecution agreement tools used by the SEC were initially developed by the DOJ, which uses them in similar manners to the SEC.

1. Criminal Liability

To establish criminal liability for securities violations, the government must satisfy a ***mens rea*** requirement that is higher than the scienter requirement or strict liability associated with civil liability. Section 24 of the Securities Act and Section 32 of the Exchange Act are the respective criminal provisions under those statutes. Both provide that criminal violations under them must have been ***willful***, and criminal liability under Section 32 for making misrepresentations in filings with the SEC will arise only if the misrepresentations were ***willful*** and ***knowing***. [15 U.S.C. § 77x (Securities Act § 24); 15 U.S.C. § 78ff (Exchange Act § 32); *see also* Securities Fraud, *supra*; Private Enforcement, *supra*.]

2. Penalties

Individuals convicted of criminal securities violations, including insider trading, may be sentenced to up to 20 years in prison, a $5,000,000 fine, or both. Organizations convicted of criminal securities violations may be sentenced to up to a $25,000,000 fine, as well as probation. [15 U.S.C. § 78ff (Exchange Act § 32); *see also* 18 U.S.C. § 3551(c)(1) (authorizing probation as a sentence for an organization.)]

XI. State Blue-Sky Laws

After the passage of the Securities Act, federal law has played a leading role in regulating public securities offerings. Despite that leading role, the states retain jurisdiction over securities offerings for securities ***except*** when federal law has preempted their jurisdiction.

A. Registration of Securities under State Law

Both the federal and state governments regulate securities. Unless federal law preempts state law, states are free to regulate securities transactions and the players involved in them (*e.g.*, issuers, purchasers, broker-dealers, underwriters).

1. State Jurisdiction

In general, states may require the registration of securities offered and sold within their borders. This power includes the right to require that issuers or underwriters make ***disclosures*** to prospective purchasers (and to do so truthfully and completely). (Federal law also implements a disclosure-based regulatory scheme.) Some states eschew a disclosure-only system and also review an offering's ***merits*** (*e.g.*, to ensure that the issuer has a proper corporate governance structure or to limit excessive underwriter compensation).

2. Blue-Sky Laws

Each U.S. state and territory (other than the District of Columbia) has a securities statute. These ***blue-sky laws*** generally regulate securities offerings, as well as the registration and conduct of broker-dealers, investment advisers, and other financial intermediaries.

Note: The District of Columbia follows the Securities Act and does not have its own blue-sky law.

3. Uniform Securities Act

Each state is free to adopt its own blue-sky law. New York passed its ***Martin Act*** in 1921, for example, which sets it apart from other states by requiring securities to be registered only in limited cases (*e.g.*, solely intrastate, or real estate-related, offerings), and provides the state attorney general with very broad enforcement powers. [N.Y. Gen. Bus. L. art. 23-A §§ 352–353.]

a. State Adoption of the Uniform Act

In practice, most states have adopted some form of the Uniform Securities Act (as amended, the Uniform Act), a model law produced by the National Conference of Commissioners on Uniform State Laws. Few states have adopted all amendments that have been made to the Uniform Act, and many have modified its provisions when adopting their own blue-sky laws. Given the wide variety of individual state practice, this chapter treats the Uniform Act as the operative blue-sky law for all states.

4. State Securities Administrators

Just as federal securities laws are administered by the SEC, states also have administrative agencies that are responsible for securities registration, enforcement, and related functions.

a. State Securities Administrators Structure

The structure of ***state securities administrators*** varies from state to state. These agencies may:

- have leaders who are directly elected by voters (*e.g.*, New York), or who are appointed by an elected official, like the governor (*e.g.*, California);
- be focused entirely on administering blue-sky laws (*e.g.*, Alabama), or also responsible for administering laws in other areas, like insurance or banking (*e.g.*, Pennsylvania); and
- be led by a single executive leader (*e.g.*, North Carolina), or by a multi-member commission (*e.g.*, Arizona).

b. North American Securities Administrators Association

The ***North American Securities Administrators Association***, also known as NASAA, is a trade group for state securities administrators. It provides technical assistance, registration and enforcement coordination, and policy development for its members.

5. State Registration of Securities Offerings

The Uniform Act defines "security" and establishes whether transactions are subject to registration or are exempt.

a. Unlawful Transactions

Under the Uniform Act, it is unlawful to offer or sell a security in a given state unless (1) the security is registered in the state, (2) the security is exempt from registration under the Uniform Act, or (3) the security is a covered security under federal law. [Uniform Act § 301.]

6. Securities Defined

The Uniform Act defines "securities" broadly to include equity and debt interests, or the right to acquire such interests. This definition does not include most insurance policies or annuity contracts. [Uniform Act § 401(m).]

7. Exemptions from Registration

No state requires ***all*** securities to be registered before being offered or sold. The Uniform Act ***exempts*** several categories of securities from registration, including:

- federal, state, and local debt securities, or Canadian governmental debt securities;
- securities of banks, credit unions, savings and loan associations, insurance companies, and similar institutions;
- securities listed, or approved for listing, on the NYSE, Nasdaq, or Amex, or securities senior or substantially equal in rank to those listed, or approved-to-be listed, securities;
- covered securities under federal law; and
- other categories of securities.

[Uniform Act § 402.]

B. Federal Preemption of State Securities Laws

In 1996, Congress adopted the National Securities Markets Improvement Act (NSMIA), which ***preempts*** blue-sky laws ***by exempting*** several types of securities from state registration.

1. Federal Preemption for Covered Securities

The NSMIA preempted state registration requirements with respect to ***covered securities***, which include:

- securities listed, or authorized for trading, on the NYSE, NASDAQ, or other national securities exchanges added by the SEC;
- securities issued by investment companies registered under the Investment Company Act (*e.g.*, mutual funds); and
- securities offered or sold under SEC rules to certain qualified purchasers (i.e., sophisticated investors who are deemed not to need the protection of registration).

[15 U.S.C. § 77r(a)(1) (Securities Act § 18(a)(1)); *see* Exempt Offerings, *supra*.]

Note: Although the NSMIA exempts covered securities from ***registration***, it does not always preempt state requirements to file notices or to pay related fees in connection with offering those securities.

Example:

A startup company in the State of Franklin raised a total of $500,000 by selling shares to a Franklin resident who was an accredited investor. Because this offering complied with the private-offering safe harbor of Rule 506(c) of Regulation D, the offered securities were ***covered securities*** under the NSMIA and thus were exempt from state registration requirements. Franklin could still require the filing of an offering notice and the payment of a fee, however. [*See* Exempt Offerings, *supra*.]

2. NSMIA's Impact on State Jurisdiction

At the time the NSMIA was enacted, states already exempted from registration nationally listed securities and securities offered or sold to qualified purchasers. The NSMIA's most significant impact was thus to remove the registration of securities issued by investment companies (*e.g.*, mutual funds) from state jurisdiction and to create a mechanism under which federal liberalization of private-offering rules also removes private offerings from *ex ante* state regulation. [*See* Exempt Offerings, *supra*.]

C. State Anti-Fraud Laws and Securities Offerings

Although the NSMIA preempted significant parts of state jurisdiction over the registration of securities offerings, it preserved states' ***ex post enforcement authority***. In other words, although under the NSMIA many securities can be offered and sold without state registration, the states retain the power to police fraud occurring in the context of even exempt offerings.

1. Private Right of Action

The Uniform Act allows securities purchasers who are injured by fraud or other violations of blue-sky laws to bring ***private actions*** against offerors and sellers. [Uniform Act § 401; *see also* Private Enforcement, *supra*.]

2. Administrative Enforcement

The Uniform Act allows state securities administrators to investigate potential violations of blue-sky laws, including by issuing ***subpoenas***. If an administrator identifies a blue-sky law violation, he or she may issue a ***cease-and-desist order*** (including ordering ***restitution*** or ***disgorgement***) or file a civil action in state court. States cannot, however, use their enforcement powers to indirectly impose registration or other requirements that are preempted by the NSMIA. [Uniform Act § 407–8; *see* Public Enforcement, *supra*.]

Example:

GoGoCar was a publicly traded automobile manufacturer. The company included the following statement in its annual report: "GoGoCar takes its environmental obligations seriously and meets all environmental standards in its vehicles." After making this statement, it was discovered that GoGoCar vehicles had higher gas emissions than the company claimed to the public and environmental regulators. This revelation caused a significant drop in the company's stock price. The SEC opened an investigation. The Franklin state securities administrator also opened an investigation. Although under the NSMIA Franklin could not impose *ex ante* regulations on GoGoCar's public disclosures, it retained jurisdiction to take action against the company for material misstatements that affected Franklin investors.

3. Criminal Prosecution

In addition to potential private litigation and civil enforcement, states may criminally prosecute individuals or entities that violate their blue-sky laws. [Uniform Act § 409; *see also* Public Enforcement, *supra*.]

Example:

Victims of a Ponzi scheme involving $120,000 in total losses submitted a complaint to the SEC. Because the victims were all located in Franklin and the losses were relatively small, the SEC referred the case to the Franklin state securities administrator. The administrator determined that the Ponzi scheme involved investment-contract fraud and, because the promoter had used fraud as a means to steal the investors' money, it referred the matter to the district attorney in the promoter's county for criminal prosecution.