Recent Updates and Analyses of Hypothetical Problems

Securities Regulation

Cases and Materials

Fourteenth Edition

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Preface

Several changes arose after the current casebook was submitted for print. Many of those changes were anticipated in the casebook’s footnotes, but in light of their significance, we have described the final rules here.

Also included are selected updates that reflect recent securities law developments.

Instructors may want to use these materials to supplement the casebook through lectures, or they may wish to distribute these to the students as casebook/supplement readings are assigned. We have drafted the updates to work either way.

The Analyses of Hypothetical Problems reflect the most recent regulatory changes.

We hope these materials are useful to you and your students.

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RECENT UPDATES
The SEC’s Proposed 
Climate-Related Disclosures

Millennials, more than prior generations, have expressed a keen interest in the social impact of their investments. The result, among others, has been a growing focus by institutional investors on how the activities of their portfolio companies affect the environment and, in turn, a demand for greater and more consistent climate-related disclosures.

The business community is facing a generational shift, from baby boomers to millennials. Over the next decade, millennials will assume a rising role among investors, employees, and consumers, and they will become the most dominant generation not long thereafter, outstripping their Generation X parents.

Most relevant for our purposes, millennials are less focused on their investment returns than any generation since such questions were first asked. The evidence suggests not that they are indifferent to investment returns, but that they have a greater tendency to assess and even prioritize the social and other real world effects of their investments. Prior generations viewed larger social questions as belonging to the political sphere: the sphere of political campaigns, legislation, and perhaps litigation. The investment sphere was the place to make money and save for retirement. But millennial views and attitudes toward investment suggest a collapsing, or at least eroding, distinction between what were once thought of as distinct spheres of activity.

This broader, more socially conscious attitude toward investment is creating bottom-up pressure for investment funds to demonstrate how they advance socially important goals. That bottom-up pressure has now reached the upper-echelons of the market and is reshaping how these massively powerful institutional investors engage in activism. The reason why this bottom-up pressure has reached the upper echelons of the market is straightforward. The millennial generation will wield massive wealth and the race to manage that wealth has already begun.

The massive prize of managing millennial wealth has triggered a new high-stakes race among funds and has created strong competitive pressures to offer investment products that have high social value.

Michal Barzuza, Quinn Curtis & David H. Webber, Shareholder Value(s): Index Fund ESG Activism and the New Millenial Corporate Governance, 83 S. Cal. L. Rev. 1243, 1284-85 (2020).

Reflecting investor concerns, on March 21, 2022, the Securities and Exchange Commission (SEC) formally launched one of the most significant initiatives in its nearly 90-year history: proposals for public disclosure of climate-related risks. (SEC, The Enhancement and Standardization of Climate-Related Disclosures for Investors, Rel. No. 33-11042 (Mar. 21, 2022).)
Few firms, public or private, and certainly no investor, will be untouched by the forces unleashed by climate change. Thus, the historical significance of this SEC initiative is justified by the sheer enormity of climate-related risks and the diversity of forces underlying those risks.

Finalization of the new rules has been delayed, with the SEC now estimating they will be adopted by October 2023 (although, with 55 total rules in their final or proposed stages, it is unclear whether the SEC will meet that target). The delay reflects controversy around the new requirements, with the SEC receiving about 5,000 unique comment letters on the proposals. More importantly, the SEC will likely need to change some aspects of the new rules that may be too burdensome to comply, such as the currently proposed 1 percent materiality threshold for financial disclosure and disclosures of Scope 3 greenhouse gas emissions data.

**Disclosure Requirements**

The SEC proposals set forth numerous disclosure requirements that capture not just the uncertainty of how climate change might affect the firm, but also shine a light on management’s strategies to cope with potential problems a business may face. The new disclosures will appear in SEC registration statements and annual reports.

Among the items required to be disclosed:

- The board’s oversight and governance structure surrounding climate-related risks;
- The material impact(s) any climate-related risks have had or likely will have on the registrant’s business and financial statements in the short-, medium-, and long-term;
- The registrant’s climate-related targets or goals and any transition plan necessary to achieve them;
- The effect or likely effect of identified climate risks on the registrant’s strategy, business model, and outlook;
- The registrant’s process for identifying, assessing, and managing climate-related risks and whether this process is integrated into its risk management system; and
- The impact of climate-related events and transition activities on financial statement items as well as financial estimates (and related assumptions) that are affected by such climate-related events and transition activities.

1 The SEC also introduced proposed amendments to the “names rule” under the Investment Company Act of 1940, that prohibits registered investment companies from adopting names the Commission finds “materially deceptive or misleading,” with specific aspects focused on investment companies with titles that have an environmental, social, and governance (“ESG”) theme; and proposed amendments for investment advisers and investment companies to disclose additional information regarding their ESG-related investment practices.
Public companies will also be required to disclose their Scope 1 and Scope 2 greenhouse gas (GHG) emissions. Scope 1 covers direct GHG emissions from owned or controlled sources, and Scope 2 covers indirect GHG emissions from the generation of purchased electricity, steam, heating, and cooling consumed by the reporting company. Larger issuers, in addition, will be required to make disclosures relating to their Scope 3 emissions, which are indirect GHG emissions that occur in a company’s value chain.

**Do the Proposed Rules Exceed the SEC’s Mandate?**

If the new rules are adopted, challenges will include the claim that the proposals exceed the SEC’s legislative authority and question whether there is sufficient evidence that the recommendations not only are “necessary or appropriate in the public interest” but also “will promote efficiency, competition, and capital formation,” as articulated in the statement of the SEC’s mission. See, e.g., Securities Act of 1933 § 2(b).

In anticipation, the SEC’s proposing release makes the case that disclosures of climate risk are well within the criteria the SEC draws upon when deciding mandatory disclosure requirements—namely, that the information enables investors to assess a firm’s financial position, its operational performance, and management’s stewardship, provided in a manner that facilitates comparisons among registrants. The release recognizes that climate risk is a broad concern among investors, who are eager to learn how companies might be or are being affected and how their management assesses those risks and plans to address them. This is very much within the SEC’s lane.

Nevertheless, whether the new rules are within the SEC’s authority remains an open question following *West Virginia v. EPA*, 597 U.S. ___, 2022 WL 2347278, 2022 U.S. LEXIS 3268 (2022). There, the Supreme Court held that the Environmental Protection Agency (EPA) lacks authority under the Clean Air Act to impose emissions gaps by shifting electricity production from higher-emitting to lower-emitting producers. That so-called “generation shifting” approach, the Court said, represents a “major question” of extraordinary economic and political significance. The Court further explained — for the first time—that an administrative agency has no power to make decisions on such “major questions” unless Congress “clearly” gave it such authority. Finding no such clear statement in the relevant section of the Clean Air Act, the Court held that the EPA’s carbon dioxide emissions efforts strayed too far.

No doubt, once finalized, the SEC’s new climate rules will be challenged through litigation by interest groups resisting the new requirements. The U.S. Chamber of Commerce—while not officially saying it will sue—has been privately threatening a lawsuit.

The most novel of the mandated disclosures may be those for annual reporting of GHG emissions. The proposal provides that Scope 1 and Scope 2 disclosures will be required of all issuers. More challenging will be Scope 3 disclosures, as it requires disclosure related to GHGs produced by another entity outside the registrant’s operational boundary. Of particular concern is that an issuer has a duty to disclose Scope 3 emissions if they are material. Thus, registrants will need to monitor their Scope 3 emissions to comply with the new disclosure requirements if their Scope 3 emissions rise to a material level. This part of
the proposed disclosures raises an important question: Is it appropriate to mandate disclosure of information about operations that are beyond the registrant’s governance boundaries? There is no doctrine in the securities laws, or with respect to materiality, that renders that kind of disclosure beyond the scope of the SEC’s mandate. A focus on disclosing risk and enabling comparisons among investment opportunities should put a thumb on the scale in favor of the new Scope 3 requirements.

**Corporate Governance Impact**

As noted earlier, although the proposed rules do not mandate specific climate governance practices, they do require disclosures regarding the board’s oversight and governance structure around climate-related risks. Those disclosures include:

- which directors have expertise in managing climate-related risks;
- which board committees have responsibility for climate oversight;
- the processes by which the board or board committees discuss climate risk and the frequency of those discussions;
- how the board or board committees integrate climate risk into the company’s business strategy, risk management, and financial oversight; and
- how the board sets and oversees climate goals.

No doubt, the presence (or absence) of these practices will influence investor expectations and, in turn, influence how public companies manage their climate-related risks. The proposed rules may galvanize shareholder voting and activism, in particular as the new disclosures cause institutional shareholders and proxy advisory firms to focus more closely on board and management oversight. From that perspective, one might ask, to what extent are the new requirements crafted simply to inform investors of a company’s climate-related risks, and to what extent are they likely to shape how those risks are governed and even the composition of the company’s board and officers?

Many large institutional investors are already focused on the climate risk of their portfolio companies, and to that extent, the new rules may not significantly affect how those investors interact with the companies they invest in. Nevertheless, the new disclosures are in most cases more significant than what companies voluntarily disclose today, particularly with respect to GHGs. Public companies are likely to consider the potential effect of the new disclosures on stakeholders, in addition to the greater attention on climate-related governance that is likely to arise. In response, a public company may form a board committee, or expand the responsibilities of an existing committee, to include responsibility for oversight of climate-related risks and related disclosures (if they have not done so already). In line with the proposal’s focus on climate-related expertise, the committee is likely to include one or more “climate risk experts,” either at the board’s prompting or in response to stakeholder demands. In addition, the new reporting requirements will require public companies to implement comprehensive procedures to manage the new disclosures. Those controls and procedures will include a management team (potentially
under the oversight of a new C-suite manager) to oversee data collection and disclosure processes, new reporting systems, and checks-and-balances to verify data. And so, while the SEC’s expressed focus is on enhancing climate-related risk disclosure, the proposed rules are also likely to affect how climate-related risks are managed if they are adopted.
Proposed Regulation of SPACs and de-SPACs

Background

A SPAC (“special purpose acquisition company”) is a publicly-traded investment vehicle whose principal purpose is to merge with a private company and thereby bring the private company into the public capital markets. Doing so involves two separate transactions: the SPAC first goes public through its own IPO, where its shares trade on an exchange (e.g. NYSE or NASDAQ), and then some time afterwards the SPAC merges with a private company (known as a “de-SPAC” transaction). The de-SPAC brings the private company public and is typically combined with an additional capital raise.

SPACs have existed since the early 1990s, but they recently became a significant choice for issuers to go public due to certain perceived advantages over a traditional IPO, including pricing certainty and streamlined disclosure requirements. An earlier generation of SPACs in the 1990s was often comprised of smaller-sized deals relative to more recent SPACs. In the 2000s, there were year-over-year increases in the amount of equity raised by SPACs, and by 2007, SPAC IPOs accounted for nearly 22% of all IPOs in the United States. SPACs then took off, with the number and size of SPAC IPOs increasing, from 34 IPOs and $10.05 billion in 2017 to 613 IPOs and $162.51 billion in 2021. Beginning in 2022, the number of SPAC IPOs declined to 86 IPOs and $13.43 billion.

As SPACs gained in prominence, certain concerns were raised over the level of shareholder protections in a SPAC as compared to traditional IPOs. Those concerns prompted the regulatory proposals described below.

The creation of a SPAC begins with a sponsor (typically a limited liability company organized for that purpose) forming a corporation and working with an underwriter to take the SPAC public in an IPO. The SPAC has no operations nor, at this early stage, has it identified a target company with which to do a de-SPAC. Nominally, the SPAC is managed by its own directors and officers (some of which are the SPAC’s founders), and their compensation typically aligns their interests with those of the sponsor (which, in effect, is the manager of the SPAC).

Prior to the SPAC IPO, the sponsor acquires a block of SPAC shares at a nominal price that is adjusted to amount to 25% of IPO proceeds or, equivalently, 20% of post-IPO equity. This block of SPAC shares, known as the sponsor’s “promote,” is the sponsor’s compensation for setting up the SPAC and supporting the SPAC’s management while the SPAC seeks a private company to take public. In some SPACs, the sponsor’s interest increases automatically if additional equity is invested at the time of the SPAC’s later merger. In addition, concurrently with the IPO, the sponsor purchases SPAC shares and/or warrants at prices the sponsor estimates to be their fair market value. The SPAC uses the proceeds of the sponsor’s investment to cover the cost of the IPO and its operating expenses while searching for a de-SPAC target, and in some SPACs some of the proceeds are used to subsidize a return to the SPAC IPO investors. The fact that a substantial portion of the SPAC’s shares and/or warrants are held by the sponsor (either as the promote or through later purchase) can cause significant dilution to other shareholders as part of the later de-SPAC transaction.

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The SPAC raises capital in its IPO largely based on the reputation of the sponsor. The amount raised is typically one-fifth to one-third of the enterprise value of the prospective future target. In the IPO, the SPAC sells units consisting of a share, a warrant, and in some cases, a right to acquire a fraction of a share at no cost when the merger closes.

The proceeds of the SPAC IPO are placed in trust and invested in Treasuries. Under the SPAC’s charter and the terms of the trust, cash in the trust can be used only to (i) acquire a company, (ii) contribute to the capital of the company formed in the de-SPAC, (iii) distribute to shareholders in liquidation if the SPAC fails to consummate a de-SPAC, or (iv) redeem shares (as described below). The SPAC’s charter typically gives the SPAC 18-24 months to identify a target and complete a de-SPAC. If the SPAC does not merge within the relevant period (or if its shareholders have not voted to extend its life), the SPAC must liquidate and distribute funds in the trust to its public shareholders.

In the event of a liquidation, the sponsor loses its investment – meaning it has a strong incentive to ensure that a de-SPAC occurs. The warrants also have no value if a de-SPAC fails to occur. This provides the sponsor with a significant incentive to ensure that a de-SPAC transaction occurs.

A de-SPAC typically takes six months or more to complete, including raising PIPE capital (as described below). It requires SPAC board approval followed by public SPAC shareholder approval (which may occur as quickly as ten days following mailing the proxy statement). The public issuance of SPAC shares (e.g., in exchange for shares held by the de-SPAC target’s shareholders) must also be registered with the SEC, typically for U.S. domestic issuers on a Form S-4 registration statement.

A key feature of a SPAC is that, when the SPAC proposes to do a de-SPAC merger, the SPAC’s shareholders have the right to redeem their shares at a price equal to the IPO price of the SPAC’s units plus interest accumulated in the SPAC’s trust. The warrants and rights included in the units, however, remain outstanding and trade separately. Thus, investors in a SPAC IPO can redeem their shares and keep their warrants and rights at no cost. In effect, the warrants and rights serve as compensation for investors in the SPAC IPO for allowing their cash to be used to set up the SPAC as a public company.

In addition, SPAC and target management actively market the proposed de-SPAC to potential investors, going on what are referred to as “SPAC roadshows.” The roadshow has two objectives. One is to attract interest in the public market. A SPAC’s initial investors generally exit by selling or redeeming their shares. Much of the cash lost to redemptions can be replenished in PIPE investments by third parties or sponsors, but for most SPACs the replacement is partial. The sponsor prefers that IPO investors sell (rather than redeem) their shares and thereby leave cash in the SPAC to be invested as part of the de-SPAC. Consequently, the sponsor devotes considerable effort to developing interest among potential secondary buyers of the SPAC’s outstanding shares. In some cases, a sponsor may make side agreements with investors who commit not to redeem their shares.

The second objective of the SPAC roadshow (or, in some cases, a separate roadshow) is to attract new private investment into the proposed de-SPAC, in the form of private investments in public equity, or “PIPEs,” that are made concurrently with the de-SPAC. In
some cases, a SPAC lines up PIPE investors at the time of its IPO with forward purchase agreements. Even if it has these commitments, however, the SPAC often seeks additional PIPE investments. Thus, not only is the de-SPAC the transaction by which the target goes public, it is also the transaction in which a significant amount of equity is raised for the post-merger company.

In most cases, following a de-SPAC merger, individuals designated by the SPAC’s sponsor take a position within the combined company, most commonly a board seat. In approximately one quarter of those combined companies, a designee of the sponsor becomes the board chair and, less frequently, the CEO or other officer. Of course, directors may in the future be removed by the new company’s shareholders, and officers may be removed by the board.

**Proposed Rule Changes**

Concerns regarding potential abuses in SPAC and de-SPAC transactions prompted the SEC on March 30, 2022, to propose new rules that would impose additional disclosure requirements on SPAC IPOs and de-SPACs. The new rules have not been adopted, with finalization scheduled to occur by October 2023 (although, with 55 total rules in their final or proposed stages, it is unclear whether the SEC will meet that target).

The proposed rules include:

- New disclosure requirements in SPAC IPOs and de-SPAC transactions regarding the sponsor of the SPAC, potential conflicts of interest, and dilution of shareholder interests.

  ✓ Disclosures include information on the nature and amounts of all compensation that has or will be awarded to, earned by or paid to the sponsor, its affiliates, and any promoters for all services rendered in all capacities to the SPAC and its affiliates, as well as the nature and amounts of any reimbursements to be paid to the sponsor, its affiliates, and any promoters upon completion of a de-SPAC transaction.

  ✓ Disclosure of any actual or potential material conflicts of interest between (1) the sponsor or its affiliates or the SPAC’s directors, officers, or promoters and (2) unaffiliated security holders. They could include the contingent nature of sponsor compensation that may induce the sponsor and its affiliates to pursue a de-SPAC transaction that may not necessarily benefit the shareholders, the time pressure the sponsor is under to enter into a de-SPAC transaction, whether the sponsor is involved in multiple SPACs, and when a sponsor and/or its affiliates hold financial interests or have contractual obligations to other entities, including entities with which the SPAC is exploring entering into a de-SPAC transaction.

- Disclosure and procedural requirements in de-SPAC transactions, including disclosure of the background, material terms, and effects of the de-SPAC transaction and a fairness determination by the SPAC as to the de-SPAC transaction and any related financing transactions. The SPAC must also disclose the reasons for engaging in a particular de-SPAC transaction and whether it reasonably believes it and any
related financing transactions are fair or unfair to unaffiliated security holders. In addition, the SPAC must disclose whether or not it or its sponsor received any report, opinion, or appraisal from an outside party relating to the consideration or fairness of the consideration to be offered to security holders or the fairness of the de-SPAC transaction or any related financing transaction to the SPAC, the sponsor, or unaffiliated security holders.

- Requiring the SPAC and target company in a de-SPAC transaction be treated as co-registrants on the Form S-4 registration statement filed by the SPAC as part of the de-SPAC transaction. Doing so will extend Securities Act § 11 liability for any material misstatements or omissions in the Form S-4 registration statement at the time of effectiveness to the target company’s directors and principal officers (subject to any due diligence defense they may assert), incentivizing them to more carefully review the target company disclosures in the registration statement.

- The Private Securities Litigation Reform Act of 1995 (PSLRA) provides a safe harbor for forward-looking statements under the Securities Act and Exchange Act, protecting an issuer from liability for forward-looking statements in any private right of action under the Securities Act or Exchange Act when, among other things, the forward-looking statement is identified as such and accompanied by meaningful cautionary statements. The safe harbor is not available for forward-looking statements made in connection with IPOs or offerings by blank check companies. The proposed rules would also make the PSLRA safe harbor unavailable to SPACs.

- The time between a SPAC IPO and de-SPAC transaction can be considerable. However, to the extent a de-SPAC transaction is a way to bring a private target company to the public capital markets, the SEC believes investors would benefit from the same rigor and diligence an underwriter would exercise as part of a traditional IPO. Accordingly, under the new rules, a person who acted as an underwriter in a SPAC IPO, and later participates in the distribution of securities as part of the de-SPAC transaction, or any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction, will be deemed to be engaged in the distribution of securities of the surviving public entity in the de-SPAC transaction, i.e., that person will be an underwriter within the meaning of Section 2(a)(11) of the Securities Act. While not exhaustive, the SEC observed that acting as a financial advisor to the SPAC, assisting in identifying potential de-SPAC target companies, negotiating merger terms, finding and negotiating PIPE or other financing, or receiving compensation in connection with a de-SPAC transaction could all constitute underwriter participation in the transaction.

- Aligning more closely the financial statement requirements in a de-SPAC transaction with those in a traditional IPO. In addition, the SEC proposed enhanced disclosure requirements for financial projections used in a de-SPAC transaction, reflecting the SEC’s view that the SPAC and de-SPAC structures present increased risks, including conflicts of interest by the SPAC sponsor.
Embattled ALJs?

A plurality of the Supreme Court arguably has been pursuing a two-front war against the Administrative State:

First, this faction has significantly curbed (or seems about to curb) the enforcement powers of administrative agencies, including the SEC. Initially, it did this by finding that administrative law judges ("ALJs") must be appointed by someone under Presidential control, see Lucia v. SEC, 138 S. Ct. 2044 (2018). More recently, it granted certiorari on a Fifth Circuit decision, Cochran v. SEC, 20 F.4th 194 (5th Cir. 2021) (en banc), on the issue of whether ALJs must also be subject to a corresponding Presidential removal power.

Second, in granting certiorari in Axon Enterprise, Inc. v. Federal Trade Commission, 986 F.3d 1173 (9th Cir. 2021), the Court seems intent on overruling a longstanding "implied preclusion" doctrine under which defendants in an administrative proceeding cannot challenge the constitutionality of (or other defects in) the agency’s action in federal court, but instead must wait until the issue is resolved on the merits before bringing such a challenge. A recent Fifth Circuit decision, Jarkesy v. SEC, 34 F. 4th 446 (5th Cir. 2022), raised the same issue with respect to the SEC’s ALJ proceedings.

On November 7, 2022, the Supreme Court heard oral arguments in Cochran and Axon Enterprise; the Court has not yet issued its decision. And the Supreme Court granted certiorari in Jarkesy on June 30, 2023.

Cochran v. SEC

Section 25(a)(1) of the Exchange Act (15 USC §78y(a)(1)) provides, in part, that “[a] person aggrieved by a final [SEC] order . . . may obtain review of the order in the United States Court of Appeals” (emphasis added). Until recently, every Circuit that reviewed this provision concluded that Section 25 implicitly strips jurisdiction over pre-final challenges to SEC enforcement proceedings. In Cochran v. SEC, 20 F.4th 194 (5th Cir. 2021) (en banc), the Fifth Circuit reached the opposite conclusion. A Fifth Circuit panel initially affirmed. On rehearing en banc, however, the Fifth Circuit, relying on Free Enterprise Fund v. Public Company Accounting Oversight Board, 561 U.S. 477 (2010) (invalidating certain limits on the President’s removal power over executive branch officials), concluded that an administrative proceeding is, on its own, an injury sufficient to justify pre-final review. Accordingly, the Fifth Circuit reasoned, federal district courts have jurisdiction to consider claims challenging the constitutionality of an SEC administrative proceeding even before a final judgment is entered – conflicting with prior decisions where courts denied that the burden of legal proceedings constituted an injury sufficient to justify pre-final review. On May 16, 2022, the U.S. Supreme Court granted certiorari in Cochran. Axon Enterprise, Inc. v. Federal Trade Commission, 986 F.3d 1173 (9th Cir. 2021), presents essentially the same question in the context of the Federal Trade Commission.

Cochran began with an SEC administrative action against a CPA, Michelle Cochran, for failing to comply with Public Company Accounting Oversight Board auditing standards. The SEC ALJ fined Cochran and banned her from practicing before the SEC for five years. Cochran objected to the SEC’s adoption of the ALJ’s decision.
Before the SEC ruled on Cochran’s objection, the Supreme Court issued its decision in Lucia v. SEC, 138 S. Ct. 2044 (2018), which held that SEC ALJs are officers of the United States under the Appointments Clause, requiring that they be appointed only by the President, “Courts of Law,” or “Heads of Departments.” In response to Lucia, the SEC remanded all pending administrative proceedings, including Cochran’s, for new hearings before constitutionally appointed ALJs.

Cochran sued in federal district court to enjoin the SEC’s administrative enforcement proceedings, arguing the converse of Lucia – that SEC ALJs enjoy multiple layers of “for-cause” removal protection and, therefore, they are unconstitutionally insulated from the President’s Article II removal power. The district court dismissed the claim for lack of subject matter jurisdiction, with which the Fifth Circuit disagreed. The Fifth Circuit observed that Cochran’s removal-power claim fell outside of Exchange Act § 25, reasoning that the statute provides that only “person[s] aggrieved by a final order of the Commission” may petition the court of appeals to review that final order. The statute does not address people, like Cochran, who have not yet received a final order, nor does it say anything about people, again like Cochran, who have claims that have nothing to do with a final order the Commission might one day issue. Rather, Cochran’s removal-power claim challenged the constitutionality of the tribunal, not the legality or illegality of its final order, and since her injury had nothing to do with a final order, her claim fell outside of Section 25.

Jarkesy v. SEC

Cochran addressed a federal district court’s jurisdiction to hear pre-final claims regarding the constitutionality of the SEC’s ALJ process. In Jarkesy v. SEC, 34 F. 4th 446 (5th Cir. 2022), issued just two days after the Supreme Court granted certiorari in Cochran, the Fifth Circuit went a step further, finding that the SEC’s ALJ process is constitutionally deficient in three ways. The Supreme Court granted certiorari on June 30, 2023.

Section 929P(a) of the Dodd-Frank Act empowers the SEC to bring securities fraud actions for monetary penalties either in its own administrative forum, presided over by an ALJ and without a jury, or in a traditional federal court established under Article III of the Constitution. In 2013, the SEC brought an enforcement action in an administrative proceeding against George Jarkesy, Jr. and Patriot, an investment adviser, alleging various violations of the federal securities laws. Jarkesy managed two hedge funds that attracted over 100 investors and held about $24 million in assets. The D.C. Circuit rejected the defendants’ efforts to enjoin the SEC proceedings, citing a lack of jurisdiction. An SEC ALJ then concluded that the defendants had committed securities fraud, and the defendants appealed to the Fifth Circuit.

On May 18, 2022, the Fifth Circuit (in a 2-to-1 decision) vacated the SEC decision as unconstitutional on three independent grounds:

(1) The Fifth Circuit concluded that bringing the enforcement action in the SEC’s administrative forum violated Jarkesy’s Seventh Amendment right to a jury trial. Although Congress can authorize an administrative agency to adjudicate a claim where the government is suing to enforce a statutory “public right,” the Fifth Circuit held that Jarkesy’s
Seventh Amendment jury trial right was violated because the SEC’s claims did not concern public rights alone. Rather, the Fifth Circuit reasoned, actions for monetary penalties under the federal securities laws are sufficiently similar to common law fraud actions and sufficiently involve private rights that the targets of such actions are entitled to a jury trial.

(2) The Fifth Circuit also found that authorizing the SEC either to bring an enforcement action before an ALJ or in an Article III court, without providing the SEC guidance on how to make that election, was an unconstitutional delegation of Congress’s “essential legislative functions.” Congress can only delegate regulatory power to an agency if it provides an “intelligible principle” or guidance that allows the agency to only exercise executive power when using that authority. The court reasoned that the “mode of determining” which cases are assigned to administrative tribunals is within the control of Congress, not the executive branch, and giving the SEC exclusive authority and discretion to decide where to bring an enforcement action was an unconstitutional delegation of legislative power.

(3) Finally, echoing Cochran, the Fifth Circuit concluded that ALJs who preside over the SEC’s administrative proceedings are unconstitutionally insulated from Presidential oversight in violation of Article II of the Constitution. To fulfill that obligation, the President must have sufficient control over those performing substantial executive functions. Since ALJs can only be removed for cause by the joint action of the SEC’s Commissioners and members of the Merit Systems Protection Board (“MSPB”), and SEC Commissioners and MSPB members can only be removed by the President for cause, the Fifth Circuit held that restricting the removal of SEC ALJs through two layers of “for-cause” protection is unconstitutional.

* * *

What does this mean for the SEC’s administrative enforcement powers? The scope of the SEC’s ability to bring internal administrative actions will continue to be a topic of scrutiny over the Supreme Court’s 2023-2024 term. Given that certiorari was granted in all three cases (Cochran, Axon Entreprise, and Jarkesy), it appears that at least four Justices are sympathetic to claims of administrative overreaching or at least expect to see the parameters of the SEC’s administrative enforcement powers spelled out.
Primary Direct Listings and Securities Act § 11 Tracing

On December 22, 2020, the SEC approved a New York Stock Exchange rule change that allows companies going public to raise capital through a primary direct listing (which may also include sales by selling shareholders) (referred to as a “Primary Direct Floor Listing”). The rule had been approved by the SEC in August 2020, but the approval order was stayed in September 2020 after the Council of Institutional Investors filed a petition for review. After a de novo review of the proposed rule, the SEC found that the NYSE had met its burden to show that the proposed rule change is consistent with the Exchange Act. On May 19, 2021, after a number of back-and-forth proposals, the SEC also approved a rule for direct listing and raising capital on the Nasdaq Global Select Market (referred to as a “Direct Listing with a Capital Raise”).

Essentially, a “direct listing” involves a registered public offering of securities directly into the public market with no underwriters, no underwriting commissions (but, perhaps, advisory fees paid to financial advisors), and no road show or similar marketing expenses. Rather than sales through the underwriters to initial investors, the initial sales in a primary direct listing are conducted through the exchange. The company sells newly-issued primary shares directly into the opening trade, with the IPO price determined by the opening trade auction, not by agreement between the company and underwriters (as is the case in a traditional firm commitment underwriting).

Prior to the approvals, only secondary sales were permitted in a direct listing. For some companies, secondary direct listings were sufficient since those issuers were able to access capital through the private markets. Secondary direct listings were valuable in promoting shareholder liquidity and enabling firms to create the publicly-traded “currency” that companies can use in acquisitions and similar transactions. Nevertheless, for many companies, limiting direct listings to secondary sales made it difficult to raise capital in the less-costly public equity market or only possible if they were willing to pay the underwriters a hefty commission equal to 7% of the offering amount. Moreover, in traditional firm commitment underwritings, not all potential investors are allocated shares, and so they must look to buy stock in the secondary market. A direct listing could permit some of those investors to purchase securities as part of their primary sale. Finally, under the new rules, the IPO price is determined by the opening trade auction, rather than through agreement between the issuer and underwriters, which provides an alternative way to price securities offerings that may better reflect aftermarket prices.

Some investor groups warned that a primary direct listing could diminish investor protections, since traditional underwriters could no longer conduct a due diligence review of the issuer’s registration statement. The SEC acknowledged the concerns, particularly the potential for the absence of traditional due diligence and traditional underwriter liability.

Concerns were also raised about the ability to assert claims under Securities Act § 11 in light of problems shareholders may face in “tracing” their purchased shares to a registration statement that allegedly includes a material misstatement or omission. On June 1, 2023, in Slack Technologies v. Pirani, 2023 WL 3742580, the Supreme Court addressed this question, solidifying the tracing requirement for private plaintiffs seeking to assert a Section 11 claim, holding that the plaintiffs must show they own stock that was issued pursuant to an allegedly
misleading registration statement even if such tracing is practically impossible in the context of a direct listing. In effect, due to the difficulty of tracing shares, the decision blocks future Section 11 claims involving direct listings pursuant to which unregistered and registered shares are listed at the same time.

The litigation arose from the 2019 direct listing of Slack Technologies (“Slack”) on the NYSE. Slack listed 118 million new shares pursuant to a registration statement and 165 million shares that were previously issued without a registration statement. In contrast to a traditional IPO, in which company shares (whether newly issued or resold on behalf of existing stockholders) are underwritten by one or more banks and then resold to a “book” of investors, a direct listing facilitates the direct sale into the market of any and all shares held by preexisting shareholders (whether or not specifically identified in the registration statement relating to the direct listing). As a result, there was no way for purchasers in the Slack direct listing to determine whether they bought shares subject to the registration statement for the direct listing or shares otherwise available in the market for sale.

Fiyyaz Pirani bought 250,000 Slack shares following its direct listing, and later sued Slack under Securities Act §§ 11 and 12 for alleged misstatements and omissions in the registration statement. Slack moved to dismiss Pirani’s lawsuit on the basis that Pirani failed to show he acquired shares registered pursuant to Slack’s registration statement, i.e., the shares he purchased could have been among the 165 million shares issued before Slack’s registration statement became effective. The district court held that, because all of Pirani’s shares were “of the same nature” as the shares issued pursuant to the registration statement, Pirani had standing under Section 11 (without regard to whether the shares he held could be traced to the registration statement). A split Ninth Circuit upheld the lower court’s decision, finding that Slack’s interpretation of Section 11 would “create a loophole large enough to undermine the purpose of [the statute]” and, therefore, a rigid tracing requirement was not required in direct listings.

In a unanimous decision, on June 1, 2023, the Supreme Court vacated and remanded the Ninth Circuit’s ruling, finding that Section 11’s language required shares be traced to the allegedly false registration statement. In reaching its decision, the Supreme Court honed in on the key textual question:

Does the term ‘such security’ [found in § 11(a) of the Securities Act] refer to a security issued pursuant to the allegedly misleading registration statement? Or can the term also sometimes encompass a security that was not issued pursuant to the allegedly misleading registration statement?

The Supreme Court, focusing on the language in Section 11 and throughout the Securities Act, reasoned that the use of the definite article in Section 11(a), the repeated use of the word “such’ to narrow the law’s focus[,]” the structure of the statute, and Section 11’s damages cap, which ties recovery to “the value of the registered shares alone,” demonstrated that Slack’s view that “such security” must be traced to a registration requirement was “the better” reading. The Court concluded that the better reading of Section 11 requires a plaintiff to plead and prove that he purchased shares traceable to the allegedly defective registration statement, and remanded for the Ninth Circuit to consider that question in the first instance.
The Supreme Court expressly took no position on whether its ruling applies equally to Section 12(a)(2), instructing the lower court only to “vacate its judgment with respect to Mr. Pirani’s [Section] 12 claim . . . for reconsideration in [] light of our holding today about the meaning of [Section] 11.” At oral argument, questions from some Justices suggested they were not convinced that—or at a minimum were open to questioning whether—the standing requirements of the two provisions are co-extensive, with some Justices suggesting that the scope of Section 12(a)(2) may be broader because it may apply outside the context of a registration statement. Accordingly, the Court stated, “[W]e express no views about the proper interpretation of §12 or its application to this case. Nor do we endorse the Ninth Circuit’s apparent belief that §11 and §12 necessarily travel together, but instead caution that the two provisions contain distinct language that warrants careful consideration.” Note also that Exchange Act § 10(b) may be applicable to misrepresentations made in direct listings without a tracing requirement.
Howey, Crypto-assets, and the S.D.N.Y.

In the midst of ongoing Congressional proposals for the new regulation of crypto-assets, two recent Southern District of New York cases, decided within 10 days of each other, applied Howey to the question of whether crypto-coins are “securities” with opposite results that turned on the question, arising under Howey, of whether investors made their purchases with an expectation of profit based on the efforts of others.

In SEC v. Ripple Labs Inc., 2023 U.S. Dist. LEXIS 120486 (S.D.N.Y. July 13, 2023), Judge Analisa Torres ruled that the XRP token linked to Ripple was a security when sold directly to institutions but not when offered to the public on exchanges. Judge Torres’s reasoning was as follows (footnotes and citations omitted):

1. Institutional Sales

* * *

The third prong of Howey examines whether the economic reality surrounding Ripple’s Institutional Sales led the Institutional Buyers to have “a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.” In this context, profit means an “income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.” The reasonable expectation of profits from the efforts of others need not be the sole reason a purchaser buys an investment; an asset may be sold for both consumptive and speculative uses. Moreover, “[t]he inquiry is an objective one focusing on the promises and offers made to investors; it is not a search for the precise motivation of each individual participant.”

Based on the totality of circumstances, the Court finds that reasonable investors, situated in the position of the Institutional Buyers, would have purchased XRP with the expectation that they would derive profits from Ripple’s efforts. From Ripple’s communications, marketing campaign, and the nature of the Institutional Sales, reasonable investors would understand that Ripple would use the capital received from its Institutional Sales to improve the market for XRP and develop uses for the XRP Ledger, thereby increasing the value of XRP.

Starting in 2013, Ripple marketed XRP to potential investors, including the Institutional Buyers, by distributing promotional brochures that touted XRP as an investment tied to the company’s success. For instance, in the “Deep Dive” brochure, which was circulated to prospective investors, Ripple explains that its “business model is predicated on a belief that demand for XRP will increase . . . if the Ripple protocol becomes widely adopted,” and “[i]f the Ripple protocol becomes the backbone of global value transfer, Ripple . . . expects the demand for XRP to be considerable.” Similarly, the “Ripple Primer” states that Ripple “hopes to make money from XRP if the world finds the Ripple network useful.” The “Gateways” brochure also explains that “Ripple’s business model is based on the success of [XRP],” and
includes a graphical representation of bitcoin’s price change below the text: “Can a virtual currency really create and hold value? Bitcoin proves it can.”

Later, through its XRP Market Reports, Ripple continued to connect XRP’s price and trading to its own efforts. Ripple’s Q1 2017 XRP Markets Report states that the company’s efforts—including its “vocal . . . commitment to XRP,” the announcement of a new business relationship, and “continu[ing] to sign up banks to commercially deploy its enterprise blockchain solution and join its global payments network”—may have had an impact on XRP’s price increase and “impressive” trading volume. The Q2 2017 XRP Markets Report highlights XRP’s “dramatic” and “stunning” price increase and notes that “[t]he market responded favorably to [Ripple’s] escrow and decentralization announcements.” Similarly, Ripple’s Q1 2020 XRP Markets Report states that XRP’s liquidity was “bolstered through new use cases for XRP outside of cross-border payments.”

During this time, Ripple’s senior leaders echoed similar statements on various public channels. In a February 2014 interview, Larsen said, “for Ripple . . . to do well, we have to do a very good job in protecting the value of XRP and the value of the network,” and asked potential investors to “[g]ive [Ripple] time” to “add[] the most value to the protocol.” In July 2017, David Schwartz, who was then chief cryptographer at Ripple, wrote on Reddit that “Ripple’s interest[s] closely (but, yes, not perfectly) align with those of other XRP holders.” In February 2018, Schwartz posted on Reddit that what “really set[s] XRP apart from any other digital asset” is the “amazing team of dedicated professionals that Ripple has managed to amass to develop an ecosystem around XRP.” In a December 2017 interview, Garlinghouse stated that XRP gave Ripple “a huge strategic asset to go invest in and accelerate the vision [it] see[s] for an internet of value.” And, in March 2018, Garlinghouse said at a press conference that “Ripple is very, very interested in the success and the health of the ecosystem and will continue to invest in the ecosystem.”

Ripple and its senior leaders publicly emphasized the complexity of creating an “internet of value” and the need for extensive capital to solve this “trillion dollar” problem. For instance, in October 2017, Garlinghouse declared in a YouTube video: “I have no qualms saying definitively if we continue to drive the success we’re driving, we’re going to drive a massive amount of demand for XRP because we’re solving a multitrillion dollar problem.” In July 2017, Schwartz wrote on Reddit that, “Ripple can justify spending $100 million on a project if it could reasonably be expected to increase the price of XRP by one penny over the long term.” In November 2017, Schwartz posted on XRP Chat that Ripple would use its “war chest” to put upward pressure on XRP’s price.

These statements, and many more, are representative of Ripple’s overall messaging to the Institutional Buyers about the investment potential of XRP and its relationship to Defendants’ efforts. Clearly, the Institutional Buyers would have understood that Ripple was pitching a speculative value proposition for XRP with potential profits to be derived from Ripple’s entrepreneurial and managerial efforts.
Further, the nature of the Institutional Sales also supports the conclusion that Ripple sold XRP as an investment rather than for consumptive use. In their sales contracts, some Institutional Buyers agreed to lockup provisions or resale restrictions based on XRP’s trading volume. These restrictions are inconsistent with the notion that XRP was used as a currency or for some other consumptive use. “Simply put, a rational economic actor would not agree to freeze millions of dollars . . . if the purchaser’s intent was to obtain a substitute for fiat currency.” Certain Institutional Sales contracts required the Institutional Buyer to indemnify Ripple for claims arising out of the sale or distribution of XRP, and other contracts expressly stated that the Institutional Buyer was purchasing XRP “solely to resell or otherwise distribute . . . and not to use [XRP] as an [e]nd [u]ser or for any other purpose.” These various provisions in the Institutional Sales contracts support the conclusion that the parties did not view the XRP sale as a sale of a commodity or a currency—they understood the sale of XRP to be an investment in Ripple’s efforts.

Therefore, having considered the economic reality and totality of circumstances surrounding the Institutional Sales, the Court concludes that Ripple’s Institutional Sales of XRP constituted the unregistered offer and sale of investment contracts in violation of Section 5 of the Securities Act. 15

2. Programmatic Sales

The Court next addresses Ripple’s Programmatic Sales, which occurred under different circumstances from the Institutional Sales. The SEC alleges that in the Programmatic Sales to public buyers (“Programmatic Buyers”) on digital asset exchanges, “Ripple understood that people were speculating on XRP as an investment,” “explicitly targeted speculators[,] and made increased speculative volume a ‘target goal.’”

Having considered the economic reality of the Programmatic Sales, the Court concludes that the undisputed record does not establish the third Howey prong. Whereas the Institutional Buyers reasonably expected that Ripple would use the capital it received from its sales to improve the XRP ecosystem and thereby increase the price of XRP, Programmatic Buyers could not reasonably expect the same. Indeed, Ripple’s Programmatic Sales were blind bid/ask transactions, and Programmatic Buyers could not have known if their payments of money went to Ripple, or any other seller of XRP. Since 2017, Ripple’s Programmatic Sales represented less than 1% of the global XRP trading volume. Therefore, the vast majority of individuals who purchased XRP from digital asset exchanges did not invest their money in Ripple at all. An Institutional Buyer knowingly purchased XRP directly from Ripple pursuant to a contract, but the economic reality is that a Programmatic Buyer stood in the same shoes as a secondary market purchaser who did not know to whom or what it was paying its money.

Further, it is not enough for the SEC to argue that Ripple “explicitly targeted speculators” or that “Ripple understood that people were speculating on XRP as an investment,” because
a speculative motive “on the part of the purchaser or seller does not evidence the existence of an ‘investment contract’ within the meaning of the [Securities Act].” “[A]nyone who buys or sells[, for example,] a horse or an automobile hopes to realize a profitable ‘investment.’ But the expected return is not contingent upon the continuing efforts of another.” The relevant inquiry is whether this speculative motive “derived from the entrepreneurial or managerial efforts of others.” It may certainly be the case that many Programmatic Buyers purchased XRP with an expectation of profit, but they did not derive that expectation from Ripple’s efforts (as opposed to other factors, such as general cryptocurrency market trends)—particularly because none of the Programmatic Buyers were aware that they were buying XRP from Ripple.

Of course, some Programmatic Buyers may have purchased XRP with the expectation of profits to be derived from Ripple’s efforts. However, “[t]he inquiry is an objective one focusing on the promises and offers made to investors; it is not a search for the precise motivation of each individual participant.” Here, the record establishes that with respect to Programmatic Sales, Ripple did not make any promises or offers because Ripple did not know who was buying the XRP, and the purchasers did not know who was selling it. In fact, many Programmatic Buyers were entirely unaware of Ripple’s existence.

The Programmatic Sales also lacked other factors present in the economic reality of the Institutional Sales which cut in favor of finding “a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.” For instance, the Programmatic Sales were not made pursuant to contracts that contained lockup provisions, resale restrictions, indemnification clauses, or statements of purpose. Similarly, Ripple’s promotional materials, such as the “Ripple Primer” and the “Gateways” brochure, were widely circulated amongst potential investors like the Institutional Buyers. But, there is no evidence that these documents were distributed more broadly to the general public, such as XRP purchasers on digital asset exchanges. Nor is there evidence that Programmatic Buyers understood that statements made by Larsen, Schwartz, Garlinghouse, and others were representations of Ripple and its efforts.

Lastly, the Institutional Buyers were sophisticated entities, including institutional investors and hedge funds. An “examination of the entirety of the parties’ understandings and expectations,” including the “full set of contracts, expectations, and understandings centered on the sales and distribution of” XRP supports the conclusion that a reasonable investor, situated in the position of the Institutional Buyers, would have been aware of Ripple’s marketing campaign and public statements connecting XRP’s price to its own efforts. There is no evidence that a reasonable Programmatic Buyer, who was generally less sophisticated as an investor, shared similar “understandings and expectations” and could parse through the multiple documents and statements that the SEC highlights, which include statements (sometimes inconsistent) across many social media platforms and news sites from a variety of Ripple speakers (with different levels of authority) over an extended eight-year period.
Therefore, having considered the economic reality and totality of circumstances, the Court concludes that Ripple’s Programmatic Sales of XRP did not constitute the offer and sale of investment contracts.

Does the Howey requirement, that an investor must have an expectation of profit based on the efforts of others, turn on whether “Ripple [knew] who was buying the XRP, and [whether] the [retail] purchasers [knew] who was selling it”? Presumably, the answer is “no,” so long as there was a reasonable expectation of profit based on the efforts of others at the time of the investment. At this early motions stage, should the expectation-of-profit analysis turn on whether promotional materials “were distributed more broadly to the general public” than to institutional investors or that retail investors “understood that statements made by [Ripple founders] and others were representations of Ripple and its efforts”? Again, the answer presumably is “no,” so long as a reasonable person under the circumstances would expect profits from the investment to result from the efforts of others. Deciding that retail (rather than institutional) investors were not sophisticated enough to understand how Ripple would make money, and thereby denying them the protection of the securities laws, seemingly turns the disclosure requirements at the core of the securities laws on their head.

In SEC v. Terraform Labs Pte. Ltd., 2023 U.S. Dist. LEXIS 132046 (S.D.N.Y. July 31, 2023), Judge Jed Rakoff ruled that various crypto-assets issued by Terraform Labs were securities, directly rejecting Judge Torres’s analysis in Ripple Labs. Judge Rakoff’s reasoning was as follows (citations omitted):

Under Howey, the SEC must adequately also plead that the investors not only invested in a common enterprise providing the possibility of future profits, but also that they were led to believe that it was the efforts of the defendants or other third parties that could earn them a return on their investment. The qualification that the investors’ expectations be reasonable is an important one. The SEC need not prove that each and every investor was personally led to think that profits would follow from their investment in the defendants’ products. If an objective investor would have perceived the defendants’ statements and actions as promising the possibility of such returns, the SEC has satisfied Howey’s requirement.

Through the facts alleged in its Amended Complaint, the Court concludes that the SEC meets this requirement. Beginning with investors in UST coins, the complaint adequately alleges that the defendants – through social media posts, at investor conferences, in monthly investor reports, and at one-on-one meetings with investors – repeatedly touted the profitability of the Anchor Protocol and encouraged UST coin purchasers to unload their tokens into that investment vehicle. Those profits, the defendants allegedly stated, would come about through the defendants’ unique combination of investing and engineering experience.

Similarly, as to LUNA coin investors, the defendants allegedly coaxed investors to continue purchasing LUNA coins (and indirectly wLUNA coins) by pointing out the possibility of future investment returns. In particular, they said that profits from the continued sale of
LUNA coins would be fed back into further development of the Terraform ecosystem, which would, in turn, increase the value of the LUNA coins. And, as with the UST coins, the defendants premised their case for LUNA’s profitability on the defendants’ particular investment and technical acumen.

The scheme surrounding the MIR tokens was, according to the Amended Complaint, nearly identical to that involving LUNA, except that the defendants’ linked the MIR tokens’ worth to the growth and development of the Mirror Protocol, rather than to the Terraform blockchain network more generally. And much the same could be said of the mAssets (discussed further below).

In conclusion, the SEC’s claim that the defendants held out to the coins’ consumers the possibility of profiting from their purchases is supported by specific factual allegations in the Amended Complaint, including readouts of investor meetings, excerpts of investor materials, and screenshots of social media posts made by Mr. Kwon and other Terraform executives. Because these particularized allegations, if true, clearly “nudge the [SEC’s] claims across the line from conceivable to plausible,” the SEC’s assertion that the crypto-assets at issue here are securities under Howey survives the defendants’ motion to dismiss.

It may also be mentioned that the Court declines to draw a distinction between these coins based on their manner of sale, such that coins sold directly to institutional investors are considered securities and those sold through secondary market transactions to retail investors are not. In doing so, the Court rejects the approach recently adopted by another judge of this District in a similar case, SEC v. Ripple Labs Inc., 2023 WL 4507900 (S.D.N.Y. July 13, 2023). There, that court found that, “[w]hereas ... [i]nstitutional [b]uyers reasonably expected that [the defendant crypto-asset company] would use the capital it received from its sales to improve the [crypto-asset] ecosystem and thereby increase the price of [the crypto-asset],” those who purchased their coins through secondary transactions had no reasonable basis to expect the same. According to that court, this was because the re-sale purchasers could not have known if their payments went to the defendant, as opposed to the third-party entity who sold them the coin. Whatever expectation of profit they had could not, according to that court, be ascribed to defendants’ efforts.

But Howey makes no such distinction between purchasers. And it makes good sense that it did not. That a purchaser bought the coins directly from the defendants or, instead, in a secondary re-sale transaction has no impact on whether a reasonable individual would objectively view the defendants’ actions and statements as evincing a promise of profits based on their efforts. Indeed, if the Amended Complaint’s allegations are taken as true – as, again, they must be at this stage – the defendants’ embarked on a public campaign to encourage both retail and institutional investors to buy their crypto-assets by touting the profitability of the crypto-assets and the managerial and technical skills that would allow the defendants to maximize returns on the investors’ coins.
As part of this campaign, the defendants said that sales from purchases of *all* crypto-assets – no matter where the coins were purchased – would be fed back into the Terraform blockchain and would generate additional profits for *all* crypto-asset holders. These representations would presumably have reached individuals who purchased their crypto-assets on secondary markets – and, indeed, motivated those purchases – as much as it did institutional investors. Simply put, secondary-market purchasers had every bit as good a reason to believe that the defendants would take their capital contributions and use it to generate profits on their behalf.
Amendments to Simplify, Harmonize, and Improve the Offering Framework

The amount of capital raised in offerings in the United States that are exempt from 1933 Act registration vastly exceeds the amount raised in SEC-registered offerings. Emerging companies (“startups”) continue to rely on private placements to fund growth, often deferring an initial public offering or bypassing it altogether to sell the business to a strategic acquirer. As a result, exempt offerings have become a critical part of the capital markets, although the legal framework—cobbled together over many years through new statutes, case law, SEC and SEC staff guidance, changes in regulation and safe harbors, and market practice—can be difficult to navigate.

On November 2, 2020, the SEC voted 3-2 to adopt amendments that “simplify, harmonize, and improve certain aspects” of the framework for exempt offerings. See SEC Release No. 10844 (Nov. 2, 2020). The most significant provisions are described below. Where applicable, the new or amended Rules are also set out below.

The amendments adopted by the SEC generally:

- Increase the offering limits for Regulation A, Regulation Crowdfunding, and Rule 504 offerings, and revise certain individual investment limits;

- Establish consistent rules governing certain offering communications, including permitting certain “test-the-waters” and “demo day” activities;

- Establish, in one broadly applicable rule, an integration framework that addresses the ability of issuers to move from one exemption to another, or between exempt and registered offerings; and

- Harmonize certain disclosure and eligibility requirements and bad actor disqualification provisions.

We describe significant aspects of those amendments below.
Offering and Investment Limits

The SEC amended the offering and investment limits for certain 1933 Act exemptions.

For Regulation A, the amendments (i) raise the maximum 12-month offering limit under Tier 2 of Regulation A from $50 million to $75 million and (ii) raise the maximum 12-month offering limit for secondary sales under Tier 2 from $15 million to $22.5 million.

For Regulation Crowdfunding, the amendments (i) raise the maximum 12-month offering limit in Regulation Crowdfunding from $1.07 million to $5 million and (ii) amend the investment limits for investors by (1) removing investment limits for accredited investors and (2) using the greater of their annual income or net worth when calculating the investment limits for non-accredited investors.

For Rule 504 of Regulation D, the amendments raise the 12-month maximum offering limit from $5 million to $10 million.
Rule 241: Test-the-Waters for Exempt Offerings

The SEC used its general exemption authority under Section 28 of the 1933 Act to create Rule 241, allowing an issuer to solicit indications of interest, orally or in writing, from any prospective investor (not limited to qualified institutional buyers or institutional accredited investors) in a contemplated exempt offering before determining which exemption it will rely on to conduct the offering. The Rule cannot be used if the issuer has already decided on an applicable exemption. Such communications are deemed to be an offer of a security for sale for purposes of the antifraud provisions of the federal securities laws.

A written communication under this Rule may include a means to indicate to the issuer that a person is interested in a potential offering (including the responder's name, address, telephone number, and/or email address). However, no solicitation or acceptance of money or other consideration, nor of any commitment, binding or otherwise, from any person is permitted (and if money or other consideration is sent in response, it must not be accepted) until the issuer determines the exemption and the exempt offering is commenced (and, where applicable, the filing, disclosure, or qualification requirements of such exemption are met). In line with the foregoing, any Rule 241 communication must state that: (1) the issuer is considering an exempt offering but has not determined a specific exemption; (2) no money or other consideration is being solicited or will be accepted; (3) no sales will be made or commitments to purchase accepted until the issuer determines the exemption and any required filing, disclosure, or qualification requirements are met; and (4) any indication of interest is non-binding.

Note that, depending on how it is made, a Rule 241 communication may constitute general solicitation. In that case, before conducting an exempt offering that does not permit general solicitation (e.g., an offering under Rule 506(b)), the issuer must determine whether the Rule 241 communication and subsequent offering should be integrated, which may render the exemption for the second offering unavailable. In that case, it may still be possible for the issuer to rely on Rule 152 (providing a general principle of integration and certain safe harbors, discussed below), for example, if the issuer waits 30 days following termination of the Rule 241 activity before commencing the private offering. The issuer must have a reasonable belief, based on the facts and circumstances, that each purchaser in the private offering was not solicited through general solicitation by the issuer (or any person acting on the issuer's behalf), or the issuer (or such person) must have established a substantive relationship with such purchaser before commencement of the private offering. In other words, an issuer cannot identify investors through general solicitation under Rule 241 and then sell to those investors in a subsequent private offering.

The SEC stated in the adopting release that an issuer may reasonably conclude, depending on the particular facts and circumstances, that test-the-water communications limited to qualified institutional buyers and institutional accredited investors would not constitute general solicitation. This approach may be an optimal way to test the waters for issuers who are likely to conduct a private offering.

The SEC amended Regulation A and Regulation Crowdfunding to require that Rule 241 generic solicitation materials be publicly available as an exhibit to the offering materials filed with the Commission if the Regulation A or Regulation Crowdfunding offering is commenced.
within 30 days of the generic solicitation. In addition, if the issuer sells securities under Rule 506(b) within 30 days following a Rule 241 communication to any purchaser that is not an accredited investor, the issuer must provide the purchaser with any written materials delivered under Rule 241 a reasonable time before the sale. This requirement applies whether or not the issuer engaged in general solicitation under Rule 241 and whether or not the Rule 241 communication is subject to integration with the Rule 506(b) offering.

Finally, Rule 241 does not preempt any state “blue sky” laws. In light of the novel nature of this new exemption and concerns over potential misuse, the SEC concluded that preemption is not warranted at this time.
Rule 152: General Principle of Integration and Safe Harbors

As the casebook describes, the SEC and courts developed various ways to determine when multiple offerings should be “integrated”—i.e., treated as a single offering—for purposes of determining what single 1933 Act exemption is applicable, including the five-factor test in Regulation D. The five factors, listed in a prior Note to Rule 502(a), and used to determine whether offers and sales should be integrated for purposes of Regulation D, were whether: (i) the sales are part of a single plan of financing; (ii) the sales involve the issuance of the same class of securities; (iii) the sales have been made at or about the same time; (iv) the same type of consideration is being received; and (v) the sales are made for the same general purpose.

In adopting Rule 152, the SEC noted that the 1933 Act integration framework for registered and exempt offerings has consisted of a mixture of rules, SEC and SEC staff guidance, and market practices that have evolved over time, making the integration framework increasingly complex. Accordingly, in light of statutory and regulatory changes to the 1933 Act’s exemptions, developments in the capital markets, and evolution in communications technology, the SEC decided it was appropriate to simplify the 1933 Act integration framework.

New Rule 152 replaces old Rule 152, as well as Rule 155 (which has been reserved). The new Rule also replaces the safe harbors set forth in various exemptions. Specifically, the prior integration rules under Regulation A (Rule 251(c)), Regulation D (Rule 502(a)), Rule 147 (Rule 147(g)) and Rule 147A (Rule 147A(g)) have been amended to now cross-refer to new Rule 152 to determine whether offers and sales should be integrated. Rule 152, as amended, is intended to simplify the existing approach to integration by establishing a general principle of integration that looks to the facts and circumstances of each offering, supplemented by four non-exclusive safe harbors that address specific situations.

General Principle (Rule 152(a))

Rule 152(a) provides a general principle of integration for all offerings not covered by a safe harbor in Rule 152(b). Introductory language in Rule 152 states that, because of the objectives of the Rule and the policies underlying the Securities Act, the provisions of the Rule will not have the effect of avoiding integration for any transaction or series of transactions that, although in technical compliance with the Rule, are part of a plan or scheme to evade the registration requirements of the Securities Act.

Under Rule 152(a), offers and sales will not be integrated if, based on the particular facts and circumstances, the issuer can establish that each offering either complies with the registration requirements of the 1933 Act or an exemption from registration is available for the particular offering. In making this determination:

- For an exempt offering prohibiting general solicitation (Rule 152(a)(1)): The issuer must have a reasonable belief, based on the facts and circumstances, with respect to each purchaser in the exempt offering prohibiting general solicitation, that the issuer (or any person acting on the issuer’s behalf) either: (i) did not solicit such purchaser through the use of general solicitation; or (ii) established a substantive relationship
with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation. (Conversely, and as noted in Rule 152’s adopting release, if a permissible general solicitation for one offering describes the material terms of a concurrent or subsequent offering for which general solicitation is not permitted, the solicitation may violate the prohibition on general solicitation in the concurrent or subsequent offering.)

- For two or more concurrent exempt offerings permitting general solicitation (Rule 152(a)(2)): In addition to satisfying the requirements of the particular exemption relied on, general solicitation offering materials for one offering that include information about the material terms of a concurrent offering under another exemption may constitute an offer of securities in such other offering. In that case, the offer made in one offering must comply with all the requirements for, and restrictions on, offers under the exemption being relied on for the other offering, including any legend and communications requirements.

The general principle applies, for example, when an issuer conducts (i) an IPO alongside a Rule 506(b) offering, (ii) a Rule 506(c) alongside a Rule 506(b) offering, or (iii) a Rule 506(c) offering alongside a Rule 147A offering (in each case, not covered by one of the safe harbors described below):

- In scenario (i), the offerings are not integrated if investors in the Rule 506(b) offering are not solicited through the registration statement or if the issuer (or a person acting on the issuer’s behalf) established a substantive relationship with the investors prior to commencement of the Rule 506(b) offering.

- In scenario (ii), the offerings are not integrated if investors in the Rule 506(b) offering were not solicited through general solicitation under the Rule 506(c) offering or if the issuer (or a person acting on the issuer’s behalf) established a substantive relationship with the investors prior to commencement of the Rule 506(b) offering.

- Finally, in scenario (iii), general solicitations are permitted under both Rule 506(c) and Rule 147A. Each, however, has its own requirements (e.g., sales only to accredited investors under Rule 506(c), and sales only to residents of the issuer’s state and resale limitations under Rule 147A). In addition to satisfying the respective requirements of Rule 506(c) and Rule 147A, if offering materials for one offering include information about the material terms of the other offering, the offer made in one offering must comply with all the requirements for, and restrictions on, offers under the exemption being relied on for the other offering, including legend and communications requirements.

Likewise, an issuer may undertake concurrent offerings in reliance on Rule 506(c) and Regulation A, so long as the issuer meets all of the conditions of each exemption, including reasonable steps to verify that all purchasers in the Rule 506(c) offering are accredited investors. If the issuer were to discuss, in any general solicitation materials used for the Rule 506(c) offering, the material terms of the Regulation A offering, the Rule 506(c) general solicitation must comply with all the requirements for offers under Regulation A, including all necessary legend and other requirements.
Note that, for concurrent offerings or offerings separated by 30 days or less, which are unable to rely on the 30-day safe harbor discussed below, if an offering pursuant to an exemption that does not permit general solicitation is conducted concurrently with or after an offering that does permit general solicitation, (i) the issuer must limit offerees in the offering that does not permit general solicitation to those with which it had a substantive relationship before commencement of that offering and (ii) the relationship cannot have been established through the recent or concurrent offering that permits general solicitation.

What constitutes a pre-existing, substantive relationship? The SEC confirmed in the adopting release that “the existence of such a relationship prior to the commencement of an offering is one means, but not the exclusive means, of demonstrating the absence of general solicitation in a Regulation D offering.” Accordingly, an offer of the issuer’s securities to a person with whom the issuer, or a person acting on its behalf, has a pre-existing substantive relationship would not constitute general solicitation, so long as the relationship was established prior to commencement of the offering.

A “pre-existing” relationship is one that an issuer or, alternatively, a person acting on the issuer’s behalf—e.g., a broker-dealer or investment adviser—has formed with an offeree before commencement of the offering. SEC staff interpretations of whether a “pre-existing, substantive relationship” can be established on the issuer’s behalf have generally been based on procedures established by broker-dealers for their clients as part of their suitability determinations. However, whether or not there is a sufficient relationship to not constitute general solicitation will depend on the particular facts and circumstances and does not depend on the third-party being a broker-dealer or investment adviser.

A “substantive” relationship is one in which the issuer (or a person acting on its behalf) has sufficient information to evaluate, and does, in fact, evaluate, an offeree’s financial circumstances and sophistication in determining the offeree’s status as an eligible investor. Self-certification alone (e.g., by checking a box), without knowledge of a person’s financial circumstances or sophistication, is insufficient to form a “substantive” relationship.

An issuer may develop its own pre-existing, substantive relationships with offerees, but it may be difficult to do so in the absence of a prior business relationship or a recognized legal duty to the offerees. The relationship cannot be formed as part of the offering, which may make it practically difficult for an issuer to obtain and evaluate information about particular offerees before commencing the offering. In particular, the SEC noted in the adopting release, “in the absence of a prior business relationship or a recognized legal duty to offerees, it is likely more difficult for an issuer to establish a pre-existing, substantive relationship, especially when contemplating or engaged in an offering over the internet.” Examples of investors with which an issuer may have a pre-existing, substantive relationship include: the issuer’s existing or prior investors; investors in prior deals of the issuer’s management; friends or family of the issuer’s control persons; and, if the issuer relies on third parties, clients with which a broker-dealer, investment adviser, or other person on the issuer’s behalf has established such a substantive relationship.
Safe Harbors (Rule 152(b))

Safe Harbor 1 (Rule 152(b)(1)): Rule 152(b)(1) provides that any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with the other offering. The safe harbor applies to offerings for which a registration statement has been filed and to exempt offerings. If, however, an exempt offering for which general solicitation is not permitted follows by 30 calendar days or more an offering that allows general solicitation, the general principles in Rule 152(a)(1) shall apply. In this latter case, the issuer must have a reasonable belief, based on the facts and circumstances, that each purchaser in the exempt offering prohibiting general solicitation was not contacted through general solicitation by the issuer (or a person acting on the issuer’s behalf), or that the issuer (or such person) established a substantive relationship with such purchaser prior to commencement of the exempt offering prohibiting general solicitation.

The move to 30 days is a significant change from the six-month period that prior integration safe harbors required. The SEC cited changes over time to the markets, technology, and the securities laws as reasons why 30 days is a sufficient length of time. That period is enough to prevent the improper avoidance of SEC registration by artificially dividing a single offering into multiple offerings.

The SEC noted in the adopting release that the 30-day safe harbor may not be used as a means to circumvent the prohibition on general solicitation in an exempt offering to which such prohibition applies. The SEC indicated that “regardless of whether an issuer meets the requirements of the 30-day safe harbor from integration, an issuer conducting an offering of securities under an exemption prohibiting general solicitation, such as Rule 506(b), must still ensure that it has not engaged in general solicitation, and meets the other terms and conditions of the relevant offering exemption.”

Recall that offerings relying on Rule 506(b) are limited to no more than, or the issuer reasonably believes there are no more than, 35 purchasers of securities. For this purpose, “purchasers” exclude any accredited investor (see Rule 501(e)(1)(iv)). To prevent serial Rule 506(b) offerings to up to 35 non-accredited investors (“non-AIs”) each month, the number of non-AI purchasers permitted in all Rule 506(b) offerings, now within a 90-day period, is capped at 35 (see Rule 506(b)(2)(i)).

Safe Harbor 2 (Rule 152(b)(2)): Offers and sales made in compliance with Rule 701, pursuant to an employee benefit plan, or in compliance with Regulation S (Rules 901 through 905) will not be integrated with other offerings. This safe harbor restates the prior non-integration safe harbor for offers and sales under Rule 701 and includes employee benefit plans. It also codifies the SEC’s long-standing position that offshore transactions made in compliance with Regulation S generally will not be integrated with registered or exempt domestic offerings.

Regarding Regulation S, notwithstanding Rule 152(b)(2), offering participants must consider whether general solicitation permitted by an exempt offering in the United States could be considered “directed selling efforts,” prohibited in a concurrent Regulation S offering outside the United States. Compliance with both Regulation S and another applicable
exemption, such as Rule 506(c), will depend on the particular facts and circumstances. For example, use of the same website to solicit U.S. investors under Rule 506(c) and investors under Regulation S could raise concerns over directed selling efforts that are prohibited by Regulation S. The offering materials on the website could be deemed to have the effect of conditioning the market in the United States. In that situation, the SEC advised, the issuer should take steps to distinguish the U.S. and Regulation S offering materials.

**Safe Harbor 3 (Rule 152(b)(3)):** An offering for which a 1933 Act registration statement has been filed with the SEC will not be integrated if made subsequent to:

- A terminated or completed offering for which general solicitation is not permitted.
- A terminated or completed offering for which general solicitation is permitted and made only to qualified institutional buyers and institutional accredited investors.
- An offering for which general solicitation is permitted that terminated or completed more than 30 days prior to the commencement of the registered offering.

In the adopting release, the SEC noted that “[o]ffers and sales preceding registered offerings that do not involve general solicitation are generally not the type of offerings that, when taken together, appear to be susceptible to concerns relating to the prior offers and sales conditioning the market for the registered offering.” Regarding the third bullet point, the SEC noted that Rule 152(b)(3)(iii) does not impose an additional requirement beyond that set forth in the 30-day safe harbor of Rule 152(b)(1), but rather is meant to clarify the application of that provision to subsequent registered offerings.

**Safe Harbor 4 (Rule 152(b)(4)):** Offers and sales made in reliance on an exemption for which general solicitation is permitted will not be integrated if made subsequent to any terminated or completed offering. The rationale for this safe harbor is that offers and sales that precede an exempt offering that permits general solicitation generally are not the type of transaction that will condition the market for the subsequent offering.

The adopting release offered guidance on an issuer’s ability to rely on Rule 152(b)(4) in an offering that was commenced in reliance on an exemption that did not permit general solicitation, but where the issuer subsequently wished to continue in reliance on an exemption that does permit general solicitation. The SEC’s view was that the issuer may rely on Rule 152(b)(4) if, for example, the issuer commenced an offering under Rule 506(b) (which prohibits general solicitation) and, thereafter, engaged in general solicitation in reliance on Rule 506(c), so long as once the issuer engages in general solicitation, it relies on Rule 506(c) for all subsequent sales, effectively terminating the Rule 506(b) offering. Sales must be made exclusively to accredited investors, and the issuer must take reasonable steps to verify the accredited investor status of each purchaser. The use of general solicitation in reliance on Rule 506(c) will not affect the exempt status of prior offers and sales under Rule 506(b). The SEC also noted that it is unnecessary for an issuer to use different offering materials for offerings that rely on different exemptions, so long as the issuer satisfies the disclosure and other requirements of each exemption.
Commencement and Termination/Completion of Offerings

Rule 152’s non-integration provisions are tied to the “commencement” and “termination or completion” of two or more offerings. Rules 152(c) and (d) provide a non-exclusive list of factors to consider in determining when an offering has commenced and when it has terminated or completed. Rule 152(c) provides that an offering of securities will be deemed to be commenced at the time of the first offer of securities in the offering by the issuer or its agents. Rule 152(d) provides that an offering will be deemed terminated or completed when an issuer and its agents cease efforts to make further offers to sell the issuer’s securities in such offering.

Each Rule then includes a non-exclusive list of factors to consider:

**Exempt Offerings.** In the case of offerings under Section 4(a)(2), Regulation D, or Rules 147 or 147A, an offering is commenced on the date the issuer first made an offer in reliance on those exemptions, and the offering is terminated or completed on the later of the date (i) the issuer enters into a binding commitment to sell all securities to be sold under the offering (subject only to conditions outside the investors’ control) or (ii) the issuer and its agents cease efforts to make further offers to sell securities in such offering.

The adopting release notes that private communications between an issuer (or its agents) and prospective investors in an exempt offering in which general solicitation is prohibited, such as under Rule 506(b) or Section 4(a)(2), may be considered the commencement of an offering if such private communication involves an offer of securities. In addition, Rule 152(c) provides that, for purposes of Rule 241 (a new test-the-waters provision, discussed previously), the commencement of an offering is the date the issuer first made a generic offer soliciting interest in a contemplated securities offering for which the issuer had not yet determined which exemption under the 1933 Act to rely on.

Note that treatment of test-the-waters communications under Rule 241, as well as test-the-waters communications under Rule 255 (Regulation A) and new Regulation Crowd-funding Rule 206 (discussed below), is different than the treatment of test-the-water communications under Rule 163B for registered offerings (as discussed below). Specifically, the SEC noted in the adopting release that communications between an issuer, or its agents and underwriters, and qualified institutional buyers and institutional accredited investors, including those that would qualify for the safe harbor in Rule 163B, will not be considered as the commencement of a registered public offering for purposes of Rule 152, while “the commencement of private communications between an issuer, or its agents, including private placement agents, and prospective investors in an exempt offering in which general solicitation is prohibited, such as under Rule 506(b) or Section 4(a)(2), may be considered as the commencement of the nonpublic exempt offering for purposes of Rule 152, if such private communication involves an offer of securities.”

**Regulation A.** A Regulation A offering commences on the earlier of the date the issuer first made an offer soliciting interest in a contemplated securities offering in reliance on Rule 255 (the existing test-the-waters provision) or the public filing with the SEC of a Form 1-A offering statement. It is terminated or completed on: (i) the withdrawal of an offering statement under Rule 259(a); (ii) the filing of an exit report on Form 1-Z pursuant to Rule
257(a) not later than 30 days after termination or completion of a Tier 1 offering; (iii) the declaration by the SEC that the offering statement has been abandoned under Rule 259(b); or (iv) for a delayed or continuous offering, the date after the third anniversary of the date the offering statement was initially qualified, on which Rule 251(d)(3)(i)(F) prohibits the issuer from continuing to sell securities using the offering statement (i.e., the offering statement has become “stale”), or any earlier date on which the offering terminates by its terms.

**Crowdfunding.** A crowdfunded offering commences on the earlier of the date the issuer first made an offer soliciting interest in a contemplated securities offering in reliance on Regulation Crowdfunding Rule 206 (a new test-the-waters provision, discussed below) or the public filing with the SEC of a Form C offering statement (which includes the information required by Rule 201). It terminates on the deadline to reach the target offering amount identified in the offering materials pursuant to Rule 201(g) or indicated by the Regulation Crowdfunding intermediary in any notice to investors delivered under Rule 304(b).

**Registered Offerings.**

**Rule 163B Test-the-Waters.** Offers by the issuer, or persons acting on behalf of the issuer, limited exclusively to qualified institutional buyers and institutional accredited investors, including those that would qualify for the safe harbor in Rule 163B, will not be considered the commencement of a registered offering for purposes of Rule 152.

**Registered, Continuous Offerings.** A registered, continuous offering that commences promptly on the date of initial effectiveness of the registration statement will be deemed to commence on the date the issuer first filed its registration statement for the offering with the SEC. Termination or completion of a continuous offering could be evidenced by the filing of a prospectus supplement or amendment indicating that the offering has been terminated or completed, or any other factors that indicate that the issuer has abandoned or ceased its public selling efforts in furtherance of the offering, which could be evidenced by the filing of a Form 8-K or the issuance of a widely disseminated public disclosure by the issuer, or its agents, informing the market of the offering’s termination or completion. Termination or completion of the offering may also occur as a result of an offering terminating by its terms or the withdrawal, abandonment, or expiration (after the third anniversary of the initial effective date) of the registration statement.

**Registered, Delayed (Shelf) Offerings.** A delayed offering will be deemed to commence on the earliest date on which the issuer or its agents commence public efforts to offer and sell the securities, which could be evidenced by the earlier of (i) the first filing with the SEC of a prospectus supplement describing the shelf offering or (ii) the issuance of a widely disseminated public disclosure, such as a press release, confirming the commencement of the offering. Termination or completion of a shelf offering may be evidenced by the same factors as those for registered, continuous offerings (described above). Note that a shelf offering may be deemed terminated or completed even though the issuer’s shelf registration statement may still have securities available to offer and sell in a later offering. Since a particular shelf offering may be deemed terminated or completed in accordance with Rule 152, offerings under shelf registration statements can rely on the 30-day safe harbor of Rule 152(b)(1) even though a later offering may take place under the same registration statement.
Rule 148: Demo Days and Similar Events

Rule 148 provides that certain “demo day” and similar communications will not be deemed to be a general solicitation or general advertising. The Rule provides a safe harbor for communications made in connection with a seminar or meeting in which more than one issuer participates that is sponsored by a college, university, or other institution of higher education, state or local government or instrumentality thereof, nonprofit organization, angel investor group (meaning a group of accredited investors that holds regular meetings and has defined processes/procedures for making investment decisions, and is neither associated nor affiliated with brokers, dealers, or investment advisers), incubator, or accelerator. Thus, for example, Rule 506(b) prohibits the use of general solicitation to offer an issuer’s securities. A demo day that complies with Rule 148 will not be deemed to constitute a general solicitation and, therefore, does not foreclose an offering of securities pursuant to Rule 506(b).

Within the Rule, the SEC adopted limitations on the information that may be conveyed regarding the offering of securities. No advertising for the event can reference a specific offering by an issuer. In addition, the type of information communicated or distributed by or on the issuer’s behalf must be limited to: (1) a notification that the issuer is in the process of offering or planning to offer securities; (2) the type and amount of securities being offered; (3) the intended use of proceeds; and (4) the unsubscribed amount in an offering. The sponsor of the seminar or meeting is also prohibited from: (i) making investment recommendations or providing investment advice to attendees; (ii) engaging in any investment negotiations between the issuer and investors attending the event; (iii) charging attendees any fees, other than reasonable administrative fees; and (iv) receiving any compensation with respect to the event that would require registration of the sponsor as a broker or dealer under the 1934 Act or as an investment adviser under the Investment Advisers Act of 1940.

The Rule also places certain restrictions on online participation if the event allows attendees to participate virtually, reflecting the SEC’s concern that these events may allow broad offering-related communications to non-accredited investors. Accordingly, online participation is limited to: (i) individuals who are members of, or otherwise associated with, the sponsor organization; (ii) individuals who the sponsor reasonably believes are accredited investors; and (iii) individuals who have been invited to the event by the sponsor based on industry or investment-related experience, reasonably selected by the sponsor in good faith and disclosed in the public communications about the event.

The Rule codifies existing practice, but it is not the only way for a demo day to not constitute general solicitation. In the adopting release, the SEC acknowledged that “if the issuer’s presentation at a ‘demo day’ or similar event constitutes an offer of securities, the issuer would not be deemed to have engaged in general solicitation if the organizer of the event has limited participation in the event to individuals or groups of individuals with whom the issuer or the organizer has a preexisting substantive relationship or that have been contacted through an informal, personal network of experienced, financially sophisticated individuals, such as angel investors.”
Regulation Crowdfunding: Test-the-Waters and Other Communications

The SEC adopted Rule 206 to permit Regulation Crowdfunding issuers to test the waters orally or in writing with potential investors prior to filing a Form C with the SEC. Rule 206 is based on Rule 255 in Regulation A.

A written communication under this Rule may include a means to indicate to the issuer that a person is interested in a potential offering (including the responder’s name, address, telephone number, and/or email address). However, as with Rule 255, Rule 206 requires issuers to include the following legends in test-the-waters materials: (i) no money or other consideration is being solicited, and if sent, will not be accepted; (ii) no offer to buy the securities can be accepted and no part of the purchase price can be received until the offering statement is filed, and only through an intermediary’s platform; and (iii) a prospective purchaser’s indication of interest is non-binding. Test-the-waters materials under Rule 206 are considered offers that are subject to the antifraud provisions of the federal securities laws. The SEC also amended Rule 201(z) to require issuers to include any Rule 206 solicitation materials with the Form C filed with the Commission. Test-the-waters communications are not required to be conducted through intermediary platforms.

Unlike Rule 255 of Regulation A, which permits issuers to use test-the-waters materials both before and after an offering statement is filed, Rule 206 only permits issuers to test the waters before the Form C is filed. After the Form C is filed, any offering communications are required to comply with the terms of Regulation Crowdfunding, including the Rule 204 advertising restrictions.

The SEC also amended Rule 204 of Regulation Crowdfunding to permit oral communications with prospective investors once a Form C is filed, as long as the communications comply with the requirements of Rule 204. The SEC also expanded the information an issuer may provide under Rule 204 to include (i) a brief description of the planned use of proceeds of the offering and (ii) information on the issuer’s progress toward meeting its funding goals. In addition, the SEC amended Rule 204 to provide that an issuer may include information about the terms of a crowdfunded offering in the offering materials for a concurrent offering, such as in an offering statement on Form 1-A for a concurrent Regulation A offering or a registration statement filed with the SEC. The information provided about the Regulation Crowdfunding offering must be in compliance with Rule 204, including the requirement to include a link directing the potential investor to the intermediary’s platform as required by Rule 204(b)(1).
Harmonization of Regulation A and Regulation D Disclosures

The SEC addressed differing financial disclosure requirements for Regulation A and Regulation D. (The SEC also adopted amendments to simplify compliance with Regulation A, e.g., regarding the redaction of confidential information in material contracts, permitting draft offering statements to be made public on EDGAR, permitting incorporation by reference on Form 1-A, and permitting the declaration of a post-qualification amendment as abandoned.) The changes to Rule 502(b), to align disclosure with Regulation A, are described below.

If a non-accredited investor participates in a Rule 506(b) offering, the issuer must furnish that investor with the information required by Rule 502(b), including financial and non-financial information, a reasonable time prior to the sale of the securities. It must also provide these investors with the opportunity to ask questions and receive answers about the offering.

The SEC amended Rule 502(b) to align the financial information that non-reporting issuers must provide to non-accredited investors in a Regulation D offering with what is required under a Regulation A offering, as follows:

- For Regulation D offerings of $20 million or less, Rule 502(b) refers issuers to paragraph (b) of part F/S of Form 1-A, which applies to Tier 1 Regulation A offerings (financial statements are not required to be audited, unless the issuer has already obtained an audit for another purpose); and

- For offerings of greater than $20 million, Rule 502(b) refers issuers to paragraph (c) of part F/S of Form 1-A, which applies to Tier 2 Regulation A offerings (financial statements must be audited, but interim financial statements need not be audited).

The effect is to reduce the Rule 506(b) financial disclosure requirements for non-reporting companies that sell to non-accredited investors.

The amendments also eliminate the Rule 502(b) provision that permits an issuer, other than a limited partnership, that cannot obtain audited financial statements without unreasonable effort or expense, to provide only the issuer’s audited balance sheet.
Rule 506(c): Verifying Accredited Investor Status

Rule 506(c) permits general solicitation so long as the issuer takes “reasonable steps to verify” that all purchasers are accredited investors. It also includes “non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor” (Rule 506(c)(2)(ii)). Although the Rule makes clear that the verification methods are non-exclusive, the SEC has been concerned that the Rule may be encouraging market participants to treat them as exclusive. The SEC is also aware that some market participants view the methods as onerous.

In response, the SEC added a new item to the non-exclusive list:

(E) In regard to any person that the issuer previously took reasonable steps to verify as an accredited investor in accordance with this paragraph (c)(2)(ii) [which sets out the requirement to use “reasonable steps to verify” accredited investor status and non-exclusive verification methods for natural persons], so long as the issuer is not aware of information to the contrary, obtaining a written representation from such person at the time of sale that he or she qualifies as an accredited investor. A written representation under this method of verification will satisfy the issuer’s obligation to verify the person’s accredited investor status for a period of five years from the date the person was previously verified as an accredited investor.

Accordingly, an issuer that previously took reasonable steps to verify a person’s accredited investor status may satisfy its verification obligation over the next five years by obtaining a written representation from that person at the time of sale that he or she qualifies as an accredited investor, so long as the issuer is not aware of information to the contrary.

The adopting release also reaffirmed the SEC’s principles-based approach to verification, in particular, that issuers are not required to use any of the methods set forth in the non-exclusive list and can apply the reasonableness standard directly to the facts and circumstances presented by the offering and investors in question. According to the SEC, the principles-based method was intended to “provide issuers with significant flexibility in deciding the steps needed to verify a person’s accredited investor status and to avoid requiring them to follow uniform verification methods that may be ill-suited or unnecessary to a particular offering or purchaser in light of the facts and circumstances.” The SEC indicated that it continues to believe the following factors are among those that should be considered: (i) the nature of the purchaser and the type of accredited investor the purchaser claims to be; (ii) the amount and type of information the issuer has about the purchaser; and (iii) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering and the terms of the offering, such as the minimum investment amount.

The SEC also reiterated its view that an issuer’s “reasonable steps” standard under Rule 506(c) may not be substantially different from the “reasonable belief” standard under Rule 506(b). For example, an issuer’s receipt of a representation from an investor as to its accredited investor status could meet the “reasonable steps” requirement if the issuer reasonably takes into consideration a prior substantive relationship with the investor or
other facts that make the accredited status apparent. However, requiring an investor to simply check a box in a questionnaire, by itself, is not sufficient unless the issuer or its agent has additional information that reasonably supports the purchaser’s accredited investor status.
Other Changes to Regulation A, Regulation D, and Regulation Crowdfunding

**Bad Actor Disqualification.** The SEC amended Regulation A, Regulation D, and Regulation Crowdfunding to harmonize the bad actor disqualification provisions. The amendments adjust the lookback requirements in Regulation A and Regulation Crowdfunding to include the time of sale in addition to the time of filing.

**Regulation A.** Regulation A has made it a condition for an issuer conducting a Regulation A offering to have filed with the SEC all reports required to be filed pursuant to Rule 257 during the two years before filing the offering statement (or for such shorter period as the issuer was required to file such reports). The SEC amended Regulation A to now address delinquent filings by 1934 Act reporting companies that are not required to file reports under Rule 257. Issuers that fail to file all reports required to have been filed by Sections 13 or 15(d) of the Exchange Act during the two years preceding the filing of an offering statement are ineligible to conduct a Regulation A offering.

**Regulation Crowdfunding.** Section 4A(f)(3) of the 1933 Act prohibits investment companies, as defined in the Investment Company Act of 1940 (“1940 Act”) (or companies that are excluded from the definition of an investment company under Section 3(b) or 3(c) of the 1940 Act), from relying on the Regulation Crowdfunding exemption. Regulation Crowdfunding does not include an exception to this statutory prohibition. As a result, issuers have not been able to use special purpose vehicles that invest in a single company and that are investment companies (or companies excluded from the definition) to conduct Regulation Crowdfunding offerings. Investors who purchase securities in a crowdfunded offering, therefore, must hold the securities in their own name. Over time, market participants have identified a number of practical issues that this prohibition raises, potentially limiting the utility of Regulation Crowdfunding, such as unwieldy capitalization tables and some administrative complexities.

In response, the SEC adopted Rule 3a-9 under the 1940 Act to exclude from the definition of “investment company” a crowdfunding vehicle that meets specific conditions so that it functions as “a conduit for investors to invest in a business that seeks to raise capital through a crowdfunding vehicle.” The conditions require the crowdfunding vehicle to act solely as a conduit for directly acquiring, holding, and disposing of securities issued by a single crowdfunding issuer, while also obtaining “a written undertaking from the crowdfunding issuer to fund or reimburse the expenses associated with its formation, operation, or winding up, receiv[ing] no other compensation, and [requiring] any compensation paid to any person operating the vehicle [to be] paid solely by the crowdfunding issuer.” Under Rule 3a-9, the crowdfunding vehicle will be a co-issuer formed by or on behalf of the underlying crowdfunding issuer and will not have a separate business purpose.
MD&A Amendments

The SEC adopted amendments to Regulation S-K, including changes to financial disclosure and MD&A requirements. Among the changes, the amendments adopt a more principles-based approach to disclosure. Certain of the most significant changes to the MD&A requirements are described below. See SEC Release No. 10890 (Nov. 19, 2020).

The amendments are based on the SEC staff’s November 2016 Report on Modernization and Simplification of Regulation S-K, as well as a July 2016 concept release on the business and financial disclosure requirements in Regulation S-K. They are part of a broader “disclosure effectiveness initiative” (DEI) undertaken by the SEC and its staff, partly at the direction of Congress under the Jumpstart Our Business Startups (JOBS) Act of 2012 and the Fixing America’s Surface Transportation (FAST) Act of 2015. The general purpose of these amendments is to drop requirements that have become obsolete, replace prescriptive rules with principles-based requirements, and clarify certain other requirements.

**Item 303(a).** New Item 303(a) codifies longstanding SEC guidance which states that a registrant should provide a narrative explanation of its financial statements that enables investors to see the registrant “through the eyes of management.” It also emphasizes the importance of statistical data in enhancing a reader’s understanding of the registrant’s financial condition and results of operations.

(a) *Objective.* The objective of the discussion and analysis is to provide material information relevant to an assessment of the financial condition and results of operations of the registrant including an evaluation of the amounts and certainty of cash flows from operations and from outside sources. The discussion and analysis must focus specifically on material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This includes descriptions and amounts of matters that have had a material impact on reported operations, as well as matters that are reasonably likely based on management’s assessment to have a material impact on future operations. The discussion and analysis must be of the financial statements and other statistical data that the registrant believes will enhance a reader’s understanding of the registrant’s financial condition, cash flows and other changes in financial condition and results of operations. A discussion and analysis that meets these requirements is expected to better allow investors to view the registrant from management’s perspective.

As the adopting release explains:

These objectives provide the overarching requirements of MD&A and apply throughout amended Item 303. As such, they emphasize a registrant’s future prospects and highlight the importance of materiality and trend disclosures to a thoughtful MD&A. These amendments are intended to remind registrants that MD&A should provide an analysis that encompasses short term results as well as future prospects. Consistent with this amendment
and current guidance, . . . amended Item 303(a) specifies that the disclosure must include matters that are reasonably likely, based on “management’s assessment” to have a material impact on future operations.

Consistent with this approach, our amendments also incorporate current guidance that MD&A is intended to provide disclosures from “management’s perspective.” . . .

. . . Given the historical and continued importance of materiality in MD&A, we are not, as suggested by some commenters, adopting modifications to be more explicit or prescriptive. Rather, we continue to believe that MD&A’s materiality-focused and principles-based approach facilitates disclosure of complex and often rapidly evolving areas, without the need to continuously amend the text of the rule to update or impose additional prescriptive requirements. These amendments are intended to further emphasize these goals.

**Item 303(a)(3)(ii).** This Item was amended to require a company to disclose when it knows of events that are *reasonably likely* to cause (as opposed to *will* cause, in the prior Item) a material change in the relationship between costs and revenues, such as known or reasonably likely future increases in costs of labor or materials, price increases, or inventory adjustments. The SEC clarified that “whether a matter is ‘reasonably likely’ to have a material impact on future operations is based on ‘management’s assessment.’”

In the adopting release, the SEC explained how companies should analyze and disclose known trends, demands, commitments, events, or uncertainties, reiterating its “longstanding emphasis that analysis in this area should be based on objective reasonableness.” The SEC noted that, in evaluating whether a known trend or uncertainty is reasonably likely, “the development of MD&A disclosure should begin with management’s identification and evaluation of what information . . . is important to providing investors and others an accurate understanding of the company’s current and prospective financial position and operating results.” Further, the disclosure obligation is based on materiality—namely, what would be considered important by a reasonable investor in making a voting or investment decision. The SEC indicated that the “reasonably likely” threshold “does not require disclosure of any event that is known but for which fruition may be remote, nor does it set a bright-line percentage threshold by which disclosure is triggered.” Instead, it “requires a thoughtful analysis that applies an objective assessment of the likelihood that an event will occur balanced with a materiality analysis regarding the need for disclosure regarding such event.”

Thus, when applying the “reasonably likely” threshold, companies should consider whether a known trend, demand, commitment, event, or uncertainty is likely to come to fruition. If it is reasonably likely to have a material effect on the company’s future results or financial condition, disclosure is required. The SEC noted that known trends, demands, commitments, events, or uncertainties (i) that are not remote or (ii) where management cannot assess the likelihood they will come to fruition, but where they would be reasonably likely to have a material effect on the company’s future results or financial condition if they came to fruition, should be disclosed if a reasonable investor would consider the omission as significantly altering the mix of information made available in the company’s disclosures.
The SEC advised that “[t]his analysis should be made objectively and with a view to providing investors with a clearer understanding of the potential material consequences of such known forward-looking events or uncertainties.”

**Item 301.** The SEC also eliminated Item 301 of Regulation S-K, which required most registrants to furnish selected financial data in comparative tabular form for each of the registrant’s last five fiscal years. Item 301 disclosure was required in an annual report on Form 10-K or a registration statement on Form S-1. The SEC noted that, for reporting companies, financial data from earlier years is readily available through the EDGAR system, unlike when the precursor to Item 301 was adopted in 1970. The tagging of financial information using eXtensible Business Reporting Language (XBRL) has facilitated access to information in the financial statements that selected financial data was meant to highlight. For IPO issuers, there are no prior filings to reference, but the SEC noted that emerging growth companies, which represent a growing proportion of IPOs, are already permitted to exclude disclosure of the earlier two of the five years required by Item 301.

In addition, disclosures required by Item 303 are expected to continue to elicit material trend disclosure. Item 303 requires disclosure of trend data, and the Commission reiterated its guidance, emphasizing the importance of this disclosure in MD&A. In light of these requirements, the SEC does not anticipate that eliminating Item 301 will discourage or otherwise reduce an issuer’s disclosure of material trends.

**Item 303(b).** Amended Item 303(b) requires a company to describe, in quantitative and qualitative terms, the underlying reasons (instead of just the causes) for any material changes from period-to-period in one or more line items in the company’s financial statements. The amendment is largely consistent with prior SEC guidance. Its purpose is to encourage companies to provide a more meaningful discussion of the reasons that contribute to material changes in the company’s financial position.

The SEC also added a requirement in Item 303(b) to disclose critical accounting estimates. Although not specified in Item 303, the Commission has stated in prior guidance that, when preparing MD&A, registrants should consider whether accounting estimates and judgments could materially affect reported financial information. Nevertheless, many registrants have simply repeated the discussion of significant accounting policies from the notes to the financial statements—since U.S. GAAP requires disclosure of significant accounting policies in the notes but does not require similar disclosure of estimates and assumptions, except in limited circumstances. New Item 303(b)(3) is intended to go beyond accounting standards to explicitly require disclosure of critical accounting estimates in the MD&A to provide meaningful insight into the uncertainties related to these estimates and reported financials and how the accounting policies of registrants faced with similar facts and circumstances may differ. A critical accounting estimate is defined as an estimate made in accordance with GAAP that involves a significant level of estimation uncertainty and has had or is reasonably likely to have a material impact on the registrant’s financial condition or results of operations.

(3) Critical accounting estimates. Critical accounting estimates are those estimates made in accordance with generally accepted accounting principles that involve a significant level of estimation uncertainty and have had or are
reasonably likely to have a material impact on the financial condition or results of operations of the registrant. Provide qualitative and quantitative information necessary to understand the estimation uncertainty and the impact the critical accounting estimate has had or is reasonably likely to have on financial condition or results of operations to the extent the information is material and reasonably available. This information should include why each critical accounting estimate is subject to uncertainty and, to the extent the information is material and reasonably available, how much each estimate and/or assumption has changed over a relevant period, and the sensitivity of the reported amount to the methods, assumptions and estimates underlying its calculation.

Instructions to paragraph 303(b).

1. Generally, the discussion must cover the periods covered by the financial statements included in the filing and the registrant may use any presentation that in the registrant’s judgment enhances a reader’s understanding. . . .

2. . . . The discussion must not merely repeat numerical data contained in the financial statements.

3. Provide the analysis in a format that facilitates easy understanding and that supplements, and does not duplicate, disclosure already provided in the filing. For critical accounting estimates, this disclosure must supplement, but not duplicate, the description of accounting policies or other disclosures in the notes to the financial statements.

4. For the Liquidity and Capital Resources disclosure, discussion of material cash requirements from known contractual obligations may include, for example, lease obligations, purchase obligations, or other liabilities reflected on the registrant’s balance sheet. Except where it is otherwise clear from the discussion, the registrant must discuss those balance sheet conditions or income or cash flow items which the registrant believes may be indicators of its liquidity condition.

5. Where financial statements presented or incorporated by reference in the registration statement are required by Rule 4-08(e)(3) of Regulation S-X to include disclosure of restrictions on the ability of both consolidated and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans or advances, the discussion of liquidity must include a discussion of the nature and extent of such restrictions and the impact such restrictions have had or are reasonably likely to have on the ability of the parent company to meet its cash obligations.

6. Any forward-looking information supplied is expressly covered by the safe harbor rule for projections. See Rule 175 under the Securities Act, Rule
8. Discussion of commitments or obligations, including contingent obligations, arising from arrangements with unconsolidated entities or persons that have or are reasonably likely to have a material current or future effect on a registrant’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements or capital resources must be provided even when the arrangement results in no obligations being reported in the registrant’s consolidated balance sheets. Such off-balance sheet arrangements may include: guarantees; retained or contingent interests in assets transferred; contractual arrangements that support the credit, liquidity or market risk for transferred assets; obligations that arise or could arise from variable interests held in an unconsolidated entity; or obligations related to derivative instruments that are both indexed to and classified in a registrant’s own equity under U. S. GAAP.

Note that registrants are required to disclose how much an estimate and/or assumption has changed over a relevant period. This is intended to allow an investor to better evaluate the uncertainty associated with the critical accounting estimate by observing changes in estimates or assumptions over time. The intent is for registrants to provide investors with a greater understanding of the variability that is reasonably likely to affect the financial condition or results of operations so investors can adequately evaluate the estimation uncertainty of a critical accounting estimate.

In addition, Item 303(a)(4) previously required, in a separately-captioned section, disclosure of a registrant’s off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on a registrant’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors. The adopting release noted that changes in U.S. GAAP since the implementation of Item 303(a)(4) have resulted in substantial disclosure overlap. Accordingly, that Item has been replaced by a principles-based instruction, in paragraph 8 of the Instructions to paragraph 303(b), that requires registrants to discuss commitments or obligations, including contingent obligations, arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on a registrant’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements, or capital resources.

Item 303(c). To date, in quarterly reports on Form 10-Q, Item 303(b) has required that MD&A compare the most recent quarter to the comparable quarter of the prior year. New Item 303(c) permits MD&A in a Form 10-Q to compare the most recent quarter to either the corresponding quarter of the prior year or the immediately preceding quarter. If a registrant changes from one approach to the other, it must explain the reason for the change and present both comparisons in the filing when it first makes the change. This amendment reflected the SEC’s recognition that not all businesses are seasonal, and a comparison to the corresponding quarter of the preceding year (as has been required) may not be as meaningful as a comparison to the preceding quarter.
SEC Disgorgement Authority

In *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), the Court held that disgorgement by the SEC is a “penalty” and, therefore, subject to the same five-year statute of limitations as civil penalties the SEC ordinarily seeks. It also cast some doubt on the Commission’s ability to seek disgorgement in the first place. In *Liu v. SEC*, 140 S. Ct. 1936 (2020), the Supreme Court affirmed the SEC’s disgorgement ability, cabining it by “longstanding equitable principles.” Among other things, the Court limited disgorgement as a remedy against multiple wrongdoers and required disgorged amounts to be limited to the wrongdoer’s net profits and awarded only to the victims.

In Congress’s most recent response, buried deep within the $740.5 billion National Defense Authorization Act (“NDAA”), which was passed on January 1, 2001, were significant amendments to Section 21(d) of the Exchange Act (NDAA Section 6501) that give the SEC explicit statutory authority to seek “disgorgement . . . of any unjust enrichment by the person who received such unjust enrichment” in civil actions in the federal courts. They also doubled the statute of limitations for disgorgement claims in scienter-based securities law cases, permitting them now to be brought within ten years, twice as long as the statute of limitations after *Kokesh*. In addition, Section 6501 tolls the disgorgement and equitable relief statutes of limitations for periods of time during which a defendant is outside the United States. (The amendments, however, affirm the five-year limitations period to seek disgorgement for nonscienter-based securities law violations.) Finally, “[t]he Commission may seek a claim for any equitable remedy, including for an injunction or for a bar, suspension, or cease and desist order, not later than 10 years after the latest date on which a violation that gives rise to the claim occurs.”

The amendments do not address several elements of the *Liu* decision, including that the amount disgorged may not exceed the wrongdoer’s net profits and disgorgement must be obtained for the benefit of investors. As a result, although the case law since *Liu* has largely favored the SEC, deferring to its discretion in identifying harmed investors and approximating net profits, there still remain a number of open points the federal courts must unpack such as the parameters of “legitimate business expenses” appropriate for deduction.

Now with a 10-year statute of limitations for disgorgement for securities fraud violations, parties may face protracted SEC investigations as the SEC staff attempts to establish more substantial disgorgement amounts. Moreover, these new provisions are likely to encourage the SEC to charge scienter-based violations to obtain disgorgement over a longer period. In addition, with the benefit of a 10-year statute of limitations, the SEC staff may be reluctant to settle nonscienter-based charges, for example, under Sections 17(a)(2) and (3) of the Exchange Act, without the defendants agreeing to a larger disgorgement amount in exchange for the SEC dropping the scienter-based charges. The amendments will also incentivize the SEC to claim that its newfound statutory authority, no longer grounded in equitable principles, extends well beyond the limitations placed on disgorgement in *Liu*. 

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ANALYSES OF
HYPOTHETICAL PROBLEMS
CHAPTER 2: THE BASIC STRUCTURE AND PROHIBITIONS
OF THE SECURITIES ACT

The dates in some Problems pre-date amendments and rules that exist today. In all cases, we will analyze the questions using the rules as in effect today.

Problems (1-15)

New Corp., a privately-held company principally financed by six venture capital firms, needs to raise $250 million in an IPO to bring its new cell phone to market. Assume that New Corp.’s revenues in its last fiscal year were $1.4 billion [Eds. note: and, therefore, New Corp. is not an emerging growth company]. This new product significantly advances the state of the art, because it can make phone calls, receive and send emails, pick up T.V. and radio signals from a dedicated satellite with over 200 channels, including cable, and download a library of over 10,000 movies and music albums. It also has a computer chip that enables it to search the web, solve mathematical problems, and translate languages. Nevertheless, its feasibility will not be demonstrated until it can be mass-produced. Assume that New Corp. is not a reporting company and has not yet filed a registration statement.

Problem 2-1

On January 10, New Corp.’s chief executive, Max Headroom, calls Thomas Whiteshoe, the head of corporate finance for Bache, Halsey and Co., a major underwriter, in New York from his office in Silicon Valley, California, and asks Whiteshoe if his firm would be willing to lead an underwriting group in an IPO for New Corp. that would raise at least $50 million in equity. Whiteshoe says his firm knows about New Corp. and would be very interested in serving as lead underwriter. “I can fly out there tomorrow with my team, and we could work out a letter of intent by the end of the week.” “Let’s do it,” replies Headroom. By the end of the week, they have entered into a letter agreement that provides that Bache, Halsey will use its best efforts to effect a ten million share offering at a price consistent with other IPOs in the same industry. The agreement further provides that it creates no enforceable obligation, except that New Corp. will pay Bache, Halsey’s reasonable expenses incurred in the offering. No registration statement has been filed. Any problems under § 5? Suppose, instead, this letter agreement did require Bache, Halsey to underwrite at least a minimum number of shares at a minimum price?

Analysis:

Initially, it should be noted that this is an interstate phone call that establishes the jurisdictional nexus through the “use of any means or instruments of transportation or communication in interstate commerce or of the mails” (see Sections 5(a)(1) and (c) of the 1933 Act). However, this is clearly within the “preliminary negotiation” exemption created by Section 2(a)(3):

The terms defined in this paragraph and the term “offer to buy” as used in subsection (c) of section 5 shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or
indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer).

What if the letter of intent was “binding” or “enforceable” in some way? (Even though such a letter is usually expressly “not binding”—except to obligate the issuer to reimburse the underwriters for their reasonable, out-of-pocket expenses and, in some cases, to indemnify the underwriters for any losses, claims, damages, or other liabilities they may incur.) The language of Section 2(a)(3) talks about “preliminary negotiations or agreements.” Thus, a binding agreement itself is not a problem, at least so long as it is “preliminary.” Unusual as it would be, a firm agreement to underwrite would probably still be a “preliminary” agreement, because most likely it would be contingent on future developments (e.g., satisfactory due diligence by the underwriters (more about this in chapter 11 of the casebook), the filing and effectiveness of a registration statement and, possibly, no material adverse change in the issuer’s financial position or the capital markets).

What cannot be done at this stage is for the underwriters to actually buy shares, including for future resale to the public. That would violate Section 5(a)(1) (assuming the requisite use of interstate commerce or the mails). If title were passed, this would no longer be a “preliminary agreement.” Violating Section 5(a)(1) would trigger rescission under Section 12(a)(1), subject to the statute of limitations in Section 13.

Is Rule 163 available? Conceivably, a student could refer to Rule 163, but (i) Rule 163 only applies if the company is a well-known seasoned issuer (WKSI), which New Corp. is not (it is not yet even a reporting company), (ii) it extends only to issuer communications, not to those by, e.g., prospective underwriters, and (iii) sales still are not permitted.

Is Rule 163A available? Thirty days are likely to elapse before the filing of a registration statement. But (i) like Rule 163, Rule 163A exempts issuer communications, not those by, e.g., prospective underwriters, (ii) Rule 163A only exempts communications that do not reference a securities offering, and (iii) like Rule 163, sales still are not permitted under Rule 163A.

Is Rule 163B available? Rule 163B permits issuers to engage in oral or written communications with potential investors that are, or are reasonably believed to be, qualified institutional buyers or institutional accredited investors. The Rule extends the accommodations previously available to emerging growth companies under Section 5(d) of the 1933 Act to all issuers. Presumably, Bache, Halsey is a qualified institutional buyer or an institutional accredited investor under Rule 163B(c). Unlike Rule 163A, Rule 163B expressly contemplates the issuer, or a person acting on its behalf, describing the upcoming securities offering to certain prospective investors. But, like Rule 163, (i) Rule 163B exempts issuer communications, not those by, e.g., prospective underwriters (who presumably are not yet “a person authorized to act on behalf of [the] issuer”), and (ii) sales still are not permitted under Rule 163B.
Problem 2-2

Assume in the alternative that Ponderosa Partners, a venture capital firm owning 8% of New Corp., participates in these negotiations. It attends because it has a contractual right set forth in the private placement agreement by which it acquired its New Corp. shares to include these shares in the first registration statement filed by New Corp. After much negotiation, Ponderosa and Bache, Halsey agree that Bache, Halsey will seek to include half of Ponderosa’s shares (i.e., 4%) in the offering. Any problems now under Section 5?

Analysis:

The point of this Problem is to help students recognize that Section 5(c) applies to “any person,” including those other than the issuer, the underwriters, and any agents.

Ponderosa wants to be a selling shareholder, but it does not fit within Section 2(a)(3). This is because it is not an issuer and, with only 8% ownership of New Corp., it does not control New Corp. and, therefore, is unlikely to be an affiliate (and no facts suggest that New Corp. controls Ponderosa or that they are both under any direct or indirect common control).

Even if the registration statement is not filed for more than 30 days, Rule 163A only exempts communication made by, or on behalf of, the issuer, and thus it does not apply to Ponderosa. Also, it does not permit the securities offering to be mentioned.

Unlike Rule 163A, Rule 163B expressly contemplates the issuer, or a person acting on its behalf, describing the upcoming securities offering to certain prospective investors. But Rule 163B exempts communication made by, or on behalf of, the issuer, and thus it also does not apply to Ponderosa.

If Ponderosa is not an underwriter or dealer (and we know it is not the issuer), it can in communicating rely on the Section 4(a)(1) exemption from Section 5(c). However, Section 4(a)(1) does not cover Bache, Halsey.

Practically, one answer is to delay this discussion until after the registration statement is filed, because Section 5(c) by its terms drops out of the picture on the filing of the registration statement. Still, this would mean that the registration statement, as initially filed, would not contain the still unresolved terms of the selling shareholders’ deal with the underwriters.

Another practical solution may be to confine these discussions to face-to-face meetings that involve no use of interstate phone calls or the mails. The practical problem here is that emails and similar electronic messages tend to be used almost automatically.

Finally, Section 5(c) does not preclude all communications, but only those that seek “to offer to sell or offer to buy” the securities. Often, in cases where a shareholder has negotiated “piggyback registration rights” (which are what is involved here), the underwriters will indicate they are unwilling to include selling shareholders’ shares in the IPO because it will look to the market like those shareholders are “bailing out” of the company. Conceivably, the underwriters’ statement is not forbidden by Section 5(c) because it is a refusal to buy (and not a solicitation). Correspondingly, Ponderosa could indicate it was standing on its contractual rights with New Corp. and would seek an injunction if New Corp. were to register...
its shares without including its stock. This is also not an offer to sell but an exercise of contractual rights and threat to use litigation. Some compromise between these positions might be reached without either side making an offer to sell or offer to buy.

**Problem 2-3**

Also attending these meetings is Kleiner, Gilson Partners, another well-known West Coast venture capital firm, which owns 10% of New Corp., but has no contractual registration rights. It attends, in part, because it wishes to “monitor” the negotiations and make certain that Ponderosa does not receive any advantage over it, and, in part, because it serves as an investment advisor for several related hedge funds that may wish to buy in the offering. Any problem?

**Analysis:**

If Kleiner controls New Corp. (in other words, if it is an affiliate of New Corp.), it would be covered by Section 2(a)(3) with regard to “preliminary negotiations and agreements.” But it is far from clear that 10% ownership confers such control, and generally, venture capital firms avoid such control.

Even if Kleiner did control New Corp., the problem is more basic. Kleiner is acting, in part, as an advisor to hedge funds who may purchase in the public offering. Thus, not only is it a seller (the “sell side”), it is also on the “buy side.” Section 2(a)(3) only permits the issuer to negotiate with “underwriters who are or are to be in privity of contract with the issuer.” This language is intended to preclude “downstream selling efforts” to persons such as selling group members (who will not sign the underwriting agreement and, thus, will not be “in privity of contract” with the issuer). Kleiner is representing prospective purchasers who are even further downstream than a selling group member.

Rule 163A permits the issuer to communicate with Kleiner, but not about the offering.

Until the adoption of Rule 163B, that would have ended the analysis; including Kleiner in the meetings would have created problems under Section 5(c), triggering rescission under Section 12(a)(1). Rule 163B changes this. It expressly contemplates New Corp., or a person acting on its behalf, describing the upcoming securities offering to Kleiner, standing on the buy side, if it is a qualified institutional buyer or institutional accredited investor under Rule 163B(c). Note, however, that Rule 163B exempts communication made by, or on behalf of, the issuer, and thus it also does not apply to Kleiner itself. However, if Kleiner is not an underwriter or dealer (we know it is not the issuer), it can in communicating rely on the Section 4(a)(1) exemption from Section 5(c).

**Problem 2-4**

Immediately following the letter of intent’s execution, Whiteshoe calls senior executives at two other underwriters and invites them to join his firm as co-managing underwriters in the New Corp. offering. When they agree, a letter agreement among the three underwriters is executed. Permissible or not at this stage?
ANALYSIS:

So long as Whiteshoe calls only firms that will sign the underwriting agreement with the issuer (and thus be “in privity” with New Corp.), he is exempted by Section 2(a)(3). This letter agreement (which is uncommon) would be a “preliminary agreement.”

But you may wish to tweak this Problem. Suppose a person that Whiteshoe calls at one dealer tells him his firm is temporarily out of the underwriting business, but it would like to buy 5,000 shares at the usual dealer’s discount for several of its major customers. Suppose Whiteshoe agrees to reserve shares out of his firm’s allocation. Any problems? The dealer is making an illicit offer to buy, and Whiteshoe (depending on his specific language) may be offering to sell. Whiteshoe might simply acknowledge the dealer’s offer—not a problem for Whiteshoe under Section 5(c), but by offering to buy, the dealer still has a problem.

PROBLEM 2-5

Whiteshoe next emails some 50 other underwriting firms around the country, inviting them to join the prospective underwriting group. Permissible?

ANALYSIS:

If Whiteshoe only sends letters to firms he expects to join the underwriting group, he can come within the clause of Section 2(a)(3) that exempts “preliminary negotiations . . . among underwriters who are or are to be in privity of contract with an issuer.” Even though some firms will reject Whiteshoe’s offer, this is still a “preliminary negotiation” and often such negotiations fail (at least with respect to the rejecting underwriters). It is important that the financial institutions are approached to become “underwriters,” as defined in Section 2(a)(11), but that term is very capacious.

What if the letters solicit dealers to become either underwriters or selling group members? Selling group members are not underwriters under Section 2(a)(11) (since they are persons “whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors’ or sellers’ commission”) and, therefore, they are not covered by Section 2(a)(3).

PROBLEM 2-6

Three of the smaller broker-dealers emailed by Whiteshoe respond that they are not in a position to underwrite (because of net capital problems). Still, they would each be willing to buy between 2,000 and 5,000 shares from Bache, Halsey in the offering if they can be given the usual selling discount. Is there any problem with their offer? What if Bache, Halsey agrees to their request, acknowledging they will be sold the shares at the initial offering price minus the standard retail selling discount?

ANALYSIS:

(1) This is an offer by dealers in violation of Section 5(c). (They are not underwriters. How do we know this? Because of the reference to the “usual selling discount,” which appears to take them out of the Section 2(a)(11) underwriter definition. Section 2(a)(11) defines the term “underwriter” and then states that “such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and
customary distributors’ or sellers’ commission.”) If they respond by email, an interstate phone call, or the mails, they have used the requisite means or instrumentality of interstate commerce.

Here, it is relevant to ask: Why does the Securities Act want to prohibit this? Presumably, the answer is that they have not yet received the Act’s mandated disclosure in the form of a prospectus. In general, “downstream” selling beyond the underwriters is prohibited until disclosure is available (although note new Section 5(d) (for emerging growth companies) and Rule 163B that permits testing-the-waters communications prior to the filing of a registration statement).

What if the offer to buy is made by an individual investor and not the dealers? Recall Section 4(a)(1), which exempts transactions by a person who is not an issuer, underwriter, or dealer. The individual investor is covered by the exemption; the dealers are not.

(2) What if Bache, Halsey agrees to sell to the dealers? Arguably, it has not offered to sell, but only accepted the three dealers’ offers—so there is no apparent problem under Section 5(c). Still, this agreement would violate Section 5(a)(1), as it has made use of the requisite means to sell such securities. The facts suggest it has reached a binding agreement, rather than just indicating it will try to accommodate their orders. No binding firm agreement to sell or buy shares can be reached prior to the effective date of the registration statement without triggering rescission under Section 12(a)(1).

**PROBLEM 2-7**

Following the letter of intent’s execution, Bob Sales, New Corp.’s Vice President for Public Relations, purchases a full-page ad in Fortune Magazine, which has the headline, “Big Things Are Coming!” The advertisement describes the technological capability of New Corp.’s cell phone, which will not roll off the assembly line for at least another six months. Assume that New Corp. is negotiating with wholesalers who will carry its brand and hopes by this ad to attract their attention. Assume, in the alternative, that (a) New Corp. published a similar advertisement six months ago describing its new product or (b) it has never before paid for such an advertisement.

**ANALYSIS:**

It may be useful for the students to go through the communications exemptions:

Rule 163? No, New Corp. is not a well-known seasoned issuer (WKSI).

Rule 163A? Maybe—but it depends on the timing. Will New Corp. ensure that the ad does not run during the 30-day period? Also, could New Corp. be/become a penny stock? If so, it would be blocked from relying on Rule 163A.

Rule 163B? The communications, in Fortune Magazine, are being made to the general public, not limited to qualified institutional buyers or institutional accredited investors—and so Rule 163B is not available.
Rule 135? No. Recall that Rule 135 is strictly construed. Here, the required legend is missing and the ad appears to include information regarding New Corp. that is outside of what is permissible under Rule 135.

Rule 168? No, New Corp. is not a reporting company.

Only Rule 169 can be used. Rule 169(b)(1)(ii) certainly permits advertisements, and the ad seems aimed at wholesalers (which satisfies Rule 169(d)(3)). The main issues will be Rule 169(d)(1) (i.e., has it “previously released or disseminated information of the type described in this section in the ordinary course of its business”? and Rule 169(d)(2) (i.e., was the “timing, manner, and form” in which the ad was released “consistent in all material respects with similar past releases”?). The two alternatives straddle this issue: (a) the first says the company published a similar advertisement six months ago and (b) the second says it has never before paid for such an advertisement.

If New Corp. had advertised other products in Fortune Magazine or other major media, the current advertisement might comply with Rule 169. Note, however, that Rule 169 is a safe harbor. A failure to comply with it does not automatically mean that one has violated Section 5(c). Counsel can always look to SEC Release No. 5180 (excerpted in the casebook) to determine if this communication is an offer to sell, i.e., an attempt to condition the market for the offering. Still, the headline “Big Things Are Coming” raises doubt as to what New Corp. is suggesting is the “Big Thing.”

**PROBLEM 2-8**

Assume the same facts as in Problem 2-7, except that the Fortune ad now forecasts that New Corp. will have its new cell phone available for distribution by July 30, a date six months away. Although its ability to do so is uncertain, you may assume that this is a good faith estimate. Any problem now under Section 5? What if, instead, New Corp. was a reporting company?

**ANALYSIS:**

This ad now contains “forward-looking” information (see Rule 168(b)(2)(ii)). Rule 168 permits this, but New Corp. does not qualify for this safe harbor because it is not a reporting company.

Rule 169 only permits disclosure of “factual business information,” and Rule 168 specifically distinguishes “factual business information” from “forward-looking information.”

All is not lost, however, because Rule 169 is only a safe harbor. The plaintiff or the SEC is still required to show that this announcement was an attempt to condition the market for its future stock offering. Consider SEC Release No. 5180 again, which expressly covers advertisements. If New Corp. never before announced new products this far in advance (recall that SEC Release No. 5180 refers to “continued” communications), this would be a relevant factor pointing toward a finding that the ad was market conditioning. Conversely, facts suggesting a need on New Corp.’s part to notify suppliers and customers would point in the opposite direction. Note, however, that SEC Release No. 5180 covers only “factual” matters, not forecasts, raising the question whether these forecasts are covered by the Release. The
SEC’s more recent relaxed approach to forward-looking information may argue in favor of
the Release applying in this case as well.

What if New Corp. is a reporting company? Rule 168 would be applicable in that case.
Rule 168(d), however, requires previous releases in the ordinary course of business and
consistent timing, manner, and form with similar past releases.

Note that Rule 163A could apply here if this is 30 or more days before the filing of the
registration statement. We do not know if New Corp. will be a “penny stock” and, thereby,
lose Rule 163A’s availability (see Rule 163A(b)(3)(iii)). A practical solution—If New Corp. is
not a penny stock issuer, and does not fall within SEC Release No. 5180’s guidance or Rules
168 or 169, then New Corp. may simply choose to wait 30 days before filing the registration
statement.

**Problem 2-9**

The day after New Corp. enters into its letter of intent, it issues a press release indicating
it intends to make an IPO of its common stock for approximately $50 million by the end of
the year, with Bache, Halsey managing the offering for the underwriters. No copy of this
press release is filed with the SEC. The press release is picked up by the Wall Street Journal,
which announces the same facts the next day. Any problems? Query: Was anything left out
of this notice that should have been stated?

**Analysis:**

(1) Neither Rule 168 nor 169 can cover this. See Rules 168(c) and 169(c), which both
exclude communications that contain “information about the registered offering.”

Rule 163A is not available where the communication “reference[s] a securities offering.”
See Rule 163A(a).

Rule 163B is not available because the communication is a public press release to
potential investors who are not qualified institutional buyers or institutional accredited
investors.

Only Rule 135 is left. The problem is that this notice refers to Bache, Halsey managing
the offering, which violates Rule 135. See Rule 135(a)(2)(v) (“without naming the
underwriters”).

(2) What was left out? Rule 135(a)(1) requires a legend stating that this notice “does not
constitute an offer of any securities for sale.” Is this very formalistic? Yes. But that is the way
the Section 5 exemptions have been read for 80+ years: Anything not expressly permitted is
forbidden. Recall the ChrisCraft analysis in the casebook. Only since 2005 has this changed
significantly (see, e.g., Rule 163, which permits failures to legend and file with the SEC to be
fixed later).

**Problem 2-10**

A month after issuing the foregoing press release, New Corp. publishes a second
advertisement, this time in Forbes, again indicating that it will soon be producing a new, revolutionary cell phone with break-through capabilities, which product is now closer to production because of its previously announced IPO with several major underwriters. Is this announcement permissible? Would it be permissible if New Corp. were a reporting company?

**ANALYSIS:**

First, in responding, should we consider Rule 168 or Rule 169? Rule 168 applies to reporting companies, and Rule 169 applies to all companies.

On the one hand, this announcement follows a prior announcement; thus, New Corp. arguably can say it previously released such information “in the ordinary course of its business” (Rule 169(d)(1)).

On the other hand, its reference to the now-closer production date may look more like forward-looking information, which only Rule 168 can protect.

But one need not debate these questions here. Since the advertisement references the offering, it clearly flunks Rule 169(c). For the same reason, it flunks Rule 163A even if the registration statement is filed more than 30 days later (see Rule 163A(a)).

If New Corp. were a reporting company, it would flunk Rule 168, also because of the reference to the offering (see Rule 168(c)).

In fact, only Rule 135 permits a non-WKSI to reference the securities offering to the general public, but Rule 135’s conditions are not satisfied here—no legend and disclosure beyond what is permitted. Recall again *ChrisCraft* (in the casebook) and the “exclusive list.”

**PROBLEM 2-11**

Assume that no one reacts or responds to the advertisement outlined in Problem 2-10 above. Forty days later, New Corp. files its registration statement on Form S-1. The SEC now advises New Corp. that its prior ad in Forbes violated Section 5(c) of the Securities Act. In the alternative, assume that investors who purchased New Corp.’s stock in the subsequent IPO later seek rescission under Section 12(a)(1) of the Securities Act because of the alleged Section 5(c) violation. What defense can New Corp. raise to both claims? Would it make a difference if the former advertisement just proclaimed: “Major Break Through! New Corp Announces that its Revolutionary New Cell Phone will Soon be Available” (and then described its product in more detail, without discussing the contemplated IPO)?

**ANALYSIS:**

The passage of 40 days hints that Rule 163A will be available. But the announcement did “reference” the offering. As a result, it is excluded by Rule 163A(a).

For a non-WKSI, only Rule 135 is available—but, again, the required legend is missing and there is more information than Rule 135 permits.
A WKSI might look to rely on Rule 163, but it must then comply with the legending, filing, and free-writing prospectus requirements. Note the corrective features (but what is an "inmaterial" omission of the legend, and what does it mean to omit it in "good faith"?).

What if the communication falls outside the safe harbors? You may still consider the analysis in SEC Release No. 5180. That Release, however, is unlikely to help in this case, since the offering and underwriters are described.

The question regarding alternative language at the bottom of this Problem essentially asks what would happen if no reference was made to the offering. Under this revised assumption, even though this is a very pushy ad that may be seeking to condition the market for the stock offering, Rule 163A seems to protect it.

Is Rule 169 applicable in this alternative case? No, the advertisement contains forward-looking information.

Again, one can fall back onto SEC Release No. 5180 if the safe harbors fail to apply. Neither the offering nor the underwriters are described in this alternative scenario. But the advertisement still contains forward-looking information that falls outside the Release.

**PROBLEM 2-12**

One week after New Corp.’s press release announcing its contemplated offering, IPO Securities, Inc., a broker-dealer that specializes in high-tech companies and IPOs, sends out a research report strongly recommending to investors that they buy shares in New Corp.’s offering. IPO Securities does not plan to participate in the underwriting group conducting the offering. Assume further that (a) it sells its research reports as independent research to a group of subscribers, including several members of the New Corp. underwriting group, for $6,000 per month from each subscriber, and (b) New Corp. recently hired IPO Securities to develop a “shareholder relations plan” for New Corp. once it becomes publicly held.

**ANALYSIS:**

First question: Is New Corp. an emerging growth company (see Section 2(a)(19) and Rule 405)? If it is an emerging growth company, then the research report is permissible under Section 2(a)(3). Section 2(a)(3) provides, in relevant part, that a research report (which may include a written, electronic, or oral communication) about an emerging growth company shall be deemed for purposes of Section 2(a)(10) (which defines “prospectus”) and Section 5(c) not to constitute an offer to sell securities, even if the broker that prepared the report is participating or will participate in the offering.

If New Corp. is not an emerging growth company, we must ask whether New Corp. is a “reporting company.” In this case, because this is an IPO, New Corp. is not yet a reporting company and, therefore, Rules 138 and 139 are inapplicable.

Only Rule 137 can apply. Rule 137 provides that a broker or dealer that is not an offering participant in a registered offering but publishes or distributes research reports with respect to an issuer’s securities will not be considered to be engaged in a distribution of the issuer’s securities and therefore not to be an underwriter in the offering. In addition, Rule 137, when
coupled with Section 4(a)(3)(B) and Rule 174, imposes a 25-day blackout period after the effective date of an initial public offering whose shares are listed on a national securities exchange; a 90-day blackout period for an unlisted initial public offering; and no blackout period if the company is already publicly reporting. Prior to the SEC’s 2005 reforms, Rule 137 applied only to reporting companies, but that changed, and it now covers non-reporting companies as well.

Still, there are problems here. Although IPO Securities is not participating in the offering under Rule 137(a), it is selling its research for $6,000 a month (or $72,000 a year) to subscribers, including several syndicate members. Rule 137 does not preclude the sale of independent research (at the “regular subscription or purchase price,” see Instruction (2) to Rule 137(b)), so long as the conditions of Rule 137(b) are satisfied (and see the Instruction to Rule 137(b)). But Rule 137(b) precludes payments from “participants in the distribution,” which term includes any of the underwriters. In the adopting release, the SEC noted, “[I]ndependent research that is prepared by an entity not participating in an offering but paid for by a broker or dealer participating in an offering will be distributed by an offering participant and thus will not satisfy the requirements of Securities Act Rule 137 and cannot be used in reliance on the safe harbor.” In addition, New Corp. hired IPO Securities to implement a “shareholder relations plan.” Whatever that means, it seems to offend Rule 137(b)(1) (which restricts payments from the issuer).

There are separate FINRA rules regarding research reports that are described below in the analysis of Problem 2-14.

**PROBLEM 2-13**

Following the IPO Securities research report, New Corp. receives phone calls and emails from a number of other securities analysts, each asking questions or requesting an interview. To handle these requests without undue waste of time or effort, New Corp. invites a group of ten of these analysts to its headquarters for a tour of its facilities, an inspection of its new product, and a joint interview with its CEO, Max Headroom. Any problems here?

**ANALYSIS:**

First, do Rules 137, 138, or 139 apply here? No. Those rules relate to dealer communications; here we are back to issuer communications.

Threshold question: Does this constitute an offer to sell under Section 5(c)? Most likely, yes. It seems to go beyond what is contemplated under SEC Release No. 5180, e.g., by inviting analysts to the New Corp. headquarters for the first time. New Corp. may argue that meeting with analysts does not constitute an offer to sell, but only if there is no reference to the offering. Here, however, there is a practical problem: The proposed offering has already been announced, and these are research analysts charged with analyzing New Corp. in connection with the offering.

Rule 163A? Perhaps, if there is a 30-day cooling-off period. But, again, the issuer cannot refer to the offering, raising the same practical problem as noted above.
Rule 163B? If the analysts work for investors who are qualified institutional buyers or institutional accredited investors, and the purpose is “to determine whether such investors might have an interest in a contemplated registered securities offering,” then the issuer can “test the waters” through oral or written communications. Some research analysts may simply want to meet the CEO to publish research reports (like the IPO Securities report) that are distributed to people who are not qualified institutional buyers or institutional accredited investors. That would appear to be beyond the scope of Rule 163B (and, subject to Rule 137, those reports may also be problematic communications for the firms issuing them).

Rule 169? It will be difficult to rely on this safe harbor if there is no prior history of conducting similar meetings. In that case, it may look more like market conditioning. And, as noted above, the communication is likely to contain information about the offering. Information about the offering is expressly excluded from Rule 169 (see Rule 169(c)).

This is not a “preliminary negotiation” protected by Section 2(a)(3), because the CEO is speaking to analysts.

Therefore, this is likely to be considered a de facto road show forbidden by Section 5(c) prior to the date the registration statement is filed—subject to meeting the requirements of Rule 163B (and subject to New Corp. being an emerging growth company, as described below).

Separately, are there any concerns under Regulation FD for New Corp. to provide company information to some analysts (who presumably work for broker-dealers or investment advisors) and not to the public at large? Rule 100 of Regulation FD prohibits “an issuer, or any person acting on its behalf,” from “disclos[ing] any material nonpublic information regarding that issuer or its securities to,” among others, a broker-dealer or investment advisor. However, Rule 101(b) defines “issuer” to include only reporting companies, which New Corp. is not. What if, instead, New Corp. is a reporting company (and, therefore, an “issuer” under Regulation FD)? In that case, Rule 100 generally restricts private communication of material nonpublic information. But note the exception in Rule 100(b)(2)(iii)(F) [the last clause in Rule 100], which permits “[a]n oral communication made in connection with the registered securities offering after filing of the registration statement for the offering under the Securities Act” (emphasis added). What this means is that oral communications to broker-dealers, investment advisors, and others, that would otherwise be prohibited under Rule 100, are permitted during a “traditional” road show—but this would occur after the registration statement has been filed (which does not appear to be the case in this Problem).

Finally, what if New Corp. is an emerging growth company? Section 5(d) permits emerging growth companies to “engage in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors . . . to determine whether such investors might have an interest in a contemplated securities offering,” including prior to when a registration statement is filed. Consequently, if it is an emerging growth company, New Corp. can communicate with analysts who work for potential investors who are qualified institutional buyers or institutional accredited investors. As noted before, some research analysts may simply want to meet the CEO to publish research reports (like the IPO Securities report) that are distributed to people who are not qualified
institutional buyers or institutional accredited investors. That would appear to be beyond the scope of Section 5(d) (but, pursuant to Section 2(a)(3), those reports would be permissible communications for a broker-dealer that issues them).

**Problem 2-14**

A broker-dealer that will participate in the offering publishes a comprehensive list of recommended securities and includes New Corp. among its “strong buys” (along with 50 other firms, with New Corp. receiving no special attention or prominence). The broker-dealer has long published such reports in the regular course of its business, but this is the first time it has listed New Corp. Would it make any difference if New Corp. were a reporting company?

**Analysis:**

A threshold question: Is New Corp. an emerging growth company (as defined in Section 2(a)(19) and Rule 405)? If so, then pursuant to Section 2(a)(3), the research reports prepared by a broker-dealer are deemed, for purposes of Section 2(a)(10) (the prospectus definition) and Section 5(c), not to constitute an offer to sell a security, even if the broker-dealer is participating or will participate in the offering.

If New Corp. is not an emerging growth company, the Problem appears to be addressing Rule 139—specifically, “industry reports,” which include “a comprehensive list of securities currently recommended by” the broker-dealer (see Rule 139(a)(2)(iii)). This appears not to be an “issuer-specific research report” under Rule 139(a)(1). New Corp., however, does not meet any of the standards specified in Rule 139(a)(1) or (2), in particular, it is not a reporting company. In addition, we do not know if New Corp. would be a “penny stock” under Rule 139(a)(1)(ii)(C) (for issuer-specific research reports) or 139(a)(2)(ii) (for industry reports).

Alternatively, if New Corp. is a reporting company and not a penny stock or other excluded issuer, it would satisfy the issuer-related requirements of the Rule (see Rules 139(a)(2)(i) and (ii) for industry reports). Rules 139(a)(2)(iii) and (iv), regarding the report’s content and format, also appear to be satisfied. From the facts (which state that the New Corp. information is published “along with 50 other firms”), it appears that “[t]he research report includes similar information with respect to a substantial number of issuers in the issuer’s industry” in accordance with Rule 139(a)(2)(iii). The facts also state that “New Corp. [is] receiving no special attention or prominence,” indicating that the information about New Corp. is given “no materially greater space or prominence” in accordance with Rule 139(a)(2)(iv).

The question is whether, under Rule 139(a)(2)(v), “at the time of the publication or distribution of the research report, [the broker] is including similar information about the issuer or its securities in similar reports.” The Problem does not tell us if that is occurring.

Note that a “recommendation” of a stock constitutes a research report under the broad definition of “research report” in Rule 139(d) (and also in Rule 138(d)). The same is true in Section 2(a)(3) for emerging growth companies—but the definition there is even broader, covering “written, electronic or oral communication” (emphasis added), as opposed to Rules 138(d) and 139(d), which cover only “written communications” (as defined in Rule 405).
It may be useful to note here that FINRA places limits on the issuance of a research report by a distribution participant. Under FINRA Rule 2241 (which covers equity securities), but not Rule 2242 (which covers debt securities), a member firm’s policies and procedures must prohibit research analysts from publishing research or making public appearances (i.e., they must establish a “quiet period”) in connection with an issuer’s IPO (if the member firm participates as an underwriter or dealer) or an issuer’s secondary offering (if the member firm participates as a manager or co-manager). The policies and procedures must stipulate the following quiet periods: (i) a minimum of ten days in the case of an IPO; and (ii) a minimum of three days in the case of a secondary offering. Rule 2241 expressly excludes from the quiet period: (i) the publication or distribution of a research report or public appearance following an IPO or secondary offering by an emerging growth company; (ii) the publication or distribution of a research report, or the making of a public appearance, concerning the effects of significant news or other significant events on an issuer, provided that the firm’s legal or compliance personnel provided prior authorization before such publication was distributed or public appearance was made; and (iii) the distribution of research reports or the making of public appearances pursuant to Rule 139.

But does the publication of a comprehensive list of securities recommendations amount to a “research report”? The answer is “no” for purposes of FINRA Rule 2241(a)(11), even though it is “yes” under Rule 139(d). Rule 2241(a)(11) requires a communication to include “an analysis of equity securities of individual companies or industries . . . and that provides information reasonably sufficient upon which to base an investment decision” to be a research report. Moreover, a “research report” does not include communications that are limited to “statistical summaries of multiple companies’ financial data, including listings of current ratings” (Rule 2241(a)(11)(A)(iv)). Thus, no FINRA rule is violated by publishing a comprehensive list of securities recommendations (and, in any event, Rule 139 reports are excluded from the quiet periods), although a more complete research report may violate FINRA Rule 2241. Rule 139 has a broader definition of “research report,” but under these facts, if New Corp. is publicly reporting, publication is still permitted (subject to the analysis above).

**Problem 2-15**

New Corp. publishes a “tombstone ad” in the Wall Street Journal, carrying only the information traditionally permitted in such an ad, and indicates that the securities may not be sold, nor may offers to buy be accepted, until a registration statement covering the securities has become effective. Can it do this?

**Analysis:**

Two things to note: First, in addition to a pre-effective tombstone ad, this could be an “identifying statement” (see Rule 134); and second, traditionally such an ad or identifying statement includes reference to the offering and the underwriters.

Can New Corp. do this? No, doing so violates Section 5(c), triggering the Section 12(a)(1) rescission right.

This is an issuer communication, not a dealer communication, and so Rules 137, 138, and 139 are not applicable.
In general, tombstone ads/identifying statements are carved out of the definition of prospectus by Section 2(a)(10)(b), but they are not carved out of the Section 2(a)(3) definition of “offer to sell.” Tombstone ads, therefore, typically are covered by Rule 134. Rule 134 states that the term “prospectus” shall not include a communication permitted by the rule that is published “after a registration statement relating to the offering . . . has been filed”—and so Rule 134 addresses the separate question of whether the ad would be a prospectus after a registration statement is filed. It does not, however, exempt this ad from Section 5(c).

Rule 135? Not available, since the ad names the underwriters.

Rules 168, 169, and 163A cannot exempt the ad because it references the offering.

Rule 163 is only available to well-known seasoned issuers (WKSIs), which New Corp. is not.

Rule 163B is not available since the ad is public and not limited to qualified institutional buyers and institutional accredited investors.

**Problems (16-31)**

Assume that New Corp. (which was earlier described in Problems 2-1 to 2-15) has now filed a registration statement covering an offering of 10,000,000 shares. It is still not a reporting company; nor has it previously sold securities to the public, but it earned revenues in its last fiscal year of $1.4 billion.

[Eds. note: Why are revenues relevant to this analysis? Because if New Corp. has greater than $1.07 billion in total annual gross revenues, it cannot qualify as an emerging growth company. See Section 2(a)(19) and Rule 405. If New Corp. is not an emerging growth company, then, e.g., Section (2)(a)(3) (relating to broker-dealer research reports) and Section 5(d) (relating to communications with qualified institutional buyers and institutional accredited investors before or after filing a registration statement) are not applicable.]

**Problem 2-16**

Smithers, a registered representative in the Boston office of Bache, Halsey & Co., calls Mrs. Emily Thomas, a retired 75-year-old lady, and tells her this will likely be a hot offering that could run up in price on the first day. Being a greedy old lady, Mrs. Thomas says the offering sounds interesting. Smithers mails her a copy of the preliminary prospectus. What liability might Smithers face, either under Section 5 or otherwise?

**Analysis:**

There is no violation of Section 5 here, as Smithers is free to mail out the preliminary prospectus. Offers are now permitted since the registration statement has been filed.

Is Smithers’ oral communication with Thomas a “prospectus,” which subjects the communication to Section 5(b)(1)? No, Section 5(b)(1) is not implicated by the oral communication. Section 2(a)(10) defines “prospectus” to mean “any prospectus, notice,
circular, advertisement, letter, or communication, written or by radio or television,” and so does not pick up Smithers’ phone call. Delivery of the preliminary prospectus is subject to Section 5(b)(1), but because the preliminary prospectus presumably meets the requirements of Section 10, Section 5(b)(1) is satisfied.

Note that when a broker-dealer recommends the purchase of a specific security, it must have a reasonable basis to believe that a recommended transaction or strategy is suitable for the customer (this has been described as a “know your customer/know your product” standard). On June 5, 2019, the SEC adopted Regulation Best Interest (BI), which established a new standard of conduct under the 1934 Act for broker-dealers when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer. Factors considered in determining whether a recommendation has taken place include whether the communication “reasonably could be viewed as a ‘call to action’” and “reasonably would influence an investor to trade a particular security or group of securities.” The more individually tailored the communication is to a specific customer or targeted group of customers about a security or group of securities, the greater the likelihood the communication may be viewed as a “recommendation.”

Regulation BI enhances the broker-dealer standard of conduct beyond traditional suitability obligations. It states that, when making a recommendation to a retail customer, a broker-dealer must act in the best interest of the retail customer at the time the recommendation is made, without placing its financial or other interest ahead of the retail customer’s interests. This general obligation is satisfied if the broker-dealer complies with four component obligations:

- **Disclosure Obligation:** provide certain required disclosures in writing, before or at the time of the recommendation, about the recommendation and the relationship between the broker-dealer and its retail customer (e.g., the scope and terms of the relationship with the retail customer and any conflicts of interest that are associated with the recommendation);

- **Care Obligation:** exercise reasonable diligence, care, and skill in making the recommendation;

- **Conflict of Interest Obligation:** establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest; and

- **Compliance Obligation:** establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation BI.

So, Smithers can solicit Thomas under Section 5, and it can deliver the preliminary prospectus under Section 5(b)(1), but his recommendation must be done in compliance with his FINRA obligations and Regulation BI.

Note that state law may impose higher standards on Smithers, for example, including a “fiduciary” obligation on broker recommendations to retail customers.
PROBLEM 2-17

Smithers encloses in the envelope with the preliminary prospectus that he mails to Mrs. Thomas a small broker’s card that invites her to request that a specified number of shares be reserved for her in the offering. Across the top of this card, he writes: “This could be a very interesting offer. I think 500 shares would be a good investment for you.” If, as in-house counsel to Bache, Halsey, you learn of this a week later, what steps do you advise your client to take?

ANALYSIS:

Smithers has made a written recommendation. The broker’s card is a “prospectus” under the broad definition of that term in Section 2(a)(10), and on its face, it does not appear to satisfy Section 10. Absent a way for it to (i) become a Section 10 prospectus or (ii) fall outside the definition of prospectus, the broker’s card will violate Section 5(b)(1) and thus trigger rescission under Section 12(a)(1).

Two different analyses should be considered:

First, Rule 134(d) (which communication is referred to as a “broker’s card”) might exempt this communication, depending on how we construe what Smithers has written. A broker’s card that meets the requirements of Rule 134(d) is not a “prospectus” and, therefore, does not need to satisfy Section 10 for its delivery to comply with Section 5(b)(1). Students might be advised that the purpose of Rule 134(d) is to permit the inclusion in the mailing of a preliminary prospectus a broker’s card on which the customer can simply indicate how many shares she wants “reserved” (or “circled”) for the customer’s account. Here, Smithers went beyond what is normally in a broker’s card to actually recommend a purchase (“I think 500 shares would be a good investment for you.”). Initially, Rule 134(d) requires that a prospectus satisfying Section 10 precede or accompany the communication it permits. That requirement is satisfied here. It then permits the broker to “solicit an offer to buy” or an expression of interest, but it does not permit him to make recommendations personalized to the customer. In that respect, Smithers’ note seems to go beyond the bounds of Rule 134(d). Also, Rule 134(d) requires a mandatory legend, which has not been included here. Query: Should the permissibility of this aggressive sales behavior depend upon the inclusion of a meaningless boilerplate legend?

The second possible approach arises under Rule 433 and its concept of a “free writing prospectus” (“FWP”). Rule 433(b)(2) permits a FWP in an IPO, but requires that it be preceded or accompanied by the preliminary prospectus (which happened here). However, Rule 433(c)(2)(i) also mandates a legend (which was omitted). Does that mean the letter cannot be treated as a FWP? Rule 164 may provide a remedy. Rule 164(c) provides that “[a]n immaterial or unintentional failure to include the specified legend in a free writing prospectus . . . will not result in . . . the loss of the ability to rely on this rule so long as: (1) A good faith and reasonable effort was made to comply with the legend condition; (2) The free writing prospectus is amended to include the specified legend as soon as practicable after discovery of the omitted or incorrect legend;” and (3) the FWP is retransmitted with the correct legend.
Also, the FWP may need to be filed with the SEC or retained by the broker-dealer. Rule 433(d)(1)(ii) requires an offering participant to file a FWP “that is used or referred to by such offering participant and distributed by or on behalf of such person in a manner reasonably designed to lead to its broad unrestricted dissemination.” If it is not required to be filed—for example, if the FWP is not distributed in a way that is “reasonably designed to lead to its broad unrestricted dissemination”—then Rule 433(g) requires the offering participant to retain the FWP for three years. The question is whether the broker’s card sent to Thomas was “distributed . . . in a manner reasonably designed to lead to its broad unrestricted dissemination.” Broker’s cards are often sent to a wide range of prospective investors, and so, on these facts, the FWP may need to be filed with the SEC. Smithers, however, personalized the card sent to Thomas, and so perhaps one could argue that this FWP was sent to only one person. Bache, Halsey’s failure to file the card with the SEC can still be remedied under Rule 164(b), where a later filing is possible subject to the conditions of that paragraph. Likewise, the failure to retain a FWP under Rule 433(g) can be remedied pursuant to Rule 164(d).

Query: If either Rule 134(d) or Rules 164/433 are available, which should Bache, Halsey prefer? Recall that Rule 164 includes a number of remedial provisions in the event the FWP fails to comply with Rule 433’s requirements. Rule 134(d) is strictly construed, without any remedial provisions. But treating the broker’s card as a FWP means it is now subject to Section 12(a)(2) liability as a prospectus for any material misstatement or omission. Not so with a Rule 134(d) broker’s card, which is removed from the Section 2(a)(10) definition of prospectus, and therefore, is not exposed to the same liability.

Further query: Does Bache, Halsey, as practical matter, want its customers’ names/addresses publicly disclosed if the broker’s cards are filed with the SEC? Rule 134(d) may also be the practical choice if the letters are broadly disseminated, since the SEC filings would be publicly available, and Bache, Halsey may prefer not to publicly disclose its customer communications.

PROBLEM 2-18

Armitage & Co., a broker-dealer that intends to join the New Corp. underwriting syndicate, publishes a monthly comprehensive list of securities that it is recommending to clients, and it now adds New Corp. to that list. Any problem? Would your answer change if New Corp. were a reporting company? Assume, in the alternative, that Armitage will not be a member of the New Corp. syndicate.

ANALYSIS:

Importantly, because New Corp. is not considered an emerging growth company (see Section 2(a)(19) and Rule 405), Armitage cannot take advantage of the Section 2(a)(3) emerging growth company research report exemption, which provides that for purposes of Section 2(a)(10) (the definition of prospectus), the research report “shall be deemed . . . not to constitute an offer for sale or offer to sell a security, even if the broker or dealer is participating or will participate in the registered offering.” In that case, because the research report is not a prospectus, Section 5(b)(1)’s prospectus requirements are not triggered.

We, therefore, return to Rule 139. We first looked at Rule 139 during the Quiet Period because Rule 139 exempts certain research reports from Section 5(c), but recall, it also
removes qualifying reports from the Section 2(a)(10) definition of prospectus. In that case, if the research report is not a prospectus, Section 5(b)(1)’s prospectus requirements are not triggered.

The report appears to be an industry report, which includes “a comprehensive list of securities currently recommended by” the broker-dealer (see Rule 139(a)(2)(iii)). This appears not to be an “issuer-specific research report” under Rule 139(a)(1). Nevertheless, New Corp. does not meet any of the standards specified in Rule 139(a)(1) or (2), in particular, it is not a reporting company. In addition, we do not know if New Corp. would be a “penny stock” under Rule 139(a)(2)(ii).

If New Corp. were a reporting company, this research report would satisfy Rule 139(a)(2)(i). However, although Armitage satisfies a part of Rule 139(a)(2)(v), because it regularly publishes research “in the regular course of its business,” we do not know that Armitage “is including similar information about the issuer or its securities in similar reports” (Rule 139(a)(2)(v)) or that its analysis of New Corp. “is given no materially greater space or prominence” than what is given to other securities or issuers (Rule 139(a)(2)(iv)). Also, like before, we do not know that Rule 139(a)(2)(ii) is satisfied; New Corp. might fall under the definition of penny stock.

If Armitage is not and does not intend to be a participant in the offering, it can publish this comprehensive list under Rule 137, subject to meeting the requirements of that Rule. Among other requirements, recall those set out in the analysis of Problem 2-12.

PROBLEM 2-19

A Bache, Halsey registered representative mails a letter to several customers, offering New Corp. common stock, but he does not enclose a preliminary prospectus because he knows they have already received a New Corp. preliminary prospectus from other dealers at his firm. Any problems?

ANALYSIS:

This letter could fall under Rule 134(d), the broker’s card exemption, depending on its content (recall Problem 2-17). Use of a letter, rather than a card, does not affect Rule 134(d)’s applicability. Rule 134(d) requires that the letter be preceded by a Section 10 prospectus, as it has been here, because a preliminary prospectus is a Section 10(b) prospectus. Note that, as a practical matter, Bache Halsey is likely to resend the preliminary prospectus with the letter to avoid any doubt that Rule 134(d)’s requirements were satisfied. Also, this letter must contain the Rule 134(d) required legend, and there is no indication in these facts that it does. As a result, unless the legend was already included, Rule 134(d) is unavailable.

Another alternative is to consider this letter to be a free writing prospectus under Rule 433. Rule 433(b)(2) permits a free writing prospectus in an IPO, but requires that it be preceded or accompanied by the preliminary prospectus (which happened here, but again, is likely to be resent to ensure compliance with Rule 433). Treating the letter as a free writing prospectus may be impractical if, as explained in Problem 2-17, it must be filed with the SEC (see Rule 433(d)(1)(ii)). Alternatively, if there is no “broad unrestricted dissemination,” Bache, Halsey must retain the letter for three years (see Rule 433(g)). The question is
whether the letter, which the facts tell us was sent to “several customers,” was “distributed . . . in a manner reasonably designed to lead to its broad unrestricted dissemination.” Bache, Halsey’s failure to file with the SEC can still be remedied under Rule 164(b), where a later filing is possible, subject to the conditions of that paragraph. Likewise, the failure to retain a free writing prospectus under Rule 433(g) can be remedied pursuant to Rule 164(d).

In either case, Rule 433(c)(2)(i) mandates a legend, which may have been omitted. But, unlike for Rule 134(d), the free writing prospectus requirements include corrective provisions, such as Rule 164(c) for legends—specifically, “[a]n immaterial or unintentional failure to include the specified legend in a free writing prospectus . . . will not result in . . . the loss of the ability to rely on this rule so long as: (1) A good faith and reasonable effort was made to comply with the legend condition; (2) The free writing prospectus is amended to include the specified legend as soon as practicable after discovery of the omitted or incorrect legend;” and (3) the FWP is retransmitted with the correct legend. Therefore, even if Rule 134(d) is unavailable, Bache, Halsey may be able to treat the letter as a free writing prospectus.

Problem 2-20

Mrs. Thomas calls back Smithers and says: “Yes, I want to buy 500 shares, and I am mailing you a check for 500 shares at the offering price.” What must Smithers do?

ANALYSIS:

Smithers must tell her to hold the check (or, if it is sent, send it back to Mrs. Thomas immediately and not cash it). Any payment would evidence that a sale occurred, and that would violate Section 5(a)(1), triggering a rescission right under Section 12(a)(1). Mrs. Thomas must retain the right to call off this transaction until the registration statement is declared effective. All that Smithers can do at this stage is solicit “indications of interest” (which are non-binding) or “offers to buy” (which cannot be accepted or made irrevocable).

In a firm commitment underwriting, a broker’s registered representative normally would have contacted her customers after the registration statement was filed to see if there was interest in investing (but, as noted before, without any commitment by the customers). Those indications of interest are sometimes referred to as “soft circles.” After the registration statement is declared effective by the SEC (and priced by the underwriters and the company), the registered representative will contact her customers again to inform them as to the price (and the number of shares that the underwriter has available for them), and then ask them to buy. The customers’ purchase commitments are sometimes referred to as “hard circles.” Oral agreements are enforceable as to investment securities under the Uniform Commercial Code. See, e.g., Uniform Commercial Code § 8–113, “Statute of Frauds Inapplicable,” which states: “A contract or modification of a contract for the sale or purchase of a security is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the contract or modification is not capable of performance within one year of its making.”
**PROBLEM 2-21**

Smithers also calls a small brokerage firm in Little Rock, Arkansas, and offers to reserve 1,000 shares for its customers once the registration statement becomes effective? Okay?

**ANALYSIS:**

This is permissible. Smithers is inviting the Little Rock firm to join the selling group. It will not take underwriting risk, but it will buy shares after the effective date for resale to customers who have given them firm orders. For this marketing function, they will receive the “usual and customary distributors’ or sellers’ commission” (in the language of Section 2(a)(11)).

You may want to briefly describe the underwriting economics here. For IPOs between $20 million and $80 million in size, the underwriters’ commission is 7% (this is so apparently fixed and invariable in the marketplace as to have raised antitrust price-fixing issues, both in the past and currently). The dealer’s spread (i.e., the “distributors’ or sellers’ commission”) is likely to be in the 3% to 4% range. Thus, if the stock is sold to the public at $10 per share, the underwriters are likely to pay the issuer $9.30 per share and sell to a selling group dealer at between $9.60 and $9.70 per share (i.e., the customary 3% to 4% spread). Of course, the underwriters may decide to dispense with the selling group if they feel they can market the entire issue themselves. This means that, in a $20 million offering, $1.4 million goes to the underwriters who receive all of it (or only part of it, if they decide to market through dealers).

**PROBLEM 2-22**

Smithers mails copies of the preliminary prospectus to all members of the Deepdale Golf Club (some 1,500), of which club he is also a member. Moreover, he calls 150 of them over the two days following his letter’s receipt. Is this permissible?

**ANALYSIS:**

There is no limitation under the 1933 Act on the number of persons who may be solicited in a public offering—either by phone (i.e., a “cold call”) or by mailing the preliminary prospectus. Recall the broker’s FINRA and Regulation Best Interest obligations, described in Problem 2-16.

**PROBLEM 2-23**

Other members of the New Corp. syndicate send their own sales brochures, each slightly different, to their customers describing the New Corp. offering in very favorable terms. Can this be done? Under what conditions?

**ANALYSIS:**

Broker-dealers can prepare their own sales brochures (if the issuer permits this). This will need to be done under Rule 433 as a free writing prospectus. As noted earlier, in the case of an IPO, Rule 433—subject to the remedial provisions in Rule 164—requires those brochures (or free writing prospectuses) to be filed with the SEC (no later than the date of first use (see Rule 433(d)(1)) and contain a mandatory legend (Rule 433(c)(2)(i)). In the case
of an IPO or unseasoned issuer, they must also be preceded or accompanied by a preliminary prospectus (Rule 433(b)(2)(i)).

The bigger issue here is whether the issuer wants individual underwriters or dealers to use their own sales literature. The issuer may restrict their right to do so in the underwriting agreement (or, at least, require its prior approval). Two considerations, in particular, may lead the issuer to preclude the underwriters from creating their own free writing prospectuses: fear of liability and a desire for consistency.

Regarding liability, the principal concern is Section 12(a)(2)—that there may be a material misstatement or omission in a brochure, the risk of which may be greater if each underwriter is preparing its own. But why is the issuer concerned with disclosure liability on brochures prepared by syndicate members? On its face, Section 12(a)(2) holds the seller of securities liable for any damages, and in a firm commitment underwriting, the sellers are the underwriters and other brokers, not the issuer. For this, see Rules 159A(a)(2) and 159A(a)(3), where the issuer is included as a seller (even though the underwriter or broker, not the issuer, is in privity with the buyer). Rule 159A(a)(2) covers free writing prospectuses prepared or used by an issuer, and Rule 159A(a)(3) covers “[t]he portion of any other free writing prospectus . . . relating to the offering containing material information about the issuer or its securities provided by or on behalf of the issuer.” (Note that Rule 433(h)(2), like Rule 159A(a)(3), also distinguishes issuer information from an issuer-prepared free writing prospectus (which is covered in Rule 433(h)(1)). Even though, for purposes of Rule 159A(a) (see Notes to Paragraph (a) of Rule 159A), an offering participant is not deemed to be an agent or representative of an issuer solely by being an offering participant (which parallels Rule 433(h)(3)), as an issuer, you are unlikely to want to take risk on brochures that are being prepared on your behalf or on issuer information that can be traced to you, unless there are procedures in place to ensure their accuracy.

**Problem 2-24**

Assume next that New Corp. has a long-standing company website, and it hyperlinks that website to the research report prepared by Armitage & Co., which is not planning to join the underwriting syndicate. What is the significance of this hyperlink?

**Analysis:**

Recall that, standing alone, the research report may be covered by Rule 137. The issue is whether the hyperlink changes that analysis.

You may want to begin by asking whether posting the Armitage report on the issuer’s website makes it a prospectus. This takes us, first, to the definition of “graphic communication” in Rule 405, which specifically references “Internet web sites,” and second, the definition of “written communication” in Rule 405, which includes a “graphic communication.” Of course, the content of the report is critical, but any favorable statements can be seen as an effort by New Corp. to sell the securities or otherwise condition the market. Hence, this would be impermissible “free writing”—but for Rule 433.
Rule 433(e) expresses the SEC’s current approach to “envelope theory.” It tells us that the research report that is hyperlinked can be a “written offer.” As a result, the filing conditions of Rule 433(d) apply to this “offer” unless it is otherwise exempt.

Not only must this research report be filed with the SEC, but it must bear the legend required by Rule 433(c)(2)(i). This is tricky because New Corp. cannot add a legend to a report on Armitage’s website (and, because Armitage is not a distribution participant, Armitage does not want to concede it has authored a free writing prospectus). The only answer is to put the legend on or next to the hyperlink on New Corp.’s website. It would also be advisable to hyperlink the research report to the preliminary prospectus to satisfy Rule 433(b)(2)’s requirement for IPO/unseasoned issuers that the most recent version of the preliminary prospectus “precede or accompany” the FWP (see Note 1 to Paragraph (b)(2)(i) of Rule 433).

**Problem 2-25**

In the alternative to the preceding question, New Corp. does not hyperlink to any outside source, but it does include a separate section on its website, captioned “New Corp. Historical Financial Information,” which sets forth financial information about New Corp. that is not incorporated by reference into its registration statement and that is not referred to in any offering document. Must New Corp. file this information with the SEC as a free writing prospectus?

**Analysis:**

No. This variation takes us through Rule 433(e)(2). This “historical issuer information” is exempted from Rule 433(e)(1), which otherwise might convert the website information into a prospectus. Note that the historical issuer information must be identified as such, and it must be placed in a separate section of the issuer’s website. Forward-looking statements made in this section would presumably cost New Corp. the ability to rely on Rule 433(e)(2).

**Problem 2-26**

Bache, Halsey schedules road shows in four cities at which New Corp. management will speak to securities analysts and institutional investors. It also prepares an electronic version of this road show and makes it generally available to investors on both Bache, Halsey’s website and New Corp.’s website. This electronic version is posted as of the date of the first actual road show, but it differs in that no projections as to next year’s earnings or revenues are made. Must Bache, Halsey or New Corp. file the road show with the SEC as a free writing prospectus?

**Analysis:**

It is useful to begin with the definition of “road show” in Rule 433(h)(4). It requires the presence of issuer management and a “presentation regarding an offering.” This is broad and could apply to relatively informal meetings with institutional investors or securities analysts, i.e., the CEO having an informal discussion and drinks with three analysts. (Recall the “de facto road show” in Problem 2-13.)

The next step is to turn to Rule 433(d)(8). To understand it, you may wish to start with the case of an oral road show with no electronic media used. Nothing in Rule 433 or Rule 405
makes such a road show a written offer or violates Section 5(b)(1). It is an oral communication, and an oral communication is not a prospectus.

If, however, a corporate official at the road show employs “graphic communication” (see the definition in Rule 405), then this is a written communication that could constitute impermissible free writing in violation of Section 5(b)(1), triggering a rescission right under Section 12(a)(1). However, if the graphic communication is available only during a live, real-time communication to a live audience, it will not be considered a graphic communication and, therefore, not a written communication (see the definitions of “graphic communication” (“Graphic communication shall not include a communication that, at the time of the communication, originates live, in real-time to a live audience . . . although it is transmitted through graphic means.”) and “written communication” in Rule 405, and Note to Paragraph (d)(8) of Rule 433). Since it is not a written communication, it is not a prospectus.

As a practical matter, some institutional investors will be unable to attend the road show, and they may request an electronic recorded version of it. This version will almost certainly constitute a “graphic communication” and, thus, a “written communication” and prospectus. Section 5(b)(1) requires that any such prospectus meet the requirements of Section 10, for which a Rule 433 free writing prospectus will qualify.

Special attention should be paid to the SEC filing requirements for a road show. Rule 433(d)(8)(i) makes a road show that is a written communication a free writing prospectus for which no filing is required. But Rule 433(d)(8)(ii) takes back much of this concession in the case of non-reporting issuers (such as New Corp.) that offer equity and convertible equity securities by making a filing of the free writing prospectus with the SEC necessary unless the issuer makes “at least one version of a bona fide electronic road show available without restriction by means of a graphic communication to any person”—which, as a practical matter, means it should be on the issuer’s website.

The last sentence of Problem 2-26 poses a special issue: The electronic version of the road show differs from the live version (here, by the omission of projections as to next year’s earnings). This omission was presumably based on the issuer’s fear of Section 12(a)(2) and Rule 10b-5 liability to a large class of public shareholders for projections that may later turn out to be overly optimistic. As noted before, the language of Rule 433(d)(8)(ii) indicates that no SEC filing is required if the issuer “makes at least one version of a bona fide electronic road available” on its website. It goes on to note that there can be “more than one version of a road show,” and in that case, only one version must be made available to the public without restriction “no later than the other versions.” Rule 433(h)(5) then defines “bona fide electronic road show” to be a written communication transmitted by graphic means that, “if more than one road show that is a written communication is being used, includes discussion of the same general areas of information regarding the issuer, such management, and the securities being offered as such other issuer road show or shows for the same offering that are written communications.” The result?—It seems to permit selective disclosure of projections to institutions, but not to public investors, so long as the “same general areas of information” are covered in what is made publicly available. Is this fair?

Again, the usual legending requirement applies (see Rule 433(c)(2)(i)). Finally, because this is a non-reporting issuer, the free writing prospectus must be preceded or accompanied
by a preliminary prospectus (Rule 433(b)(2)(i)). But this can be satisfied if the electronic free writing prospectus contains a hyperlink to the preliminary prospectus (see Note 1 to Paragraph (b)(2)(i) of Rule 433).

**Problem 2-27**

New Corp.’s CEO, Jane Purcell, decides to appear on CNBC’s new program, “IPO Week,” to discuss her company. No payment is made by anyone to CNBC, or any affiliate thereof, with respect to this appearance. What must New Corp. do as a result of this appearance?

**Analysis:**

In the recent past, this T.V. appearance might have been a “free writing” in violation of Section 5(b)(1) (since it would be a written communication offering a security, and therefore a prospectus, but not one that meets the requirements of Section 10).

Since 2005, Rule 433 permits it. A T.V. appearance is a “written communication” (see Rule 405). Rule 433(f) says that any written offer provided by the issuer or an offering participant and disseminated by an unaffiliated person “that is in the business of publishing, radio, or television broadcasting” is a free writing prospectus. Hence, Purcell’s appearance will likely constitute a free writing prospectus, because she is conditioning the marketplace for investors to buy stock.

But neither Purcell nor the issuer has made any payment for this appearance. This is significant, because Rule 433(f)(1) dispenses with the usual requirement of Rule 433(b)(2)(i) that a preliminary prospectus precede or accompany the free writing prospectus. Similarly, the legend requirement of Rule 433(c)(2) is waived (with respect to the T.V. appearance, although New Corp. must legend whatever it files with the SEC), and the filing requirement of Rule 433(d) is altered to the extent the filing can be made within four business days (versus, normally, on the date of first issue) after the issuer or offering participant “becomes aware of the publication, radio or television broadcast, or other dissemination” (see Rule 433(f)(1)(ii)). Of course, it would be impossible to precede a T.V. interview with a preliminary prospectus because one does not know who the interview will reach.

You may wish to give your students a variation on this Problem in the form of a paid T.V. “infomercial.” Because Rule 433(f)(1)(i) is not satisfied (or, in the case of infomercials subject to Section 17(b), in light of what is required by Rule 433(b)(2)(i)), this T.V. ad must be accompanied or preceded by a preliminary prospectus. Not surprisingly, this has the practical effect of blocking paid T.V. and radio ads.

What if a well-known seasoned issuer (WKSI) did an infomercial? In that case, there is no preliminary prospectus delivery requirement, although the issuer must still satisfy the legending and filing requirements.

What if the issuer is an emerging growth company? Since the ad is to the general public, and not limited to qualified institutional buyers or institutional accredited investors, Section 5(d) does not help. The issuer would need to rely on Rule 433. For the same reason, Rule 163B does not offer any protection here to any issuer (emerging growth company or otherwise).
PROBLEM 2-28

Assume that Jane Purcell unintentionally misstates a fact about New Corp. in her T.V. interview on CNBC. What should counsel do?

ANALYSIS:

This problem of a mistake is addressed by Rule 433(f)(2)(ii), which states that the filing to be made under Rule 433(f)(1)(ii) "may include information that the issuer . . . reasonably believes is necessary or appropriate to correct information included in the communication." This may not solve the problem if a million T.V. viewers saw the interview, but it is intended to reduce the risk of Section 12(a)(2) and Rule 10b-5 liability.

PROBLEM 2-29

Instead of appearing on a T.V. show, Jane grants an interview with the host of the CNBC show and a Wall Street Journal reporter. Based on this interview, they each report favorably about New Corp. Must New Corp. distribute a preliminary prospectus to those reading or seeing these stories? Must it file the stories themselves with the SEC, or can it give the SEC only the materials and information provided to the media?

ANALYSIS:

Rule 433(f) covers "[a]ny written offer for which an issuer . . . or any person acting on its behalf provided, authorized, or approved information that is . . . published . . . by a person . . . in the business of publishing, radio or television broadcasting." Thus, even though Purcell did not appear, she did provide information for the article or T.V. report, and Rule 433(f)(1) applies. Again, there is the same four-business-day filing requirement, and again the "preceded or accompanied by a preliminary prospectus" requirement set forth in Rule 433(b)(2)(i) is waived.

For purposes of what must be filed with the SEC, Rule 433(f)(2)(iii) permits the issuer to file only "a copy of the materials provided to the media, including transcripts of interviews or similar materials." Thus, the issuer could file the article or T.V. report, or if it is concerned about potential liability on the article or report, it could choose to file only a transcript of the interview.

Materials filed with the SEC must also be legended (see Rule 433(f)(1)(ii)).

PROBLEM 2-30

Bache, Halsey modifies the free writing prospectus it was distributing to prospective investors (and which it had previously filed with the SEC) to bring the document more in line with the SEC’s “plain English” policy. There are changes on virtually every page, and the document is made three pages shorter, but all the changes are non-substantive. Must this new document be filed with the SEC?

ANALYSIS:

The SEC’s “plain English” policy appears in Rule 421(d).
The facts tell us there has been no substantive change from the prior version of this free writing prospectus, which was filed with the SEC. If so, Rule 433(d)(3) provides that filing of the amended document is not required where there is no substantive change.

In practice, however, rather than risk a later argument over whether a change is substantive or not, Bache, Halsey is likely to file anyway.

**Problem 2-31**

New Corp. is very happy with a favorable story about it that unexpectedly appears in Fortune magazine. New Corp. did not supply information for this story. New Corp. emails this story to all participating underwriters and selling group members and also posts it on its website. Some of the underwriters also post it on their own websites. You are counsel to New Corp., and you learn of this days later. What should you do?

**Analysis:**

You may want to suggest to students that they analyze this and similar problems by, first, identifying what the Securities Act problem is; second, determining if there is a way for the communication not to be a prospectus (and, therefore, avoid liability for material misstatements or omissions under Section 12(a)(2)); and third, finding whether the document can qualify as a Section 10(b) prospectus (e.g., a free writing prospectus) that satisfies Section 5(b)(1).

Initially, this Problem covers old ground. Once this story is posted on the issuer’s website, the SEC is very likely to view it as a written offer. See Rule 433(e)(1) (which codifies the SEC’s prior “envelope” theory).

Presumably, it is not “historical issuer information,” which could be exempt under Rule 433(e)(2). Nor can this be called regularly released factual business information under Rule 169, because it has not previously been released or disseminated by the issuer in the ordinary course of business (see Rule 169(d)(1)). Since New Corp. is an IPO issuer, Rule 168 is not applicable.

Hence, to avoid the release of an impermissible “free writing,” the story must be deemed a “free writing prospectus.” It can be hyperlinked to the preliminary prospectus to satisfy Rule 433(b)(2)(i), it will need to be legended under Rule 433(c), and it will need to be filed under Rule 433(d).

The real problem here is that the general counsel just learned about all this after the fact. Rule 433(d)(1) requires a filing “no later than the date of first use.” Hence, this might be an impermissible “free writing” that cannot be saved by Rule 433—but for Rule 164.

Recall that Rule 164 is critical to issuers, because it provides an after-the-fact way to clean up a messy problem. A belated filing is authorized by Rule 164(b) if the free writing prospectus is filed “as soon as practicable after discovery of the failure to file.” Rule 164(c) articulates a similar standard with regard to the mandatory legend.
This is ambiguous language, because it is not clear whose discovery of the failure to file triggers the “as soon as practicable” language. Conceivably, dozens within New Corp. were aware that the material was on its website. What if a junior in-house lawyer tried, unsuccessfully, to convince her seniors in New Corp. that it was necessary to file a free writing prospectus? Assume that a week went by while this issue was debated internally. Does this constitute “as soon as practicable”? All that is clear, in answer to this revised question, is that counsel needs to move as expeditiously as possible.

Problems (32-36)

New Corp.’s registration statement is declared effective on September 1. New Corp. will become a reporting company and will be listed on Nasdaq.

Problem 2-32

Bache, Halsey has prepared a glossy brochure that it mails to its customers the day after effectiveness. Can Bache, Halsey treat this material as being exempted by Section 2(a)(10)(a)? Or what must it do?

Analysis:

This Problem is asking whether Access = Delivery in this case.

Recall that students may want to analyze this and similar problems by, first, identifying what the Securities Act problem is; second, determining if there is a way for the communication not to be a prospectus (and, therefore, avoid liability for material misstatements or omissions under Section 12(a)(2)); and third, finding whether the document can qualify as a Section 10(b) prospectus (e.g., a free writing prospectus) that satisfies Section 5(b)(1).

Section 2(a)(10)(a) immunizes written communications disseminated after the effective date of the registration statement if, prior to or accompanying this dissemination, a Section 10(a) “final” prospectus was “sent or given” to the person to whom the written communication was made. But, today, the Section 10(a) prospectus typically is no longer delivered pursuant to Rule 172 or Rule 174. While this is sufficient for purposes of Sections 5(b)(1) and (2), SEC Release No. 8591 indicates it does not satisfy the “sent or given” requirement of Section 2(a)(10)(a). In SEC Release No. 8591, the Commission indicated that only actual sending or delivery would work for purposes of Section 2(a)(10)(a) (see SEC Release No. 8591 at *44783 n. 561).

Why doesn’t access or electronic delivery work in this case? Probably, the SEC wanted the “glossy brochure” in our hypothetical to constitute a free writing prospectus, thereby (i) forcing it to be filed with the SEC and contain the usual legend and (ii) perhaps more importantly, causing it to become subject to liability under Section 12(a)(2) for a material misstatement or omission.

What about a glossy brochure that is prepared and delivered as a free writing prospectus for a non-reporting or unseasoned issuer (prior to the registration statement being effective)? Recall that, under Rule 433(b)(2)(i), it must be accompanied or preceded by a Section 10(b)
preliminary prospectus, which may be done via a hyperlink (see Note 1 to Paragraph (b)(2)(i) of Rule 433). Does Access = Delivery here? No—actual delivery (including via hyperlink) is required. This is the second case when Access still does not equal Delivery.

PROBLEM 2-33

Bache, Halsey sends a preliminary prospectus 48 hours in advance to each customer to whom it expects to send a confirmation of sale in compliance with Rule 15c2-8. Then, it emails to its customers (including even those who have not consented to electronic delivery) confirmations of sale containing the information specified in Rule 10b-10. Nothing else is done, except that Bache, Halsey delivers shares to those shareholders requesting to hold them in their own name. Any problem?

ANALYSIS:

Two things to note: First, the confirmation of sale is required to be delivered by Rule 10b-10 under the 1934 Act; and second, even though Rule 15c2-8 under the 1934 Act specifies that the preliminary prospectus must be delivered 48 hours prior to sending a Rule 10b-10 confirmation, as a practical matter, an underwriter is likely to send the preliminary prospectus to all its customers as soon as it is available—much earlier than the 48-hour period. Doing so is part of the underwriter’s marketing effort, and it also avoids the risk of a 48-hour delay in the event a prospective purchaser did not already receive the preliminary prospectus.

Let’s start with the basics: If the conditions in Rule 172(c) are satisfied, Rule 172(a)(1) now permits electronic delivery of the confirmation of sale (which is a prospectus under the definition in Section 2(a)(10)). No consent by the investor to electronic delivery is necessary.

Similarly, if the conditions in Rule 172(c) are satisfied, Rule 172(b) dispenses with the obligation under Section 5(b)(2) to accompany or precede the delivery of the purchased securities with a Section 10(a) prospectus.

In both cases, each underwriter or dealer selling securities (that is not exempt from the prospectus delivery obligation by Section 4(a)(3) or Rule 174 (see Rule 173(a)), or the issuer, if it is making the sale directly, must provide, not later than two business days after the transaction, the notice required by Rule 173. Noncompliance, however, is not costly. Even if the underwriter, dealer, or issuer fails to comply with Rule 173, Rule 173(c) provides that compliance with Rule 173 “is not a condition to reliance on Rule 172.”

Thus, on the facts of this Problem, Bache, Halsey appears not to have complied with Rule 173, but there is no private remedy available to investors, and Sections 5(b)(1) (regarding the confirmation of sale) and 5(b)(2) (regarding the delivery of a Section 10(a) final prospectus) have not been violated.

One variation on this Problem should be raised. What if Bache, Halsey, to comply with Rule 15c2-8, emails the preliminary prospectus to someone who did not elect electronic delivery? Or, alternatively, it claims that the posting of the preliminary prospectus on the issuer’s website is sufficient on the premise that “access equals delivery.” Does this satisfy Rule 15c2-8? Neither approach works. SEC Release No. 8591 makes clear that, to satisfy
Rule 15c2-8, the preliminary prospectus must be “deliver[ed]” and not simply posted. This is the third principal carve-out from the SEC’s general Access = Delivery approach.

**Problem 2-34**

Goldman, Lynch is a dealer that has not participated in the offering. Two weeks after the effectiveness of the New Corp. registration statement, it recommends to a long-standing client that it purchase several thousand shares of New Corp. The customer agrees to do so. On making the purchase and delivering the shares to its customer, must Goldman, Lynch deliver a copy of the final prospectus? Must it do anything else?

**Analysis:**

This Problem examines what has happened to the prospectus delivery requirement applicable to dealers who are not underwriters. That obligation is set forth in Section 4(a)(3) of the Securities Act. In this case, the delivery obligation is triggered “two weeks after the effectiveness of the New Corp. registration statement,” which is within the 25-day delivery period in accordance with Section 4(a)(3)(B) and Rule 174.

Prior to the 2005 offering reforms, a dealer would have been obligated to deliver a Section 10(a) prospectus for 90 days in the case of an IPO (see the last sentence of Section 4(a)(3)). This period was shortened to 25 calendar days under Rule 174(d) if the issuer listed on an exchange or Nasdaq, and prospectus delivery by dealers was waived under Rule 174(b) if the issuer was a reporting company.

Although Rule 174 remains on the books, Rule 174(h) directs you to Rule 172 for any remaining prospectus delivery obligations that are not otherwise exempted. In effect, Rule 172 is a catch-all that largely eliminates any prospectus delivery obligation. Rule 172, however, does not apply in all remaining cases. For example, the conditions in paragraph (c) to rely on Rule 172 may not be met, and some issuers and transactions are excluded from Rule 172 by Rule 172(d).

Can a dealer rely on Rule 172 if the issuer fails the condition in Rule 172(c)(3) to file a Section 10(a) final prospectus pursuant to Rule 424? Yes. Rule 172(c)(4) makes clear that dealers are relieved of their prospectus delivery obligation, even when the issuer has not properly filed the final prospectus under Rule 424. Why is that? Dealers (as opposed to underwriters) cannot compel the issuer to file its final prospectus under Rule 424. Underwriters, who are in contractual privity with the issuer, can make the Rule 424 filing a covenant in the underwriting agreement.

Recall that, in general, a broker-dealer must also deliver to its customer, “at or before completion of [a] transaction,” a confirmation of trade pursuant to Rule 10b-10 under the 1934 Act. Rule 10b-10 confirmations fall within the Section 2(a)(10) definition of “prospectus” (which includes any “communication . . . which . . . confirms the sale of any security”), historically raising issues under Section 5(b)(1) since such confirmations were not Section 10 prospectuses. Today, delivery of a 10b-10 confirmation no longer raises the same concerns, since they are exempt from Section 5(b)(1) pursuant to Rule 172(a)(1).
PROBLEM 2-35

Blythe & Co., a small broker-dealer that did not participate in the New Corp. offering, is asked by a customer to purchase 200 shares of New Corp. common stock in the secondary market in the week following New Corp.’s effectiveness. It does so, but neither includes a final prospectus nor provides the notice specified in Rule 173. Any problem here?

ANALYSIS:

This question deals with the broker’s exemption under Section 4(a)(4). Prior to Rule 172, a broker who solicited a sale would have had the same obligation as a dealer to deliver a final prospectus. That is, the Section 4(a)(4) exemption was inapplicable if the sale was solicited by the broker, thus forcing the broker-dealer to rely on Section 4(a)(3). In this case, since delivery of the shares occurred during Rule 174(d)’s 25-day period, the broker would be required to deliver a final prospectus. Today, however, Rule 172 ends the prospectus delivery obligation for this broker (subject to satisfying Rules 172(c) and (d)).

Compliance with Rule 173 is not a condition to relying on Rule 172, so Blythe & Co.’s failure to provide a Rule 173 notice will not result in the loss of Rule 172.

PROBLEM 2-36

New Corp. decides to merge with Big Co. On the merger’s approval, New Corp.’s shareholders are to receive two shares of Big Co. for each share they hold in New Corp. A registration statement on Form S-4 covering this transaction is declared effective on September 1. Must copies of the final prospectus be delivered to these shareholders?

ANALYSIS:

Here, we encounter another significant limitation of Rule 172.

Under Rule 172(d)(2), a Section 10(a) final prospectus must still be delivered in a business combination transaction (chiefly, a merger, consolidation, or exchange offer). Why? In this special context, a shareholder vote is required, and the proxy statement informing that vote serves as the final prospectus. The SEC has considered whether to extend the “access equals delivery” approach to proxies, but has not yet done so. If it does, this special exception for business combinations may be removed.

Problems (37-40)

Assume now that New Corp.’s gross revenues were $250 million in the fiscal year prior to its IPO. It is also not a reporting company.

PROBLEM 2-37

Prior to New Corp. filing its registration statement, Thomas Smith, an analyst with Bache, Halsey & Co., the lead underwriter for the proposed offering, sends a five-page letter to 25 pension and mutual funds (and also posts this letter on a blog that he runs for Bache, Halsey), analyzing New Corp.’s recent financial performance and describing it as “stellar” and “off-the-charts.” Can this be done?
**ANALYSIS:**

New Corp. qualifies as an emerging growth company ("EGC") under Section 2(a)(19) and Rule 405.

If New Corp. elects EGC status, research reports covering EGCs receive special treatment under Section 2(a)(3). The publication or distribution by a dealer of a “research report” about an EGC that is the subject of a proposed public offering of common stock, pursuant to a registration statement that the EGC proposes to file, or has filed, or is effective, shall be deemed for purposes of the Section 2(a)(10) definition of “prospectus” and Section 5(c) not to constitute an offer to sell a security, even if the dealer is participating or will participate in the registered offering. Section 2(a)(3) goes on to provide a broad definition of “research report,” meaning “a written, electronic, or oral communication that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.” If the five-page letter qualifies as a research report, then Smith is permitted to distribute it without restriction, both in writing and on the Bache, Halsey blog, regardless of Bache, Halsey being the lead underwriter for the offering.

Section 5(d) also permits New Corp. and its underwriters to engage in written or oral communications with qualified institutional buyers ("QIBs") or institutional accredited investors prior to filing a registration statement if the purpose is to determine whether such investors might be interested in purchasing the firm’s securities in an offering. (The same would be true for New Corp. even if it was not an EGC, so long as it communicated only with QIBs and institutional accredited investors (see Rule 163B).)

In this case, the letter to the pension and mutual funds would be a permissible communication under Section 5(d), assuming the funds qualify as QIBs or institutional accredited investors. The posting on the blog would be problematic, since it may be seen by non-QIBs and non-accredited investors. (If the blog were password-protected, and access was controlled, then it might qualify under Rule 163B.)

**PROBLEM 2-38**

New Corp. posts Smith’s letter on its own web site. Any problem?

**ANALYSIS:**

Now the letter is being distributed by New Corp., not by a broker or dealer, as provided by Section 2(a)(3). This is an issuer communication, consistent with the “envelope theory” the SEC has adopted for materials posted on the issuer’s web site. As noted above, an EGC is permitted to communicate with QIBs and institutional accredited investors under Section 5(d). But by posting this letter on its website, it is likely to reach potential investors who do not meet the Section 5(d) requirements.
PROBLEM 2-39

Again prior to New Corp.’s filing of its registration statement, New Corp.’s CEO, Max Headroom, invites investment officers from six major insurance companies, three large hedge funds, and two sizable mutual funds to the company’s headquarters for what he describes as a “preliminary road show.” Can this be done?

ANALYSIS:

Probably. Under Section 5(d), an EGC may engage in oral offers, which this would be, so long as the potential investors are QIBs or institutional accredited investors (basically, >$5 million in assets). If the investors all satisfy that requirement, which it appears they do, then the preliminary road show is permissible.

There is no Regulation FD problem, since it does not apply to New Corp., as a nonreporting company, at this time (recall Problem 2-13).

The SEC FAQ on this issue raises some interesting, additional points:

... Section 105(b)(2) of the JOBS Act allows a firm to avoid the ministerial burdens of organizing separate and potentially duplicative meetings and presentations among an emerging growth company’s management team, investment banking personnel, and research analysts. Section 105(b)(2) did not address communications where investors are present together with company management, analysts and investment banking personnel. This provision of the JOBS Act thus does not affect [FINRA 2241(b)(2)(L)], which prohibit[s] analysts from participating in road shows or otherwise engaging in communications with customers about an investment banking transaction in the presence of investment bankers or the company’s management. These rules – which are intended to reduce the pressure on analysts to give overly optimistic assessments of investment banking deals and guard against analysts being perceived as part of the sales and marketing team for a transaction – apply to communications with customers and other investors and do not depend on whether analysts, investment bankers, and management are participating jointly in such communications.

PROBLEM 2-40

New Corp. files its registration statement on March 1, seeking confidential review by the SEC. On April 5, the SEC responds with a letter of comments, and New Corp. files its first pre-effective amendment to its registration statement on April 12. All these documents are made publicly available on April 21, and New Corp. schedules its first formal road show in New York City for May 2nd. Any problem?

ANALYSIS:

Note that, strictly speaking, this is a confidential “submission” (not a filing) for review by the SEC staff (not the Commission itself).

Under Section 6(e)(1), the confidential submission and amendments must be publicly filed and made available at least 15 days before commencement of a road show. The road
show here is scheduled for 11 days after the public release. They cannot commence the road show for another four days.
CHAPTER 3: THE REGISTRATION PROCESS

The dates in some Problems pre-date amendments and rules that exist today. In all cases, we will analyze the questions using the rules as in effect today.

**PROBLEM 3-1**

XYZ Industries completed its IPO on March 15, 2012. It was also effective on its Form 10 under the 1934 Act, where it registered its common stock for trading on Nasdaq. As a result, XYZ became subject to the periodic reporting requirements of the 1934 Act. The offering sold 10 million shares (or 50% of XYZ's outstanding common stock) at $5 per share for $50 million to unaffiliated investors; its founders held the other 50% of XYZ's common stock. Since then, XYZ has filed all 1934 Act reports in a timely manner. Another 5 million shares were sold in early 2013 for $6 per share to public investors. It is now December 2013, XYZ's current stock price is $4 per share, and XYZ would like to do another public offering of 10 million shares (or approximately $40 million) and has found an underwriter to assist it. They would like to use “shelf registration.” What restrictions do they face at this point and in the near future? Alternatively, what if XYZ, which made a substantial profit last year, were to offer non-convertible debt securities?

**ANALYSIS:**

XYZ Industries faces two questions with respect to using shelf registration.

Recall that, for shelf registration under Rule 415(a)(1)(x), XYZ must be eligible to register using Form S-3. Form S-3 has both registrant and transaction eligibility requirements.

Form S-3's registrant requirements provide that the registrant must have been “subject to the requirements of Section 12 or 15(d) of the Exchange Act . . . for a period of at least twelve calendar months immediately preceding the filing of the registration statement on this Form” (see Form S-3, General Instructions I.A(3)(a)). This 12-month period was reached after March 15, 2013. So long as XYZ filed its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, and certain Current Reports on Form 8-K “in a timely manner” (see Form S-3, General Instructions I.A(3)(b)), it will satisfy the Form S-3's registrant requirements. (There is also the question of whether XYZ failed to pay any dividend or sinking fund installment on preferred stock or defaulted on certain obligations since the end of its last fiscal year (see Form S-3, General Instructions I.A(4)).) In addition, under the transaction requirement in General Instruction I.B(1), XYZ must have a minimum public float (i.e., common equity held by non-affiliates) of $75 million. Here, at a price of $4 per share, the public float is only $60 million; the stock held by insiders cannot be counted in this calculation.

If XYZ were instead to sell non-convertible debt securities, then it would still meet the registrant requirements under General Instruction I.A(3) (with the same question about whether XYZ failed to pay any dividend or sinking fund installment on preferred stock or defaulted on certain obligations since the end of its last fiscal year (see Form S-3, General Instructions I.A(4))). The transaction requirement is in General Instruction I.B(2), which provides, among other things, that within 60 days of filing the registration statement, (i) XYZ has issued at least $1 billion in non-convertible securities (other than common equity) in primary offerings for cash, not exchange, registered under the Securities Act, over the prior
three years, or (ii) XYZ has outstanding at least $750 million of non-convertible securities (other than common equity) issued in primary offerings for cash, not exchange, registered under the Securities Act. We do not know enough facts to determine whether shelf registration would be available for XYZ's non-convertible debt securities.

**Problem 3-2**

Alternatively, it is now late 2013, and XYZ Industries has prospered. Currently, the market value of its common stock is slightly more than $1.5 billion, and the public holds 60% of its shares. It would like to register up to $600 million in common stock for sale from time to time. It wants to get to the market as soon as possible because it believes market conditions are favorable. What additional options are now available to it? Would it matter if it was currently delinquent by 20 days in filing its Form 10-K? What if, instead, it was delinquent in filing a Form 8-K?

**Analysis:**

XYZ Industries now appears to be a well-known seasoned issuer (“WKSI”). The market value of the 60% of its stock held by non-affiliates (the “public float”) is approximately $900 million (60% x $1.5 billion), thus exceeding the $700 million level required in Rule 405 definition of WKSI. XYZ has been a reporting company and, except as described in the next two questions, it has been timely in its 1934 Act filings. There is nothing to indicate it is otherwise disqualified from using Form S-3 (e.g., it has not failed to pay a dividend or sinking fund payment on preferred stock or defaulted on certain other obligations). Thus, it is now eligible to use Form S-3 (see General Instructions I.A and I.B(1) (since its $900 million held by non-affiliates is well in excess of the $75 million threshold) to Form S-3). Because XYZ is a WKSI, it also qualifies for automatic shelf registration, so that it has immediate market access upon filing its Form S-3 registration statement with the SEC (see General Instruction I.D to Form S-3 and Rule 462(e)).

The next two questions ask what happens if XYZ has no longer filed its 1934 Act reports “in a timely manner.” In general, XYZ’s failure to be timely in its Form 10-K or Form 10-Q, and certain of its Form 8-K, reports means that XYZ is no longer eligible to use Form S-3 (see General Instruction I.A(3)(b) to Form S-3) and, because it no longer meets all the registrant requirements of Form S-3, it no longer qualifies as a WKSI (see the Rule 405 definition of WKSI). In effect, XYZ is in a “penalty box” for the next 12 months. If it is timely in its filings during that 12-month period, and assuming the other requirements of Form S-3 and the WKSI definition are met, XYZ will again qualify for use of the Form S-3 and automatic shelf registration. Note that, if XYZ was delinquent for reasons excused by Rule 12b-25(b) under the 1934 Act, the delinquency does not bar Form S-3 eligibility if the report was later filed within the time period permitted by that Rule (see General Instruction I.A(3)(b) to Form S-3).

A delinquency in certain Form 8-K filings will not result in a loss of Form S-3 eligibility (see General Instruction I.A3(b) to Form S-3). Thus, the answer to the last question depends on whether the omission relates “solely” to the specified Items of Form 8-K carved out by the General Instruction.
PROBLEM 3-3

Fifteen years ago, Ajax Corp. sold its chemical division to Achilles Industries, and the latter gave Ajax a broad release from any liability to Achilles for environmental problems or future clean-up costs. The chemical division’s principal site, however, has proven to be a toxic minefield and was subsequently made into a Superfund site. Possibly as a negotiating tactic in its battles with the environmental authorities, Achilles has disclosed it may be forced to file for bankruptcy due to the costs associated with cleaning up this site. Ajax doubts that Achilles will file for bankruptcy, but it is aware that, if Achilles does, it could be named as a “potentially responsible party” and forced to share in the clean-up costs. If it were forced to contribute, Ajax’s share could be between $25 and $60 million (and the latter number would be material to Ajax), but it cannot really estimate these costs because it is not able to visit the site. Ajax is also unable to make any objective prediction as to whether Achilles will file for bankruptcy or whether the environmental authorities will sue Ajax in such an event. Ajax must soon file its annual report on Form 10-K. Must it disclose anything about its contingent liability for the Superfund site, even if it believes the possibility that Achilles will file for bankruptcy to be only around 40%?

ANALYSIS:

This Problem works off SEC Release No. 6835 and its two-part standard for evaluating trends, commitments, events, or uncertainties. Specifically, (1) is the known trend, demand, commitment, event, or uncertainty likely to come to fruition? If management determines it is not reasonably likely to occur, no disclosure is required. (2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event, or uncertainty, on the assumption it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur.

Turning to the first part, even if management decides there is only a 40% chance of these adverse events occurring, this does not enable it to say that none of these events is “reasonably likely to occur.” A 40% probability falls within the “reasonably likely” range; indeed, some practitioners believe a one-third probability is the floor of this “reasonably likely” zone.

Second, if management cannot determine that the adverse events are “not reasonably likely to occur,” it must (i) objectively evaluate the consequences of the known trend, commitment, event, or uncertainty on the assumption it will come to fruition and (ii) determine whether a material effect on the issuer’s financial condition or operations is not reasonably likely to occur. Here, Ajax cannot say it is unlikely that Achilles will file for bankruptcy (it does not know one way or the other). Nor can it say that the possible $60 million liability is not material to it. Finally, even if management decides there is only a 40% chance of these adverse events occurring, recall from above that a 40% probability falls within the “reasonably likely” range. Ajax cannot say that a material effect on its financial condition or operations is not reasonably likely to occur. Hence, Ajax is required to disclose the “worst case” possibility. The MD&A disclosure requirement is set forth in Item 303 of Regulation S-K. In disclosing the worst case, Ajax can (indeed, it should) disclose the assumptions underlying this scenario, including some sense of the likelihood of the events occurring or not, and what Ajax may do to minimize its exposure.
Note that the standard of disclosure in SEC Release No. 6835 is different from Basic’s traditional probability/magnitude test of materiality under Rule 10b-5. Nevertheless, in assessing liability, a court may use a standard consistent with Basic’s traditional probability/magnitude tradeoff, finding it to be a material omission to fail to disclose the registrant’s potential liabilities for the required cleanup of toxic waste under environmental laws.

Problem 3-3 also raises the special case of environmental liabilities, which are treated differently by Item 103 of Regulation S-K. Item 103(a) requires disclosure of “any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject.” Item 103(c)(3) then clarifies that Item 103(a) includes administrative and judicial proceedings arising under federal, state, or local laws “regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment” and that such proceedings shall not be deemed “ordinary routine litigation incidental to the business” and shall be disclosed when, among other circumstances, a governmental authority is a party to the proceeding “unless the registrant reasonably believes that such proceeding will result in . . . monetary sanctions . . . of less than $300,000” or, at the registrant’s election, such other threshold that the registrant determines is reasonably designed to result in disclosure of a proceeding that is material to its business or financial condition, which the registrant discloses in its annual and quarterly reports, and which does not exceed the lesser of $1 million or one percent of the registrant’s current consolidated assets. This may result in a low threshold for disclosure. In effect, the Commission has given environmental liabilities a special status under its disclosure rules (and this may show the impact of environmental lobbying on the SEC), although the SEC has resisted other attempts to use the federal securities laws as a lever to promote social goals unrelated to investor interests. Here, it is unclear that there is a “pending” environmental proceeding (one appears to be pending against Achilles, but Ajax has not yet been named). Still, Item 303 alone is sufficient to require disclosure by Ajax.

**Problem 3-4**

Morgan Financial Services, Inc. has a shareholder-approved qualified stock option plan that authorizes its Compensation Committee to grant options to management to purchase up to 30 million shares over a defined period. The plan requires that all options be granted at the market price of the stock on the date of grant by the Compensation Committee. On July 1, 2002, the Committee granted an option to its CEO, Dudley Doright, to purchase 1 million shares at the then-market price of $30 per share. However, one week before, on June 24, 2002, Morgan’s stock price had fallen to $27 per share (its lowest for the year). In granting the stock option, the Committee never discussed what the current price was, and did not date the corporate minutes, leaving this task to Morgan’s Assistant Secretary. The Assistant Secretary, however, backdated the option to June 24th (and, hence, to $27 per share). Five years later, in 2007, these details were uncovered as part of an overall review of stock option practices shortly before Doright’s stock option expired. As it turns out, Morgan’s stock price fell in 2003 to $25 per share (before Doright’s stock option vested and became exercisable), and the stock price never again reached $27. Doright’s counsel argued that the whole matter is immaterial because there was “not a dollar’s loss or dilution to any shareholder.” But, while
no longer CEO, Doright remained as Chairman of the Board. Was the option-backdating material? What if Doright had retired from all corporate offices in 2006?

**ANALYSIS:**

While this Problem involves the specific problem of backdating stock options, it poses the broader issue of management integrity that traces back to *Franchard*. Item 402 of Regulation S-K requires detailed disclosures of executive compensation, including, among others, stock option awards. This information was knowingly falsified, since the options were granted at a price below that authorized by the company’s stock option plan. Students should be made aware that Section 13(b)(5) of the Exchange Act states that “[n]o person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in [§ 13(b)(2)].” This provision has no materiality requirement. In all likelihood, Doright could be criminally prosecuted if he authorized, condoned, or knew of the backdating.

Defense counsel might question whether the Compensation Committee’s meeting minutes constitute “records” for purpose of Sections 13(b)(2) and 13(b)(5). Here, a leading case is *SEC v. World-Wide Coin Investments, Ltd.*, 567 F.Supp. 724 (N.D. Ga. 1983), which broadly defined the term “records” for purposes of Section 13(b)(2) to include “virtually any tangible embodiment of information kept or made by an issuer.”

Further, the CEO of a public corporation is required to certify, both annually and quarterly, the accuracy of the company’s financial statements under Sections 302 and 906 of the Sarbanes-Oxley Act. It is also a crime under Section 303 of the Sarbanes-Oxley Act and Rule 13b2-2 under the 1934 Act to make or cause to be made a materially false or misleading statement to the company’s auditor (and the CEO normally is required to represent the accuracy of the company’s books and records to the auditor). Thus, even though there was no financial loss to the company, the CEO’s involvement in a crime seems highly likely. As the casebook notes, when directors or officers receive a personal benefit from an unlawful transaction, courts have generally found its nondisclosure to constitute a material omission. In this case, the CEO’s conduct amounted to self-dealing, even in the absence of a profit, and probably a criminal violation. Its materiality seems clear.

What if Doright resigned from the board and is not seeking reelection? Is his conduct immaterial to the shareholders’ voting decision? It appears to show a material weakness in the company’s internal controls, as to which controls Doright’s successor CEO and the CFO must report, both annually and quarterly. Also, the auditor must attest to the company’s internal controls with its own report. Particularly if the auditor believes there is a material weakness and will so report, counsel would be foolish to let management certify otherwise.

**PROBLEM 3-5**

The allocation of stock in hot IPOs has long been a controversial issue. Inevitably, large or repeat customers appear to receive preference over retail customers in the allocation of shares in hot IPOs. Suppose, then, that FINRA proposes, under pressure from Congress, an allocation rule under which underwriters must do one of the following:
(a) allocate IPO shares on a “first-come, first-served” basis to the persons who first request an allocation (probably subject to some ceiling—say 10,000 shares—on this right of priority); or

(b) prorate the shares the underwriter is to receive among all its customers who request allocations (thus, if the underwriter intends to buy 1 million shares and receives indications of interest from its customers for 2 million shares, every customer would receive at least 50% of its requested allocation).

Would such rules be preferable to the current system (in fact, variations on these rules are in effect in some other countries)? What would be their likely impact?

ANALYSIS:

This is less a factual problem than a policy debate. We begin to discuss stabilization in response to this Problem, and we continue the analysis in Problem 3-6. The analysis here and below goes beyond what may be necessary to teach students, but we include it here for reference.

The SEC permits underwriters (but not the issuer) to “stabilize” a share’s price—in effect, to place a floor under the market price for the shares—while it distributes the shares into the market (see Rule 104 of Regulation M, which covers stabilizing activities in connection with an offering). Underwriters are not contractually obligated to stabilize a share’s price, although many do so as a reputational matter to show issuers their commitment to the stock and the issuer’s new shareholders. It also avoids investors (to whom they sold shares as part of the IPO) incurring a quick loss, many of whom have other relationships with the underwriters and may not be happy if their shares quickly lose value. To the extent of any stabilization, underwriters hope to keep repurchases to a minimum. After all, they are in the business of distributing shares, not looking to buy them back in the secondary market. The amount of stock the underwriters repurchase could expose them to millions of dollars in potential losses. Regulation M sets forth the detailed rules regarding stabilization, but the bigger issue is whether it is inherently misleading to support the price while selling stock to the public. (Of course, there is disclosure that stabilization may occur in the prospectus (see, e.g., Item 508(l) of Regulation S-K), but it is fairly generic and may be lost on retail investors.)

Note that part of this process involves what is called a “green shoe” (or “green shoe option”), named after the Green Shoe Manufacturing Company (now called Stride Rite), which first employed the strategy when it went public. As part of the selling process, underwriters typically allot stock in an offering to different customers and may “over-allot” by selling more shares as part of the initial distribution than were what was originally offered. For example, ABC Company might offer 1,000,000 shares at $100 per share, but when the stock finally goes public, the underwriters may sell up to an extra 15% (150,000 shares, for a total of 1,150,000 shares sold in the offering). There are two ways for the underwriters to cover its 150,000 share “short” position, i.e., the sale of the additional 150,000 shares. First, if the underwriters subsequently repurchase shares as part of their stabilizing activities, those shares can be used to settle the underwriters’ overallotment. Accordingly, if the secondary trading price falls below $100 per share, and the underwriters repurchase shares as part of their stabilizing activity, those shares may be used to settle the underwriters’ overallotment of up to 150,000 shares. Second, underwriters typically include a provision in the underwriting agreement that gives them the right to buy from the issuer at the IPO price additional shares equal to up to 15% of the total number of shares being
offered (see FINRA Rule 5110(g)(9), prohibiting an overallotment option of more than 15% of the amount of securities being offered in a firm commitment underwriting). So, if the secondary trading price rises above $100 per share, and there are no stabilizing activities, the underwriters can “exercise the green shoe” to cover the additional 150,000 shares they sold. Likewise, if the secondary share price sometimes rises above and sometimes drops below the IPO price, so that there is only some stabilization, the underwriters may use repurchased shares to settle a portion of the overallotment, with the remainder bought from the issuer under the green shoe.

To tie this together, if investors see a stock go public in a 10-million-share IPO at $10 per share, for example, and the stock price remains flat at $10 in the aftermarket, they may think there was enough demand for the offering to sustain at least the IPO price in later trading. But, in truth, the underwriters may have repurchased a large quantity of shares at $10 per share to prevent the market price from falling below the initial IPO level. In that case, the underwriters can use the repurchased shares to settle any overallotment of shares. Stated differently, the underwriters are likely to have overallotted shares in anticipation of the possibility of stabilization, with any repurchased shares (if stabilization occurs) used to cover the overallotment. If, instead, the stock price remains flat (or rises above $10 per share), without stabilization, the underwriters can exercise the green shoe option (up to 150,000 shares). The green shoe, therefore, benefits the issuer by helping mitigate the underwriters’ risk in stabilizing the stock price: (1) if the stock price goes down, the underwriters can cover their overallotment with repurchased shares as part of stabilization; but (2) if stabilization becomes unnecessary, the underwriters can rely on the green shoe to cover their overallotment.

Shortly after the distribution is completed, the underwriters may cease their stabilizing repurchases (and, to the extent not used to cover an overallotment, begin selling shares they repurchased back to the market). The result may be a sudden drop in price. For the investors’ benefit, should there be a requirement to provide daily public disclosure of the aggregate amounts repurchased as part of stabilization?

A contrary position is that stabilization is the only way to protect the offering from a “bear raid” by short sellers. Although short sellers may not be able to purchase shares in the offering (see Rule 105 of Regulation M, discussed further below), they can still generate fear and downward price pressure among skittish investors who are holding a newly-issued and untested stock. Would it make sense to prohibit short selling for the first few weeks after an IPO or other offering by a still non-reporting company? If this were done, should stabilization also correspondingly be barred?

Finally, consider the relationship between the potential cost of stabilization and the underwriters’ ability to decide to whom to sell shares. In addition to short sales and bear raids, downward pressure on a share’s price may reflect investors who, seeing a quick rise in price, choose to “flip” the shares to make a short-term profit. Flipping places downward pressure on share price, and seeing this, other investors may decide to sell as well, creating greater instability in the market. Recall that underwriters would prefer not to stabilize—and so they are likely to prefer investors who are longer-term shareholders and less likely to flip the stock. A rule that takes sales discretion away from the underwriters—and increases the
likelihood of investors who are flippers—may increase the cost of any later stabilizing activity.

**Problem 3-6**

Stabilization is a means of protecting the issuer against a raid [e.g., a “bear raid”] by short-sellers, who hope to create and profit from panic. But stabilization may mislead the retail investor who may think that a “flat” offering (i.e., one with no initial run-up in price) shows a stable market and a relative equilibrium between supply and demand for the stock. In fact, the “flat” price may be the consequence of underwriters placing a temporary floor under the offering price; when that temporary floor is removed, the stock price will likely decline. Would it be simpler just to preclude short-selling for some period (say, ten days) after the IPO offering begins? Or would this reform aggravate the problem by producing a more volatile, less reliable market? Alternatively, in light of the strong tendency toward underpricing in IPOs, are stabilizing purchases justifiable on this ground? What would happen if the current rule did not exist? How would underwriters likely respond if they could not stabilize?

**Analysis:**

This question poses another policy trade-off. Again, like Problem 3-5, the analysis here may go beyond what is needed for students, but we include it for reference.

It is not hard to assemble a political coalition that dislikes short-selling (some corporate managers blame rapid share declines not on their own failures, but on raids by conspiring short-sellers). In the contemporary era of active hedge funds, they may sometimes be right. Abuses by short-sellers were a principal driver for adopting Regulation SHO in 2005 (and its later amendments), including the prevention of potentially manipulative or abusive short-selling from further driving down the price of a security that already experienced a significant intra-day price decline. (Regulation SHO is discussed further below.) By contrast, few are willing to recognize that stabilization activities may mislead investors, creating an illusion of stability (as described in Problem 3-5).

The SEC did respond to the perception that short-selling in connection with public offerings was on the rise and had become abusive. It did so by amending Rule 105 of Regulation M to make it unlawful to effect a short sale during the “Rule 105 restricted period” (which typically begins five business days before pricing and ends with pricing) and then purchase the same security in the offering. This was a change from the old rule in response to evidence showing that the rule was being substantially evaded. Typically, this was done by structuring a purchase so that it did not appear to be used to “cover” the original short sale; under the current rule, it is only necessary that there be (i) a short sale during the restricted period and (ii) a purchase in the offering; it is no longer necessary to show that the purchase was used to “cover” the short sale.

In light of the current rule, is stabilization really needed? Presumably, it is needed to keep the price of the offering stable, but whether preserving price stability is desirable or misleading remains a debatable question. In favor of allowing stabilization is the fact that Regulation M does not restrict most short-selling, but only short sales followed by purchases of the stock in the offering. Thus, short-sellers can make massive sales prior to the pricing of
the offering and cover in the secondary market. Underwriters may feel the need to be able to offset these sales through stabilization, but retail investors may not understand the potential decline to which they are exposed when stabilization stops.

Note that Regulation M is unlikely to help in the case of an IPO, since shares are not publicly traded during the Rule 105 restricted period (i.e., before the company has gone public). Instead, there may be other regulatory constraints that limit the ability to short-sell IPO stock (although there is a mixture of views among regulators, practitioners, and academics about the factors that affect IPO short-selling). One explanation relates to Regulation SHO. Pursuant to Section 10(a) of the 1934 Act, the SEC has the authority to regulate short-sales of securities registered on a national securities exchange. Among its requirements, Rule 203(b)(1) of Regulation SHO generally prohibits broker-dealers from accepting a short-sale order in any equity security, or effecting a short-sale order in an equity security for its own account, unless the broker-dealer has (i) borrowed the security, (ii) entered into a bona-fide arrangement to borrow the security, or (iii) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. In other words, the short-seller must have access to the security it is shorting, including by borrowing the shares (typically for a fee, against the delivery of collateral to the lender, and with the obligation to return the shares to the lender at a future date). Consequently, market participants may short-sell an IPO stock, but the short-seller must “locate” the shares in compliance with Rule 203(b)(1). The broker-dealer executing a short-sale order has to reasonably believe that the equity to be sold short can be borrowed and delivered on the settlement date before short-selling can occur. The problem with IPO shares is that, compared to more seasoned issuers, there are fewer shares eligible to be loaned. Regulation SHO, therefore, constrains short sales, although that constraint is likely to weaken over time as more shares become available for lending.

Arguably, this exacerbates the transparency problem for retail investors. Not only does stabilization provide temporary (and hidden) support for IPO share prices, but the relative absence of short-selling limits the amount of downward pressure on share prices until some later date (when more shares are available for lending). The combined effect may be to further mislead a less-sophisticated IPO investor’s understanding of the secondary market for the shares she purchased.

**Problem 3-7**

As part of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Congress authorized the SEC to pass new rules designed to reduce fraud in the buying and selling of “penny stocks” by regulating the use of proceeds and giving investors a right of rescission. These rules made it more costly for underwriters, brokers, and anyone else (including agents, finders, and consultants, among others) participating in the sale and distribution of penny stocks (defined as stocks with a price of less than $5). The goal was to raise the quality of all equity offerings, including those in the penny stock category and the non-penny stock category. Do you think the statute was successful? How might you design an empirical study to test the efficacy of this statute?
ANALYSIS:


In this paper, we present an empirical study of whether the PSRA has been effective in dissuading fraudulent issuers from the IPO market. We compare several measures of issuer quality in the pre- and post-legislation periods. We find that every measure consistently indicates a lack of significant improvement in issuer quality. The probability of an IPO lawsuit increases significantly from 2 percent of all IPOs in the pre-PSRA period to 3.73 percent in the post-PSRA period. We observe a decline in delisting frequency in the post-PSRA period, but this decline is not robust after we control for post-PSRA changes in macroeconomic conditions and firm characteristics. Instead, we find evidence that the abnormal return to a portfolio of nonpenny stocks worsens in the post-PSRA period. The intercept that we obtain by regressing the returns to a portfolio of nonpenny stocks on the Fama-French factors declines from an insignificant -0.01 percent per month in the pre-PSRA period to a marginally significant -0.39 percent per month in the post-PSRA period.

We present evidence that attributes the lack of an improvement in issuer quality to the migration of speculative issuers to the nonpenny range in the post-PSRA period. The migration appears to have adversely affected the nonpenny sector of the IPO market, which was, ironically, not the target of the legislation. We find a significant increase in the average bid-ask spread of nonpenny IPOs, from 5.43 percent in the pre-PSRA period to 6.83 percent in the post-PSRA period.

Our results suggest that the PSRA of 1990 has not fundamentally altered the market for speculative IPOs. Instead, the regulation has led to cosmetic adjustments to the offer price and to shares issued in IPO offerings.
CHAPTER 4: DEFINITIONS OF “SECURITY” AND “EXEMPTED SECURITIES”

PROBLEM 4-1

Yoga Studios, Inc., a very California corporation, wants to create a nationwide chain and establish itself as the best-known school and studio for yoga exercises and meditation. The company has begun nationally advertising its trademark, the “Yoga Bear”—a patient, meditating, vegetarian bear. But the capital requirements of building a nationwide chain from a local chain in Northern California are simply too high, so it chooses to go the franchise route. For $100,000, it will sell a franchisee its name and train its staff in its approach to yoga; the franchisee also receives the exclusive franchise within a defined geography. Under the franchise agreement, the franchisor retains control over the services that may be provided and products that may be sold, and the franchisor will supply the franchisees with a broad variety of meditative and holistic health products. All employees who deal with the public must be “certified” under the franchisor’s training course, but the franchisee can hire and fire its employees, offer additional products that do not compete with any of Yoga Studios’ products, sponsor additional services, and set prices. Initially, the venture is a success and 80 franchises are sold. But then a scandal erupts when it is discovered that Yoga Studios’ special brand of ginseng contains a minute quantity of marijuana (“to facilitate the meditative experience”). Customers flee, and the franchisees sue in a class action, alleging they have been unlawfully sold a security without registration. What is your analysis of the legal issues?

ANALYSIS:

This Problem addresses the recurring problem of whether a franchising operation involves the sale of a security. Clearly, there is an investment of money ($100,000) with an expectation of profit by the franchisees. Generally, courts have been sympathetic to the franchisor but, under Howey, the critical question is whether there is a common enterprise (and, if so, whether it is horizontal or vertical) and, depending on the franchisee’s level of activity and control, whether the profits are mainly/ principally derived from the efforts of others.

It appears there is some commonality here. The franchisees use a common brand name and they all benefit from the franchisor’s efforts to advertise the franchise and make Yoga Bear a well-known trademark. The franchisor also trains and “certifies” the franchisees’ staff, and it has some (but not total) control over the services and products that the franchisees may offer. Many of the products are supplied by the franchisor, although the franchisee can sell other products that do not compete. So, an argument can be made that there is commonality—but perhaps not horizontal commonality, since each franchisee (through its own efforts, e.g., how it operates the franchise, its location, and other individual factors (also discussed further below)) is likely to gain or lose independently of gains or losses across other franchisees (even though reputational problems with the Yoga Studios’ brand of ginseng appear to have affected all franchisees). Looking at vertical commonality, it seems difficult to argue that this is strict vertical commonality since the franchisor’s returns are not based on the franchisee’s results (i.e., each franchisee pays a flat $100,000; the payment is not tied to the franchisee’s profits). This suggests that, if there is vertical commonality, it is more likely broad vertical commonality, which is recognized by federal courts in the Fifth Circuit.
The problem with this analysis is that vertical commonality considers the extent of the franchisees’ common reliance on the franchisor. You might ask the class: What is left for the franchisee to do, and how significant is it here? A student with some business knowledge may say “pricing,” i.e., that it is the franchisee who sets the prices for the products and services it offers. Also, the franchisee can hire and fire employees and determine their compensation. Moreover, the success of most services businesses depends on the rapport between the manager/franchisee and her clients. Is the manager warm, personal, friendly, and “spiritual”? Is she working around the clock, keeping close tabs on things? Can she motivate the employees trained by the franchisor to perform on the job? Because the services provided here are more intangible than those, for example, in a hamburger franchise, the role of the manager/franchiser is relatively more important to the business’s success. As a result, while there is some common reliance on the franchisor, because of the significance of each franchisee’s own efforts, we doubt a federal court (including in the Fifth Circuit) would find this arrangement to be a security under the Howey test.

**Problem 4-2**

(a) Samantha Jones, a young associate with the law firm of Dewey, Cheatem & Howe, is making a substantial income and wants to invest in a ski country condominium. Her problem is she can rarely take weekends off and will probably only use the condo three or four weekends each year. For this reason, she is particularly attracted by the brochures her real estate agent gave her for Ski Lodge Condos (“Ski Lodge”), a development being constructed by a major resort company. Ski Lodge stresses the strong economic return and tax shelter advantages associated with acquiring a unit in its development. It also encourages condo owners to place their unit on the market with Ski Lodge for a weekend rental to tourists if the owner notifies management that she will not be occupying the unit that weekend. Tourists pay between $500 and $700 to rent the unit for a weekend, and, over the year, rental income of $15,000 or more is possible. For Samantha, this economic return makes the purchase price ($250,000) acceptable. Assume next that the rental income received with respect to a unit that is rented out for the weekend is allocated according to one of the following three formulas:

1. all rental income is allocated pro rata among all owners who notify management their unit is available for rent that weekend, regardless of whether the unit is actually rented (management suggests this technique prevents them from “playing favorites” and directing rentals to preferred clients);
2. rental income is allocated only to the unit that was occupied and in the amount paid by the tenant, minus a $150 service charge that management deducts and keeps; or
3. rental income, again, is allocated on a unit-by-unit basis that reflects the actual occupancy of the unit, but it is shared on a 2/3:1/3 basis, with management keeping one-third of the rental income for its services in advertising the unit to the ski vacation market and soliciting rentals.

Under which of these options, if any, does the arrangement between Samantha and Ski Lodge amount to a security?

(b) Assume Samantha buys a unit in Ski Lodge and makes substantial improvements to it, for example, by installing a hot tub, a mini-bar, a sound system, and a luxurious king-size bed. The total cost of these improvements is $25,000, and, as a result, the unit now rents for more than any other unit in the Ski Lodge development (i.e., $850 per weekend). Does this
additional factor change your analysis? Under all, or only some, of the three rental allocation formulas discussed in part (a) above?

**ANALYSIS:**

(a) Samantha Jones (“SJ”) is making a decision that is partly investment and partly consumption. *Grenader v. Spitz*, 537 F.3d 612 (2d Cir. 1976), found that where the profit motivation was “purely incidental” to consumption, the co-op was not a security. Here, SJ’s interest in profit appears to be more than “incidental.” Still, later decisions (see, e.g., *Rice v. Braniger Organization, Inc.*, 922 F.2d 788 (11th Cir. 1991)) have looked to the “primary motive,” and SJ’s primary motive may be for vacation housing or consumption. In that regard, note that SJ was particularly attracted by brochures that stressed the strong economic return and tax shelter advantages associated with acquiring a unit. Also, the unit is not residential, and so it is more likely that SJ’s purchase was not for consumption. Consequently, while her investment may have been for a mixed use, the facts are more likely to favor finding a security, subject to the particular Circuit’s rules on commonality (analyzed next).

In all Circuits, horizontal commonality suffices for a profit-motivated investment to become an investment contract. In all three cases, SJ depends on the efforts of the manager—who presumably advertises the availability of units for rent, speaks with prospective renters, interacts with renters when they occupy a unit, arranges cleaning, etc.—to make money on her unit. Option (1) in Problem 4-2 is a simple case of horizontal commonality. There does not appear to be a pooling of investments, but the rental income is pooled among all owners, costs/resources are pooled (e.g., in maintaining the units), all profits/losses are shared together, and success is predominantly based on the efforts of the manager in marketing and maintaining the units. Option (2) is a case of broad vertical commonality, because the manager receives a flat fee and does not have its profits linked to the profits of the investor (likely to only apply in the Fifth Circuit). Option (3) is an example of strict vertical commonality, which may still work in many Circuits because the investor and the promoter each share in the enterprise’s profits.

(b) Now, SJ has invested in improvements in her unit. Increasingly, the return on her investment comes from her own efforts (not simply the promoter’s). The additions mean that SJ’s unit is no longer fungible with the others; in other words, the units are not like the fungible row of citrus trees in *Howey*. But are SJ’s efforts enough? The rent has risen from between $500 and $700 to $850. Arguably, the majority of the rent still depends on the promoter’s efforts (and SJ is still principally dependent on those efforts). Moreover, she added only $25,000, or 10%, to her original investment of $250,000. On this basis, we would say she is still sufficiently dependent on the promoter’s efforts to call this an “investment contract.”

There is still the question of commonality. Does it make sense to include SJ in the overall rental pool? Probably not, due to her individualizing her unit. So, if the unit is rented on a standalone basis, then *only* vertical commonality is available, which brings you back to the same analysis on vertical commonality as above.

You may wish to challenge your students to advise the promoter on how to avoid characterizing the investment as a security. Here, SEC Release No. 5347 (in the casebook) provides a reverse roadmap.
• The promoter should *untie* the purchase from any requirement that the buyer use the manager or anyone else pushed by the promoter to rent out the unit—potentially letting others serve as SJ’s agent. Even if SJ decides to select her own agent, if the promoter pushes the manager as part of its marketing effort, then an offer of a security will still have been made (potentially in violation of Section 5(c)). Few others are likely to attempt to become a manager/rental agent, but letting SJ use whoever she wants should satisfy the Release.

• The promoter should not emphasize the economic benefits to the purchaser of an investment (vs. consumption), and should not limit the purchaser’s personal use of the property or place any other restriction on it (i.e., the sale should be a transfer in fee simple).

• What jurisdiction are you in—horizontal vs. vertical commonality?
  
  o If in a horizontal commonality jurisdiction, do not pool related income, costs, or investment funds.

  o If in the Fifth Circuit, may also include broad vertical commonality. In that case, decrease reliance on third parties and perhaps increase self-help (owners can rent out directly on their own, not through a manager).

  o If in a strict vertical commonality jurisdiction, adopt the approach for broad vertical commonality (i.e., increase self-help), but also hire a manager and pay only a fixed fee (i.e., no skin in the game).

**Problem 4-3**

Chateau Napa is a financially-strained California winery that makes excellent cabernet. Typically, it ages its wine in oak casks for three years after harvesting. This is costly, and so to solve its cash flow problems, it offers investors the opportunity to buy cases of the latest vintage of its cabernet that has just been placed in casks (and, thus, is three years from sale) at a price equal to one-half the price of a case in its current vintage. Wine lovers, however, must purchase a minimum of three cases for a price of $1,000. To secure its promised future delivery, Chateau Napa gives a mortgage covering ten acres of its vineyard to a trustee appointed to represent all the “future delivery” wine purchasers. Chateau Napa gives its purchaser of the minimum three cases “a future delivery receipt,” and a secondary market quickly springs up on the internet (without Chateau Napa encouraging it in any way) in these certificates, with prices fluctuating as forecasts are made about whether this year’s wine harvest will be a vintage year. All told, Chateau Napa raises some $1.5 million by this technique. But does this amount to an investment contract?
ANALYSIS:

Courts have divided on facts roughly similar to those in this Problem. The litigated decisions have involved the sale for future delivery of sets of gold coins by a mining company (which still had to mine and refine the gold). Compare SEC v. Belmont Reid & Co., 794 F.2d 1388 (9th Cir. 1986), with SEC v. R.G. Reynolds Enterprise, Inc., 952 F.2d 1125 (9th Cir. 1991).

The issue is whether this is an investment contract. Here, the “future delivery” purchasers are commonly at risk if the winery fails during the three-year interval before delivery. Money is provided to a common recipient (the winery) for a common business purpose. Moreover, the specific cases of wine to be delivered are not identified, the real property collateral is undivided in its coverage of all investors, the trustee is shared, and the investors are commonly dependent on the skills of the winemaker. Finally (and perhaps more importantly), purchasers must buy an amount (3 cases of one vintage) that seems beyond the typical level of personal consumption. (Most of us would buy less wine or diversify our personal wine “portfolio” across multiple vintages.) Thus, this seems to be a profit-motivated investment, and the profits over the 3-year period will depend on the efforts of Chateau Napa, with no effort by the purchasers.

In R.G. Reynolds, regarding the future delivery of gold coins, the Ninth Circuit found the investment scheme to be a security, deciding that investors were not principally betting on world gold prices, but on the promoter’s ability to perform its contract. Here, investors are more likely to depend on the special skills of the winemaker than in the gold coin case.

Still, the larger problem with applying Howey here is that it may prove too much. It seems to apply to any contract for future delivery of valuable property where the buyer is at risk over the duration of the contract. What if you hire the world’s best designer of racing sports cars or ocean-going sailboats to build you the “ultimate” machine, and the process starts from scratch and will take two years to complete? Is this a security? Perhaps the car/boat is intended for consumption, not investment, but that is not always clear.

The countervailing factor is that purchasers may consume much (even all) of the product. Should this case instead be decided under a Forman analysis? Cases subsequent to Forman have found cooperative apartments not to be securities, even when (1) there was a high profit potential on resale and (2) the co-op rented out its ground floor to high-rent-paying retailers. See Grenader v. Spitz, supra Problem 4-2; Rice v. Branigar Organization, supra Problem 4-2. These cases found a predominantly consumption motive by the buyer to make the investment a non-security. But does this produce a very subjective test, where some buyers want to drink the wine and others want to resell the receipts? Would the analysis change depending on whether particular purchasers are targeted—a group of law students (consumption, most likely over a single weekend) vs. a group of law professors (mostly investment)?

Our analysis is that (1) if an investor were buying only one case, this would clearly not be a security (because consumption would be the predominant motivation for most purchasers) and (2) if an investor were required to buy ten cases, it would clearly be a security (since the investor was more likely profit-motivated and dependent on the efforts and ability
of the wine-maker). But the three cases in Problem 4-3 are in the gray zone and can be debated.

**PROBLEM 4-4**

Morgan Bank wishes to transfer some risky loans (at a large discount) to a sophisticated purchaser. The purchaser—Hedged Risk Associates ("HRA"), a large hedge fund—is only willing to purchase these risky assets if Morgan will manage them and assume some of the risk. They strike a deal in which: the loans will be transferred to a limited partnership, LHIW Partners; Morgan will be the general partner (and will receive 10% of the profits and losses); and HRA will be the sole limited partner (with 90% of the profits and losses). Morgan will service the loans and sue any borrowers who default. On that basis, HRA will contribute 90% of the previously agreed purchase price for the loans (which price is 65% of the loans' face value). Under the terms of the LHIW limited partnership, Morgan must agree to liquidate the partnership, sell the assets, foreclose on the assets, or take any other financial measure with respect to these assets as 51% in interest of the limited partners instruct it (and HRA is the only limited partner). Six months later, HRA concludes that Morgan defrauded it by failing to disclose how close the loans were to defaulting (and how many were actually in default). It brings suit under Rule 10b–5 under the 1934 Act. What result on Morgan’s motion to dismiss? Would it make a difference if HRA took a 45% limited partnership interest, and another hedge fund, Pequot Partners—managed by the same investment adviser—took the other 45% limited partnership interest, with Morgan still holding the residual 10% interest?

**ANALYSIS:**

This hypothetical resembles *Steinhardt*.

You might argue that this appears to be vertical commonality, specifically “strict” vertical commonality, because profits are shared on a 90%/10% basis. In the Second Circuit, strict vertical commonality may still be the test under *Howey* for a security (but probably not in the Seventh Circuit). The problem is that HRA’s powers are extensive (as the sole limited partner, where the LHIW business is directed by 51% in control of LHIW’s limited partnership interests), and it has de facto control over LHIW and its operations, so that it is not “dependent” on the general partner for *Howey* purposes.

If *Life Partners* remains good law (and it does in the D.C. Circuit), the defendant might also argue that its “post-purchase activities” were largely ministerial (with the real service being the initial selection of the loan portfolio). We doubt this argument will carry the day. How Morgan goes about selling the assets, foreclosing on the assets, or taking other financial measures to realize value for HRA are non-ministerial post-purchase tasks at the core of realizing value on the LHIW portfolio.

Does the fact that there are two funds, with a common advisor, change any of this analysis? No. The decisions are made by one person (the investment adviser) even if the assets are split between two funds, so functionally it is the same as having a single limited partner.
PROBLEM 4-5

(a) Suppose a business corporation finds itself in financial difficulties. It owes its suppliers for goods sold on an open-account basis. To avoid bankruptcy, the company issues term notes to 45 of its trade creditors evidencing the debts. Is this a commercial or investment transaction?

(b) In *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), the defendant broker-dealer offered federally insured $100,000 certificates of deposit (“CDs”) of savings banks to the public and agreed to maintain a secondary market in the CDs. In addition, Merrill Lynch offered a variety of other services, which included screening banks to determine which offered the most competitive yields, monitoring the creditworthiness of the banks, and negotiating for the best terms with these banks. The plaintiff alleged: (1) the defendant failed to disclose that the interest rates on their CDs were lower than the interest rates paid by the banks on direct sales of CDs; and (2) the defendants pocketed the difference between the rates as an undisclosed commission. Were the CDs sold through the Merrill Lynch program securities? The Second Circuit said yes, but would the D.C. Circuit majority in *Life Partners* agree? Or would they classify these services as “pre-purchase” services? Should this distinction matter when applying the *Reves* criteria rather than the *Howey* criteria?

(c) Along with nine other sophisticated investors, Mr. Brooke Trout, a highly sophisticated investor, is approached by a broker-dealer, Montgomery, Inc., who solicits them to provide bridge loans in the amount of $100,000 each (or $1 million in total) to Technifuture Inc., a start-up company expected to conduct an IPO in approximately 12 to 18 months once it has brought its new digital email phone into production. The loans will bear interest at 13%, and each will be independently secured by real estate owned by Technifuture or its controlling shareholders. Trout hopes to supply Technifuture with computer software through a firm he controls. When Technifuture goes into bankruptcy, Trout sues Montgomery for misleading statements that it allegedly made. Montgomery moves to dismiss the lawsuit on the basis that the notes are not securities. What result?

ANALYSIS:

(a) Here, we need to apply the *Reves* criteria.

First, the seller’s motivation is not to raise money for general use by the business, but to hold off bankruptcy by evidencing a pre-existing obligation and committing to pay a specified rate of interest on it. The notes provide creditors with better evidence of the pre-existing obligation. *Reves* says that if the note “is exchanged . . . to correct for the seller’s cash-flow difficulties . . . , the note is less sensibly described as a ‘security.’” This case can be understood to involve a cash flow difficulty.

Second, the issuance of the notes does not involve a “plan of distribution;” perhaps they may be sold to a factor, but common trading in the notes is unlikely.

Third, the “reasonable expectations of the public” do not seem to be a relevant consideration here because the notes are being given to commercial creditors, not retail investors or small customers. Among commercial creditors, these notes are not being used to
raise money but to hold off bankruptcy, making them less likely to be understood to be securities.

Fourth, there is no risk-reducing factor or applicable regulatory scheme evident here. Therefore, on balance, this is probably not a security.

(b) *Gary Plastics* continues to be good law in the Second Circuit and elsewhere. See, e.g., *SEC v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005); *SEC v. Eurobond Exch. Ltd.*, 13 F.3d 1334 (9th Cir. 1994). The former case cited *Gary Plastics* to explain why it would not follow *Life Partners* in a case involving viatical settlements. Services in picking an appropriate portfolio (whether bonds, CDs, warehouse receipts for whiskey, or other debt instruments), even though performed pre-purchase, seem to be viewed by most courts as relevant under the *Howey* test and its “dependent on the efforts of others” prong. These cases view the selection and assembly of a portfolio of instruments as governed more by *Howey* than *Reves*, particularly in light of Merrill’s agreement to maintain a secondary market and its ongoing monitoring of the banks’ credit quality.

How does one distinguish *Gary Plastics* from the *Marine Bank* case (in the casebook)? In *Marine Bank*, CDs were found not to be securities, in part, because banks are separately regulated by the banking regulators, and so there is less need for CDs to be regulated by the SEC as securities. *Gary Plastics*, however, does not simply involve the sale of CDs. Merrill also screened and selected the CDs, maintained a post-purchase secondary market, assessed/monitored the creditworthiness of the issuing banks, and (allegedly) negotiated the best terms for the purchasers. Consequently, *Gary Plastics* is not part of the *Reves* analysis, which extends only to notes; as noted before, under *Howey*, the totality of the arrangement is what triggered the federal securities law analysis.

(c) These notes are different than the notes in paragraph (a).

First, capital is being loaned to Technifuture as part of a capital-raising function, whereas in subpart (a), commercial creditors were simply receiving better evidence of the company’s indebtedness to induce them not to place the firm in bankruptcy. In (c), the seller’s motivation is to raise money for the business and the buyer is looking at a very high 13% return (suggesting high risk as well). The duration of the notes (up to 18 months) is well beyond the 9-month duration of Section 3(a)(3), and the longer maturity probably increases the likelihood of finding these notes to be securities. The “plan of distribution” factor probably points in the opposite direction, as bridge loans in the amount of $100,000 each are not easily traded (nor were the investors given instruments in smaller denominations that could be traded). Investor expectations can be debated; these were sophisticated investors who should not have assumed the notes were securities. Conversely, some courts have looked to what hypothetical reasonable investors would assume (and that is never clear). The fourth (or risk-reduction) factor could be seen as satisfied by the mortgage on real estate (i.e., collateral reduces the risk). Conversely, this factor could be seen as satisfied only when oversight by some regulatory agency reduces the risk, and that factor is not present here.

Where are we? *Reves* implicitly views high-risk debt as a security, particularly when sold to individuals. The notes probably will not be traded, but they have no legitimate risk-
reducing characteristics. Even if each of the last three Reves characteristics are seen as pointing toward a finding of no security (which, at least, is arguable), we think most courts would still find the first factor to be decisive and rule that the placement of high-risk notes (with over a one-year maturity) with individuals gave rise to a security.
CHAPTER 5: THE PRIVATE OFFERING EXEMPTION:  
SECTIONS 4(A)(2) AND 4(A)(5)

PROBLEM 5-1

BioTech, Inc., a young start-up that is not yet a reporting company, needs to raise $10,000,000 to complete the testing of a potential drug, which, if successful, promises to have broad applications and be a major innovation in cancer treatment. But there is no reliable way to estimate whether it will prove successful. The most that can be said is that (i) the drug looked promising in trials on mice and (ii) it has at least a 10% chance of providing significant benefits for humans. If successful, the drug could make BioTech worth $1 billion or more to the major pharmaceutical companies that would wish to acquire it for its new drug.

At present, BioTech has very limited funds and could not afford the cost, time, or delay incident to a public offering. Nor do underwriters want to touch it, given the high risk it faces. BioTech, however, is a potentially interesting investment for some institutional investors and some high-wealth “angel” investors who like to invest in high-risk start-ups.

BioTech’s CEO, Dickie Nerd, knows he needs a capital infusion within weeks to stay in business. Without the assistance of counsel or an investment banker, he approaches over 100 institutions and high-wealth investors, asking them if they would be interested in private equity investments in the bio-tech area, but making no attempt to comply with any exemptive rules (because he is simply unaware of their existence).

Assume Mr. Nerd finds some 20 persons or entities that may be willing to provide such financing. He probably approached some persons who would not qualify as accredited investors, and none of those he found who are interested in investing (all of whom would qualify as accredited investors) has any prior relationship with BioTech. Mr. Nerd does not believe there is time (or money) available to prepare a disclosure document equivalent to a registration statement. But he is quite willing to answer questions, take the investors on a tour of the company, and give them free rein to inspect whatever they like and talk to whomever they please inside the company. You are brought in at the last minute to serve as counsel for the company. Can you structure this offering (without significantly changing the foregoing facts) to be an exempt private placement? Both Mr. Nerd and the investors want you to deliver such an opinion as a condition of the closing.

ANALYSIS:

Nerd has made no attempt to comply with Regulation D, and compliance with Section 4(a)(5) is not possible because the offering is for $10 million, well above the exemption’s $5 million ceiling. Thus, we are thrown back to the federal common law of Section 4(a)(2).

Ralston Purina focuses on whether investors “need the protection of the [1933] Act” and “have access to the kind of information which registration would provide.” It is unclear that the 20 prospective purchasers would all qualify as sufficiently sophisticated to meet the first test. Even if they do, however, two basic problems remain: (1) unsophisticated offerees may have received offers earlier; and (2) even the sophisticated purchasers may not have received sufficient “access” to information about the issuer and offering. Under the post-Ralston Purina case law (prior to Rule 146 and, eventually, Regulation D), even a single unqualified offeree (or the inability to establish the qualifications of all offerees) could end the availability of Section 4(a)(2). But is there any need to be this Draconian? Or should the approach be “No Harm, No Foul” when an unqualified offeree does not purchase and, thus, suffers no loss?
Obviously, Regulation D adopts much of the latter philosophy—but, under Section 4(a)(2), a single unqualified offeree can destroy the entire exemption, resulting in a violation of Section 5(c), with rescission liability for all investors (including those who are sophisticated and have sufficient access) under Section 12(a)(1).

You might ask students whether today’s courts should follow these precedents. One position, of course, is that of stare decisis. Another is that, where the SEC gives a workable exemption (e.g., Regulation D) and issuers fail to use it, it is their own silly fault and they should expect no judicial sympathy. Doran, however, does show a court attempting to “modernize” old case law.

While Doran liberalized the law, the opinion still noted that “the number of offerees, not the number of purchasers, is the relevant figure in considering the number of persons involved in an offering.” Here, as many as 100 people were “approached” by Nerd. (In Doran, there appears to have only been eight offerees.) Still, these facts do not necessarily mean that everyone approached by Nerd received an “offer;” the facts may suggest they were only screened to determine if they had an interest in a later offer and, therefore, they should not count as offerees at that earlier stage. (This goes to the question of what constitutes an “offer.” A general inquiry about a person’s experience with private investments in biotech (and other) startups is likely not to arise to the level of an “offer”—although, coming from Nerd, the CEO of a biotech startup, it is more likely that even this general discussion will be understood as an offer to sell BioTech shares.)

Counsel might prepare a formal offer letter for the remaining 20 prospective investors and seek to characterize the earlier discussions as merely “screening.” They could acknowledge, in signing this letter, that they had received no prior offer. At some point, however, this may distort the facts and raise ethical concerns. Nerd may seek to reinterpret what he did or said. If the lawyer decides that offers were made, she is duty-bound to tell the client the offering is not lawful under Section 4(a)(2) and must be terminated, with a future offering possible when it will no longer be integrated with the terminated offering.

If BioTech’s counsel determines that the current offering must be terminated, Rule 152 under the 1933 Act (discussed in the next chapter, but which provides a general principle and four safe harbors from integration) will make it easier for BioTech to later commence an offering that complies with the private placement or other requirements. The problem in this case is that BioTech needs capital “within weeks” to stay in business and so its offerings may not qualify for a safe harbor.

If the offering goes forward, prospective investors should also be encouraged to hire their own counsel, or independent counsel should be hired for them at the issuer’s expense. The final 20 prospective investors should be screened for sophistication—for example, prior experience in private placements and/or the ability to assess biotech (or other) startups. If, after screening, there is any doubt about the sophistication of any of them, those prospective investors should be excluded or a purchaser representative (at the issuer’s expense) could be appointed to give them “vicarious sophistication.” It is unclear if this works under the common law, but no reason is evident why a court should not accept this approach (which is permitted by Regulation D).
Even if the exemption survives the considerable hurdle presented by the large number of “potential offerees,” there remains the formidable question of “access” and disclosure. In Hill York, the Fifth Circuit said “that every offeree had to have information equivalent to that which a registration statement would disclose.” Clearly, Regulation D does not demand this, but again, that safe harbor is not applicable to this Problem. Doran appears to have accepted the idea that, at least in the case of highly sophisticated purchasers, disclosure and access are disjunctive requirements. That is, even if the equivalent of information in a registration statement is not affirmatively provided to prospective purchasers, it may be sufficient if sophisticated investors had full access to such information and could ascertain the relevant facts for themselves. Hence, a lawyer seeking to legitimize this offering would need to provide an elaborate question-and-answer session (a so-called “dog and pony” show) between the prospective investors and senior management. Prospective investors would be provided with all available financial information and statements and invited to meet with the company’s research scientists.

As a practical matter, BioTech’s lawyer would probably prepare a disclosure document that stresses the high risk of an investment, the unpredictability of the technology, and the restrictions on transfer and limited liquidity of the BioTech shares. This would be essential not simply because of Section 5, but also to mitigate antifraud liability under Rule 10b-5.

Formal offers would be extended only to the remaining investors (after the 20 prospective investors were screened for sophistication, as described above, and provided with access). They would be required to execute investment covenants and fill out investor questionnaires that demonstrate they are sophisticated and have prior experience with private offerings.

On this basis, although there is legal risk, a lawyer could conclude that the Section 4(a)(2) exemption is available. A key risk would surround whether Nerd’s earlier conduct in approaching (at least on a preliminary basis) some 100 potential investors amounted to a general solicitation. If Nerd used any form of written advertisement or website that discussed the issuer, for example, it is doubtful this offering could be salvaged.

**Problem 5-2**

(a) The Tucson Cowboys Inc., a triple-A minor league baseball team with a relatively good earnings history, wants to raise $8 million to build a new stadium. They are prepared to sell a 25% interest to each of two former superstars who recently retired—Barry Bondie and Manuel Romirez. Both players have ample resources to pay $4 million each, but neither graduated from college nor has any experience with financial statements. The Tucson Cowboys have not prepared any disclosure document remotely resembling a prospectus; also, because their controlling shareholder does not like to deal with lawyers, they do not know about, and have made no attempt to comply with, any SEC exemptive rule. But they have hired a registered representative from a local brokerage firm to represent both of the proposed investors and evaluate the transaction for them. They will give the representative complete access to their books and will answer any questions he has. They expect to pay the representative $25,000 for his services (and this payment will be disclosed to both investors). Will this work? What else would you recommend without fundamentally changing the transaction?

(b) In the alternative, suppose the net worth of each player is under $1 million and they are being asked to invest $200,000 each. Their motivation to invest is partly to obtain jobs as
bench coaches with the team, hopefully to begin working their way back to the major leagues as coaches. What result now?

**ANALYSIS:**

(a) Both ex-stars qualify as accredited investors under Regulation D (see Rule 501(a)(5)), but no attempt has been made to comply with that Regulation. Section 4(a)(5) could be relied upon, except that $8 million exceeds its limit.

The registered representative could qualify as a “purchaser representative” under Regulation D (see Rules 501(i) and 506(b)(2)(ii)), but, again, it is unclear whether this works in a common law setting. Here, both players do have a high degree of sophistication and knowledge about baseball teams. They can evaluate the operational side of the team, but not its financial prospects. Thus, the representative is not assisting naïve and inexperienced rookies, but experts on baseball who need help on the financial side of the transaction. Use of such an expert has a better chance of working here.

What else should be done? An elaborate effort should be made to give them “access” in the form of meetings with the coaches and general manager. Financial statements should be provided to the registered representative. And they should either retain legal counsel or have experienced counsel retained for them.

Even when all of this is done, there remains the risk a court will still find they need to receive the same information as in a registration statement (even though this would not be a requirement for accredited investors under Regulation D). This differs from the analysis in *Doran*, but that case is not controlling in all Circuits, and other courts may follow *Hill York*.

Under Regulation D, no representative needs to be appointed and no disclosure needs to be provided if they qualify as accredited investors. If they do not, Regulation D requires an elaborate disclosure document, which the owner is probably unwilling to authorize.

(b) With a net worth now under $1 million, neither qualifies as an accredited investor under Rule 501(a)(5) of Regulation D or presumably under Section 4(a)(5) (see Section 2(a)(15)(iii)). They might argue, if they are already bench coaches, that they are “accredited investors” under Rule 501(a)(4) to the extent that bench coaches qualify as “executive officers.” However, the definition of “executive officer” in Rule 501(f) requires a person to “perform[ ] a policy-making function;” and bench coaches do not do that. Alternatively, they could be appointed as Vice Presidents of the Tucson Cowboys and, if they had a real managerial role, they might be found to be accredited investors.

Since the total amount raised is only $400,000, this transaction could fall under Section 4(a)(5) if the two could qualify as accredited investors (which is dubious based on their reduced net worth and lack of policy-making roles, see Section 2(a)(15)(iii)).

Note that if a purchaser representative were appointed and advised them to invest 20% of their limited net worth in this risky and illiquid enterprise, the representative would need to consider his or her obligations under Regulation Best Interest (recall Problem 2-16).
CHAPTER 6: LIMITED AND OTHER OFFERING EXEMPTIONS

The dates in some Problems pre-date amendments and rules that exist today. In all cases, we will analyze the questions using the rules as in effect today.

PROBLEM 6-1

BioTech, Inc. (“BioTech”) again faces a capital-raising crisis: It must raise $10 million quickly, or it will not be able to continue operations, even though it has a “miracle drug” that may end up being just that. Its CEO, Dickie Nerd, approaches and makes offers to nearly 100 potential investors. Eventually, he finds 20 accredited investors who will invest the capital. As BioTech’s attorney, you must decide: Can this offering be considered exempt from registration under Section 4(a)(2) (now pursuant to Rule 506 of Regulation D)? What information or access must BioTech provide?

ANALYSIS:

This is the same problem as Problem 5-1, but now the answer is clearer.

Until recently, Rule 504 would not have been applicable due to a $5 million offering cap. That has changed. The SEC increased Rule 504’s 12-month offering limit to $10 million. (Rule 504 was previously issued pursuant to Section 3(b)(1), but to increase the offering size, the SEC has relied on its general exemptive authority under Section 28.) BioTech’s offering must satisfy Rule 504’s other requirements. Nothing indicates that the offering has been registered in one or more states (Rule 504(b)(1)(i) or (ii)). Consequently, to satisfy Rule 504, (1) Nerd cannot have conducted a general solicitation (Rule 504(b)(1)) or (2) if he did a general solicitation, sales can only be made to accredited investors (Rule 504(b)(1)(iii)). The “bad actor” disqualifications in Rule 506(d) also cannot be applicable (Rule 504(b)(3)).

The Rule 506 safe harbor may be available for this offering, assuming the “bad actor” disqualifications in Rule 506(d) are not applicable. (Note that bad acts before September 23, 2013, are not disqualifying, but Rule 506(e) requires that they be notified to each purchaser a reasonable time prior to sale.)

Under Rule 506(b), the number of offerees does not matter so long as a general solicitation is not made. In addition, the number of purchasers has little relevance so long as most qualify as accredited investors. The balance cannot exceed 35 purchasers, calculated in accordance with Rule 501(e), during each 90-day period. (The 90-day limitation was recently added due to the shortened integration time frame under Rule 152, which otherwise could permit issuers to undertake serial Rule 506(b) offerings each month to up to 35 non-accredited investors in reliance on the new 30-day safe harbor, potentially resulting in unregistered sales to a significant number of non-accredited investors in a year.)

Under Rule 506(c), a general solicitation is permissible so long as reasonable steps are taken to verify that all purchasers are accredited investors. Rule 506(c) provides a principles-based method for verification of accredited investor status, as well as a non-exclusive list of verification methods that issuers may use when seeking to satisfy the verification requirement with respect to natural persons. A recent amendment includes a new verification safe harbor that permits an issuer to rely on a written representation from an investor the issuer took reasonable steps to verify as an accredited investor (in accordance with Rule...
within the preceding five years that such person remains an accredited investor as of the time of a subsequent sale so long as the issuer is not aware of information to the contrary.

The need to furnish registration-style information is largely eliminated under Regulation D, because Rule 502(b)(1) makes clear that the information described in (b)(2) must only be furnished if a purchaser is not an accredited investor. (For Regulation D offerings by non-reporting companies that include non-accredited investors, Rule 502(b) was recently amended to align the financial information that issuers must provide investors with the less burdensome disclosure requirements of Regulation A.) The one respect in which a vestigial “access” requirement survives is in Rule 502(b)(2)(v), which requires the issuer to provide an “opportunity to ask questions concerning the terms and conditions of the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished under paragraph (b)(2)(i) or (ii) of this Rule 502.” Thus, if no information is furnished under Rule 502(b)(2)(i) or (ii), then no “additional information” need be provided. Under Rule 502(b)(2)(v), the only requirement that remains is that investors be provided an “opportunity” to ask questions concerning the terms and conditions of the offering at a reasonable time prior to the purchase of securities.

The one issue that carries over from Problem 5-1 involves whether Nerd made a general solicitation. As we know from Problem 5-1, the facts are not very revealing. If Nerd’s contacts were all face-to-face or telephone contacts, this may not be a general solicitation. The key question is whether he had a pre-existing substantive relationship with the persons he contacted. Use of electronic media (which the facts do not suggest) would likely destroy the private character of the offering. But none of this is a problem if sales are made only to accredited investors pursuant to Rule 504(b)(iii) or Rule 506(c). We are told that all 20 purchasers are accredited investors, and so whether or not there was a general solicitation is no longer important to the analysis.

**Problem 6-2**

Same problem and same facts, except that now Nerd has found 30 accredited investors and also three sophisticated persons who do not qualify as accredited investors. Again, there is the same need to act quickly, expeditiously and at low cost. What advice do you give as BioTech’s securities counsel?

**Analysis:**

Now, counsel must face the fact that including non-accredited investors will force BioTech to prepare the enhanced disclosure required by Rule 502(b)(2) just to provide disclosure to three investors (less than 10% of the total) who most likely will not be able to make a major financial contribution.

The non-financial disclosure mirrors what is required under Regulation A or, if the issuer is not eligible to use Regulation A, Part I of a registration statement (see Rule 502(b)(2)(i)(A)). The financial disclosure requirements were recently amended. For non-reporting companies, amended Rule 502(b) aligns the disclosure requirement with the less burdensome disclosure requirements of Regulation A. Specifically, for offerings of $20 million or less, Rule 502(b)(2)(i)(B)(1) refers such issuers to paragraph (b) of part F/S of Form 1-A, which applies
to Tier 1 Regulation A offerings. For offerings of greater than $20 million, Rule 502(b)(2)(i)(B)(2) refers issuers to paragraph (c) of part F/S of Form 1-A, which applies to Tier 2 Regulation A offerings. (Previously, offerings over $7.5 million were obligated to include the financial statements required in a registration statement.)

Even as amended, providing this disclosure is costly. Hence, if these three non-accredited investors are excluded from the transaction, the deal can proceed much more quickly and cheaply. No doubt, the antifraud provisions of the federal securities laws will necessitate the preparation of some form of disclosure document—among other things, highlighting the risks of the investment—but not the equivalent of a Regulation A offering circular or a prospectus.

**Problem 6-3**

Suppose, despite the use of at least some reasonable efforts to comply with Rule 506, BioTech does sell to one individual who lacks the requisite sophistication to be “capable of evaluating the merits and risks of the prospective investment.” Can the other investors rescind if BioTech’s stock price later declines?

**Analysis:**

There are two levels to this answer.

First, the issuer must only “reasonably believe” that each purchaser qualifies as sophisticated (see Rule 506(b)(2)(ii)).

Second, even if the issuer was somewhat negligent (so that it failed to satisfy this Rule), the other investors do not necessarily acquire a rescission right due to the limitation in Rule 508(a)(1). This provision states that “[a] failure to comply” does not confer rescission rights on other investors if the failure “did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity.” Here, the requirement that each investor be “sophisticated” in Rule 506(b)(ii) does not protect other investors who are sophisticated themselves, at least so long as the additional conditions in Rules 508(a)(2) and (3) are also satisfied. In short, under Regulation D, generally only those who are directly injured get the opportunity to rescind; others are unable to use the issuer’s failure with respect to someone else to gain a rescission right. This contrasts with Section 4(a)(2) where, you will recall, sophisticated investors receive a rescission right if offers (not even sales) are made to other, unsophisticated prospects.

Is this result desirable? On the one hand, sophisticated investors should not get a windfall as a result of a violation that does not impact them. On the other hand, given BioTech’s limited assets, the other investors may need to buy out the rescinding investor (or fund the repurchase by BioTech of that investor’s shares) or otherwise watch BioTech sink into insolvency. Rational investors may not want their co-investors to be able to easily acquire a rescission right where the cost may fall on them.

What if, instead of a violation regarding sophistication, there is a violation on the prohibition against general solicitation; the offer is made through the mass media. Is this covered by Rule 508? No, Rule 508(a)(2) includes some violations that per se are not covered

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by Rule 508. A failure to comply with Rule 502(c) regarding general solicitation is not protected, and so it will result in a failure where it is a condition under Regulation D.

**Problem 6-4**

Buzz’s Steakhouse, Inc. (“Buzz”) is a local chain of “steak and ale” restaurants doing business in New York, New Jersey, and Pennsylvania. It has a loyal clientele, some of whom are eager to invest in this family-owned business. Between January 1 and February 28, 2007, Buzz sells 1,000,000 shares of its common stock at $4.50 per share to some 30 investors, most of whom are loyal customers, but none of whom are accredited or sophisticated investors. In September, it contacts some institutional investors and sells another 2,000,000 shares, this time at $8 per share to ten of them. Assume there were no offers made between March 1, 2007, and September 10, 2007. Has Buzz complied with Regulation D?

**Analysis:**

What rule does the first offering rely on? It is an offering to loyal customers who are not accredited or sophisticated investors, and the amount is below $10 million. Section 4(a)(5) and Rule 506(c) are not possible; a condition in both cases is that all purchasers be accredited investors.

Rule 506(b) is possible (assuming no general solicitation), if there is a purchaser representative to assist the 30 purchasers in evaluating the merits and risks of the investment (see Rule 506(b)(2)(ii)). Rule 506(b)(2)(i) permits up to 35 sophisticated but non-accredited investors during a 90-day period. But recall that if Buzz relies on Rule 506(b), and one or more investors are not accredited, it must provide issuer information in accordance with Rule 502(b)(1). Also, recall the special provisions of Rule 502(b)(2)(iv) (regarding the material terms of the offering provided to accredited investors also being given to non-accredited investors) and Rule 502(b)(2)(v) (regarding access).

Rule 504 may also be available (the offering size is below the newly-raised $10 million cap), so long as BioTech publicly files and delivers to investors a substantive disclosure document in accordance with applicable state law or, if a state does not have a registration requirement (such as New York), where the disclosure document required to be filed in another state is delivered in that state.

What rule does the second offering rely on? The September offering was for $16 million, so it must be Rule 506. Section 4(a)(5) is not possible, since the offering is above the $5 million limit. (There is not enough information here to support reliance on the intrastate exemption, Section 3(a)(11) or Rules 147 or 147A.)

Is there an aggregation issue here? Rule 506 and Rule 504 offerings are not aggregated. There is no dollar cap under Rule 506 (unlike under Rule 504).

Is there an integration issue here? Previously, a non-integration safe harbor was established under Regulation D if there was a “clean” six-month period between the offerings. Rule 152, which takes the place of the prior Regulation D safe harbor, includes a general principle on integration (Rule 152(a)) and four non-integration safe harbors (Rule 152(b)). Rule 152(a)(1) states that, for an exempt offering prohibiting general solicitation, the issuer must have a reasonable belief, based on the facts and circumstances, with respect to each
purchaser in the exempt offering prohibiting general solicitation, that the issuer (or any person acting on the issuer’s behalf) (i) did not solicit such purchaser through the use of general solicitation or (ii) established a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation. Rule 152(b)(1) goes on to provide a non-integration safe harbor as follows: “Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with such other offering, provided that for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation, the provisions of Rule 152(a)(1) shall apply.”

There are four fact patterns to consider here, depending on whether the first offering was under Rule 504 or Rule 506(b) and the second offering was under Rule 506(b) or Rule 506(c).

(1) If the first offering was under Rule 504, and the second offering was under Rule 506(c), the Rule 152(b)(1) non-integration safe harbor applies, since more than 30 days separates the first and second offerings and both permit a general solicitation.

(2) If the first offering was under Rule 504, and the second offering was under Rule 506(b), the Rule 152(b)(1) non-integration safe harbor applies, but pursuant to the proviso, which directs you to Rule 152(a)(1), only so long as Buzz has a reasonable belief, based on the facts and circumstances, with respect to each purchaser in the Rule 506(b) offering (which prohibits general solicitation), that the issuer and its agents did not solicit such purchaser through the use of general solicitation or had a prior substantive relationship with such purchaser.

(3) If both offerings are under Rule 506(b), then neither permits a general solicitation and there will be fewer than 35 sophisticated but non-accredited investors during a 90-day period (see Rule 506(b)(2)(i)).

(4) Finally, if the first offering was under Rule 506(b), and the second offering was under Rule 506(c), the Rule 152(b)(1) non-integration safe harbor applies (without reference to the proviso), since more than 30 days separate the first and second offerings, and the general solicitation under Rule 506(c) took place after completion of the offering under Rule 506(b) (which prohibits general solicitation).

**Problem 6-5**

Amalgamated Widget, Inc. (“AWI”) is a well-known reporting company with a market capitalization of just over $10 billion. It runs the largest chain of sporting goods stores and one of the largest pizzeria companies in the United States. Thus, everyone knows it and is familiar with its commercials extolling its sneakers and pizzas (which smell remarkably alike). Since AWI is already so widely recognized, it decides to do a sizeable private placement of stock in February 2016 for nearly $2 billion (or 20% of its market capitalization) under Rule 506(c), including through general solicitation and general advertising. It knows that some non-accredited investors will attempt to buy because it is offering its shares for $1 below
market price on the date of the offering. Thousands of investors apply, and as general counsel to AWI, you must deal with the following cases:

(a) several investors have provided photocopies of their executed Form 1099 tax returns for 2014, which show each to have made more than $200,000 in that year; some also provide returns for 2012 and/or 2013. You are worried that these photocopies might be fraudulent and not reflect their actual incomes for those years;
(b) some investors provide a brokerage statement showing that they hold more than $1 million of securities in such account;
(c) Jones, a resident of New Jersey, provides a letter from Smith, who is an experienced and respected tax attorney practicing with a major law firm in New York City. The letter states Smith’s view that, after a reasonable investigation by him of Jones’s status, Jones is an accredited investor;
(d) despite a bank statement for one investor (Klein) showing him to have $1.5 million in total assets, you are aware that your brokerage firm just liquidated Klein’s account for failure to meet the firm’s margin call for $700,000.

Is the information sufficient in each case? Or is more needed? Explain.

ANALYSIS:

Here we are being asked to consider the verification process for accredited investors under Rule 506(c). In general, Rule 506(c)(2)(ii) requires the issuer to take “reasonable steps to verify” a purchaser’s accredited investor status. Included within the Rule are non-exclusive and non-mandatory safe harbors to verify the status of natural persons, provided the issuer does not have actual knowledge that a purchaser is not an accredited investor.

This Problem’s different scenarios go through the safe harbors for natural persons:

(a) Rule 506(c)(2)(ii)(A) permits the issuer to rely on Internal Revenue Service forms that report the purchaser’s income for the two most recent years. This offering was completed in 2016, and so the evidence of income must cover earnings in 2014 and 2015. The evidence you have received does not cover 2015. Moreover, you suspect the statements are fraudulent—drawing into question whether relying on them is “reasonable” in verifying accredited investor status. In addition, Rule 506(c)(2)(ii)(A) requires a written representation from the purchaser that she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year. That representation is missing.

(b) In determining net worth, Rule 506(c)(2)(ii)(B) permits reliance on documents dated within the prior three months that show assets and liabilities. Brokerage statements are included among the types of documentation that can demonstrate assets. Here, it is unclear how old the brokerage statements are. Moreover, the purchaser must represent in writing that all liabilities necessary to make a determination of net worth have been disclosed. That representation is missing, and so it is unclear what liabilities the purchasers have or their net worth.

(c) Rule 506(c)(2)(ii)(C) permits reliance on a written confirmation from certain professionals of a purchaser’s accredited investor status based on such person or entity having taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months. This letter appears to qualify so long as
the verification took place within the prior three months.

(d) In determining net worth, in accordance with Rule 506(c)(2)(ii)(B), you cannot rely on a bank statement that shows $1.5 million in assets when you know there are liabilities that have not been properly disclosed. Recall that the purchaser must represent in writing that all liabilities necessary to make a determination of net worth have been disclosed. That representation is missing, and knowing of the liabilities, reliance on the bank statement alone is insufficient.

In addition to these four scenarios, recall that a recent amendment to Rule 506(c)(2) includes a new verification safe harbor that allows an issuer to establish that an investor, who the issuer previously took reasonable steps to verify as an accredited investor in accordance with Rule 506(c)(2)(ii), remains an accredited investor as of the time of a subsequent sale, if the investor provides a written representation that she continues to qualify as an accredited investor and the issuer is not aware of information to the contrary. The written representation under this method of verification will satisfy the issuer's verification obligation for five years from the date of original verification.

**Problem 6-6**

Returning to Buzz, assume, in the alternative, that Buzz wishes to offer only 120,000 of its shares at $8 per share to some 15 or 20 loyal customers. It does not want to prepare a formal prospectus or similar offering document, and it realizes its prospective investors are ordinary people who do not have any special investment experience. Buzz’s friendly broker, Hot Shot Securities, believes it can find investors for Buzz by inviting them to “investment seminars” it sponsors by advertising in northern New Jersey and Westchester newspapers. As securities counsel, what is your advice?

**Analysis:**

Buzz, as a non-reporting company, can use Rule 504 for this small offering of $960,000. It is well below the new $10 million limit for Rule 504 offerings. However, Buzz faces a difficult choice: The seminar technique favored by Hot Shot may violate Rule 502(c) (restricting a general solicitation) to the extent that restriction is applicable. Under Rule 504(b)(1), the prohibitions of Rule 502(c) are suspended if Buzz files a “substantive disclosure document” with at least one state “blue sky” regulator or, alternatively, if Buzz sells only to accredited investors, which is not who it is targeting. (For the same reason, Rule 506(c) is not available. Also, there is not enough information here to support reliance on the intrastate exemption, Section 3(a)(11) or Rules 147 or 147A.) Hence, on its face, Buzz and Hot Shot must choose between filing some form of substantive disclosure document under state law (although, most likely, not requiring the level of disclosure that Rule 502(b) would require for sales to sophisticated non-accredited investors under Rule 506(b)) or observing the limitations on manner of offering mandated by Rule 502(c).

Also, the securities issued by Hot Shot will be “restricted securities” under Rule 502(d) unless Buzz makes the state “blue sky” filing required by Rule 504(b)(1). (Resale restrictions
What we do not know is what Hot Shot means by an “investment seminar.” One possible solution is for Hot Shot to invite interested participants to an investment seminar that discusses the pros and cons generally of investing in illiquid securities, as well as how to do so, but without discussing any particular issuer or security. Rule 502(c) states that “neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising.” No doubt, by advertising in the newspapers, interest in the seminar is being generally solicited and advertised. But if Buzz is not mentioned (in the advertisement or at the seminar), is an offer of its shares being made? Through the seminar, Hot Shot will learn more about the attendees—their experience with investing, their sophistication, and perhaps their financial situation. Based on the relationship that Hot Shot develops with some attendees, it might then approach them about investing in Buzz. That private approach, based on the substantive relationship developed through the investment seminar, should not be treated as a general solicitation.

Rule 504(b) permits Buzz to rely on that safe harbor so long as there is no general solicitation and the shares are treated as “restricted securities.” Rule 502(b) (Information Requirements) does not apply in this case. If Buzz does not want to prepare a formal prospectus or offering document, including the state “blue sky” filing required by Rule 504(b)(1), this approach to the investment seminars may also be an option. Most likely, Buzz will still prepare a short disclosure document highlighting the riskiness of the investment as one means to address any Rule 10b-5 concerns.

**Problem 6-7**

(a) New Co., incorporated in 2006 in Delaware, has 2,000,000 shares of common stock currently outstanding, held by some 45 shareholders. New Co. is not a reporting company. Its balance sheet currently shows negative equity, and it has no prospect of profits this year. Most of its shareholders (approximately 25) are also its officers and/or employees. Those shareholders are computer engineers and web design specialists who hope to help New Co. launch the latest advance in micro-communications—a hand-held communications device that can translate oral speech into emails (and vice versa) and send them around the globe instantaneously. If it is successful, there will be extraordinary profits; if not, none. Given that the company represents an “all-or-nothing” gamble, New Co.’s board adopts an employee stock option plan under which it reserves 500,000 shares of New Co.’s common stock. So far, New Co. has granted options relating to 100,000 shares pursuant to this plan during the first four months of this year (without registering the stock or preparing or distributing any disclosure document to its employees). Is this permissible? If so, how many stock options may it grant under its stock option plan during the remainder of this year?

(b) Roughly contemporaneously with granting options for 200,000 shares, New Co. sells 200,000 shares in a private placement to ten institutional investors. Any problems?

(c) Shyster and Dimwitty, a law firm, handled the incorporation of New Co. and assisted in drafting its employee stock option plan. It is willing to take an option under the stock option plan (which, by its terms, extends to consultants and advisers) instead of a cash payment of its fees. Is this permissible?
ANALYSIS:

(a) What safe harbor is New Co. relying on?

Not Regulation A—there is no reference to an offering circular or offering statement.

Probably not Rule 504—again, there is no substantive disclosure document, which must be filed with a state “blue sky” regulator unless all the purchasers are accredited investors; that is unlikely since the options are being given to employees. It is possible that sales to officers/employees are based on a pre-existing substantive relationship, so that no general solicitation is involved—but this is risky, particularly if stock or options are granted to incoming employees.

Not Rule 506—again, we do not know if all the purchasers are accredited investors, but that is unlikely, and there is no reference to the substantive disclosure document that Rule 502(b) requires to be delivered to non-accredited investors.

New Co. is most likely proceeding under Rule 701 and is limited by Rule 701(d)(2) to issuing, during any 12-month period, the greatest of: (i) $1 million, (ii) 15% of its total assets, or (iii) 15% of its outstanding common stock. We cannot tell if the $1 million test has been exceeded. We also do not know New Co.’s total assets. (Although it is near insolvency, “total assets” does not subtract liabilities, and so we do not know if this alternative measure would work.) Because New Co. has already granted options equal to 100,000 shares, we do know that the 15% of outstanding common stock test would limit it to granting options equal to another 200,000 shares, because 300,000 shares equals 15% of the 2,000,000 shares outstanding on the date of its last balance sheet. But the other two tests may authorize more. Under Rule 701(e), the only disclosure that must be provided is a copy of the employee benefit plan or contract, as applicable.

(b) Rule 152(b)(2) provides: “Offers and sales made in compliance with Rule 701 [or] pursuant to an employee benefit plan . . . will not be integrated with other offerings.” See also Rule 701(f). Hence, there is no problem here.

(c) Rule 701(c)(1) precludes the issuance of shares to consultants and advisers, who must be “natural persons” (see Rule 701(c)(1)(i)), for services “in connection with the offer or sale of securities in a capital-raising transaction.” Rule 701 requires a stock option plan to be compensatory, rather than as part of a capital-raising effort. Accordingly, it would seem permissible to allow shares to be issued to this law firm for work done at the corporate formation stage (not involving an offer or sale of securities), including the drafting of the employee stock option plan.

You might want to take this time to reinforce to students that Rule 701 shares are illiquid. Shares provided to employees under Rule 701 are “restricted securities” (see Rule 701(g)). Issuers relying on Rule 701 have not objected to this lack of liquidity. Why not? Rule 701 is intended to cover compensation to attract and retain employees—registration is not required, because Rule 701 views these securities as employee compensation, not investment—and, as an employer, you would prefer that employees not be able to “cash out” of their holdings easily and then leave the company. In other words, illiquidity is good because it keeps employees at the company. But employees are not bound forever. There are
later exemptions from registration that permit resales (such as Rule 144, discussed later in
the casebook), and the company can also register the shares for resale sometime in the future.

**Problem 6-8**

(a) In addition to selling 4,000,000 shares of its stock to ten institutions (all of whom easily qualify as accredited investors) at \$2 per share, Start-up Corp., a newly formed corporation, plans to sell 1,000,000 shares of the same class of stock at the same price to several corporate officers, including Ms. Judy Jones, the Corporate Secretary, Vice President, and Deputy General Counsel. Ms. Jones earns approximately \$175,000 per year and has a net worth (with her spouse or spousal equivalent) of approximately \$500,000. It is imperative to Start-up Corp. that it avoids the cost and delay of preparing a full-scale disclosure document. In this light, can Start-up Corp. sell to Ms. Jones?

(b) In addition, Start-up Corp. has contemporaneously received an offer from Venture LLP, a recently organized Massachusetts limited partnership with ten limited partners, to buy 1,000,000 shares at the same \$2 price per share. Of Venture’s ten limited partners, eight are highly experienced in private equity investments, and each has a net worth of well over \$1 million. The remaining two limited partners, university professors in economics who teach finance courses, each possess a net worth of below \$1 million. They were given their limited partnership stakes in return for advisory services—past and prospective—that they have performed or will perform for the partnership. Can Start-up Corp. accept this offer? What must it do if it accepts this offer?

**Analysis:**

(a) The concern here is with the definition of “executive officer” in Rule 501(f). That definition requires one to “perform[,] a policy making function.” If Ms. Jones is an executive officer, she qualifies as an “accredited investor” under Rule 501(a)(4). But, it is not obvious that a corporate secretary, vice president, and deputy general counsel ordinarily have a policy making function. Additional facts would be necessary to show she performs a policy making role.

One might note here the contrast with *Ralston Purina*. In that case, key employees included staff at all levels of the company. The court did not draw the line at policy making, although it did focus on whether offerees could fend for themselves and had sufficient access to information to assess the merits and risks of the offered securities. Today, the SEC arguably discourages sales to persons below the policy making level. Ms. Jones also does not qualify as an accredited investor under Rules 501(a)(5) or (a)(6).

(b) For Venture to qualify as an accredited investor, it must satisfy Rules 501(a)(3) or (a)(8). We do not know Venture’s total assets (for purposes of Rule 501(a)(3)), but we do know it cannot satisfy Rule 501(a)(8) because two of its limited partners are not accredited investors. One answer might be to capitalize Venture at \$5 million (so long as it was not formed for the specific purpose of buying Start-up shares). But the total investment it is making comes to only \$2 million, and the limited partners might well be reluctant to put more money into Venture simply to become accredited.

If Start-up were to deal with Venture as a sophisticated purchaser (and not as an accredited investor) under Rule 506(b), it would be required to provide the information under Rule 502(b)(1). In that case, it could also accept Ms. Jones’ offer under paragraph (a) above.
The offer is presumably being made under Rule 506(b), and not Rule 504, because the total amount to be raised between paragraphs (a) and (b) is over $10 million. Ms. Jones probably qualifies as sophisticated (individually or with a purchaser representative), even though she is not accredited, particularly in light of her special access to the company.

**Problem 6-9**

To create incentives for key employees, New Corp., upon its organization in January 2006, adopted an employee stock option plan under which it reserved 500,000 shares of common stock. From February 15 through December 2006, New Corp. granted options to purchase a total of 400,000 shares of common stock to 72 employees under the plan (such options were granted every other month by the Board of Directors). The options were granted at prices ranging from $.10 to $.50 per share. Each option had a term of five years and was exercisable each year for 20% of the shares covered by that option, subject to the continued employment of the optionee. Each employee received a summary of the stock option plan, but no further information regarding New Corp.’s business or prospects. The company intends to continue to grant options under the plan. Currently, New Corp. has 600,000 shares of its common stock outstanding. Can this offering qualify for an exemption from registration?

**Analysis:**

This question focuses on Rule 701(d)(2), which limits the securities that may be offered pursuant to Rule 701 during any 12-month period to the greatest of: (1) $1,000,000, (2) 15% of the issuer’s total assets, and (3) 15% of the outstanding amount of the class of securities being offered and sold.

Some 400,000 shares were offered pursuant to options granted in 2006. New Corp. has 600,000 outstanding shares (not counting the shares underlying options issued under Rule 701 (see Rule 701(d)(3)(iii)), and 15% of 600,000 = 90,000. The 400,000 shares issued to date is well in excess of 90,000 shares, and so category (3) is unhelpful.

We do not know New Corp.’s total assets, and so we cannot calculate category (2).

But the 400,000 options were granted at exercise prices between $.10 and $.50 per share. In calculating aggregate sales price, options are valued based on the exercise price of the options (see Rule 701(d)(3)(i)). Even at the maximum price of $.50, this would come to only $200,000 (and it probably comes to much less). Thus, we are well below the $1 million ceiling.

The only disclosure required by Rule 701(e) has been provided.

**Problem 6-10**

If the preceding offering does qualify for an exemption, is that exemption lost when New Corp. sells 2,000,000 shares of its common stock on January 15, 2007, to 15 accredited investors and six sophisticated individuals in an otherwise qualified private placement? Will the two offerings be integrated?

**Analysis:**

Presumably, New Corp. is making contemporaneous offerings under Rules 701 and 506. Rule 152(b)(2) provides: “Offers and sales made in compliance with Rule 701 [or] pursuant to
an employee benefit plan . . . will not be integrated with other offerings.” Hence, there is no problem here.

PROBLEM 6-11

Start-Up Corp., a Delaware corporation and non-reporting company, is a high-tech venture capital-financed company that is approaching an eventual IPO. As of December 31, 2011, it had total assets of $100 million and 50 million shares of common stock outstanding (mostly held by institutional investors). In 2012, it hired several high-level executives to staff itself for its upcoming IPO. All previous stock options were issued at a $1 per share exercise price. In 2012, Start-Up Corp. issued options to purchase 6 million shares to several new executives, including a new chief operating officer, a new chief financial officer, and a new treasurer, giving them the same disclosures it gave to prior option holders (basically, a copy of its stock option plan and their employment agreement, but no financial disclosures). Most of these executives exercised their options in 2012. These executives were highly sophisticated (although not necessarily wealthy), but Start-Up Corp. was also making other private placements at the same time to various institutional investors. Do you see any problem? If this transaction were still pending, what practical advice would you give Start-Up Corp.’s general counsel?

ANALYSIS:

This is a Rule 701 problem. The 6 million shares sold in 2012 (sales of securities underlying options are counted as sales on the date of option grant, see Rule 701(d)(1)) are less than 15% of the 50 million shares outstanding, and under Rule 701(e), the only disclosures normally are delivery of the compensation benefit plan or contract, as applicable. There is no integration between the Rule 701 offering and the private placements (see Rule 152(b)(2)).

The 6 million shares were sold (presumably at the same price as, or higher than, the prior stock options, at a $1 option price) for a total of $6 million. Under Rule 701(e), the trigger for greater disclosure is if the aggregate sales price or amount of securities sold during any consecutive 12-month period exceeds $10 million. If that threshold is crossed (which does not appear to be the case here—but we do not know if there were sales in 2011 that should be included in the same running 12-month limitation, nor do we know the actual price at which the 6 million shares were sold), additional disclosure is required under Rule 701(e), including risk disclosure (see Rule 701(e)(3)) and financial statement disclosure equivalent to what would be required in a Form 1-A offering statement under Regulation A (see Rule 701(e)(4)).

PROBLEM 6-12

Jersey Co. (“Jersey”) is a privately-held New Jersey corporation with its principal place of business in the Meadowlands of New Jersey. The company derives virtually all of its revenues from amusement parks it operates in New Jersey. It owns no assets outside of New Jersey, and it plans to use the proceeds of a $7 million offering of its convertible debentures to finance the expansion of its Wilderness Adventure Park in the southern New Jersey pinelands. Fifty percent of its common stock is owned by four members of the Soprano family, well-known New Jersey entrepreneurs. On June 30, 2003, Jersey sold $3 million of these debentures to the New Jersey State Pension Fund and $2 million to Jersey Investments
("Investments"), a newly-organized limited partnership with ten limited partners (and a corporate general partner that is a New Jersey corporation). Investments is organized under the New Jersey limited partnership statute and has its office in Newark, New Jersey. Eight of the ten limited partners reside in New Jersey, with the other two residing in New York. On September 30, 2003, the last $2 million of the debentures are sold to the pension funds of two New Jersey-based unions.

(a) Do you see any problems with this offering to this point?

(b) On November 1, 2003, Tony Soprano, an officer and large shareholder of Jersey, sells 50,000 shares (or 8% of Jersey’s outstanding common stock) to five local businessmen, all residents of New Jersey, for $1.5 million. No disclosure document is prepared or delivered, and three of the businessmen do not qualify as accredited investors. Are there any problems?

(c) On April 2, 2004, over nine months after it acquired its debentures, the New Jersey State Pension Fund sells half of its Jersey debentures to the New York State Pension Fund in a private sale that they negotiate. Any problem?

(d) On December 5, 2003, Jersey files a registration statement on Form S-1 covering the sale of $20 million in convertible debentures. It is declared effective on February 5, 2004. Assume, in the alternative, that the same $20 million is sold on the same date pursuant to a Regulation A offering. Any issues?

(e) On October 15, 2003, Jersey, at the direction of its controlling shareholders, loans $3.5 million to two New York corporations, Gambino Operations, Inc. and Bonnano Properties Co., both privately-held firms. The transactions close in New Jersey and are documented with notes obligating each borrower to pay interest at the compounded annual rate of 12½%. “It was just too good an offer to refuse,” explains Tony Soprano, a Jersey director. Any problem?

(f) In the alternative to (e) above, Jersey decides to use $7 million from the proceeds of its $20 million debenture offering to repay a high-interest bank loan it earlier secured from First National Bank of Philadelphia. Is the issue now any different than in (e)?

**ANALYSIS:**

We will analyse this question under Rules 147 and 147A, which appear to be where the facts are directing us.

(a) Both Jersey Co. and Jersey Investments appear to be New Jersey “residents” under Rules 147(d)(1) and 147A(d)(1). An issue arises under Rules 147(d)(3) and 147A(d)(3) if the “newly organized” limited partnership is seen as “organized for the specific purpose of acquiring securities offered pursuant to this rule.” If so viewed, it will not be deemed a New Jersey resident because two of its limited partners are not residents of New Jersey. But the facts do not tell us that this partnership was formed specifically to acquire securities under Rule 147 or Rule 147A. Has the limited partnership made other investments? Were the other investments also made pursuant to Rule 147 or Rule 147A? Did it raise capital well in excess of this investment? Does it otherwise do business in New Jersey? The issue is open, but it is far from clear-cut. If it can show other business activities or investments in New Jersey, it would not appear to have been created for the “specific purpose” of participating in this transaction.

(b) Rules 147 and 147A, by their terms, apply to “[a]n issuer, or any person acting on behalf of the issuer,” and do not extend to controlling persons. In interpreting Section 3(a)(11), however, the SEC stated in SEC Release No. 4434 (Dec. 13, 1961): “A secondary offering by a controlling person in the issuer’s State of incorporation may be made in reliance
on a section 3(a)(11) exemption provided the exemption would be available to the issuer for a primary offering in that State. It is not essential that the controlling person be a resident of the issuer's State of incorporation.” The question is the extent to which a controlling shareholder may rely on SEC Release No. 4434 if Rule 147 is available to the issuer. (The analysis does not necessarily extend to Rule 147A, which—notwithstanding the similarity in language with Rule 147—was adopted by the SEC pursuant to its general exemptive authority under Section 28 of the 1933 Act, not Section 3(a)(11).)

On the assumption that Tony Soprano is part of the Jersey control group, Mr. Soprano may argue that his sale of Jersey common stock was made in reliance on Section 3(a)(11) since the company satisfies Rule 147, including Rule 147(c)(i) (at least 80% of its consolidated gross revenues from the operation of a business in New Jersey). However, we do not know how the common stock was originally issued (the Problem only describes the sale of convertible debentures). If the shares were privately placed to persons both inside and outside New Jersey, it stretches Section 3(a)(11) and Rule 147 to allow it to be used for secondary sales when the primary offering would not have qualified under an intrastate exemption.

Rule 144 or Section 4(1½) may provide an exemption for Soprano’s resale, although they would not necessarily permit a disclosure-less transaction by a non-reporting company. State “blue sky” requirements must also be considered.

(c) This transaction may be nine months after the New Jersey fund’s acquisition of the debentures, but it is not nine months “from the date of the sale by the issuer of a security pursuant to this rule.” See Rules 147(e) and 147A(e). That offering process did not end until September 30, 2003, with the sale of the final $2 million. The sale on April 2, 2004, squeaks over the current six-month time period, and therefore, this sale still appears to comply with Rules 147(e) and 147A(e).

(d) The issue here is whether a completed Rule 147 or Rule 147A offering should be integrated with an offering of similar securities a little over two months later that (1) is registered or (2) relies on Regulation A.

Rule 152 provides two non-exclusive safe harbors that are applicable here:

(1) Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with such other offering, provided that for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation, the provisions of Rule 152(a)(1) shall apply.

(3) An offering for which a registration statement under the Act has been filed will not be integrated if it is made subsequent to: (i) A terminated or completed offering for which general solicitation is not permitted; (ii) A terminated or completed offering for which general solicitation is permitted made only to qualified institutional buyers and institutional accredited investors; or (iii) An offering for which general solicitation is permitted that
terminated or completed more than 30 calendar days prior to the commencement of the registered offering.

Rule 152 also includes a definition of “termination or completion” of an offering. For a Rule 147 or Rule 147A offering, Rule 152 states that “the termination or completion of an offering is deemed to have occurred when the issuer and its agents cease efforts to make further offers to sell the issuer's securities under such offering.” It then sets out a “non-exclusive list of factors [that] should be considered in determining when an offering is deemed to be terminated or completed,” which for a Rule 147 or Rule 147A offering are “the later of the date: (i) The issuer entered into a binding commitment to sell all securities to be sold under the offering (subject only to conditions outside of the investor’s control); or (ii) The issuer and its agents ceased efforts to make further offers to sell the issuer’s securities under such offering.” We will assume that either factor applies to the sale of the Jersey debentures in this Problem.

The Problem first asks about a registered offering. The filing of the registration statement (and, presumably, “the first offer of securities in the offering by the issuer or its agents,” see Rule 152(c)) took place more than 30 days after completion of the Rule 147 or Rule 147A offering and is covered by safe harbors (1) and (3)(iii) (quoted above).

The Problem then asks, in the alternative, what if “sales” under Regulation A are made on the same date. We do not know when the Regulation A offering commenced. Under Rule 152, a factor to consider in determining when a Regulation A offering has commenced is “the earlier of the date the issuer first made an offer soliciting interest in a contemplated securities offering in reliance on Rule 255, or the public filing of a Form 1-A offering statement.” If the Regulation A offering commenced 30 days or more after completion of the Rule 147 or Rule 147A offering, then safe harbor (1) will apply. If it commenced less than 30 days after completion of the Rule 147 or Rule 147A, then no safe harbor applies. In that case, Rule 152 provides some general principles to determine whether to integrate the two offerings:

[O]ffers and sales will not be integrated if, based on the particular facts and circumstances, the issuer can establish that each offering either complies with the registration requirements of the Act, or that an exemption from registration is available for the particular offering. In making this determination: . . . (2) For two or more concurrent exempt offerings permitting general solicitation, in addition to satisfying the requirements of the particular exemption relied on, general solicitation offering materials for one offering that includes information about the material terms of a concurrent offering under another exemption may constitute an offer of securities in such other offering, and therefore the offer must comply with all the requirements for, and restrictions on, offers under the exemption being relied on for such other offering, including any legend requirements and communications restrictions.

Depending on the circumstances, both the Rule 147/147A offering and the Regulation A offering may each be required to “comply with all the requirements for, and restrictions on, offers under the exemption being relied on for such other offering, including any legend requirements and communications restrictions.” That may not be practical if the Regulation
A offering is intended for investors outside New Jersey. In that case, the better course may be for Jersey to wait to commence the Regulation A offering until 30 days have passed.

(e) This is essentially the fact pattern in SEC v. McDonald, 343 F.Supp. 343 (D. Minn. 1972) (excerpted in the casebook). There, the proceeds from the sale of notes were to be used principally, if not entirely, to make loans to land developers outside the state in violation of Section 3(a)(11).

The Problem suggests that Jersey does not satisfy the net proceeds requirement of Rule 147(c)(2)(iii) or Rule 147A(c)(2)(iii). But fear not! This is not the only one way for Jersey to establish that it is “doing business” within New Jersey. Gross revenues, consolidated assets, and location of a majority of the issuer’s employees may also be used to establish that Jersey is “doing business” in New Jersey. Prior to Rule 147 being amended, Jersey essentially needed to satisfy all of these requirements to be “doing business” within New Jersey, but later changes—now stating the conditions in the alternative—liberalized Rule 147 (and now Rule 147A).

(f) This question again goes to use of proceeds. This is the fact pattern in Master Financial, Inc. SEC No-Action Letter (May 27, 1999). Rule 147(c)(2)(iii)’s and Rule 147A(c)(2)(iii)’s use of a proceeds test is articulated in terms of the issuer using “at least 80% of the net proceeds to the issuer from sales made pursuant to this rule in connection with the operation of a business . . . located in . . . such state.” In Master Financial, Inc., for purposes of Rule 147, the SEC staff accepted the payment of much of the proceeds to an out-of-state bank whose loan had financed the company’s in-state activities. The business and all its capital were, in effect, invested in-state, even if repaying the bank loan implied that much of the offering proceeds went out of state. Of course, the SEC staff may not be as liberal today, in light of the loosened requirements under Rule 147 and Rule 147A.

Problem 6-13

“Wild Bill” Hickock, a Texas oil promoter, forms a Texas master limited partnership in which he offers limited partnership interests exclusively to Texas residents. The limited partnership’s principal place of business is in San Antonio, where it maintains its bank accounts and business records. The partnership principally invests in limited partnership interests in other limited partnerships, which are also organized under Texas limited partnership law, but which then invest in oil and gas ventures located outside of Texas. Assume that these limited partnerships also have their principal place of business in Texas. Can this two-tier structure qualify under Rule 147(c) (or Rule 147A(c))? 

Analysis:

“Wild Bill” can seek to rely on Professional Consultants, Inc. SEC No-Action Letter (Dec. 19, 1980), which permitted a limited partnership resident in the Section 3(a)(11) jurisdiction to invest in other unaffiliated limited partnerships that primarily operated out of state. In contrast, in Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969), an issuer in one state directly sold interests in oil and gas leases in another state. The Sixth Circuit held that the transaction was outside the boundaries of Section 3(a)(11). The difference seems to be only the use of the intermediary layer of limited partnerships. Obviously, this no-action letter shows the SEC staff liberally interpreted Rule 147 in the belief that it would serve no purpose to do otherwise. (Presumably, Rule 147A—which contains the same relevant language as
Rule 147, but was not promulgated under Section 3(a)(11)—would be interpreted in the same way.) Good policy?

**Problem 6-14**

Two New York lawyers have started an internet website that helps New Yorkers find lawyers in New York. Its revenues come from lawyer advertising on the website. To expand, the two promoters want to sell common stock in their new company to New York attorneys, so they place a marketing document on their website that offers the stock to all New York attorneys (and only to them). What advice would you give them?

**Analysis:**

This Problem highlights one important difference between Rules 147 and 147A.

One must presume here that the internet website marketing document was seen by persons not resident in New York State. But, this problem can be solved by adding a disclaimer to the website that makes it clear it is not a solicitation of, or offer directed to, non-residents of New York. The deeper problem is that the offer itself is directed to New York attorneys, but it is possible to be a New York attorney living out of state. Rule 147(d) provides that “[o]ffers and sales of securities pursuant to this [Rule] shall be made only to residents of the state or territory in which the issuer is resident, . . . or who the issuer reasonably believes, at the time of the offer and sale, are residents of the state or territory in which the issuer is resident.” Thus, under Rule 147, the lawyer’s advice should be: (1) to rephrase the solicitation to cover only New York admitted attorneys who are residents of New York; and (2) to indicate that the offer is not open to non-residents of New York. See Rule 147(d); *Palmer & Dodge SEC No-Action Letter* (Aug. 11, 1975). Sales should also be made only to residents of New York (or to persons who the issuer reasonably believes are residents of New York).

Rule 147A(d) may be the better approach since it is conditioned *only* on sales; offers can be made to non-residents of New York so long as sales are made only to residents of New York (or to persons who the issuer reasonably believes are residents of New York).

Both Rule 147(d) and Rule 147A(d) also include guidance on determining residence.

**Problem 6-15**

Webco, Inc., a Delaware corporation (“Webco”), announces it will donate ten shares of its common stock, traded at $5 per share on Nasdaq, to the International AIDS Foundation, a respected and independent foundation, for each person who sends it an email with a return address on or before December 1, 2003. Webco’s counsel requests “as a formality” a no-action letter from the SEC’s staff that such a donation will not violate Section 5 of the 1933 Act. As the SEC attorney responding to this no-action request, what is your response?

**Analysis:**

This question involves the facts in *Simplystocks.com SEC No-Action Letter*, 1999 WL 51836, and *Jones and Rutten*, 1999 SEC No-Act Letter 555. Here, as in those cases, Webco still gains something of value from each individual who registers with it (by sending the email with return address), and this satisfies the test of Section 2(a)(3). Consequently, each “sale” of a security must be registered with the SEC or exempt from registration.
**Problem 6-16**

XYZ Inc., a reporting company ("XYZ"), faces a liquidity crisis. It cannot pay the soon-to-be-due principal on the bonds of its wholly-owned subsidiary, Subsidiary Co., which mature at the end of this year. Hence, it offers the following exchange: 3 shares of XYZ's stock, currently trading at $30 per share, for each $100 in principal of the debt represented by the bonds. The bonds are held by approximately 400 holders, most of whom are institutions, as well as by several individuals. XYZ hopes to be able to pay the debt in full of those who do not accept its offer. What are the exemptions from registration available for this offering?

**Analysis:**

What exemptions from registration are available here? The short answer may be: None.

At first glance, this is not a Section 3(a)(9) exchange because XYZ is not seeking to exchange securities with its own “existing security holders exclusively” (as Section 3(a)(9) requires), but with Subsidiary's debtholders. (This case does not fit within the bankruptcy exemptions, nor is it a Rule 145 transaction (because no vote is required). The number of non-accredited holders may also exceed the 35-person ceiling in Rule 506(b).)

Nonetheless, the SEC has shown some flexibility in determining who the issuer is for purposes of Section 3(a)(9). In *Union Carbide Corp. SEC No-Action Letter* (Sept. 6, 1994), [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH), Para. 76, 910, the SEC found that a parent/subsidiary relationship was sufficient to allow the use of Section 3(a)(9) where the holding company was to be eliminated and the subsidiary was to issue its shares to former shareholders of the holding company in the same proportion as the shares they held in the holding company (again, this transaction would not fit within Rule 145, because there was no vote). The present fact pattern is not identical to *Union Carbide*, and so an SEC no-action letter would need to be sought.

Alternatively, XYZ could consider merging Subsidiary into itself (and, thereby, assuming Subsidiary's debt) so that XYZ would be exchanging its stock for what would now be its bonds following the merger.

The SEC may also find it sufficient under Section 3(a)(9) if XYZ fully and unconditionally guarantees Subsidiary's bonds and then exchanges those bonds for XYZ shares. But be careful. If XYZ guarantees Subsidiary's bonds, it potentially changes the credit quality of the bonds (and the negotiation position of the bondholders, who may no longer wish to exchange their now-more-valuable bonds on the same terms).

**Problem 6-17**

Assume the same facts as in Problem 6-16, except that the debt is now owed by XYZ (not its subsidiary) and elaborate negotiations are conducted between a committee representing the institutional investors and XYZ, which is represented in these negotiations by its investment adviser, Goldman, Merrill (which later charges a $4 million fee for its services). Ultimately, they reach a revised deal under which the bondholders will be given two shares of XYZ stock plus $34 in cash for each $100 in principal amount of debt exchanged by them. Does any aspect of this transaction raise securities law problems? Evaluate.
**Analysis:**

We are assuming now that the debt was issued by XYZ, and not its subsidiary, so there is an exchange between the issuer and its existing security holders. The new issue this problem raises is the role of the investment bank. Section 3(a)(9) says its exemption is available “where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange.” But is Goldman, Merrill soliciting here? Or, is it negotiating at arm’s length? In an important no-action letter, *Seaman Furniture Co. SEC No-Action Letter* (Oct. 10, 1989), [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH), Para. 79,360, the SEC drew a line between providing professional services and advice (including providing objective information as an information agent and being involved in negotiations) and solicitation. Here, no retail investors are approached by Goldman, Merrill, and their only role seems to be that of a negotiator. Hence, it is likely that the analysis in *Seaman Furniture* would apply here.

Students may think that the payment of cash by the issuer violates the “exclusively” requirement in Section 3(a)(9). Yet, for once realistic, the SEC does not care if the issuer pays cash plus securities to the security holders, although it does preclude the payment of cash by the security holders (except as permitted by Rule 149). Indeed, Rule 150 expressly permits the issuer to pay cash in addition to the securities it is offering.

**Problem 6-18**

The foregoing exchange was made on April 1, 2008. XYZ pays $275 million in cash and, as a result, finds itself facing a cash flow problem. XYZ, therefore, sells 1 million shares of its preferred stock, which carries a 10% annual cumulative dividend, to a group of 20 large institutional investors on September 1, 2008. Do you see any problem here?

**Analysis:**

Here we face an integration question. XYZ issued common stock in the April 1, 2008, exchange and now, on September 1, 2008 (five months later), it sells preferred stock. We are not told the basis for the September 1 sale, but by selling to “20 large institutional investors,” XYZ may be attempting to rely on Rule 506(c).

Here, again, a Rule 152(b)(1) safe harbor may provide the basis for not integrating the two offerings:

(1) Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with such other offering, provided that for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation, the provisions of Rule 152(a)(1) shall apply.

Neither Section 3(a)(9) nor Rule 506(c) prohibits a general solicitation, and so the proviso (which refers us to the general principles of integration in Rule 152) does not apply. As noted in Problem 6-12, Rule 152 defines when an offering commences and when it is completed. Here, we do not know when the offering that resulted in the September 1 sale commenced.
However, if more than 30 days separate completion of the April 1 exchange and commencement of the later 506(c) offering, the safe harbor will apply.

Note the predicament XYZ faces if the Section 3(a)(9) and Rule 506(c) offerings are integrated. Section 3(a)(9)’s use of the adverb “exclusively” comes into play as the original source of the integration doctrine. You may wish to emphasize the dual meaning given to “exclusively” in Section 3(a)(9)—the securities must be (1) only exchanged with existing shareholders (and not sold to other investors); and (2) no other consideration may be received from the shareholders (subject to the modest exception in Rule 149). Complying with this condition may not be possible if the two offerings are integrated.

**Problem 6-19**

ABC Industries (“ABC”) sold $50,000,000 of its 7% bonds in a private placement on June 1, 2006. Now, in early April 2007, ABC offers bondholders a chance to exchange those bonds for its common stock at a favorable ratio. The transaction will comply with Section 3(a)(9). Joe Retail, an accredited investor, purchased $100,000 of ABC’s bonds (at the time, he was an Executive Vice President of ABC, but he retired on December 30, 2006), and he exchanged all his bonds for ABC common stock. A week later, on April 5, 2007, he decided to sell the common stock. Can he sell? When and under what conditions?

**Analysis:**

We will assume that ABC is a non-reporting private issuer. Joe Retail bought ABC’s bonds in a private placement in June 2006 and exchanged them for ABC’s common stock in April 2007. The bonds he acquired in 2006 were “restricted securities,” which he exchanged in 2007 (before the one-year holding period expired under Rule 144(d)(1)(ii)). What is the status of the new securities received in the Section 3(a)(9) exchange? Are they similarly restricted? If they are, he cannot sell under Rule 144 on April 5, 2007; he must wait until June 1, 2007 (although sales pursuant to Section 4 (1½) may be possible if its conditions are met; sales pursuant to Rule 144A may not be possible due to fungibility (although the Problem is silent about if/where the stock is traded)). The predominant view is that the restricted securities keep their “taint,” which is not washed off by the Section 3(a)(9) exchange transaction. However, the holding period for the bonds can also be tacked on to the holding period for the common stock. Although Retail was an affiliate, he has not had that status since December 30, 2006, and so this factor is no longer relevant in April 2007 (see Rule 144(b)(1), which defines the conditions to rely on Rule 144 for sales by “any person who is not an affiliate of the issuer at the time of sale, and has not been an affiliate during the preceding three months”). For an overview, see R. Campbell, Resales of Securities Under the Securities Act of 1933, 52 Wash. & Lee L. Rev. 1333, 1356-60 (1995).

**Problem 6-20**

Two local bus companies in New Jersey announced a stock-for-stock merger. Assume that under New Jersey law, the New Jersey Transportation Commission must approve any such merger and, under its governing statute, it must consider the impact of the merger on “consumer safety, efficient operations, the public’s need for low-cost public transportation, and the public interest generally.” Assume the Commission holds an elaborate, ten-day public hearing, after notifying everyone, including shareholders of both companies, and hears detailed testimony from dissident minority shareholders of one company that the merger is
unfair to them. Nonetheless, the Commission expressly finds the merger to be fair to all concerned, including the minority shareholders. Does this approval qualify for purposes of Section 3(a)(10)?

**ANALYSIS:**

The language of Section 3(a)(10) requires that “the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions . . . by any . . . other governmental authority expressly authorized by law to grant such approval.” In effect, Section 3(a)(10) has a dual test for agency approvals: (1) the agency must have express statutory authority to approve the fairness of the transaction; and (2) it must explicitly find that the transaction is fair to the affected investors. Neither element was satisfied here. The facts do not indicate that the Transportation Commission was “expressly authorized” to approve the fairness of the merger’s terms, but instead it was directed to consider the merger’s effect on different public interests.

**PROBLEM 6-21**

Software Co. is a reporting company listed on Nasdaq. It files a registration statement on Form S-3 for an offering of 10 million shares of common stock on June 1, 2007, but then market conditions deteriorate. Its underwriters tell it that the offering is currently infeasible. They suggest, however, that they can place 2 to 3 million shares with a small group of pension funds in a private “PIPE” transaction at a price of $1.50 per share. What, if any, are the legal obstacles to such an offering?

**ANALYSIS:**

Under Rule 152, there is a 30-day safe harbor following withdrawal of the registration statement (which is done pursuant to Rule 477 and requires a 15-day period to see if the SEC objects). Such withdrawal coincides with the termination of the public offering under Rule 152(b)(1):

1. Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with such other offering, provided that for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation, the provisions of Rule 152(a)(1) shall apply.

Presumably, the follow-on PIPE transaction will be done pursuant to Rule 506(c) solely to institutional accredited investors (the pension funds), commencing 30 days after the registration statement is withdrawn. For these purposes, “commencement” is defined in Rule 152(c) as “the date the issuer first made an offer of its securities in reliance on” this exemption.
CHAPTER 7: OFFERINGS BY UNDERWRITERS, AFFILIATES, AND DEALERS

The dates in some Problems pre-date amendments and rules that exist today. In all cases, we will analyze the questions using the rules as in effect today

PROBLEM 7-1

Your old college roommate and the best man at your wedding has launched a small start-up company in Silicon Valley. He convinces you to invest $200,000, and, because you are “best lawyer he knows” (he was always good at flattery), to write the first draft of the registration statement for a small offering where his firm is chiefly buying the stock of a rival firm in an exchange offer. But they are also looking for additional financing, and he convinces you to give him the email addresses of 100 or so of your law firm’s better-heeled clients. He solicits them to invest, and about 20 do. He uses your name as a reference with several, and a few call you to ask your opinion (which is favorable if “you are willing to accept some risk”). Are you an underwriter?

ANALYSIS:

No case reaches quite this far to find someone to be an underwriter, but the language of Chinese Benevolent Association is sweeping and could be read to cover these facts. Recall, in that case, a not-for-profit association and its officers solicited offers for bonds issued by the Government of China for patriotic reasons (and without any contractual agreement or economic interest), served as intermediaries who received payments from investors, and delivered these funds to the Bank of China; in some cases, the Association also received securities from the Bank to deliver to investors. All in all, this was a largely ministerial role.

Here, a lawyer is writing the registration statement, investing his own funds in the transaction, and providing the email addresses of some 100 potential investors (20 of whom purchase in the offering). Arguably, the defendant in this transaction was (in the language of Chinese Benevolent Association) “participating in a transaction with an issuer.”

The problem with this approach is that it proves too much and could make any law firm drafting a registration statement into an underwriter. If a valid distinction can be drawn between this hypothetical and Chinese Benevolent Association, it probably lies in the fact that the defendant here did not solicit purchasers (although it did help the underwriters solicit by giving the names of a number of possible investors, some of whom did purchase, permitting his name to be used as a reference, and providing a favorable opinion).

In SEC v. Cavanaugh, 1 F.Supp.2d 337 (S.D.N.Y.), aff’d 155 F.3d 129 (2d Cir. 1998), the SEC’s complaint (alleging that individual shareholders associated with management who sold unregistered shares were underwriters) was upheld, with the district court stating: “Individuals who participate in an unlawful distribution, regardless of what form their participation takes, may be considered underwriters.” Id. at *13-*14. To be sure, Problem 7-1 does not involve an “unlawful distribution.” However, even though it may push the envelope to extend Chinese Benevolent Association this far, there is still a risk the lawyer will become a “statutory” underwriter (meaning he falls within the Section 2(a)(11) definition of “underwriter,” even if he is not in the underwriting business).
**PROBLEM 7-2**

Your law firm has a unique practice of representing IPO clients on a “stock only” basis. That is, rather than charging the $1 million to $1.5 million fee charged by comparable firms, your firm will take stock (valued at the initial offering price) in lieu of cash. The offering was initially priced at $25 per share, but because the price rose on the first day to $60, your firm has made a bundle and would like to realize its profit as soon as it can. Although your firm’s stock was fully registered, it agreed to a lock-up under which the firm would not sell any shares until six months after the offering. Is the firm now an underwriter as one who “participates” in a distribution? What if, during the period between one month after the offering and the end of the lock-up agreement, your firm occasionally buys the issuer’s stock in the secondary market (because the lead underwriter, who also is buying, advises you that otherwise the stock price will slip)?

**ANALYSIS:**

Now, the defendant law firm that represents the IPO issuer will receive shares in the offering (at least 40,000 to 50,000 shares, it seems). (Note that, due to real or apparent conflicts of interest, there may be bar association limitations or restrictions on stock compensation.)

Arguably, you have “a direct or indirect participation in any such undertaking” in the language of Section 2(a)(11), and you have done more than the broker-dealer did in **Harden** (referenced in the casebook, involving a qualified independent underwriter (“QIU”)). Recall that in **Harden**, the court found that Section 11 liability extended to a QIU who was found to be part of the underwriting—even though it did not solicit or sell shares, but simply acted as an independent pricing agent. This is quite a broad reading of what constitutes “participation” and may extend to the law firm in this Problem. Still, the key in **Harden** was that the NASD intended the QIU to have Section 11 liability. Here, as strong as your economic interest is in the success of the offering, and as conflicted as this law firm may be, it has not solicited investors or sold securities or, like a QIU, priced them.

Also note the Second Circuit’s decision in **Byrnes** (referenced in the casebook), which found that sellers who included their stock in a registration statement, after exercising their piggyback rights, could be statutory underwriters (participating in a distribution). The defendants’ case was not helped by disclosure in the registration statement that indicated they might be deemed statutory underwriters. None of those facts are here—but including selling stockholders as underwriters is a sweeping decision that, nevertheless, might also pick up this Problem’s law firm.

Thus, up until the law firm begins to make purchases in the secondary market, there is an open question about whether they would be deemed to be an underwriter. On the one hand, the law firm did receive securities from an issuer with a view to their later distribution (i.e., sales, perhaps pursuant to piggyback rights, like in **Byrnes**) within a relatively short six months. On the other hand, the law firm was not directly involved in any solicitation or sales (but then neither were the selling shareholders in **Byrnes**). On balance, as noted before, since the law firm was not involved in the solicitation or sales process, we doubt they would be deemed to be an underwriter. However, once they begin to make “stabilizing” purchases in the market, they are performing in a functionally similar manner as an underwriter and, hence, should be deemed to be an underwriter. (Indeed, as an “affiliated purchaser” the firm
may have violated Rule 101 of Regulation M.) The SEC might also argue that, in purchasing shares at the lead underwriter’s suggestion, it was acting as an “accomplice” (a theory that was accepted in the Cavanaugh litigation referenced in the Problem 7-1 analysis).

**Problem 7-3**

Dana runs a blog where she comments on the economy, markets, and, on occasion, particular stocks. When one of her favorite companies went public, Dana wrote a series of blog posts extolling the virtues of the company, the quality of its products, and its commitment to doing good for the world. She even included a link on her website where her readers could access the company’s regulatory filings and, when the company eventually offered its stock for sale, a link that connected her readers to the company’s prospectus. Dana received no compensation or consideration of any kind for her actions. Has Dana violated Section 5?

**Analysis:**

Do Dana’s blog posts constitute an “offer” of the company’s shares? Extolling the company’s virtues, products, and commitment to doing good—these appear to constitute an “offer,” as that term is broadly construed in Section 2(a)(3). In some cases, Dana’s activities may have occurred before a registration statement was filed in violation of Section 5(c). Some blog posts may also constitute “prospectuses” (as graphic communications that offer shares for sale) that fail to comply with Section 5(b) (unless they qualify as free writing prospectuses under Rule 433, which the facts do not indicate). None of this matters, however, to the extent these are “transactions by [a] person other than an issuer, underwriter or dealer” (Section 4(a)(1)), which are exempt from Section 5. Since Dana is not an issuer or a dealer, the question is whether she is someone who falls within the definition of “underwriter” in Section 2(a)(11).

We return again to Chinese Benevolent Association and its sweeping definition. Specifically (in the language of Section 2(a)(11) and Chinese Benevolent Association), if Dana “sells for an issuer in connection with[ ] the distribution of any security, or participates or has a direct or indirect participation in any such underwriting,” she may be considered to be an underwriter. Dana is particularly likely to fall within the definition since she links to the company’s regulatory filings and prospectus. Whether or not she was compensated does not affect the analysis. As Chinese Benevolent Association noted: “The solicitation of offers to buy the unregistered bonds, either with or without compensation, brought defendant’s activities literally within the prohibition of the statute.”

Note that Rule 137 does not extend to Dana, even though she has not received any consideration, directly or indirectly, from the issuer or any participant in the distribution. First, strictly speaking, Rule 137 applies to broker-dealers, and Dana appears to be neither. But, second, and more importantly, Dana is publishing and distributing more than research reports by linking to the company’s prospectus. This is closer to participating in a distribution than if she published only blog posts.

**Problem 7-4**

Investor A purchases common stock in a private placement by a major airline on May 30, 2019. Shortly thereafter, a terrorist-induced air crash shocks the markets and collapses the price of airline stocks. Investor A sells the shares on July 1, 2019, claiming that the terrorist
disaster was totally unforeseen and represented an historically fundamental change of circumstances. Assume that, as an attorney in the SEC’s Enforcement Division, you were asked to advise the Commission and its staff whether this is a legitimate claim that should be accepted.

**ANALYSIS:**

This question explores the “change in circumstances” doctrine. In adopting Rule 144, the SEC effectively disowned that doctrine, indicating in its adopting release that it did not consider the doctrine functionally related to the interests of investors. Today, the SEC will not respond to no-action letter requests asking it to rule that there has been a sufficient change in circumstances to permit a resale of securities purchased in a private placement. Still, the SEC may be stuck with the doctrine because of the statutory language of Section 2(a)(11), with its emphasis on “view to . . . the distribution of any security.”

Nonetheless, the facts in this Problem do not show any change in circumstances that would permit a resale. As *Gilligan, Will & Co.* (referenced in the casebook) made clear, an investor cannot rely on the continued profitability of the issuer, with the failure to remain profitable being a change in circumstances. The Second Circuit called this intention to retain the stock, only so long as profitable, as “equivalent to a purchase . . . with a view to . . . distribution.” Indeed, well before the 9/11 tragedy, airlines suffered economic reversals because of hijackings (which were common a decade earlier). That airlines could be exposed to terrorism was not an unknown risk, but even if one disagrees and sees it as new and novel, it was well understood that airlines could become unprofitable for any number of reasons (because several had been in bankruptcy). Thus, the SEC is certain to require investors to hold for the minimum six-month or one-year period (depending on whether the issuer is public or not) required under Rule 144.

**PROBLEM 7-5**

Ebarka Eban, a 7’ 3” center who plays in the European Basketball League, is the first draft choice in the first round of this year’s NBA draft. He signs with the New York Knicks on August 30, 2015—a team which, as usual, finished last—for $50 million over five years plus one million shares in the Knicks, which are sold to him on that date in a valid private placement at $1.50 per share (the trading price on Nasdaq was then $8 per share and the 1 million shares represent 5% of the Knicks’s outstanding shares). A week later, Eban pledges his shares in the Knicks to the Bank of New York as partial collateral for a $60 million loan, which he promptly uses to buy a controlling stake in a franchise in the European Basketball League. On February 8, 2016, Eban announces he will play that season for his European team, and thereby (i) breaches his contract with the Knicks and (ii) defaults on his loan with the Bank of New York. The Bank of New York wants to sell the shares it received in the Eban pledge on Nasdaq, which is where the Knicks are traded. Can it?

**ANALYSIS:**

The Knicks have given this year’s rookie a large block of stock (1 million shares). This might be done under Rule 701 if the Knicks are a non-reporting issuer and this was part of a “written compensation contract” (see Rule 701(c)). Recall that, in that case, the shares will be restricted (see Rule 701(g)).
The Knicks, however, are traded on Nasdaq, and so they are a publicly reporting company. Rule 701 is not available (see Rule 701(b)). If the Knicks are public, the transfer to Eban must be done as a private placement, most likely under Rule 506. Like Rule 701, the stock will be restricted. Perhaps Eban is an accredited investor (in which case, the Knicks may have relied on Rule 506(c)), or perhaps he is not accredited but sophisticated in his own right or with a “purchaser representative” (in which case, the Knicks may have relied on Rule 506(b)).

Eban pledges the shares to the Bank of New York one week later as partial collateral for a loan. Five months later, he defaults on his contract with the Knicks and his loan with the Bank of New York. Can the Bank sell? Under *Guild Films*, the answer is “no” (assuming it will be a broad sale in the public market). The bank’s seizure of the collateral upon default would be deemed a purchase by it with a clear intent to resell, i.e., with a “view to . . . distribution” (in the language of Section 2(a)(11)).

Rule 144 tempers this harsh result, but under Rule 144(d)(1)(i) (on the basis that the Knicks are a publicly reporting company), there is a six-month holding period.

Note that we do not look to Rule 144(d)(3)(iv) because Eban is not an “affiliate” of the issuer when he owns only 5% and is not a director or officer. (The Knicks do not “control” Eban either, as evidenced by his default on the contract).

What result? The Bank can tack Eban’s holding period prior to the pledge (i.e., a trivial one week) to its own holding period—meaning that 20 days still remain before the six-month holding period is satisfied (on February 28).

The facts may suggest to some that Eban intended to breach the contract from the outset. But this does not help the Bank, because it suggests Eban never acquired the shares with investment intent and the Bank is part of the distribution process.

**Problem 7-6**

In Problem 7-5, assume now that Eban buys 1 million Knicks shares from the Knicks at $1.50 per share after becoming their first draft choice (when the market price was $8 per share). Two months later, he is injured in a motorcycle accident, and uncertainty exists about his ability to play next year. Because Eban’s employment contract required him not to ride motorcycles (and only Rolls Royces), an employment negotiation follows, at the end of which Eban is traded to the Nets for a second round draft choice in next year’s draft, gives back half his cash bonus, and sells his 1 million Knicks shares back to Mr. J. Dolan, the Knicks’s controlling shareholder, for $2.25 per share (when the market price was $5 per share). The sale of the Knicks shares occurs six months and two days after Eban’s acquisition of the shares. Any securities law problems here?

**Analysis:**

Now, Eban sells the stock back to the Knicks in a compromise. Is Eban an underwriter? The analysis turns on whether there is a distribution and, in turn, whether there is a sale to the investing public. This could be viewed as a Section 4(1½) transaction. Or, more simply, we could say that there was no “distribution,” because that term means the process by which
securities move from an issuer through an underwriter to reach the investing public. Here, the stock never reached the public, and hence there was no distribution.

**Problem 7-7**

The Rutgers family has always controlled Rutgers Industries, a reporting company traded on Nasdaq, since their grandfather, Raritan Rutgers, founded it in 1925. But today, they own only 28% of the stock among them. Nevertheless, on the nine-person Rutgers board, they hold five seats. When the oldest Rutgers director—Brunswick Rutgers—dies suddenly, the family decides to replace him with their family lawyer, Somerset Trenton. Because Trenton owns no Rutgers shares, they have the company sell him 2 million shares (or 2% of the outstanding shares) at a price of $3 per share on October 1, 2016, in a private placement. Rutgers is behind in its filing of 1934 Act reports, and, as a result, Rule 144 is not available to its usual extent. Rutgers's average weekly trading volume ranges between 250,000 and 500,000 shares per week. Nonetheless, on his retirement from his law firm on October 30, 2017, Trenton (who remains a director of Rutgers) sells 1.5 million Rutgers shares on Nasdaq on November 5, 2017, in an unsolicited broker’s transaction. Can he do this? What if he resigned from his position on the Rutgers board on the same day he resigned from his law firm?

**Analysis:**

Trenton is potentially an affiliate of Rutgers Industries or, in the language of Section 2(a)(11), he may be an “issuer” since he is a “person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.” “Control,” in turn, is defined as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise” (see Rule 405). The SEC considers being a director relevant to whether someone directly or indirectly controls the issuer.

Here, Trenton is a director (he only retired from his law firm, not the board), and as the family lawyer, he appears to be part of a “control group” that has long run this company by holding five of the nine board seats (nothing suggests a supermajority voting requirement) and at least 28% of the stock.

Rule 144(b)(2) states that an affiliate “who sells restricted securities, or any person who sells restricted securities or any other securities for the account of” an affiliate “shall be deemed not to be an underwriter of those securities within the meaning of Section 2(a)(11) of the Act if all of the conditions of this rule are met.”

For reporting issuers, Rule 144(c)(1) requires Rutgers to have filed all required 1934 Act reports during the 12 months preceding sale, other than reports on Form 8-K. The Problem tells us that Rutgers is behind in its filing of 1934 Act reports, but we do not know which reports; if they are just Form 8-K reports, there is no effect. If, however, Rutgers is delayed in filing other reports (and the Problem tells us that, due to the delay, “Rule 144 is not available to its usual extent”), then Trenton will need to wait until all reports are filed for the preceding 12 months before he can rely on Rule 144. (Presumably, as part of the control group, Trenton has some influence over Rutgers becoming current on its reports.)
The Problem states that Trenton received his shares “in a private placement,” which suggests they are restricted (see Rules 144(a)(3)(i) or (ii)). Trenton held his shares for over 1 year, and so his sale would satisfy the general holding period rule for both restricted and unrestricted stock (see Rule 144(d)(1)).

Rule 144(e) limits the amount of securities (restricted or not) that can be sold for Trenton’s account during a three-month period to the greatest of (i) 1% of the shares outstanding and (ii) certain average weekly trading volumes. In this case, Trenton is selling shares in an unsolicited brokerage transaction (consistent with Rules 144(f) and (g)). However, because Rutgers is selling more shares than are permitted under either cap, if he is an affiliate, this transaction violates the Rule.

The Problem goes on to ask whether the analysis would change if Trenton resigned from his position on the Rutgers board on the same day he resigned from his law firm. We will assume, in that case, that Trenton is no longer part of the control group and, therefore, is no longer an affiliate. Rule 144(b)(2) (which requires compliance with all of the above conditions) covers both sales for the account of affiliates and for the account of “any person who was an affiliate at any time during the 90 days immediately before the sale.” However, sellers who are not affiliates at the time of sale, and have not been affiliates for the three months preceding sale, who are selling restricted securities of a public issuer, must only comply with (1) the holding period requirement and (2) the current public information requirement (see Rule 144(b)(1)(i)). As noted before, Trenton has satisfied the holding period requirement, but he must still address Rutgers’ delay in filing its 1934 Act reports. If Trenton sells more than three months after he was an affiliate, and if he held the restricted securities for at least one year (which the facts indicate he has), the current public information requirement appears to no longer be applicable (see Rule 144(b)(1)(i)).

**Problem 7-8**

Medium Tech, Inc. is a Nasdaq-listed reporting company that designs software and web sites for large corporate clients. Becky Gill was hired by Medium Tech two years ago, at which point she purchased 10,000 shares from Medium Tech in a private sale (the purchase price was $120,000, and she paid $20,000 in cash and gave a full recourse promissory note for $100,000, which was secured by a pledge of securities having a market value of $80,000). Becky paid off this note in full three months ago. Becky’s title is Director of Web Design for Medium Tech, which is an important creative position, but does not make her an executive officer (she does not perform a policy making function). Becky now owns 25,000 shares in Medium Tech, having also purchased 5,000 shares in the open market on Nasdaq last week and 10,000 shares on the exercise of a stock option three months ago. Becky was awarded the stock option under the company’s employee stock option plan, which is a “qualified” plan. She is not quite clear on whether shares received under the stock option plan are registered. You are counsel to Merrill, Shearson, the brokerage firm, which she has asked to help her sell all of the stock she can without registration (she wants to buy a ski chalet in Colorado). Medium Tech has 1,400,000 shares outstanding, and its average weekly trading volume over the last four weeks has been 10,000, 13,000, 16,000, and 14,000 shares, respectively. Advise Becky as to what she can and cannot now sell.
**ANALYSIS:**

Is Becky an affiliate? Most likely not—she does not have a “control” relationship with Medium Tech (see Rule 405), reflected in her minimal share ownership and her not being an executive officer (and not performing a policy making function). For a non-affiliate, the conditions to rely on Rule 144 are set out in Rule 144(b)(1).

Becky’s 10,000 shares were sold to her in a “private sale,” and so they appear to be “restricted securities” under Rules 144(a)(3)(i) or (ii). Under Rule 144(d)(1)(i), the holding period for the shares of a reporting company is six months. However, Becky’s holding period is tolled under Rule 144(d)(2) because the collateral posted for the promissory note did not equal the value of the loan (see Rule 144(d)(2)(ii)). The holding period did not restart until the loan was paid off three months ago, meaning she must hold the shares for three more months to meet Rule 144(d)(1)'s requirements.

The 5,000 shares purchased in the open market (presumably pursuant to Section 4(a)(1)) are not restricted securities. Resales of unrestricted securities by a non-affiliate do not need to rely on Rule 144; those resales can also rely on Section 4(a)(1). Hence, those shares can be sold at any time (illustrating the death of the old fungibility doctrine).

The 10,000 shares purchased upon exercise of a stock option have been held only three months. If the stock option plan was registered (typically on Form S-8), the shares would not be restricted securities and could be sold by Becky (a non-affiliate) at any time. If the stock plan was not registered, the securities are likely to be restricted (see, e.g., Rule 144(a)(3)(i) (non-public offering) and (ii) (Rule 701(c))). Under Rule 144(d)(1)(i), the holding period for the shares of a reporting company is six months. In this case, Becky must hold the shares six more months, since Becky exercised an employee stock option to buy the shares for cash, and the period that she held the option does not count toward the holding period (see Note 2 to Paragraph (d)(3)(x) of Rule 144). The SEC, however, has recognized a special exception for stock bonus plans, which permits a plan participant to effect resales of securities issued under the plan without compliance with Rule 144, where (i) the issuer is a reporting company, (ii) the stock is actively traded, and (iii) the number of shares being distributed is relatively small in relation to the shares issued and outstanding (see SEC Release No. 6188). Becky’s plan is not a stock bonus plan, but a qualified plan, and if she wished to rely on this administrative interpretation, a no-action letter request would be prudent.

In sum, today Becky can safely sell the unrestricted 5,000 shares purchased in the market. Since she is not an affiliate, she need not worry about the volume restrictions of Rule 144(e).

**PROBLEM 7-9**

Same facts as in the preceding problem, except that now (i) Becky Gill has been promoted to Executive Vice President and made a director of Medium Tech (and, therefore, may be considered an affiliate of Medium Tech), (ii) Becky financed her purchase two years ago of 10,000 Medium Tech shares with a full-recourse bank loan (not a loan from Medium Tech), and the bank received no collateral other than a pledge of the Medium Tech shares, and (iii) Becky gave 2,000 of the 5,000 shares she recently purchased in the market to her 19-year-old son, Ronald, as a birthday present. Ronald sold those shares last week to buy a “really hot” car. Now, how many shares can Becky sell immediately?
ANALYSIS:

Is she now an affiliate? Arguably, yes, and certainly more so now than in Problem 7-8. Rule 144(a)(1) defines the affiliate of an issuer as one who, directly or indirectly, “controls” the issuer. “Control,” in turn, is defined as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise” (see Rule 405). Becky owns a total of 25,000 shares (close to 2% of Medium Tech), but perhaps more importantly, she is now Executive Vice President and a director of Medium Tech. On this basis, the Problem tells us (presumably reflecting her authority over Medium Tech’s management and policies), Becky can now be considered an affiliate. As an affiliate, she must satisfy all the conditions of Rule 144 if she expects to rely on it (see Rule 144(b)(2)).

Medium Tech is a publicly-traded (and reporting) company, and so the holding period for any restricted securities is six months (see Rule 144(d)(1)(i)).

Recall that, in Problem 7-8, Becky’s holding period for the 10,000 shares was tolled under Rule 144(d)(2) because the collateral posted for the promissory note did not equal the value of the loan (see Rule 144(d)(2)(ii)). That is not the case here. The SEC’s staff takes the position that where money is borrowed from a third party to purchase restricted stock (i.e., not “borrowed” from the seller by using a promissory note as part of the purchase consideration), Rule 144(d)(2) is inapplicable. The 5,000 shares purchased in the open market are not restricted securities, and so there is no holding period.

Recall, from Problem 7-8, that Becky also purchased 10,000 shares upon exercise of a stock option, and they were held for only three months. If the stock option plan was registered (typically on Form S-8), the shares would not be restricted securities. If the stock plan was not registered, the securities are likely to be restricted (see, e.g., Rule 144(a)(3)(i) (non-public offering) and (ii) (Rule 701(c))). (Although, as noted, the SEC has recognized a special exception for stock bonus plans, if Becky were to wish to rely on this administrative interpretation, a no-action letter request would be prudent.)

Based on the above, Becky will have satisfied the holding period requirement (or the requirement will not apply) for 15,000 shares and, possibly, all 25,000 shares. However, because Becky is an affiliate, securities sold for her account must also comply with the volume limitations in Rule 144(e)(1). Referring to the facts in Problem 7-8, 1% of the class is 14,000 shares and the average weekly trading volume is slightly lower. For purposes of Rule 144(e)(1), in counting shares that are sold, Becky must include “all sales of securities of the same class sold for the account of such person within the preceding three months (emphasis added).” Rule 144(a)(2)(i) states that, for these purposes, a “person” includes “[a]ny relative . . . [who] has the same home as such person.” Hence, the sale of 2,000 shares by Becky’s son, Ronald, must be subtracted from the number she can sell directly (assuming that Ronald lives in her home).

As a result, Becky is able to sell up to 12,000 shares under Rule 144. Those shares come from the 10,000 shares she held for two years plus the 5,000 shares she bought publicly, and
(because it is unclear if she has met Rule 144’s holding period requirement) perhaps includes the 10,000 shares purchased upon exercise of a stock option.

**Problem 7-10**

(a) Donald Duck is the Vice Chairman of Disney Enterprises, Inc., the movie studio. On January 10, 2016, he makes a gift of 1 million shares to each of his three nephews, Huey, Dewey, and Louie (none of whom live with Donald). The 3 million shares have been held by Donald Duck for over ten years. Disney has 100 million shares of its common stock outstanding, and its average weekly trading volume is 600,000 shares. On June 30, 2016, Huey, Dewey, and Louie each independently decides to sell 500,000 shares. Any problem?

(b) Same facts as before, but Huey, Dewey, and Louie agree that sales of 500,000 shares by each of them would depress the market. Thus, they agree that Huey will sell in Week One, Dewey in Week Two, and Louie in Week Three. Assume further that Louie has become an affiliate of Disney. Any problem now?

(c) Same facts as before, except that Huey, Dewey, and Louie—all very eligible bachelors—share a swinging East Side townhouse.

**Analysis:**

(a) Disney is a public company, and we will assume that these shares are not restricted. Donald Duck, however, is likely to be an affiliate in light of his position as Vice Chairman. For that reason, Rule 144(e)(1) is applicable.

Huey, Dewey, and Louie are “donees” under Rule 144(e)’s aggregation rule. For that reason, under Rule 144(e)(3)(iii), the amount sold by Donald and the amount sold by any donee during any three-month period must be aggregated for six months after the donation. Recall, however, that Rule 144(e) applies only “[i]f any securities are sold for the account an affiliate of the issuer.” The only affiliate here is Donald, and Donald is not selling. Moreover, the SEC’s staff takes the position that cross-aggregation among donees or beneficiaries is not required. In other words, we aggregate sales by a donor and one or more donees, but not between donee and donee if there is no sale by the donor.

The result would be different, pursuant to Rule 144(a)(2), if Huey, Dewey, and Louie lived in the same home as Donald. Now, they would all be treated as the same person (i.e., this would involve sales by or for the account of an affiliate since everyone would be treated as one person with Donald).

(b) Yes, this is a problem. The SEC staff takes the position that such an agreement (not to sell more than a specified amount during a specified period) amounts to “act[ing] in concert” under Rule 144(e)(3)(vi) and, hence, would require aggregation. Since Louie is now an affiliate, the now-aggregated sales by Huey, Dewey, and Louie will be treated as sales by or for the account of an affiliate.

Under Rule 144(e), the maximum amount that can be sold is 1 million shares (1% of Disney’s outstanding 100 million shares of common stock). All sales during three months count toward that cap, and the combined sales by Huey, Dewey, and Louie will be greater than 1 million shares.
(c) Now, under Rule 144(a)(2)(i), the three nephews in one home are deemed to be one person, again with Louie as an affiliate. Together, they cannot exceed the maximum amount (in this case, 1 million shares) that one person can sell under Rule 144(e).

**Problem 7-11**

Widget Corp., a reporting company listed on Nasdaq, has recently done a series of exempt transactions. On March 1, 2016, it sold 50,000 shares (or just under 1% of its outstanding common stock) to Bill Jones, a Widget Vice President (who is not a controlling person or affiliate), pursuant to his employment contract, which was entered into several months ago when Widget was not yet a reporting company. Widget relies on Rule 701 for its exemption. On April 15, 2016, it sold 3 million shares in an intrastate offering under § 3(a)(11), including 30,000 shares to Mike Smith, a retail investor. It is now November 1, 2016, and both shareholders would like to sell and want an opinion from you, their counsel, that they are free to use Rule 144. Can you give it to each of them? What can you advise each?

**Analysis:**

Here, we are examining the ability of two different purchasers to resell shares without registration.

Bill Jones, a non-affiliate, bought shares pursuant to Rule 701—but Rule 701 is only available to non-reporting companies (see Rule 701(b)). We must assume that Widget Corp., even though public now, was a non-public company at the time of this sale. Rule 701(g) makes such stock a “restricted security,” but Rule 701(g)(3) provides that 90 days after Widget becomes a reporting company, a purchaser under Rule 701 who is not an affiliate may resell shares without complying with Rules 144(c) or (d). Although Widget is now a reporting company, we do not know when the 90-day period began.

Rule 144(b)(1) provides that if one year has elapsed since the later of the date when shares were acquired from the issuer or an affiliate of the issuer, the issuer’s status as a reporting company under Rule 144(c) is no longer a condition of relying on Rule 144. In addition, Rule 144(d)(1) provides that the holding period for restricted securities of an issuer who is not publicly reporting, or has not been publicly reporting for a period of 90 days prior to sale, is one year. In this case, Jones has held the shares for over one year, and so even if we are uncertain about Widget’s status as a reporting company, he can resell under Rule 144.

Mike Smith, a non-affiliate, has held shares for one year and five days. Let’s assume that the offering is done under the Section 3(a)(11) safe harbor, Rule 147. (Alternatively, we can assume that the offering is completed under Rule 147A, which is a stand-alone exemption promulgated by the SEC pursuant to its authority under Section 28 of the 1933 Act, but closely parallels Rule 147.) For the first six months after the April 2013 offering ends, he can only resell to “persons resident within the state . . . in which the issuer was resident” (see Rules 147(e) and 147A(e)). Can Smith also rely on Rule 144? Securities sold under Section 3(a)(11), Rule 147, or Rule 147A are not “restricted securities” (see Rule 144(a)(3)). Hence, if Smith relies on Section 3(a)(11) (or Rules 147 or 147A), Rule 144 is not available.

After six months, can Smith resell under Section 4(a)(1)? Recall that the six-month period in Rules 147 and 147A sets out a definitive period for when securities are deemed to have come to rest within the state; the securities must come to rest before they can be resold.
to investors outside the state. Recall that, in Section 2(a)(11), the concept of an underwriter is tied to whether there is a “distribution.” Although that term is not defined, a similar coming-to-rest concept has developed in defining whether a distribution has ended for purposes of Section 2(a)(11). Recall that, prior to Rule 144, the holding period the SEC and courts used was 2 years (up to 5 years); and so, if the issuer does not rely on Rule 147 or Rule 147A, and chooses instead to rely on Section 3(a)(11), it is conceivable—even though harsh—that Smith will need to hold for that period before he can resell in reliance on Section 4(a)(1).

The other potential problem here is integration. These two offerings were within two months and both involved common stock. Rule 152(b)(2), however, provides: “Offers and sales made in compliance with Rule701 [or] pursuant to an employee benefit plan . . . will not be integrated with other offerings.” Hence, there is no problem here.

**Problem 7-12**

Assume next that Widget Corporation made a $20 million private placement of its stock in February 2016 under Rule 506, selling to some 60 investors, some accredited and some not. Several of the non-accredited investors would probably not qualify as sophisticated. One of these is Homer Pyle, an ex-Marine Corps veteran and now a member of Congress. Pyle bought 60,000 shares at $5 per share and would like to sell them at their current price ($14 per share). It is now December 2016, and the average weekly trading volume for Widget is 30,000 shares. Can he rely on Rule 144?

**Analysis:**

This looks like a very flawed attempt at a private placement, which may have violated the 35-purchaser limit and/or the sophistication requirement of Rule 506(b). But, even if Widget is liable for rescission under Section 12(a)(1), how does this affect Homer Pyle?

Homer is not an affiliate, and so the only way for him to rely on Rule 144 is if the securities are restricted. (In most cases, unrestricted securities sold by a non-affiliate will rely on Section 4(a)(1) or 4(a)(3).) Rule 144(a)(3)(ii) defines “restricted securities” to include securities “acquired from the issuer that are subject to the resale limitations under Regulation D.” The general resale limitations of Regulation D are found in Rule 502(d), including disclosure of the resale limitations and a legend on the share certificates. Presumably these “mechanical” requirements were satisfied. There is no requirement that the private placement be a legally valid one. This is a deliberately objective test intended to avoid exactly the issue of legality of the issuer’s sale which might increase the illiquidity of securities in the hands of investors. Hence, Homer is able to use Rule 144.

Do we care that Homer’s 60,000 shares exceed the average weekly trading volume of 30,000 shares? No—Homer is not an affiliate, and so the volume limitations of Rule 144 do not apply. The only issue would likely be the currency of Widget’s periodic reports for purposes of Rule 144(c). Recall from Problem 7-11 that Widget is a public company. If Homer held shares for one or more years, this condition regarding Widget’s periodic reports is inapplicable (see Rule 144(b)(1)). Here, he held shares for less than one year, and so there remains the question of whether Widget has “[f]iled all required reports . . . during the 12 months preceding” Homer’s sale (other than Form 8-K reports) (see Rule 144(c)(1)).
**Problem 7-13**

Bill Smith is a director of Widget and its largest shareholder, with 24% of its common stock. He wants to cause Mike Jones, Chief Operating Officer of Intel, to join Widget as its new CEO. He is prepared to sell Jones 1% of Widget’s stock at a price $2 below the current market price from his own personal holdings. Assume Widget has made all requisite filings with the SEC. Can Smith use Rule 144 to cover this transaction?

**Analysis:**

This Problem requires students to parse the specific language (and coverage) of Rule 144.

Smith, as a director and holder of a large block of stock, appears to be an affiliate of Widget, and his shares may have been purchased in the open market or bought under a registration statement (and, therefore, are not restricted)—meaning this Problem potentially involves the sale by an affiliate of unrestricted securities.

If these are not restricted securities, the language of Rule 144(b) does not cover this transaction, because it covers only (1) sales of restricted securities for one’s own account and (2) sales by any person of restricted or other securities “for the account of an affiliate of the issuer.” This second clause covers the broker but not the affiliate (i.e., Smith) himself. In other words, Rule 144(b)(2) covers the sale by a third party for an affiliate of both restricted and unrestricted securities, but it does not cover the sale of unrestricted securities by the affiliate itself.

If Rule 144 were to apply, sales for the account of an affiliate in accordance with Rule 144(b)(2) must satisfy, among other provisions, Rule 144(f), which requires that sales be made pursuant to a brokers’ transaction or to a market maker or in a riskless principal transaction. The Smith-Jones sale is a face-to-face transaction and so, even if Rule 144 were to apply, it would not satisfy the Rule 144(f) requirement.

Does this make the transaction into a “distribution”? No, not necessarily. Recall that Rule 144 is non-exclusive and there may be other means for Smith to effect the resale outside of Rule 144. For example, a Section 4(1½) resale might be possible if Jones satisfies the *Ralston Purina* standard—meaning he is sophisticated and has access to sufficient information on Widget to make an informed investment decision. Smith should also require Jones to purchase shares under an “investment covenant” under which he represents he is taking the shares for investment only and “not with a view to a distribution.”

**Problem 7-14**

Tardy Corp. just listed on Nasdaq 90 days ago, but already it has become six months late in filing its Form 10-Q. Joe Jones, a Tardy salesman (but not an officer or affiliate), owns 10,000 shares of Tardy common stock that he purchased six months ago in the open market. Sally Smith, a small but sophisticated investor, bought 10,000 shares of Tardy in a Tardy private placement 15 months ago. Prudence Jones, another sophisticated investor, bought 10,000 shares of Tardy two years ago in another private placement. Assume the average weekly trading volume for Tardy is 50,000 shares. Which of these investors, if any, can sell today under Rule 144?
Here we have three different sales by three different people—Joe Jones, Sally Smith, and Prudence Jones—none of whom is an affiliate of Tardy, the issuer. There is no indication of a family relationship between Joe Jones and Prudence Jones (in which case, if they live in the same home, they may be counted as a single person, see Rule 144(a)(2)(i)).

Joe Jones is not an affiliate, and he purchased “free stock” in the open market, which shares he may resell at any time so long as he does not become an affiliate. His resale is likely to be effected pursuant to Section 4(a)(1).

Sally Smith bought restricted securities. If she held the shares for less than one year, she could not rely on Rule 144 if the issuer did not comply with Rule 144(c)(1), which requires that it file all required reports under the Exchange Act (other than Form 8-K) during the 12-month period before sale. The issuer has failed to do so. Accordingly, she must wait until she has held for one year, pursuant to Rule 144(b)(1)(i), or until Tardy resolves its tardiness. Under these facts, Smith has already held for more than one year, so she can sell under Rule 144 (in compliance with Rule 144(d), since these are restricted securities) even if Tardy is not current in its public information.

Like Smith, having held for over one year, Jones can now sell her 10,000 shares pursuant to Rule 144(b)(1)(i) without regard to whether Tardy meets the current public information requirement of Rule 144(c)(1).

In no case is the average weekly trading volume relevant. AWTV becomes relevant in setting the Rule 144(e) limitation on the amount of securities sold, but it is only applicable to sales for the account of affiliates (and so not applicable to any of the sellers here).

On September 1, 2016, Delta Corp., a privately-held, non-reporting company, sells 1 million shares of its common stock to Tom Prince, its incoming chief executive officer, at $10 per share. Prince gives his demand note bearing interest at 10% per annum in return for the shares and also pledges the stock to Delta as collateral for this loan. In early 2017, Delta Corp. does an initial public offering and lists on Nasdaq. Delta Corp. now has 80 million shares outstanding and an average weekly trading volume of 200,000 shares, and its stock price has risen to $25 per share. On September 15, 2017, Prince secures another loan from City Bank for $10,000,000 and uses that loan to pay down the Delta loan. He pledges half of his Delta stock (or 500,000 shares) to secure the City Bank loan. On September 30, 2017, he sells 150,000 of his shares to Mellon Investors, a hedge fund, at $22 per share in a private sale (i.e., $3 below the then-market price). On March 30, 2018, Prince wishes to sell 200,000 additional Delta shares on Nasdaq. Do you see any problems with either of these sales?

This Problem involves two different sales by Prince, an affiliate of Delta—first, the “private sale” of 150,000 Delta shares to Mellon Investors on September 30, 2017; and second, Prince’s wish to sell additional Delta shares on Nasdaq on March 30, 2018. Both sales appear permissible.
The original sale of 1 million shares by Delta to Prince runs afoul of Rule 144(d)(2)(ii), because Prince gave Delta (the seller) a promissory note that was secured by the purchased securities as collateral. Consequently, the holding period for the shares was tolled. This problem was cured on September 15, 2017, when Prince obtained a loan from City Bank and used the proceeds of that loan to pay the full purchase price to Delta. Rule 144(d)(2)'s focus is on loans by the seller, not a third-party loan whose proceeds are used to pay the purchase price to the seller. For Rule 144 purposes, it does not matter what, if any, collateral lies under the City Bank loan.

Prince plans to sell into the public market (presumably through a brokerage transaction, see Rule 144(f)(1)) on March 30, 2018, more than six months after he paid the full purchase price to Delta (using the loan from City Bank). Since Delta appears to meet the reporting requirements of Rule 144(c)(1), Prince’s sale satisfies the six-month holding period of Rule 144(d)(1)(i)—but only so long as Delta has been public “for a period of 90 days immediately before the sale” (which the facts suggest is the case). Also, his sale is well under 1% (800,000 shares), and so it satisfies the volume limitations of Rule 144(e)(1).

The Mellon sale involves the direct face-to-face sale of restricted securities by an affiliate, i.e., not in a brokers’ transaction or in sales to a market maker or in a riskless principal transaction in accordance with Rule 144(f). Consistent with the analysis in Problem 7-13, Rule 144 is not available.

The direct sale to Mellon is likely to be best effected as a Section 4(1½) transaction. Mellon must satisfy the Ralston Purina standards—meaning it is sophisticated and has access to sufficient information on Delta (perhaps provided by Prince) to make an informed investment decision. Prince should obtain an investment covenant from Mellon and possibly provide Mellon with some form of disclosure.

Rule 701 may also cover Prince’s transactions since Delta was a non-reporting company at the time Prince received his shares—but only so long as the sale to Prince was pursuant to a written compensatory benefit plan or compensation contract (see Rule 701(c)). In that case, Prince may resell 90 days after Delta became a reporting company, without regard to Rule 144(d)’s holding period requirements (see Rule 701(g)(3)), but since Prince is an affiliate, he will still need to satisfy Rule 144’s other requirements, as described above.

**PROBLEM 7-16**

Donald Duck is a senior officer, director, and 10% shareholder of Disney, Inc., a publicly-held company. He sells one million shares (equal to 0.9% of Disney’s outstanding common stock) on January 15, 2017, and then dies of a heart attack on January 20, 2017 (after becoming upset about a commercial that employed the Aflac duck, which he considered “stereotypical”). His only beneficiaries are Huey, Dewey, and Louie, who now live separately; each would like to sell the 500,000 shares on February 20, 2017, that each expects to receive from Donald’s estate. Can they each make their contemplated sales under Rule 144? What if the executor of Donald’s estate was also a director and vice-chairman of Disney, owning 8% himself? Can he sell any of Donald’s Disney stock?

**ANALYSIS:**
The question deals with sales by a deceased affiliate, his estate, and the estate’s beneficiaries. A principal focus here is on the aggregation requirements of Rule 144(e).

Donald is a control person and, therefore, an affiliate of Disney, and the relevant cap on the amount of stock that can be sold for his account is in Rule 144(e)(1). Since Donald is an affiliate, his sale of 0.9% of Disney stock on January 15, 2017, may count toward the maximum sales limit under Rule 144(e), whether it was a sale of restricted securities or otherwise. Donald’s three nephews want to sell shares on February 20, 2017, roughly one month after Donald’s death.

Under Rule 144(e)(3)(v), sales by the affiliate decedent before his death must be aggregated with sales for the estate or the estate’s beneficiaries during any period of three months. The total may not exceed the volume limitations of Rule 144(e)(1) or, in the case of debt, (e)(2)—unless the estate or beneficiary is not an affiliate of the issuer, in which case there is no limit (see the proviso in Rule 144(e)(3)(v)).

As a less than 10% shareholder (having sold stock equal to 0.9% of Disney’s outstanding stock), and with nothing more, Duck’s estate is probably not a Disney affiliate (20% is the approximate point where most experienced lawyers draw the line). Nor do the nephews, as beneficiaries, have any control, i.e., they are also not affiliates of Disney. So, in this case, there is no limitation on the resale amount for the nephews under Rule 144(e)(3)(v).

Note that each nephew and the estate are together treated as a “person” under Rule 144(a)(2)(ii)—because each nephew is a >10% beneficiary of the estate—and so sales for the account of each nephew would include sales for the account of the estate if the Rule 144(e)(1) cap were applicable (which, as just noted, it is not).

In the second question, the executor of the estate is likely to be an affiliate if he is a director and vice chairman of Disney who owns a substantial amount of stock. Rule 144(a)(2)(ii) provides that “[t]he term person when used with reference to a person for whose account securities are sold” (emphasis added) includes “[a]ny trust or estate of which [such person or her relatives who live in the same home] serve as trustee, executor or in any similar capacity.” However, neither the executor nor the estate sold any securities, and the literal language of Rules 144(a)(2)(ii) and 144(e) applies only if one of those two sells.

The analysis changes in the third question if the executor directs the sale of the estate’s Disney stock. As noted before, under Rule 144(a)(2)(ii), when defining the person for whose account securities are being sold, the person includes “[a]ny . . . estate . . . of which [such person or her relatives who live in the same home] serve as . . . executor or in any similar capacity.” In that case, since the executor is an affiliate, and he and the estate would be treated as a single person, sales for the executor would cause sales for the estate to be subject to Rule 144(e)(1). However, this only applies if sales are for the account of the executor (as the “person for whose account securities are to be sold,” using the language of Rule 144(a)(2)). No such sale is occurring here. Accordingly, as noted before, neither the estate nor the nephews are subject to the limitation on resale amount under Rule 144(e)(3)(v).
XYZ Industries, Inc., owns 51% of the stock of Internet Ventures, Inc., a reporting company that is listed on Nasdaq. XYZ Industries, in turn, is controlled by the Rockyfella family, with John D. Rockyfella, the family’s patriarch, owning 8% and his wife, Mabel, owning 5% of XYZ Industries. On January 15, 2017, XYZ Industries sells 900,000 shares of Internet Ventures pursuant to Rule 144, and on February 1, it sells another 500,000 shares to a hedge fund in a private sale that did not involve any public offering. John D. Rockyfella has become disenchanted with Internet Ventures, but he only owns 2% of its stock. On February 15, he asks your law firm if he can sell those shares in the public market. The partner in charge of the Rockyfella account asks you to research this question and advise him of how much stock John D. Rockyfella may immediately sell and under what conditions. Assume that Internet Ventures has 100 million shares outstanding, and its average weekly trading volume is 250,000 shares.

**Analysis:**

The Rockyfella family controls XYZ and, therefore, as a group, they are affiliates of XYZ. John wants to sell his 2% of Internet Ventures in the public market, presumably pursuant to Rule 144. Where there are sales for John’s account, John and Mabel are treated as one person pursuant to Rule 144(a)(2)(i); collectively, they own 13% of XYZ. Consequently, John and Mabel are treated as one person with XYZ pursuant to Rule 144(a)(2)(iii). John and XYZ also together own 53% of Internet Ventures pursuant to Rule 144(a)(2)(iii), so they are affiliates of Internet Ventures.

Under Rule 144(e)(1), sales for the account of an affiliate within a three-month period cannot exceed 1 million shares (1% x 100 million shares, which is greater than the average weekly trading volume). XYZ sold 900,000 Internet Venture shares on January 15, 2017, pursuant to Rule 144. The 500,000 shares sold in a private sale to a hedge fund are not included in calculating the amount of shares that have been sold. That is because Rule 144(e)(3)(vii)(C) excludes sales that are “exempt pursuant to section 4 . . . and not involving any public offering,” and it appears the resale was pursuant to Section 4(1½). Therefore, John can sell up to 100,000 shares during the three months after January 15, 2017.

**Problem 7-18**

Assume the same facts as in the preceding problem, except that XYZ Industries, Inc. and the AIGG Insurance Company (which are not affiliated) also hold 9% Debentures, due in 2030, issued by Internet Ventures pursuant to a registered public offering of its debt in 2015. Each firm holds $20 million of these debentures ($100 million of these debentures were issued originally in 2015). Internet Ventures has no other debt securities outstanding. Both want to sell these debentures immediately (and they have no material, nonpublic information about Internet Ventures). To what extent can each do so?

**Analysis:**

The debt securities were registered, so they are not restricted securities. AIGG is not an affiliate of XYZ, nor is it an affiliate of Internet Ventures, because holding $20 million in debentures (without more) is unlikely to amount to control. Since the debentures are not restricted, and since AIGG is not an affiliate, they can be resold freely pursuant to Section 4(a)(1).
As we know from Problem 7-17, XYZ is an affiliate, and so it must sell the debentures in accordance with the amount limitations in Rule 144(e)(2). There, the limit is the greater of the limitation set forth in (1) Rule 144(e)(1) (= 1% x the outstanding class of $100 million during a three-month period, which is $1 million) and (2) Rule 144(e)(2) (= 10% per person for the tranche during a three-month period, 10% x $100 million, equal to $10 million). Consequently, XYZ can sell $10 million in debentures now and $10 million three months from now.

**PROBLEM 7-19**

Passive Corp.’s assets consist almost exclusively of cash and cash equivalents, and it has only nominal operations (it sold most of its assets for cash in 2014, and it simply re-invests its cash in bank certificates of deposit and rolls these over when they mature). It is, however, a reporting company, which has made all of its filings under the 1934 Act on a timely basis. Robert Promoter, Passive’s chief executive, owns 5% of its common stock and wants to sell a block amounting to 1% of Passive’s common stock into the public market pursuant to Rule 144 during every three-month period until he has sold all his shares. May he rely on Rule 144 for these contemplated sales?

**ANALYSIS:**

No. The securities of certain types of issuers cannot rely on Rule 144. Rule 144(i)(1)(i) states that the Rule is unavailable to issuers with “[n]o or nominal operations” and “(A) No or nominal assets; (B) Assets consisting solely of cash and cash equivalents; or (C) Assets consisting of any amount of cash and cash equivalents and nominal other assets.” Passive Corp. appears to fall into this category. There is an escape clause in Rule 144(i)(2)—for an issuer that previously fell within Rule 144(i)(1)(i) but has ceased to be such an issuer—but it does not seem to apply to Passive.

**PROBLEM 7-20**

Los Pollos Hermanos (“LPH”) has been a 1934 Act reporting company since going public three years ago and is current in its filings. LPH sold an additional $3 million of common stock through a Rule 506 offering seven months after the IPO. Werner Heisenberg is an accredited investor who bought 10,000 shares in the Regulation D offering. Three months after buying these shares, Heisenberg pledged the shares as collateral for a loan he obtained from the Bank of Albuquerque. Heisenberg has become insolvent and ceased to make loan payments, and the Bank seized the collateral and wishes to sell immediately to pay down the loan. As counsel to the Bank, you have been asked if the Bank can freely sell the shares. What questions do you have for Bank personnel before you determine your answer?

**ANALYSIS:**

LPH, a public company, sold $3 million of its common stock in a Rule 506 offering, including 10,000 shares to Heisenberg (an accredited investor), seven months after the IPO.

1. The first question is whether the IPO and the Rule 506 offering are integrated. This may or may not be applicable to the Bank’s resale of the shares, but to the extent LPH (or its
agent) violated Section 5 in selling shares to Heisenberg, that violation may provide the Bank the option to cause Heisenberg to put the shares back to LPH under Section 12(a)(1).

Recall that Rule 152, which takes the place of the prior Regulation D safe harbor, includes four principal non-integration safe harbors in Rule 152(b). Rule 152(a)(1) states that, for an exempt offering prohibiting general solicitation, the issuer must have a reasonable belief, based on the facts and circumstances, with respect to each purchaser in the exempt offering prohibiting general solicitation, that the issuer (or any person acting on the issuer’s behalf) (i) did not solicit such purchaser through the use of general solicitation or (ii) established a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation. Rule 152(b)(1) goes on to provide a non-integration safe harbor as follows: “Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with such other offering, provided that for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation, the provisions of Rule 152(a)(1) shall apply.”

The question is whether the Rule 506 offering involved sales to non-accredited investors. If not, Heisenberg’s purchase could be pursuant to Rule 506(c), which permits a general solicitation. The Rule 152(b)(1) safe harbor will apply. If sales were made to non-accredited investors, then the sale to Heisenberg was pursuant to Rule 506(b) which restricts any general solicitation. In that case, the proviso in Rule 152(b)(1) is triggered, and the Rule 506(b) offering must meet the requirements of Rule 152(a)(1). (Presumably it can do so, because the seven-month separation between the IPO and Rule 506 offering is a substantial period of time.)

2. Next, we want to know if Heisenberg is an affiliate of LPH. The shares he bought in the Rule 506 offering are “restricted securities,” and if resales are made “freely” pursuant to Rule 144, the requirements to satisfy that Rule will depend on Heisenberg’s relationship with LPH (see Rule 144(e)(3)(ii)).

3. If Heisenberg is not an affiliate, the volume limitations in Rule 144(e) do not apply, but there is still a holding period requirement under Rule 144(d)(1)(i). Heisenberg held the shares for three months. How long has the Bank held the shares? (Subtract (i) 3 months + (ii) how long the Bank has held the shares from the six-month holding period to determine how much longer the Bank must hold the shares.)

4. Were the shares listed on a national securities exchange or Nasdaq at the time they were issued to Heisenberg? Recall that, to be eligible under Rule 144A, the securities cannot be “fungible” with listed securities “of the same class.” The Rule 144A market is deep and so, even if Rule 144 is not immediately available, resales under Rule 144A may still be liquid and are not subject to a three-month wait.

5. You may want to consider whether Section 4(1½) resales are possible (perhaps if the shares fail Rule 144A’s non-fungibility requirement). Presumably, the shares will be sold at
a discount to their public market price, but so long as the requirements of Section 4(1½) are met, the shares can be resold under Rule 144 without waiting further.

6. Are the shares listed on a foreign securities exchange? The shares will continue to be restricted securities under U.S. securities law (see Rule 905), but resales outside the United States may still be made under Regulation S, again without a wait, if the requirements of Rule 904 are satisfied.

**Problem 7-21**

United States Industries, a reporting company whose common stock is listed on the New York Stock Exchange, makes a private placement of $100 million in face amount of 7% Convertible Debentures through Goldman Brothers, its placement agent. The debentures were purchased at their face value without any discount. The purchasers are 20 or so large institutional investors, most of whom would satisfy the definition of “qualified institutional buyer” in Rule 144A(a)(1)(i). Both these institutions and United States Industries would like to admit the debentures to the PORTAL system. Each $1,000 debenture is convertible into 20 shares of United States Industries, which, on the date the offering closed, was trading at $40 per share. Do these securities qualify for Rule 144A?

**Analysis:**

Recall that, in 2006, Nasdaq requested the SEC for approval to re-establish a trading system for equity securities only, and, in 2007, Nasdaq ceased operating the PORTAL market in favor of joining the PORTAL Alliance, which it created with certain other financial institutions for privately-placed equity securities. Here, the question is whether the convertible debentures (convertible into equity securities) qualify for resales pursuant to Rule 144A—specifically, we face the “fungibility” restriction of Rule 144A(d)(3)(i).

The convertible debentures are convertible into 20 shares, each at the then-current price of $40 per share. This makes their conversion value $800 (20 shares x $40 = $800). Their price at issuance was $1,000 (i.e., there was no discount from the debentures’ face amount). Hence, the “effective conversion premium” here (as defined in Rule 144A(a)(6)) is: $1000 [price at issuance] – $800 [conversion value] / $800 [conversion value], or $200 / $800 = 25%.

Since the effective conversion premium equals or exceeds 10%, Rule 144A(d)(3) provides that the debentures “[w]ere not, when issued, of the same class as” United States Industries’ common stock listed on the New York Stock Exchange. Hence, Rule 144A is available (assuming the other requirements are met).

You may want to show students what happens when the conversion value and market value converge; in that case, the debentures may begin to be treated as fungible with the underlying shares. For example, if the market price on the date of issuance were $50 per share (rather than $40 per share), the conversion value would be $1000 (20 shares x $50 = $1000), and the effective conversion premium would be 0%: $1000 [price at issuance] – $1000 [conversion value] / $1000 [conversion value], or $0 / $800 = 0%. Since the effective conversion premium is now less than 10%, Rule 144A(d)(3) provides that the debentures would be of the same class as United States Industries’ common stock, creating a fungibility problem.
Note also that Goldman Brothers apparently sold debentures to some non-QIBs. This appears to not comply with Rule 144A(d)(1). Goldman Brothers may sell them on the “reasonable belief” that the buyer is a QIB, but only QIBs can trade through PORTAL.

**PROBLEM 7-22**

(a) Widget Corp., a non-reporting issuer, sells $50 million of its Convertible Debentures to two distributors—Citybank and J.P. Morganbank—who, in turn, resell to 20 QIBs. A general solicitation is used. Citybank and J.P. Morganbank indicated on their websites, both preceding and following their purchase from Widget, that they would be offering the Widget debentures to QIBs. One of these QIBs—Lafayette Securities—resells four months later to five wealthy investors, none of whom are QIBs (although all are accredited investors). What exposure does Lafayette have? And what exposure do Widget, Citybank, and the QIB purchasers (other than Lafayette) face because of Lafayette’s sale?

(b) Assume now that one of Lafayette’s purchasers was not a QIB and received no information or disclosure document from Lafayette, Widget, Citybank, or anyone else. What results now for all the parties?

**ANALYSIS:**

Reasonable attorneys can disagree over the analysis of this Problem. The two distributors (Citybank and Morganbank) sold to a QIB (Lafayette). From the distributors’ perspective, they made no distribution and have no Section 5/12(a)(1) liability. Proponents of this position will place great weight on Rule 144A(e) and SEC Release No. 6862 (“Each transaction will be assessed under the Rule individually.”), which seem to say that we cabin subsequent offers and sales so that they do not affect the availability of the exemption either to “the issuer or any prior or subsequent holder thereof.” This is a broad non-integration provision, but it does not protect a seller from its own sale, and Lafayette’s sale was not in compliance with Rule 144A. The issue is whether Rule 144A(e) and the SEC Release also apply to downstream sales by the distributors’ purchasers (i.e., does an unlawful sale by Lafayette destroy Citybank’s and Morganbank’s exemption?). No case to our knowledge has interpreted this provision.

Lafayette did not resell under Rule 144A, but it too may claim it did not make a “distribution” because it sold only to “accredited investors.” Still, accredited investor status alone does not mean the purchaser meets the sophistication and access requirements contemplated by Section 4(1½). We are told in (b) that Lafayette’s purchasers received no information or disclosure document from Lafayette or anyone else. Moreover, we are not told that Lafayette obtained an investment covenant from its purchasers. Thus, Lafayette’s purchasers may be able to seek rescission against Lafayette, as it does not have an exemption from Section 5. But, if Lafayette violated Section 5 and was insolvent, it is not clear these purchasers can reach the issuer or the two distributors in light of Rule 144(e) and the SEC Release. Proponents of issuer or distributor liability might seek to rely on Gilligan, Will (referenced in the casebook), but that case’s relevance is uncertain in a Rule 144A offering that complied with the Rule’s requirements at the issuer and distributor levels.

For Lafayette to resell under Rule 144, it needed to wait eight months more (or one year in total) since the issuer is not a reporting company.
Consequently, the unsophisticated purchaser has a strong claim against Lafayette, but an uncertain claim against Widget and the distributors. Nothing in Rule 144A requires Widget and the distributors to monitor the subsequent behavior of Lafayette.

The two distributors indicated on their website that they would be offering the Widget debentures to QIBs. A general solicitation is used. Has Section 5(c) been violated? Although a problem would have arisen in the recent past, amendments to Regulation D and Rule 144A address this issue today. Regarding the initial sale by Widget, a general solicitation by the issuer (or any person acting on its behalf, which is how the distributors may be characterized) is permissible under Rule 506(c) so long as all purchasers are accredited investors. Moreover, regarding resales, Rule 144A(d)(1) requires only that the offered securities “are sold only to a qualified institutional buyer or to a purchaser that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer.” There is no limitation on a general solicitation.

**PROBLEM 7-23**

Quick Chips, a non-reporting company in Silicon Valley that produces microchips, is evaluating two capital-raising alternatives. First, it could sell 5 million shares of its common stock in a private placement through a local broker-dealer, with the purchasers being largely accredited investors (and a few QIBs). Second, it could do a Rule 144A transaction, using a large commercial bank as its “distributor.” The small brokerage firm (which lacks the contacts with QIBs to do a Rule 144A offering) argues that it can sell to a wider audience of persons (i.e., to non-QIB accredited investors, sophisticated persons, and even unsophisticated persons with a qualified purchaser representative), and it will charge a comparable fee. As securities counsel to Quick Chips, you are asked to explain what the advantages of a Rule 144A offering—both legal and economic—might be.

**ANALYSIS:**

The two options are (1) a private placement or (2) a Rule 144A offering (which is a private placement by the issuer followed by Rule 144A resales by the distributors). Although the commission may be the same in both offerings, the critical difference may be the amount realized by the issuer. The issuer is typically paid more in a Rule 144A transaction than in a private placement because there is a lower liquidity discount. Because QIBs can resell more easily, they are more likely to pay a higher price for the same securities than accredited investors in a private placement. There may, however, be greater transaction costs in a Rule 144A offering because typically it involves registration statement-like disclosure, which is what QIBs expect. Accredited investors receive little disclosure in a Regulation D offering under Rule 506(c), although the level of disclosure must be greater in a Rule 506(b) placement to non-accredited investors (who must also be sophisticated on their own or with a qualified purchaser representative).

**PROBLEM 7-24**

Belgian Industries is a Belgium incorporated company, listed on the Euronext Stock Exchange, with over 70% of its shareholders being Belgians. It is not a U.S. reporting company, but it does occasionally trade on the Nasdaq Bulletin Board, with such trading never accounting for more than 10% of the overall trading in its stock. On December 20, 2017, it makes an offering of 10,000,000 shares of its common stock in Europe pursuant to Rule
You may assume that (i) offering restrictions were implemented, (ii) no “directed selling efforts” were made by anyone in the United States, (iii) all offers and sales were made in “offshore transactions,” and (iv) the securities carry a legend to the effect that transfers are prohibited, except in accordance with the provisions of Regulation S or pursuant to an exemption from registration under the 1933 Act. After the offering, 100 million shares of Belgian Industries’ common stock are outstanding (and the average weekly trading volume is roughly 50,000 shares per week). Jacques Café, a wealthy Belgian investor, bought 800,000 shares of Belgian’s stock in the December offering. He, thereafter, sold 400,000 shares on January 15, 2018, to a U.S. broker-dealer, XYZ Securities, Inc., in a transaction negotiated in Europe. Between January 20 and January 23, 2018, XYZ Securities sold 250,000 Belgian Industries shares over the Nasdaq Bulletin Board to ten different buyers (presumably none of whom are QIBs). Are these sales in compliance with the requirements of the 1933 Act? Explain specifically why or why not, discussing the relevant rules and/or exemptions.

**ANALYSIS:**

Since our focus is the U.S. securities laws, it is easy to forget that Belgian Industries, Café, and XYZ Securities are also subject to regulation in Belgium. We will assume compliance with local law.

Under Regulation S, Belgian Industries is a foreign issuer (see Rules 405 and 902(e)), since it is incorporated under the laws of Belgium. It lacks a “substantial U.S. market interest” (“SUSMI”) in the class of securities to be offered or sold (common stock) under Rule 902(j)(1), because its shares only “occasionally trade on the Nasdaq Bulletin Board, with such trading never accounting for more than 10% of the overall trading in its stock”—and so it does not fall within the SUSMI definition.

A foreign issuer that lacks (or “reasonably believes at the commencement of the offering” that it lacks) SUSMI falls under Rule 903(b)(1) (“Category 1”). As such, only the “offshore transaction” (see Rules 902(h) and 903(a)(1)) and no “directed selling efforts” (see Rules 902(c) and 903(a)(2)) requirements of Rule 903(a) are applicable. The facts tell us that no “directed selling efforts” were made by anyone in the United States, and all offers and sales were made in “offshore transactions.” Also, because Belgian is a foreign issuer, Rule 905 does not apply to these equity securities, and they are not restricted.

Café’s sale to XYZ Securities is subject to Rule 904, and it appears to have complied with those requirements. To qualify under Rule 904(a), the offer or sale must be in an “offshore transaction” (see Rules 902(h) and 904(a)(1)) and there can be no “directed selling efforts” in the United States (see Rules 902(c) and 904(a)(2)). Rule 904(b) is inapplicable because Café is not a dealer nor “a person receiving a selling concession, fee or other remuneration in respect of” the shares (e.g., it is not a selling group member).

Café’s sale to XYZ Securities is an “offshore transaction” since it was negotiated (and presumably executed) in Europe. The offer does not appear to have been made to “a person in the United States” (emphasis added; this is a territorial restriction) and, because the transaction was negotiated in Europe, we will assume for purposes of this Problem that, at the time the buy order originated, the buyer was outside the United States (or Café “reasonably believe[d]” it was outside the United States). Therefore, for the sale to be considered an “offshore transaction,” there is no need for it to take place through a “designated offshore securities market.”
Also, there were no “directed selling efforts” in the United States by Café or any person acting on his behalf. (Query: What if Belgian Industries, on its own, conducted directed selling efforts in the United States—would that bar Café from relying on Rule 904? No. Rule 904(a)(2) barring directed selling efforts applies only to Café, an affiliate, or any person acting on their behalf. It does not extend to the issuer acting on its own.)

XYZ Securities is a broker-dealer and resold the Belgian Industries shares in the United States (over the Nasdaq Bulletin Board) to ten different non-QIB buyers. Resales in the United States fall outside the scope of Regulation S. The sales were not exempt from Section 5 pursuant to Section 4(a)(1) because XYZ Securities is a dealer. The sales were not exempt from Section 5 pursuant to Section 4(a)(3) because they occurred during the 40 days after the public offering of Belgian Industries shares (see Section 4(a)(3)(A)). Rule 144A is inapplicable, because sales were made to non-QIBs. Hence, it appears that XYZ Securities violated Section 5 (although it could have resold the shares in Europe in accordance with Rule 904).

PROBLEM 7-25

Small Co., a Delaware corporation that is not a reporting company, makes an offering of common stock in Europe on January 15, 2017, selling some 5 million shares through a combination of U.S. and European distributors. Offering restrictions are implemented; no directed selling efforts are made in the United States; the legend and stop transfer order mandated by Rule 903(b)(3)(iii) are properly complied with; and all offers and sales by the distributors are made in offshore transactions. The Gallic Fund, a French mutual fund and a QIB, buys 250,000 shares on January 15, and on February 1, it sells its shares to CalPERS, the California pension fund, pursuant to Rule 144A. Is this permissible? Can CalPERS resell, and to whom and when?

ANALYSIS:

Rule 903(b)(3)(iii) (“Category 3”) deals with equity securities of reporting and non-reporting domestic issuers like Small Co. (and also covers non-reporting foreign issuers with SUSMI that are not engaged in an “overseas directed offering”).

Rule 903(a)(1) requires the offer or sale to be made in an offshore transaction, Rule 903(a)(2) restricts any directed selling efforts in the United States, and Rule 903(b)(3)(i) requires that “offering restrictions” (see Rule 902(g)) be implemented, all of which the Problem says were complied with.

Rule 903(b)(3)(iii)(A) specifies a one-year “distribution compliance period” (see Rule 902(f)) for a non-reporting U.S. company, and it precludes distributors from offering or selling under Regulation S to any U.S. person (or for the account or benefit of a U.S. person, other than a distributor) during this period. The distributors complied with this requirement in selling to the Gallic Fund (a non-U.S. person). That offer and sale must also comply with Rule 903(b)(3)(iii)(B), which includes certain certification, covenant, legending, and other requirements, which the Problem indicates were also complied with.

It may be useful to note to students that, from the perspective of the U.S. securities laws, the sale from Small Co. to the distributors could have relied on, for example, Section 4(a)(2), and their resale from the distributors to the Gallic Fund could have relied on, for example,
Rule 144A (assuming the Gallic Fund is a QIB). Complying with Rule 903 relieves the parties from complying with the requirements of these exemptions in what appears to be a largely European transaction. But if Rule 903 was not available, we could always revert to the standard exemptions from Section 5 (and the same requirements) as in the United States.

The Gallic Fund, in turn, makes a Rule 144A sale in the United States to CalPERS. This is consistent with Rule 903(b)(3)(iii)(B)(2), which states that the purchaser (Gallic Fund) must have agreed “to resell [the Small Co. shares] only in accordance with this Regulation S . . . , pursuant to registration under the Act, or pursuant to an available exemption from registration” (emphasis added). Rule 144A is such an exemption, and so the Gallic Fund’s sale to CalPERS is consistent with Regulation S if the sale satisfies Rule 144A. (Note: If the shares were listed on the New York Stock Exchange or Nasdaq at the time the shares were issued, Rule 144A would not be available due to Rule 144A’s fungibility restriction. Section 4(1½) might be available, subject to its requirements being satisfied.) Also, the transfer of shares pursuant to an exemption does not violate the stop transfer instruction required by Rule 903(b)(3)(iii)(B)(4).

Note that Rule 905 also applies—since these are equity securities of a U.S. domestic issuer and, therefore, restricted securities. In the hands of CalPERS, these restricted securities may not be resold (absent registration) except in compliance with Section 4(a)(1)—meaning pursuant to Section 4(1½), Rule 144, or Rule 144A—or offshore again pursuant to Rule 904.

With respect to Rule 144, CalPERS cannot resell until one year has elapsed from the time Small Co. issued the shares. Small Co. is not a reporting company, and it does not meet the current public information requirement in Rule 144(c)(1). Rule 144(b)(1), however, provides that the Rule 144(c)(1) requirement is inapplicable after one year; the Rule 144(d)(1)(ii) holding period is also satisfied after one year.

CalPERS can resell immediately to other QIBs under Rule 144A. It can also resell pursuant to Section 4(1½), assuming that the applicable conditions are satisfied.

**Problem 7-26**

Assume now that Small Co. in Problem 7-25 is a reporting company listed on the New York Stock Exchange. On January 30, 2017, it makes a Regulation S offering of its common stock in Europe through two American investment banks—Merrill, Sachs and Goldman, Lynch—acting as distributors. They sell 100,000 shares of Small Co.’s common stock to:

(a) the London office of the Hartford Insurance Co., which sells insurance in the U.K. subject to U.K. regulation;
(b) the Quantitative Fund, one of the U.S.’s largest hedge funds, in what purports to be a Rule 144A transaction; and
(c) a discretionary account managed by a large U.S. broker-dealer for Count Bernadotte, the billionaire Swedish industrialist.

Which of these sales is permissible under Regulation S?

**Analysis:**

Small Co. is now a reporting domestic company that intends to make a Regulation S offering of its common stock. These transactions fall under Category 3 of Rule 903 (Rule
903(b)(3)) because Small Co. is a U.S. issuer. (Note that Rule 905 also applies, although it is not part of the main analysis in this Problem.)

Category 3 (like Categories 1 and 2) requires that any offer and sale be made in an “offshore transaction” and that there are no “directed selling efforts” (each as defined in Rule 902). In addition, Category 3 requires the implementation of “offering restrictions” (defined in Rule 902(g)) pursuant to Rule 903(b)(3)(i). The facts do not indicate whether these requirements were satisfied, but we will assume they were.

This Problem focuses on whether offers or sales of the Small Co. common stock were made in accordance with Regulation S—in this case, to a “U.S. person” during the six-month (because Small Co. is a reporting company) distribution compliance period (see Rule 903(b)(3)(iii)(A)).

(a) The London office of Hartford Insurance is not a U.S. person under Rule 902(k)(2)(v). It is a branch operating for valid business reasons and it is subject to U.K. regulation. Therefore, there is no barrier to the distributors selling to it under Rule 903(b)(3)(iii).

(b) The Quantitative Fund is a U.S. person. An offer or sale to it by the distributor will not be under Regulation S pursuant to Rule 903(b)(3)(i) and 903(b)(3)(iii)(A). A non-U.S. person purchaser from a distributor can sell to a U.S. person during the distribution compliance period if the sale is exempt from registration (see Rule 903(b)(3)(iii)(B)(2)), but that did not happen here.

Knowing this problem in advance, could the parties have structured the offering in a way to get around it (i.e., is there a sale that is possible, even if it does not comply with Regulation S)? Yes—What can be done is to break the offering into two tranches: (1) the Regulation S offering abroad and (2) a U.S. private placement to the same distributors, who then make Rule 144A resales in the United States. Note that we may have a fungibility problem here if the shares are also listed on the New York Stock Exchange at the time of issuance. (It is unclear from the facts what securities of this issuer are listed on the NYSE and whether they are of the same or similar class as the common stock.) Assuming they are not fungible, then Rule 144A is available. If the shares were listed at the time the new stock was issued, then Rule 144A is not available—although the sale to the Quantitative Fund may still be possible under Section 4(1½).

The two tranches (Regulation S and Rule 144A) will not be integrated. Rule 152(b)(2) codifies the SEC’s long-standing position that concurrent offshore offerings that are conducted in compliance with Regulation S are not currently, and will not be, integrated with registered domestic offerings or domestic offerings that are conducted in compliance with any exemption, such as Rule 144A. The adopting release stated that, when determining the availability of this safe harbor, it is still necessary to assess each transaction for compliance with Regulation S and the conditions of the other exemption. The SEC also stated in the adopting release that it does not believe that general solicitation activity for exempt domestic offerings precludes reliance on Regulation S for concurrent offshore offerings, i.e., the general solicitation activity does not necessarily violate Regulation S’s prohibition on directed selling efforts in the United States. Instead, compliance with the terms of both Regulation S and another applicable exemption, such as Rule 506(c), will depend on the facts and circumstances of a particular situation. The adopting release notes, for example, that the use of the same website to solicit U.S. investors under Rule 506(c) and offshore investors under
Regulation S could raise concerns about the issuer’s compliance with the prohibition on directed selling efforts under Regulation S, because the offering material on the website could be deemed to have the effect of conditioning the market in the United States. In such situations, the adopting release states that an issuer can take certain steps to distinguish the Regulation S and domestic offering materials.

(c) The discretionary account is not a U.S. person by virtue of Rule 902(k)(2)(i), and so there is no barrier to the distributors selling to it under Rule 903(b)(3)(iii).

**Problem 7-27**

Small Co. has 100 million shares of its common stock outstanding after the above Regulation S offering, and its average weekly trading volume is 500,000 shares. The Little Fund, a small U.S. mutual fund that does not qualify as a QIB, purchased 2 million shares of Small Co. on January 31, 2017, from the Gallic Fund, a French mutual fund that acquired the shares in the original Regulation S offering by Small Co., but Little Fund quickly sours on its investment. On March 15, it sells 500,000 shares, on April 1, it sells 300,000 shares, and on April 30, it sells 400,000 shares—all on the New York Stock Exchange. Any problem here? What can it do?

**Analysis:**

We analyze this Problem on the assumption that Small Co. is a reporting company whose shares trade on the New York Stock Exchange (which is where, we are told, Little Fund sold them).

The Problem does not tell us the basis on which the Gallic Fund resold the shares to Little Fund. But recall that Rule 905 continues to apply—these are equity securities of a domestic issuer and so they are “restricted securities.”

Rule 144A is not available. Little Fund is not a QIB, and it appears that the Small Co. shares were listed on the New York Stock Exchange at the time of issuance (hence, a fungibility problem).

The Gallic Fund could have relied on Rule 904 and sold to Little Fund in an offshore transaction so long as (i) no offer was made to a person in the United States, and either (ii)(a) Little Fund was outside the United States or the Gallic Fund reasonably believed it was or (b) the transaction was executed on a “designated offshore securities market” and neither the Gallic Fund nor anyone acting on its behalf knew that the transaction had been pre-arranged with a buyer in the United States. Alternatively, the Gallic Fund could have sold the shares to Little Fund in a Section 4(1½) transaction (assuming its requirements were met). Regardless, the shares continue to be “restricted securities” under Rule 905.

Rule 144 is not available to Little Fund in connection with its sales, since tacking the holding periods for the Gallic Fund and Little Fund takes us to less than six months, running from January 30, 2017, when the Small Co. shares were first issued (see the facts in Problem 7-26). (The required holding period is six months since Small Co. is a reporting company, see Rule 144(d)(1)(i).) Therefore, selling on the NYSE potentially violates Section 5 of the 1933 Act, subjecting Little Fund to liability under Section 12(a)(1).
There is nothing to indicate that Little Fund is an affiliate of Small Co. Therefore, Little Fund could hold the Small Co. shares until the six-month period has lapsed and then sell on the NYSE. Recall that there are no volume limitations here, since Little Fund is a non-affiliate, so the fact that total sales are greater than 1% of Small Co.’s outstanding shares or its average weekly trading volume (AWTV) is irrelevant.

Little Fund might also consider selling in a Section 4(1½) transaction. As noted above, Rule 144A is not available due to the apparent fungibility problem.
CHAPTER 9: REGULATION OF BROKER-DEALERS

PROBLEM 9-1

Ed X. Cutor worked for many years in the trust and estate side of a major bank, helping to settle major estates. Based on that experience, he forms his own firm—Ed X. Cutor Services, Inc.—and advertises on his firm’s web site (and other web sites) its willingness to locate buyers for illiquid controlling blocks held by estates. He also contacts dealers that make markets in firms in which a CEO or large shareholder has recently died to offer his services. His services include helping the buyer to value the block and make the best offer. Is Ed or his firm a broker who must register under § 15(a)?

ANALYSIS:

Doctrinally, the issue is whether Ed or his firm are “engaged in the business of effecting transactions in securities for the account of others” (see Section 3(a)(4) of the 1934 Act).

Among the factors frequently stressed are: active solicitation of transactions; whether the person is involved in negotiations between the buyer and seller; and whether the person makes valuations or advises as to the merits of the investment. See SEC v. Dowdell, 2002 U.S. Dist. LEXIS 4552 at *33 (W. D. Va. Mar. 14, 2002); SEC v. Hansen, 1994 U.S. Dist. LEXIS 17835 at *10 (S.D.N.Y. Apr. 6, 1984). Factors indicating that a person is “engaged in the business” include, among others, receiving transaction-related compensation and holding one’s self out as a broker, as executing trades, or as assisting others in completing securities transactions. See BD Advantage, Inc. (avail. Oct. 11, 2000) (citing Massachusetts Finance Services, Inc. v. SIPC, 411 F.Supp. 411, 415 (D. Mass.), aff’d 545 F.2d 754 (1st Cir. 1976), cert. denied, 431 U.S. 904 (1977)). Courts will also consider whether they can find “a certain regularity of participation in securities transactions at key points in the chain of distribution.” Id.

Here, Ed and his firm seem to be soliciting buyers and are ready to give valuations, offer advice, and participate in negotiations. This is a regular activity. Therefore, Ed and/or his firm appear to be a broker.

PROBLEM 9-2

MainStreetIPO.com has created a website on which IPO issuers are invited to auction their shares under a Dutch auction methodology. The issuer will still register its stock with the SEC and all settlements will be handled by a registered broker-dealer, but MainStreetIPO will handle the auction and its software will determine the clearing price. Based on its advertising, several thousand customers have registered with it. Is MainStreetIPO a broker-dealer? Any advice on how to redesign its relationship with the issuer to avoid registration?

ANALYSIS:

This Problem is based on an SEC decision in which the SEC found MainStreetIPO to be a broker-dealer. See In the Matter of Joseph Salvani and MainStreetIPO.com, SEC Release No. 44590 (Jul. 28, 2001).
The major factor here was probably the massive advertising and solicitation of investor interest. In a similar case one year earlier, the SEC refused to issue a no-action letter to a web-based service that ran auctions on a one-time basis for municipal bond issuers. See Muni Auction Inc. [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) Para. 77,830 (Mar. 15, 2000). In declining the request, the SEC staff emphasized that participation “at key points in the chain of distribution” (its standard test) included “assisting the issuer to structure prospective securities transactions, helping an issuer to identify prospective purchasers, . . . and participating in order-taking.” However, the staff had permitted a similar web-based service to publicize information and disclosures on its website about registered and unregistered offerings by issuers. See Internet Capital Corp. No-Action Letter (avail. Dec. 24, 1997). Where was the dividing line between these rulings? The difference appears to have been that, in Internet Capital Corp., the internet firm did not solicit or take orders.

PROBLEM 9-3

Barbary Hedges LLP is a billion dollar (or medium-sized) hedge fund, and its portfolio is roughly one half the size of the larger mutual fund families. As a result, its aggregate brokerage commissions with any underwriter are also less than those of most large mutual funds. Thus, when Barbary seeks an allocation in “hot” IPOs from Merrill Chase, the underwriter, it usually gets a much smaller allocation than it wants. To solve this problem, it begins on its own to pay those broker-dealers who are also underwriters a commission that is more than double the standard commission for an institution (i.e., it now pays roughly 1% of the transaction’s size). You are counsel at Merrill Chase. If your firm did not request this excess commission and if it assigns IPO allocations more or less in proportion to aggregate brokerage commissions received from its clients, can it accept this additional compensation? Or, can it accept the commissions but then not increase its IPO allocation to Barbary?

ANALYSIS:

FINRA Rule 5131(a) prohibits any broker-dealer from offering, or threatening to withhold, shares in a new issue “as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the” broker-dealer. As the casebook notes, this was a response to practices under which some institutional clients (most typically, hedge funds) paid very high brokerage commissions for the receipt of “hot” IPO allocations, much like Barbary is doing here. Commissions at the 1% level are very high for an institutional investor.

FINRA Rule 5131 is backstopped by Rule 2010, which can be deployed to police conduct that FINRA deems unethical or unprofessional. Rule 2010 provides: “A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.” Payment of the high commission—even if your firm did not request it—might be viewed as a “quid pro quo” payment to the extent that your firm changes how it allocates hot IPO shares. The NASD (a FINRA predecessor) previously asserted that the exchange of inflated commissions for IPO allocations represented a form of commercial bribery in violation of the “high standards of commercial honor and just and equitable principles of trade” that underlay the NASD’s rules. However, the NASD was unsuccessful in 2005 in their civil attempts to assert this theory against both Invemed Associates and Frank Quattrone (in separate cases).
Still, if this is unethical, is it also wrong or unethical to direct IPO allocations to institutional clients that have paid the broker-dealer larger aggregate brokerage commissions (even if they may pay a much smaller commission per share)? On a policy level, a legitimate debate seems possible here. Mutual funds do receive IPO allocations based on their aggregate brokerage commissions with an underwriter. If this is permissible, why is it worse that a hedge fund (which trades substantially less than most mutual funds, even of similar size) seeks to compensate by offering a higher commission per share (rather than buying more shares at a standard commission)? Is there a moral difference? Or are both practices wrong?

No one has seriously suggested that the SEC or FINRA could mandate an equal sharing or “first-come, first-served” allocation formula (although such allocation rules are known in Europe). In general, when there is a short supply, merchants favor large volume and repeat customers over retail customers. Is the effect of Rule 5131 to give an unfair competitive advantage to mutual funds over hedge funds?

**Problem 9-4**

Dean Reynolds & Co., a registered broker-dealer, pays its registered representatives higher compensation for principal trades of Nasdaq stocks in which it is the principal market maker than for other sales. Joe B. Sales, a registered representative with Dean Reynolds, calls Mr. and Mrs. Smith to recommend that they purchase stock in Keldon Oil Co., knowing that he would receive a higher commission, because Dean Reynolds makes the market in that stock. When Dean Reynolds sells stock to a customer as a dealer, it charges them the inside asked spread (i.e., the NBBO asked price) plus a mark-up. Dean Reynolds’s mark-up is always less than its standard brokerage commission. Should it and Joe B. Sales be liable (either in court or in an arbitration proceeding) when Keldon Oil’s stock price falls and the Smiths commence an action?

**Analysis:**

Here, we encounter a common conflict of interest that today is addressed by Regulation Best Interest (“Regulation BI”). (Regulation BI did not repeal FINRA’s suitability rules, but it has largely superseded them. In response, FINRA announced it will defer to Regulation BI in any case where it applies.)

The SEC adopted Regulation BI in 2019, which generally requires a broker (or associated person) “when making a recommendation of any securities transaction or investment strategy involving securities . . . to a retail customer, [to] act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker [or associated person] . . . making the recommendation ahead of the interest of the retail customer” (see Rule 15l–1(a)(1) under the 1934 Act). This new rule was expressly “designed to improve investor protection by enhancing the quality of broker-dealer recommendations to retail customers and reducing the potential harm to retail customers that may be caused by conflicts of interest” (SEC Release No. 86031 at 16).

Regulation BI (in Rule 15l–1(a)(2)) then states that the general obligation in Rule 15l–1(a)(1) is satisfied if the broker (or associated person) satisfies four component obligations. These four obligations are:
(1) **Disclosure Obligation.** A written “full and fair disclosure” to the retail customer of all material facts relating to the scope and terms of the relationship, including:

(a) “[t]he material fees and costs that apply to the retail customer’s transactions, holdings, and accounts;”

(b) the type and scope of services provided, including “any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer;” and

(c) “[a]ll material facts relating to conflicts of interest that are associated with the recommendation.”

(2) **Care Obligation.** The broker (or any associated person) must exercise reasonable diligence, care, and skill to, among other things, (i) understand the risks, rewards, and costs associated with the recommendation, (ii) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that customer’s investment profile, and (iii) not place the financial or other interest of the broker or associated person ahead of the interest of the retail customer.

(3) **Conflict of Interest Obligation.** The broker must establish, maintain, and enforce written policies designed to, among other things, (i) identify and disclose all conflicts of interest associated with its recommendations, (ii) identify and mitigate any conflicts of interest that create an incentive for an associated person to place the interest of the broker or associated person ahead of the interest of the retail customer, and (iii) identify and disclose any material limitations placed on the securities or investment strategy recommended to a retail customer, and any conflicts of interest associated with such limitations, and prevent such limitations from causing the broker or associated person from placing its interests ahead of the retail customer.

(4) **Compliance Obligation.** The broker or dealer must establish, maintain, and enforce written policies and procedures reasonably designed to achieve compliance with Regulation BI.

The Problem tells us that Joe recommended to the Smiths that they purchase Keldon Oil shares “knowing that he would receive a higher commission.” This is the kind of conflict-of-interest Regulation BI was intended to address. Even if Dean Reynolds’ mark-up is less than its standard brokerage commission, Joe’s recommendation appears to have been driven (at least, in part) by the special compensation arrangement with Dean Reynolds. Dean Reynolds was required to identify and mitigate any conflicts of interest that create an incentive for Joe to place his interests ahead of the Smiths. Moreover, Dean Reynolds and Joe were required to exercise reasonable diligence, care, and skill to not place their financial or other interests ahead of the Smiths. Finally, Joe should have disclosed the conflict in writing to the Smiths. These failures raise serious questions under Regulation BI about whether Dean Reynolds and Joe acted in the best interest of the Smiths at the time the recommendation was made.
As the casebook notes, Regulation BI does not authorize a private cause of action. Therefore, it is unlikely that investors can sue their brokers in private civil actions based on breaches of the Regulation. However, retail disputes often end up in arbitration, and commentators report that arbitration panels have regularly required brokers to share in the losses experienced by customers who are advised to buy “unsuitable” or other securities that are not in their best interest. The Arbitrator’s Manual that governs these proceedings advises arbitrators that they are to do equity and may go “beyond the written law,” and that may reflect the new standards under Regulation BI.

**Problem 9-5**

Friendly Brokerage Co., a registered broker-dealer, makes a market in the stock of Widget Corp., a Nasdaq-listed company. Currently, the NBBO (or inside spread) is $17 bid and $17 1/8 asked. Joe D. Trader gives them a limit order to sell for 5,000 shares at $17¼. Later, the NBBO widens to $17 and $17¼. But at this point Friendly, itself, sells 4,000 shares for its own account. Shortly thereafter, Widget’s stock price falls back below $16 per share. When Joe complains, Friendly explains that the bid price never moved up to $17¼ (or even close). Nonetheless, Trader thinks that Friendly stepped in front of his sell order and so brings an arbitration proceeding under NASD rules against Friendly Brokerage for his lost profit at $17¼. What result?

**Analysis:**

Joe D. Trader (“Trader”) is a customer of Friendly Brokerage, which has traded ahead of Trader’s limit order. As the casebook notes, the SEC found that a broker-dealer who traded in this fashion had “traded ahead” of its customer’s limit order in breach of its fiduciary duty to that customer. See In re E.F. Hutton and Company, Inc., SEC Release No. 25887 (Jul. 6, 1988). Although the decision was controversial at the time, it has since been codified in FINRA Rule 5320(a), which states that a broker that holds a customer limit order “is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.” Broker-dealers have no obligation to accept limit orders (although most do) and may charge a higher commission for handling such orders.

Friendly Brokerage’s boldface lie may also implicate Rule 2010, which provides: “A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.”

**Problem 9-6**

Mrs. Jones, an elderly widow living on a pension, has much of her late husband’s estate invested in the stock market (on his deathbed advice to her). Her broker is Merrill, Schwab & Co., which has information in its files showing Mrs. Jones to be a person of relatively modest means. Teddy Fastpitch is the new broker assigned by Merrill, Schwab to handle Mrs. Jones’s account. Assume in the alternative that:

(a) He recommends that she buy 1,000 shares of Volatile Co., a Nasdaq traded software company, known for its price fluctuations, in order “to put a little life in her account;” or
(b) Mrs. Jones, who is just a little bit greedy, asks his recommendation about Volatile Co. because her bridge partner, Mrs. Smith, made $2,500 last month, investing in it. Fastpitch tells her to “go ahead; it may make sense to liven up your portfolio;” or (c) He makes no recommendations, but just executes her order for Volatile without comment, even though he knows it is very risky.

Either way, Mrs. Jones buys 2,000 shares at $10 and the stock promptly falls to $2. She brings an arbitration proceeding based on NASD arbitration rules, alleging that Fastpitch breached the “suitability rule,” and she uses her nephew, Irving Brilliant, as her attorney. What result?

**ANALYSIS:**

In the first two cases, the broker made a recommendation, and so this Problem takes us back to Regulation Best Interest (“Regulation BI”) and the analysis in Problem 9-4. Recall that Regulation BI did not repeal FINRA’s suitability rules, but it has largely superseded them. In response, FINRA announced it will defer to Regulation BI in any case where it applies.

Regulation BI includes a Care Obligation (see Rule 15l–1(a)(2)(ii) under the 1934 Act). The broker (or any associated person) must exercise reasonable diligence, care, and skill to, among other things, (i) understand the risks, rewards, and costs associated with the recommendation; (ii) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer (in this case, Mrs. Jones) based on that customer’s investment profile; and (iii) not place the financial or other interest of the broker or associated person ahead of the interest of the retail customer.

Certainly, Regulation BI applies in the first two cases where Fastpitch was asked for his recommendation. He knew that Mrs. Jones was a person of limited means and was an elderly pensioner (suggesting a need for stable, less volatile investments), and so a strong argument exists that he should have warned her against this investment as unsuitable. Regulation BI does not apply in the third case, to Fastpitch’s execution of Mrs. Jones’ order, since the Regulation only covers “when [he is] making a recommendation of any securities transaction or investment strategy involving securities . . . to a retail customer.”

If a lawsuit under Rule 10b-5 was brought in federal court, proof of scienter would be a major issue before liability could be imposed, and it would need to be pled with considerable specificity. In arbitration, however, the results are less predictable, and scienter is less of an absolute requirement. As noted in Problem 9-4, even though Regulation BI does not authorize a private cause of action, it is likely that arbitration results will reflect the new standards reflected in Regulation BI.

Note, however, that once the broker-dealer warns Mrs. Jones against making an investment (assuming her mental competency), it can still execute her order to buy, even if that order is against its recommendation.

**PROBLEM 9-7**

Bank Brazil, a Brazilian bank with almost $5 billion in assets, bought some $40 million in collateralized mortgage obligations (“CMOs”) from Kuhn, Lehman & Co., an investment banking firm with a specialization in this area. Bank Brazil bought a particularly risky form
of CMO (known as an “inverse floater,” whose interest rate is inverse to the market’s rate). When interest rates rose generally in 2007, Bank Brazil lost over half the value of its investment. It claimed that it relied on Kuhn, Lehman & Co.’s predictions about the direction of interest rates. Bank Brazil has, however, its own internal staff of economic experts and securities experts. The evidence will show that Kuhn, Lehman was well aware that the trend in interest rates was very adverse to Bank Brazil (and expected that trend to continue), but it gave no warning to Bank Brazil. What result in its suit against Kuhn, Lehman under Rule 10b–5 based on suitability claims?

**ANALYSIS:**

These are approximately the facts of *Banca Cremi, S.A. v. Alex Brown & Sons, Inc.*, 132 F.2d 1017 (4th Cir. 1997) (referenced in the casebook). There, the Fourth Circuit found that the bank (which was a sophisticated international bank) had access to all the relevant information from multiple sources and was generally aware of the risks involved in investing in CMOs. It lost its right to rely on Alex Brown’s advice and recommendations as a result of its own recklessness, a failure of diligence based on a list of factors in *Myers v. Finkle*, 950 F.2d 165 (4th Cir. 1991). Among the Myers factors are: (1) the client’s sophistication level; (2) its asset level (here, $5 billion); (3) its access to relevant information; (4) its prior experience in the field; and (5) whether the advice was general or specific. Banca Cremi argued that, despite these factors, it still did not understand the investment risk in CMOs. Nevertheless, the Fourth Circuit concluded that the bank’s own in-house analysts conducted a thorough study of the risks inherent in CMOs. In fact, the bank previously rejected some investment advice given to it by Alex Brown. *Banca Cremi*, therefore, at least suggests that a sophisticated institution will have an uphill battle in seeking to rest liability on the basis of suitability.

What about Regulation Best Interest? The Regulation clearly does not apply to institutional investors. Institutions, however, continue to be covered by FINRA’s suitability rules. As the casebook notes, in a 1996 interpretation, the NASD (now FINRA) indicated its view that the obligation to make only suitable recommendations applies to institutional customers as well—unless the broker determines that the customer is capable of making an “independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations” (SEC Release No. 36,973 (Mar. 14, 1996)). Consistent with the Fourth Circuit’s analysis in *Banca Cremi*, this inquiry requires a broker to determine that (i) the relevant investment considerations will be evaluated and (ii) the persons making the investment decision have the experience, capacity, and access to information to conduct their own suitability analysis.
CHAPTER 10: TENDER OFFERS, MANAGEMENT BUYOUTS, AND TAKEOVER CONTESTS

PROBLEM 10-1

Bidder Co., a New York Stock Exchange-listed company, would like to acquire Target, Inc., which is a “reporting” company and the third largest firm in its principal industry. Because Bidder Co. expects resistance and primarily fears starting an auction, it quietly approaches some twenty institutions, who collectively own 33% of Target, and asks each of them at what price they would be prepared to sell their entire interest in Target. Target was trading in the range of $16 to $17 per share. Three institutions immediately agree to sell at prices between $19 and $20 per share. Five more sell at prices between $21 and $22 after extensive negotiations. Bidder has now acquired 8% and knows that it will soon have to file a Schedule 13D, disclosing its more than 5% ownership. It now approaches again the remaining dozen institutions and tells them it is their “final chance” to sell and that they may otherwise do less well. Ten of these twelve sell at prices between $22 and $24, with eight also negotiating a “best price” protection that they will receive any higher price Bidder pays anyone else over the next six months for Target shares. As a result, all ten of these firms will receive $24 per share. Bidder now files its schedule 13D, and Target sues to enjoin and rescind these purchases as an illegal tender offer. What result in this litigation?

ANALYSIS:

This Problem requires an assessment of the eight factors in Wellman to determine if there is a tender offer (referenced in SEC v. Carter Hawley Hale Stores, Inc. in the casebook). Here, there was (1) no active and widespread solicitation of public shareholders; (2) a solicitation was made for a substantial percentage of stock; (3) a substantial premium over the market price was paid; (4) the terms were not fixed, but were negotiable; (5) no offer was contingent on the tender of a fixed minimum number of shares; (6) the offer was open for a limited period of time after the final offer, but not with respect to the earlier offers; (7) some pressure was placed on the offerees; and (8) no public announcement was made. On this basis, it seems unlikely the offers in the Problem will be deemed a tender offer under the Williams Act.

Suppose a tender offer is commenced days later by Bidder Co. for the remaining shares at $20 (well above the earlier market price, but below the $24 price paid to the institutions). Should this change the result or trigger the “best price” rule? In both cases, the answer is “probably no.” But this raises a troubling question (even if it does not answer it): Is the SEC’s definition of tender offer too limited as a policy matter, because it can produce a disparity in the premiums received? If so, should we permit controlling shareholders to sell control at a premium (as we do)?

PROBLEM 10-2

Same facts as before, except that after buying not less than 25% of the stock, Bidder now approaches Bobbie Wasserman, Target’s CEO, who also owns 1% of the Target stock, and offers him the same $24 price offered to the institutions. He accepts, and, one week later, now owning 25%, Bidder commences an offer for the remaining stock at $21 per share. Outraged shareholders sue Wasserman for his shares and Bidder, claiming that Rule 14d–10 has been violated. What result?
ANALYSIS:

This Problem is similar to Epstein v. MCA, Inc. (excerpted in the casebook), but also different. Obviously, some courts might apply the “integral part” test of Epstein, while others would use the more formalistic approach in Lerro v. Quaker Oats (referenced in the casebook). Here, it might be argued that Wasserman’s 1% stake is too small to be critical, particularly where Bidder has already acquired at least 25% (and, consequently, would be favored to win a proxy fight). Still, as the CEO, Wasserman could cause the board to adopt a poison pill, which would at least slow the acquisition; this might justify a higher premium for his shares as a constructive bribe. On this theory, Wasserman’s sale to Bidder could be considered an “integral part” of the tender offer. Nonetheless, the Quaker Oats court seems unlikely to accept this theory, particularly where the sale was a week before commencing the public tender offer.

PROBLEM 10-3

Same facts as before, but now Wasserman, when approached, agrees to support a tender offer at $23 per share for all shares and to tender his stock into it. Bidder also agrees at this meeting to an employment contract under which Wasserman will receive compensation of $8 million next year, which is more than three times his current level and the equivalent of a $1.50 increase in the tender offer to all shareholders. Again, shareholders sue, alleging a violation of Rule 14d–10 in that the employment contract is a de facto premium to Wasserman, which violates Rule 14d–10. What result now?

ANALYSIS:

See the cases following Epstein v. MCA, Inc. (excerpted in the casebook). Those cases have split, but in most of those favoring the plaintiff, the executives receiving the alleged excessive compensation held more stock and a greater blocking position than in this Problem.

For example, in Gerber v. Computer Associates Int'l, 303 F.3d 126 (2d Cir. 2002), the CEO held 25% of the company’s stock and was arguably a controlling shareholder.

However, the cases become largely academic under the SEC’s revision of Rule 14d-10. Rule 14d-10(a)(2) provides that the best price rule applies only with respect to consideration offered and paid for shares tendered in the tender offer. Rule 14d-10(d)(1) further provides that the provisions of paragraph (a)(2) “shall not prohibit the negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, or payments made or to be made or benefits granted or to be granted according to such an arrangement, with respect to any security holder of the subject company, where the amount payable under the arrangement:

(i) Is being paid or granted as compensation for past services performed, future services to be performed, or future services to be refrained from performing, by the security holder (and matters incidental thereto); and

(ii) Is not calculated based on the number of securities tendered or to be tendered in the tender offer by the security holder.”

These provisions are satisfied if the arrangement is approved as an employment compensation, severance, or other employee benefit arrangement solely by independent directors in
the manner set forth in Rule 14d-10(d)(2). Hence, if it meets the requirements of 14d-10(d), Wasserman’s contract will be excluded.
CHAPTER 11: CIVIL LIABILITY 
UNDER THE SECURITIES ACT OF 1933

PROBLEM 11-1

In March of year two, AmericasBank sold $480 million of subordinated debt on a Form S-3 registration statement. Form S-3 incorporates by reference the registrant’s latest annual report on Form 10-K and subsequent periodic reports on Forms 10-Q and 8-K. Annual and periodic reports were prepared by AmericasBank management. The underwriting firm of Bixwell Golden was hired to be lead underwriter in the preparation of the Form S-3 in January of year one.

At the time, banks in the geographic region where AmericasBank was located were experiencing relatively high bankruptcy rates as a result of a spate of commercial loan failures. Bixwell Golden asked its law firm of Navis Jones & Ito to conduct due diligence. Partner Sarah Jones worked with three associates over a two-week period to distribute questionnaires to management; review prior SEC filings; review AmericasBank’s material contracts; and review board minutes. All minutes were provided in a timely fashion except AmericasBank Executive Committee meeting minutes for year one which had not been typed up yet. Jones asked AmericasBank CEO Ralph Smith about the delay and was informed “there were no problems in the minutes, just an overworked staff.”

Shortly after the March offering a federal depository institution regulator announced it had initiated a formal investigation of AmericasBank’s recordkeeping citing concerns about whether there had been an appropriate evaluation of the collateral for commercial loans in its home region.

AmericasBank’s subordinated debt, which had been sold at $100 per bond, slumped to $86, and in May of year two a § 11 lawsuit was filed against: (1) the board of directors of AmericasBank; (2) the underwriter Bixwell Golden; and (3) Navis Jones & Ito.

During discovery, the missing Executive Committee meeting minutes for year one were typed up. They revealed ongoing discussions between the Executive Committee (which included three inside directors: Ralph Smith; CFO Paula Larsen; and executive vice president Harriet Zahn) and the federal depository institution regulator. The federal depository institution regulator had proposed a consent settlement, in February of year two, which the Executive Committee rejected. Three long time outside directors, attorney Sarah Jones and business executives Peter Quirk and Hazel Choi, did not attend the Executive Committee meetings.

How should a court rule in a § 11 lawsuit with respect to each of the defendants?

ANALYSIS:

There are several different bases of potential liability for material misstatements or omissions in a registration statement. These include:

A. Section 11 of the Securities Act
B. Section 12(a)(2) of the Securities Act
C. Section 17 of the Securities Act
D. Rule 10b-5 under the Exchange Act
E. Section 410 of the 1956 Uniform Securities Act or other state “blue sky” provisions
F. Common law fraud or deceit
This Problem addresses liability under Section 11 of the Securities Act. Liability arises under Section 11 when there is:

A. An untrue statement of a material fact or an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading,

B. in any part of a registration statement,

C. at the time such part of the registration statement becomes effective.

Any person who acquired a security covered by the registration statement may sue:

- The issuer (included as a “person who signed the registration statement”);
- Every other person who signed the registration statement (see Section 6(a)); this includes the principal executive officer, the principal financial officer, the comptroller or principal accounting officer, and the majority of the board of directors;
- Every director or partner of the issuer at the time of filing of the registration statement;
- Every person who consents to be named as about to become a director or partner;
- Every “expert” (e.g., accountant, engineer, appraiser), with consent, who prepares or certifies any part of the registration statement; and
- Every underwriter.

There are several defenses:

A. The purchaser knew of the untruth or omission at the time of the acquisition (Section 11(a)).

B. If, after the issuer has made generally available to its security holders an earnings statement covering a period of at least 12 months after the effective date of the registration statement, the purchaser cannot prove its reliance on the untrue statement in the registration statement or reliance on the registration statement without knowing of the omission (but reliance may be
established without proof the purchaser read the registration statement) (Section 11(a)).

C. The defendant has (1) resigned or taken appropriate steps to resign from, or ceased or refused to act in, the relevant position giving rise to liability and (2) so advised the SEC and the issuer in writing (Section 11(b)(1)).

D. The defendant advises the SEC and gives reasonable public notice that part of the registration statement became effective without her knowledge (Section 11(b)(2)).

E. The “due diligence” defenses in Section 11(b)(3). These defenses are the most significant. There are three basic types:

1. A nonexpert defense with respect to nonexpertised parts of the registration statement, which requires (Section 11(b)(3)(A)):
   - reasonable investigation; and
   - reasonable ground to believe, and the nonexpert did believe, at the time the registration statement became effective, the statements were true and there was no material omission.

2. An expert defense with respect to parts of the registration statement that the defendant expertised, which requires (Section 11(b)(3)(B)):
   - reasonable investigation; and
   - reasonable ground to believe, and the expert did believe, at the time the registration statement became effective, the expertised statements were true and there was no material omission.

3. A nonexpert defense with respect to expertised parts of the registration statement, which requires:
   - no reasonable ground to believe, and the nonexpert did not believe, at the time the registration statement became effective, the expertised statements were untrue or there was a material omission.

Section 11(c) defines reasonable investigation and reasonable grounds for belief as “that required of a prudent [person] in the management of [her] own property.”

The leading case on the due diligence defense remains Escott v. BarChris Const. Corp., 283 F.Supp. 643 (S.D.N.Y. 1968). The other cases in this section of the casebook provide important guidance, particularly with respect to underwriters’ due diligence.

On May 16, 1961, BarChris offered $3.5 million in debentures under a registration statement filed with the SEC under the 1933 Act, which contained numerous material misstatements and omissions. Plaintiffs sued:
1. The persons who signed the registration statement [BarChris Corp., nine directors, and the controller];
2. Eight underwriting firms led by the lead underwriter, Drexel & Co.; and

The case considered the “due diligence” defenses each defendant could offer:

1. The issuer, BarChris, was not entitled to any of the defenses described in Section 11(b) (note that the lead-in to Section 11(b) makes clear that the listed defenses apply to defendants “other than the issuer”).

2. Only those portions of the registration statement certified by the accounting firm of Peat Marwick were “expertised.”

3. Due diligence of Kircher, BarChris’s Chief Financial Officer: The court found, “Kircher knew all the relevant facts.” Accordingly, his due diligence defense failed:

   Kircher’s contention is that he had never before dealt with a registration statement, that he did not know what it should contain, and that he relied wholly on Grant, Ballard and Peat, Marwick to guide him. He claims that it was their fault, not his, if there was anything wrong with it. He says that all the facts were recorded in BarChris’s books where these "experts" could have seen them if they had looked. He says that he truthfully answered all their questions. In effect, he says that if they did not know enough to ask the right questions and to give him the proper instructions, that is not his responsibility.

   There is an issue of credibility here. In fact, Kircher was not frank in dealing with Grant and Ballard. He withheld information from them. But even if he had told them all the facts, this would not have constituted the due diligence contemplated by the statute. Knowing the facts, Kircher had reason to believe that the expertised portion of the prospectus, i.e., the 1960 figures, was in part incorrect. He could not shut his eyes to the facts and rely on Peat, Marwick for that portion.

4. Due diligence of Birnbaum, a young lawyer who was in-house counsel and became Secretary and a director of BarChris on April 17, 1961, after the first registration statement was filed with the SEC: The court noted, “He signed the later amendments, thereby becoming responsible for the accuracy of the prospectus in its final form.” Birnbaum’s due diligence defense failed:

   Birnbaum examined contracts. In that connection he advised BarChris that the T–Bowl contracts were not legally enforceable. He was thus aware of that fact. . . .

   It seems probable that Birnbaum did not know of many of the inaccuracies in the prospectus. He must, however, have appreciated some of them. In any case, he made no investigation and relied on the others to get it
right. Unlike Trilling, he was entitled to rely upon Peat, Marwick for the 1960 figures, for as far as appears, he had no personal knowledge of the company's books of account or financial transactions. But he was not entitled to rely upon Kircher, Grant and Ballard for the other portions of the prospectus. As a lawyer, he should have known his obligations under the statute. He should have known that he was required to make a reasonable investigation of the truth of all the statements in the unexpertised portion of the document which he signed. Having failed to make such an investigation, he did not have reasonable ground to believe that all these statements were true. Birnbaum has not established his due diligence defenses except as to the audited 1960 figures. [emphasis added]

Students should take note of the higher standard to which the court held Birnbaum as a lawyer. At the very least, this is a caution to lawyers who join public company boards. Birnbaum appears to have been only four or five years out of law school—something the students may also note—which underscores how quickly the topics discussed in your Securities Regulation course can come into play.

5. Due diligence defense of Auslander, an outside director who was elected to the board on April 17, 1961: On May 10, and 15, 1961, he signed a signature page for the first and second pre-effective amendments to the registration statement filed on those days. He did not know they were signature pages for a registration statement.

The court accorded Auslander a due diligence defense for the expertised portions of the prospectus. "Auslander knew that Peat, Marwick had audited the 1960 figures. He believed them to be correct because he had confidence in Peat, Marwick. He had no reasonable ground to believe otherwise."

However, his due diligence defense as to the nonexpertised portions of the registration statement failed:

It is true that Auslander became a director on the eve of the financing. He had little opportunity to familiarize himself with the company’s affairs.

Section 11 imposes liability in the first instance upon a director, no matter how new he is. He is presumed to know his responsibility when he becomes a director. He can escape liability only by using that reasonable care to investigate the facts which a prudent man would employ in the management of his own property. In my opinion, a prudent man would not act in an important matter without any knowledge of the relevant facts, in sole reliance upon representations of persons who are comparative strangers and upon general information which does not purport to cover the particular case. To say that such minimal conduct measures up to the statutory standard would, to all intents and purposes, absolve new directors from responsibility merely because they are new. This is not a sensible construction of Section 11, when one bears in mind its fundamental purpose of requiring full and truthful disclosure for the protection of investors.
6. Due diligence defense of Grant, director and outside counsel to BarChris: Grant was sued as a director, not an attorney. Nonetheless, his burden to establish a due diligence defense was higher than Auslander’s: “[I]n considering Grant’s due diligence defenses, the unique position which he occupied cannot be disregarded. As the director most directly concerned with writing the registration statement and assuring its accuracy, more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work.”

Notably, the court was satisfied as to Grant’s integrity and honest belief that “the registration statement was true and that no material facts had been omitted from it.”

But the court concluded that Grant also could not establish a due diligence defense:

Grant contends that a finding that he did not make a reasonable investigation would be equivalent to a holding that a lawyer for an issuing company, in order to show due diligence, must make an independent audit of the figures supplied to him by his client. I do not consider this to be a realistic statement of the issue. There were errors and omissions here which could have been detected without an audit. The question is whether, despite his failure to detect them, Grant made a reasonable effort to that end.

Much of this registration statement is a scissors and paste-pot job. Grant lifted large portions from the earlier prospectuses, modifying them in some instances to the extent that he considered necessary. But BarChris’s affairs had changed for the worse by May 1961. Statements that were accurate in January were no longer accurate in May. Grant never discovered this. He accepted the assurances of Kircher and Russo that any change which might have occurred had been for the better, rather than the contrary.

It is claimed that a lawyer is entitled to rely on the statements of his client and that to require him to verify their accuracy would set an unreasonably high standard. This is too broad a generalization. It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes. The statute imposes liability for untrue statements regardless of whether they are intentionally untrue. The way to prevent mistakes is to test oral information by examining the original written record.

There were things which Grant could readily have checked which he did not check. For example, he was unaware of the provisions of the agreements between BarChris and Talcott. He never read them. Thus, he did not know, although he readily could have ascertained, that BarChris’s contingent liability on Type B leaseback arrangements was 100 per cent, not 25 per cent. He did not appreciate that if BarChris defaulted in repurchasing delinquent
customers’ notes upon Talcott’s demand, Talcott could accelerate all the
customer paper in its hands, which amounted to over $3,000,000. . . .

Grant was unaware of the fact that BarChris was about to operate Bridge
and Yonkers. He did not read the minutes of those subsidiaries which would
have revealed that fact to him. On the subject of minutes, Grant knew that
minutes of certain meetings of the BarChris executive committee held in
1961 had not been written up. Kircher, who had acted as secretary at those
meetings, had complete notes of them. Kircher told Grant that there was no
point in writing up the minutes because the matters discussed at those
meetings were purely routine. Grant did not insist that the minutes be
written up, nor did he look at Kircher’s notes. If he had, he would have
learned that on February 27, 1961 there was an extended discussion in the
executive committee meeting about customers’ delinquencies, that on March
8, 1961 the committee had discussed the pros and cons of alley operation by
BarChris, that on March 18, 1961 the committee was informed that BarChris
was constructing or about to begin constructing twelve alleys for which it had
no contracts, and that on May 13, 1961 Dreyfuss, one of the worst
delinquents, had filed a petition in Chapter X. . . .

Grant, however, was able to establish his due diligence defense with respect to the
expertised portions of the registration statement prepared by Peat Marwick.

7. Due diligence defense of lead underwriter, Drexel & Co., and Coleman, the Drexel
partner in charge and also a director of BarChris as of April 17, 1961: Ballard (assisted by
Stanton) and his law firm were outside legal counsel to the underwriters, led by Drexel.
Ballard did not read the Executive Committee meeting minutes, the minutes of BarChris’s
subsidiaries, or major contracts. He did send Stanton to read the minutes and major
contracts. The court concluded, however, that Drexel failed to establish its due diligence
defense because “no effectual attempt at verification was made.” It explained:

Stated another way, is it sufficient to ask questions, to obtain answers
which, if true, would be thought satisfactory, and to let it go at that, without
seeking to ascertain from the records whether the answers in fact are true
and complete?

I have already held that this procedure is not sufficient in Grant’s case.
Are underwriters in a different position, as far as due diligence is concerned?

The underwriters say that the prospectus is the company’s prospectus,
not theirs. Doubtless this is the way they customarily regard it. But the
Securities Act makes no such distinction. The underwriters are just as
responsible as the company if the prospectus is false. And prospective
investors rely upon the reputation of the underwriters in deciding whether
to purchase the securities. . . .

The purpose of Section 11 is to protect investors. To that end the
underwriters are made responsible for the truth of the prospectus. If they
may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase “reasonable investigation” must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of “data presented” to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company’s officers are truthful and reliable. In order to make the underwriters’ participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company’s officers or on the company’s counsel. A prudent man in the management of his own property would not rely on them.

It is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case. In the present case, the underwriters’ counsel made almost no attempt to verify management’s representations. I hold that that was insufficient.

The court held that the other underwriters who relied solely on Drexel and its lawyers were also liable.

The same conclusion applied to Coleman: “He made no investigation after he became a director. When it came to verification, he relied upon his counsel to do it for him. Since counsel failed to do it, Coleman is bound by that failure. Consequently, in his case also, he has not established his due diligence defense except as to the audited 1960 figures.”

8. Due diligence of Peat, Marwick, outside auditor: Peat, Marwick must establish the expert due diligence defense under Section 11(b)(3)(B). This defense must be established through the effective date of the registration statement—here, May 16, 1961. As is typical, Peat Marwick delivered a “cold comfort” letter through the effective date and a “bring down” of the comfort letter from effectiveness through the date of closing.

The court was particularly critical of the audit failures of Berardi to learn that (i) Capital Lanes had not been sold and (ii) Howard Lanes Annex had also not been sold.

The casebook has an outline of the Peat, Marwick program for review of the Form S-1 registration statement. As with Grant and Ballard, Berardi did nothing to verify the answers he was given. He only communicated with one BarChris officer.

The court concluded:

There had been a material change for the worse in BarChris’s financial position. That change was sufficiently serious so that the failure to disclose
it made the 1960 figures misleading. Berardi did not discover it. As far as results were concerned, his S–1 review was useless.

Accountants should not be held to a standard higher than that recognized in their profession. I do not do so here. Berardi’s review did not come up to that standard. He did not take some of the steps which Peat, Marwick’s written program prescribed. He did not spend an adequate amount of time on a task of this magnitude. Most important of all, he was too easily satisfied with glib answers to his inquiries.

This is not to say that he should have made a complete audit. But there were enough danger signals in the materials which he did examine to require some further investigation on his part. Generally accepted accounting standards required such further investigation under these circumstances. It is not always sufficient merely to ask questions.

Here again, the burden of proof is on Peat, Marwick. I find that that burden has not been satisfied. I conclude that Peat, Marwick has not established its due diligence defense.

In *Software Toolworks*, the court explored the underwriters’ due diligence defense. Much of *Software Toolworks*’ analysis parallels *BarChris*, such as the distinction between an underwriter’s responsibility for expertised and nonexpertised portions of the registration statement. The *Worldcom* opinion also addresses this issue, allowing reliance on audit opinions contained in a registration statement, but not on interim comfort letters, because they do not “expertise” the registration statement. Comfort letters, instead, are a part of the underwriters’ due diligence defense.

Any reliance, of course, may not be blind or ignore red flags. The *Software Toolworks* court held that an underwriter, presumably like every Section 11 defendant, has a burden to respond to “red flags” or warning signs. Here, the court found that the underwriter was entitled to summary judgment; its response to red flags concerning the accounting treatment of a backdated contract was reasonable.

The *Worldcom* court denied summary judgment to the underwriters, noting that what constitutes a red flag is an issue of fact. The underwriters bear the burden of showing a reasonable investigation of non-expertised portions of the registration statement and, thereafter, reasonable grounds to believe those portions were true. As the *Worldcom* court explained in the context of one discrepancy:

The Lead Plaintiff points to one issue that it contends gave the Underwriter Defendants a reasonable ground to question the reliability of WorldCom’s 1999 Form 10-K. According to the computations presented by the Lead Plaintiff, WorldCom’s reported E/R [expense to revenue] ratio was significantly lower than that of the equivalent numbers of its two closest
competitors, Sprint and AT & T.\textsuperscript{247} The Lead Plaintiff argues that, in the extremely competitive market in which WorldCom operated, that discrepancy triggered a duty to investigate such a crucial measurement of the company's health. The Lead Plaintiff has shown that there are issues of fact as to whether the Underwriter Defendants had reasonable grounds to believe that the 1999 Form 10-K was inaccurate in the lines related to the E/R ratio reflected in that filing.

The Underwriter Defendants argue that the difference in the E/R ratios was insufficient as a matter of law to put the Underwriter Defendants on notice of any accounting irregularity. In support of this, they point to the fact that this difference was publicly available information and no one else announced a belief that it suggested the existence of an accounting fraud at WorldCom.

The fact that the difference was publicly available information does not absolve the Underwriter Defendants of their duty to bring their expertise to bear on the issue. The Underwriter Defendants do not dispute that they were required to be familiar with the Exchange Act filings that were incorporated by reference into the Registration Statement. If a “prudent man in the management of his own property,” . . . upon reading the 1999 Form 10-K and being familiar with the other relevant information about the issuer’s competitors would have questioned the accuracy of the figures, then those figures constituted a red flag and imposed a duty of investigation on the Underwriter Defendants. A jury would be entitled to find that this difference was of sufficient importance to have triggered a duty to investigate the reliability of the figures on which the ratio was based even though the figures had been audited. . . .

. . . There is no basis in law to find a requirement that a red flag arises only when there is “clear and direct” notice of an accounting issue. The standard under Section 11 is whether a defendant has proven that it had “no reasonable ground to believe and did not believe” that a registration statement contained material misstatements, a standard given meaning by what a “prudent man” would do in the management of his own property. Nor is the bar lowered because there is an expert’s opinion on which an underwriter is entitled to rely. The “prudent man” standard applies to Section 11(b)(3)(C). Finally, what constitutes an ordinary business event and what constitutes a red flag is an issue of fact. These are exquisitely fact intensive inquiries that depend on the circumstances surrounding a particular issuer and the alleged misstatement. There is no category of information which can always be ignored by an underwriter on the ground that it constitutes an ordinary business event. What is ordinary in one

\textsuperscript{247} WorldCom’s E/R ratio was 43%. The expert for the Lead Plaintiff calculates that AT & T’s equivalent ratio was 46.8% and Sprint’s was 53.2%.
context may be sufficiently unusual in another to create a duty of investigation by a “prudent man.”

Regarding summary judgment, what do Software Toolworks and Worldcom suggest in practice? Defendant underwriters face a heavy burden in a summary judgment motion to demonstrate that a fact or circumstance is not a “red flag.” By contrast, they may be able to successfully demonstrate the reasonableness of their investigation and belief in response to a red flag, if there was one. What this tells practitioners is that, when assisting in due diligence, the underwriters would be well-advised to broadly define what a red flag may be, and then investigate it thoroughly as part of their review of the registration statement. In later litigation, even if the underwriters cannot prevail in a summary judgment motion on the question of what constitutes a red flag, they may still prevail on the reasonableness of their response.

The role of Rule 176(h), discussed at length in the WorldCom decision, remains uncertain. The Rule authorizes the Commission (and, presumably, the courts) to take into account as a “relevant circumstance”:

(h) Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

The Worldcom court noted that the Rule has never been interpreted, raising questions about its vitality. It does not, in any event, circumscribe a court’s discretion in conducting a review of a defendant’s due diligence defense (as the court did in Worldcom).

Turning now to Problem 11-1, how should a court rule with respect to (1) the AmericasBank board; (2) its underwriter, Bixwell Golden; and (3) its law firm, Navis Jones & Ito?

Before turning to the analysis, you may want to ask the students: Which defendant is missing from the list? The answer, of course, is AmericasBank itself, which does not have a due diligence defense.

(1) AmericasBank board. Assuming the omitted information with respect to the federal depository institution regulator is material, the three AmericasBank inside directors appear to have no due diligence defense since they engaged directly in, and had actual knowledge of, the ongoing discussions with the regulator.

Outside director Jones, who was a partner at AmericasBank’s outside legal counsel, Navis Jones & Ito, is also unlikely to establish a due diligence defense, given the analysis in BarChris of the responsibility of Grant, also a partner in the issuer’s outside counsel, not “to rely on the statement of his client.”

The ability of the other two outside directors to establish a due diligence defense is greater. The court in BarChris contrasted the burden placed on an outside director who was the issuer’s legal counsel with that of Auslander, who was an outside businessman. The ultimate issue is whether a court or jury will conclude that Quirk’s or Choi’s investigation
was reasonable. This could turn, in part, on whether there was a due diligence meeting with
directors; the directors asked reasonable questions and received confirmation that issues had
been investigated and documented; and a record was kept of the meeting.

(2) *Bixwell Golden, the underwriter.* Bixwell Golden is unlikely to establish a due
diligence defense for roughly the same reasons as Jones. This is consistent with the analysis
of Drexel & Co.’s defense in *BarChris.*

(3) *Navis Jones & Ito, the outside law firm.* There is no statutory liability for an outside
law firm under Section 11, although a law firm partner who is also a director can be sued as
a director. As a director, Jones’ training as a lawyer may impose a higher standard of care
on her (recall Birnbaum in *BarChris*) or may make it more difficult to establish a due
diligence defense if she also drafted the registration statement.

**Problem 11-2**

Howard Ripple, an attorney, wrote a tax opinion that was circulated to investors in a
limited partnership known as Organized Equipment Leasing (OEL). Ripple’s letter described
specific tax credits and deductions that would be available to investors. Several “facts” that
Ripple described in his letter were fictitious and the Internal Revenue Service subsequently
disallowed each of the tax credits and deductions Ripple described.

Over 110 investors have now brought a § 12(a)(1) lawsuit against Ripple, among o
thers. Will this suit succeed?

Would it make any difference if Ripple wrote personal notes to each investor bringing
suit recommending that “you should consider this investment seriously. It is a winner!”?

Would it make any difference if Ripple’s law firm was paid on a sliding scale basis
depending on the dollar value of limited partnership units sold?

**Analysis:**

Section 12(a) has two very different subsections.

Section 12(a)(1) imposes virtually absolute liability for an offer or sale that violates
Section 5.

Section 12(a)(2) is a more traditional antifraud provision that reaches:

1. Any person
2. who offers or sells a security (including exempt securities under Section 3, other
   than Sections 3(a)(2) and 3(a)(14))
3. by means of a prospectus or oral communication that includes a material
   misstatement of fact or an omission to state a material fact necessary to make the
   statements, in the light of the circumstances under which they were made, not
misleading
4. where the purchaser does not know of the material misstatement or omission
5. unless the defendant can sustain the burden of proof that she did not know, and in the exercise of reasonable care could not have known, of the material misstatement or omission.

Section 12(b) limits damages (depreciation in the value of the security) to those resulting from the defendant’s material misstatement or omission.

Who is a “seller” under Section 12?

_Pinter v. Dahl_, 486 U.S. 622 (1988), is the leading case. In _Pinter_, Dahl bought $310,000 of oil and gas securities from Pinter. Dahl then told others about the deal and helped them complete the agreement form, but he received no commission.

The Supreme Court analyzed when a person would be found to be a statutory seller under what is now Section 12(a)(1), and, presumably, also under Section 12(a)(2), focusing on the definition of “sale” now in Section 2(a)(3).

The Court wrote:

At the very least, however, the language of § 12(1) contemplates a buyer-seller relationship not unlike traditional contractual privity. Thus, it is settled that § 12(1) imposes liability on the owner who passed title, or other interest in the security, to the buyer for value. . . . Dahl, of course, was not a seller in this conventional sense, and therefore may be held liable only if § 12(1) liability extends to persons other than the person who passes title.

In n.21, the Court emphasized that Section 12 only imposes liability on the buyer’s immediate seller: “[R]emote purchasers are precluded from bringing actions against remote sellers. Thus, a buyer cannot recover against his seller’s seller.” In a typical firm commitment underwriting, this suggests that an investor could recover under Section 12 only from the underwriter or broker who sold her the securities. What about the issuer? Rule 159A(a) provides the answer:

(a) **Definition of seller for purposes of section 12(a)(2) of the Act.** For purposes of section 12(a)(2) of the Act only, in a primary offering of securities of the issuer, regardless of the underwriting method used to sell the issuer’s securities, _seller_ shall include the issuer of the securities sold to a person as part of the initial distribution of such securities, and the issuer shall be considered to offer or sell the securities to such person, if the securities are offered or sold to such person by means of any of the following communications:

(1) Any preliminary prospectus or prospectus of the issuer relating to the offering required to be filed pursuant to Rule 424 or Rule 497;
(2) Any free writing prospectus as defined in Rule 405 relating to the offering prepared by or on behalf of the issuer or used or referred to by the issuer . . . ;

(3) The portion of any other free writing prospectus . . . relating to the offering containing material information about the issuer or its securities provided by or on behalf of the issuer; and

(4) Any other communication that is an offer in the offering made by the issuer to such person.

The pivotal question in Pinter was: What does it mean to solicit purchases? The Court concluded that a person whose motivation is solely to benefit a buyer or who gratuitously gives advice cannot be found to be soliciting:

The person who gratuitously urges another to make a particular investment decision is not, in any meaningful sense, requesting value in exchange for his suggestion or seeking the value the titleholder will obtain in exchange for the ultimate sale. The language and purpose of § 12(1) suggest that liability extends only to the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner. If he had such a motivation, it is fair to say that the buyer “purchased” the security from him and to align him with the owner in a rescission action.

Similarly, the Court stated in n.27 that someone (such as an attorney) “who merely assist[s] in another’s solicitation efforts” could not be held liable under Section 12. This note appears to exonerate attorneys who engage solely in legal tasks, such as drafting offering documents, and are paid solely for their legal work.

In Problem 11-2, in light of Pinter n.27, Ripple is unlikely to be liable under Section 12(a)(1) for drafting opinions, even if they include materially false statements, if that is the extent of what he did. (He may face other liability, e.g., under common law fraud, and his actions certainly raise professional responsibility concerns.)

If, however, he was paid on a sliding scale, depending on the dollar value of the limited partnership units sold, his Section 12(a)(1) liability is more likely. The Pinter Court remanded the case to ascertain whether “Dahl had the kind of interest in the sales that make him liable as a statutory seller.” Liability, on this theory, would be even more likely if Ripple engaged in active sales efforts, such as writing personal notes to prospective investors.

**Problem 11-3**

Opus Mortgages sells mortgage related investments. Among other things, it will provide individual mortgages to specific homeowners and sell portfolios of mortgages to investors.

To sell these investments, Opus has a sales force that makes “cold” (unsolicited) telephone calls in which the mortgage brokers read from a script. The script states in part that “each mortgage is individually secured” and explains in detail the system of matching individual investments to individual mortgages.
Opus has twice been the subject of investigations by the State Attorney General. Two years ago, the State Attorney General and Opus signed a consent order under which Opus agreed to have financial records audited. The consent order was negotiated for Opus by general counsel and vice president, Lawrence Haydn. In the next two years, Haydn on three occasions attempted to hire an accountant to audit the financial records of Opus. On each occasion the accountant was unable to give an unqualified opinion because, as the accountant put it, “the recordkeeping is a disaster area. I am unable to determine whether or not Opus is, in fact, matching mortgages.” On several occasions Haydn reassured officials of the State Attorney General’s office that he was making a good faith effort to comply with the consent order.

More recently, after the State Attorney General received several complaints from individuals about Opus, a second investigation began. This investigation discovered, among other things: (1) that the same “script” and offering circular had been used without change; (2) that no audited financial records had ever been produced; (3) that the late chief executive officer of Opus, Koernke, had misappropriated (stolen) $7 million of Opus assets; and (4) because no matching system had ever fully been in place, Opus was forced to liquidate. The $7 million stolen by Koernke was not recovered.

Haydn subsequently has been sued for federal securities law violations by a class of investors. Can Haydn be held liable under § 12(a)(2) of the Securities Act of 1933? If so, is he entitled to a reasonable care defense?

ANALYSIS:

We will assume that (i) the mortgage related investments qualify as securities and (ii) Haydn is a person who offers or sells securities (the investments) under Section 12(a)(2).

There are two quite different questions here. First, does Section 12(a)(2) apply in connection with what appears to be an unregistered offering? Second, if it does apply, would Haydn be entitled to Section 12(a)(2)’s reasonable care defense?

In concluding that Section 12(a)(2) does not reach private sales, the Gustafson Court began its analysis with Section 10 of the 1933 Act, which refers to “information contained in a registration statement.” It did not begin with the Section 2(a)(10) definition of prospectus, which includes “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.” This is outcome determinative. If the prospectus referred to in Section 12(a)(2) is limited to a Section 10 prospectus, then Section 12(a)(2) is limited to information in a registration statement. Compare Justice Thomas’ and Justice Ginsburg’s dissents.

It does not appear that the mortgage instruments were registered with the SEC, nor is it clear what (if any) exemption Opus relied on. Assuming, however, that Opus’ sales were part of a private placement (Section 4(a)(2) or Rule 506), then Gustafson directs that a claim against Haydn under Section 12(a)(2) will fail.

If, however, Haydn were subject to Section 12(a)(2), would he be entitled to a reasonable care defense?

The authorities are divided on whether reasonable care is equal to or less than the standard provided for due diligence in Section 11. Some courts have used the terms “reasonable care” and “due diligence” interchangeably in Section 12(a)(2) cases. However, the
facts in this Problem are not even close. In 1999, Haydn negotiated a consent order under which Opus agreed to have audited financial records. No audited records were ever produced. On three occasions, auditors were unable to give an unqualified opinion, as one put it, because “recordkeeping is a disaster area.” Nevertheless, on several occasions, Haydn reassured the State Attorney General’s office he was making a good faith effort to comply with the consent order. Knowing this, Haydn would fail to establish a reasonable care or due diligence defense.

There is a separate question about whether the foregoing omissions would constitute a material misstatement or omission, with respect to the mortgage related instruments, under Section 12(a)(2).
CHAPTER 12: RULES 10B–5 AND 14A–9: FRAUD IN CONNECTION WITH A PURCHASE OR SALE OF A SECURITY OR THE SOLICITATION OF PROXIES

PROBLEM 12-1

In year one, Mondo Electronics secured a patent for a new type of “multi-thermal” battery (MTB). Its CEO, Mitch Mondo, announced in a December year one press conference that the MTB was a “breakthrough” for the battery-powered automobile. On the basis of “systematic 6-month tests,” he announced that the MTB would allow the “typical United States or foreign made automobile to drive up to 50 hours without recharging at speeds of up to 90 miles per hour.”

Mondo’s CFO explained that when full production of 10,000 batteries was achieved at Mondo’s plant late in year two, the cost per battery would be $250, which would permit retail sales of the battery at $500 per battery and approximately double Mondo’s net income.

By February of year two, Mondo’s engineers had learned that:

1. They had underestimated the weight of the typical sedan and minivan, with the consequence that the typical battery driven could achieve top speeds up to 60 miles per hour.
2. Tests over 18 months disclosed that the MTB deteriorated over time and between 12 and 18 months the MTB needed to be recharged an average of once every 28 hours.
3. More comprehensive engineering data revealed an average cost per battery of $260.
4. The same engineering study revealed that full production at Mondo’s plant could only produce 8,000 batteries per year.

Which, if any, of this data would Mondo be required to reveal under Rule 10b–5?

ANALYSIS:

In Santa Fe v. Green, 430 U.S. 462 (1977), the Supreme Court held, in a claim under Section 10(b) and Rule 10b-5, that there must be fraud, by which Congress meant “conduct . . . involving manipulation or deception.”

Among the most common Rule 10b-5 cases are those involving a material misstatement or omission by a company. Recent cases have amplified (i) a duty to correct (due to a subsequent discovery of a misstatement or omission) and (ii) a duty to update (arising from accurate initial statements that are inconsistent with subsequent developments).

In Time Warner Inc. Sec. Litig., 9 F.3d 259 (2d Cir. 1993), the Second Circuit concluded: “We agree that a duty to update opinions and projections may arise if the original opinions or projections have become misleading as the result of intervening events.” Only when a company has a duty to disclose omitted facts can such a duty to update arise. For example, in Time Warner, “having publicly hyped strategic alliances, Time Warner may have come under a duty to disclose facts that would place the statements concerning strategic alliances in a materially different light.” Specifically, the court concluded:

We do not hold that whenever a corporation speaks, it must disclose every piece of information in its possession that could affect the price of its stock. Rather, we hold that when a corporation is pursuing a specific business goal
and announces that goal as well as an intended approach for reaching it, it may come under an obligation to disclose other approaches to reaching the goal when those approaches are under active and serious consideration. Whether consideration of the alternate approach constitutes material information, and whether nondisclosure of the alternate approach renders the original disclosure misleading, remain questions for the trier of fact, and may be resolved by summary judgment when there is no disputed issue of material fact.

In contrast, in *Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410 (3d Cir. 1997), the Third Circuit held that there is a duty to correct both historical and forward-looking statements:

Imagine the following situation. A public company in Manhattan makes a forecast that appears to it to be reasonable at the time made. Subsequently, the company discovers that it misread a vital piece of data that went into its forecast. Perhaps a fax sent by the company’s factory manager in some remote location was blurry and was reasonably misread by management in Manhattan as representing sales for the past quarter as 100,000 units as opposed to 10,000 units. Manhattan management then makes an erroneous forecast based on the information it has at the time. A few weeks later, management receives the correct sales figures by mail. So long as the correction in the sales figures was material to the forecast that was disclosed earlier, we think there would likely be a duty on the part of the company to disclose either the corrected figures or a corrected forecast (or statement of historical fact) that errors of the type we have identified will be corrected.

A duty to update a forward-looking statement is limited to factual representations that remain “alive” in the minds of investors as a continuing representation. The court in *Burlington Coat* narrowly construed when that would occur:

In particular, we note three features of the existing federal securities disclosure apparatus:

1. Except for specific periodic reporting requirements (primarily the requirements to file quarterly and annual reports), there is no general duty on the part of a company to provide the public with all material information. . . . Thus, possession of material nonpublic information alone does not create a duty to disclose it. . . .

2. Equally well settled is the principle that an accurate report of past successes does not contain an implicit representation that the trend is going to continue, and hence does not, in and of itself, obligate the company to update the public as to the state of the quarter in progress. . . .

3. Finally, the existing regulatory structure is aimed at encouraging companies to make and disclose internal forecasts by protecting them from liability for disclosing internal forecasts that, although reasonable when
made, turn out to be wrong in hindsight. . . . Companies are not obligated either to produce or disclose internal forecasts, and if they do, they are protected from liability, except to the extent that the forecasts were unreasonable when made.

The court concluded:

Based on features one and two, we do not think it can be said that an ordinary earnings projection contains an implicit representation on the part of the company that it will update the investing public with all material information that relates to that forecast. Under existing law, the market knows that companies have neither a specific obligation to disclose internal forecasts nor a general obligation to disclose all material information. . . . We conclude that ordinary, run-of-the-mill forecasts contain no more than the implicit representation that the forecasts were made reasonably and in good faith.

The answer to Problem 12-1 may partly depend on the Circuit in which the case is litigated.

Mitch Mondo’s December year one press conference announcing a “breakthrough” appears to be more like the “publicly hyped strategic alliances” in *Time Warner* than the ordinary earnings forecast discussed in *Burlington Coat*.

(1) The underestimation of weight would appear to involve a duty to correct, not the duty to update, which is harder to establish. The difference between 90 and 60 miles (33-1/3%) appears to be material.

(2) The deterioration in recharge frequency from the stated 50 hours to 28 hours after 12-18 months, in contrast, involves a duty to update. It does not appear that “up to 50 hours without recharging” was a false statement when it was initially made. Nor does it seem likely that the court in *Burlington Coat* would require disclosure: “Equally well settled is the principle that an accurate report of past successes does not contain an implicit representation that the trend is going to continue.” In the Second Circuit, at most, there would be a jury question as to whether a duty to update was violated.

(3) Again, this would appear to involve a duty to update, but in all likelihood, it would not involve a material misstatement; $260 compared to $250 is likely to be quantitatively immaterial.

(4) The case for a violation here may be stronger than in Question (2), where the 50-hour estimate appeared to be initially accurate, but deteriorated over time. Here, in contrast, the production estimate appears to have always been materially wrong—indicating a duty to correct.
**Problem 12-2**

Humongous Mega Movies, Inc. (HMM, Inc.) earned over $100 million in net profits last year.

(1) Would it be material to a reasonable investor that:

(a) Its CEO, Herman Humongous, who last year earned $12.5 million in executive compensation, embezzled $10,000 from petty cash last year?
(b) Its Co-CEO, Marie Mega, has very high blood pressure and elevated cholesterol and has been ordered by her physician to take a one month vacation and try to relax? Last year Marie Mega was the executive producer of the most successful HMM film which alone was responsible for 50 percent of HMM’s net profits.

Herman Humongous, Chief Executive Officer of HMM, Inc., had dinner last night with his business school classmate, Frieda Durkheim, Chief Executive Officer of Lawrence Co. Both HMM and Lawrence are listed on the New York Stock Exchange (NYSE).

This morning average daily volume trebled on HMM, Inc. and its stock price was up 15 percent.

(2) If the appropriate NYSE representative telephones and asks if HMM, Inc. has any information about why the price and volume are up, can HMM's public relations officer state “absolutely none”?

(3) Suppose Durkheim had presented Humongous with a two-page proposed “merger of equals” and Humongous had turned it down. Could the public relations officer still state, “I know of absolutely nothing to allow for the stock price and volume increases”?

(4) Suppose Durkheim presented Humongous with a two-page proposed “merger of equals” and Humongous said, “I’ll take it to my board for consideration next week.” Could the public relations officer then state, “I know of nothing to account for the stock price and volume increases”?

**Analysis:**


In February 1969, National bought 34 percent of TSC. Five National nominees were on the TSC board. On October 16, 1969, TSC, with National directors abstaining, approved a proposal to liquidate TSC and sell its assets to National. The joint TSC-National proxy statement was challenged as false and misleading. The Supreme Court ultimately concluded that undisclosed information is material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

Several subsidiary points are worth emphasizing:

(1) Under Rule 10b-5, the standard would be: “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in
deciding [whether to buy or sell a security].”

(2) This is sometimes called the “total mix” or mosaic test.

As the casebook notes, in United Paperworkers International Union v. International Paper Co., 985 F.2d 1190, 1199 (2d Cir. 1993), the court later addressed the concept of “total mix” as follows:

The mere fact that a company has filed with a regulatory agency documents containing factual information material to a proposal as to which proxies are sought plainly does not mean that the company has made adequate disclosure to shareholders under Rule 14a–9. Corporate documents that have not been distributed to the shareholders entitled to vote on the proposal should rarely be considered part of the total mix of information reasonably available to those shareholders.

The “total mix” of information may also include “information already in the public domain and facts known or reasonably available to the shareholders.” Rodman v. Grant Foundation, 608 F.2d at 70; see Seibert v. Sperry Rand Corp., 586 F.2d 949, 952 (2d Cir. 1978). Thus, when the subject of a proxy solicitation has been widely reported in readily available media, shareholders may be deemed to have constructive notice of the facts reported, and the court may take this into consideration in determining whether representations in or omissions from the proxy statement are materially misleading. . . . However, the mere presence in the media of sporadic news reports does not give shareholders sufficient notice that proxy solicitation statements sent directly to them by the company may be misleading, and such reports should not be considered to be part of the total mix of information that would clarify or place in proper context the company’s representations in its proxy materials.

In the present case, the district court properly rejected Paper Co.'s contention that public press reports and its 10-K Report should be viewed as part of the total mix of information reasonably available to shareholders. Though the Company argued that news articles should be considered, the articles were few in number, narrow in focus, and remote in time.

(3) The test is a mixed question of law and fact. The Court appeared to discourage summary disposition of materiality issues.

(4) The reference to the “reasonable investor” is meant to invoke a character like the hypothetical reasonable person in torts law. It is not enough that a defrauded plaintiff would testify she believed the omission or misrepresentation was material.

The Court did not require a material fact to be one which would change an investment decision (or, in the case of a proxy, the vote), because this would require causation and frustrate the remedial purpose of the law. As the Court noted: “It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial
likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.”

The Supreme Court did not hold as material the omission of facts like Yarmuth not being listed as chairman of TSC or Simonelli not being listed as chairman of TSC’s Executive Committee. Other facts were disclosed:

- National owned 34 percent of TSC. No one else owned more than 10 percent.
- Five of ten TSC directors were nominated by National.
- Yarmuth was listed as President of National.
- Simonelli was listed as executive Vice President of National.

If, however, there had been no identification of Yarmuth and Simonelli at all, this would likely have been material as a matter of law.

Quantitative and Qualitative Materiality

Although Section 11, Rule 14a-9, and Rule 10b-5 do not include quantitative tests for determining materiality, numerical rules of thumb have long been common. In Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27 (2011), the Supreme Court rejected the invitation to adopt the bright-line rule that reports of adverse events related to the use of pharmaceutical products which do not rise to the level of statistical significance are immaterial as a matter of law. The Court instead reaffirmed the standard articulated in Basic and required that pharmaceutical companies evaluate the materiality of adverse event reports in light of the “total mix” of information.

In applying the “total mix” standard to the facts in Matrixx, the Court noted the following facts as relevant in evaluating materiality:

- Matrixx had received reports from three medical professionals suggesting a link between Zicam and anosmia for more than ten patients, and nine plaintiffs had initiated four product liability suits against Matrixx.
- Matrixx was aware that findings concerning the link between Zicam and anosmia were presented at a national medical conference.
- Medical researchers had made Matrixx aware of studies demonstrating a biological causal link between the intranasal application of zinc (the active ingredient in Zicam) and anosmia.
- Matrixx had not conducted any research of its own relating to anosmia and, as a result, it would have had no basis for rejecting out of hand the findings of the other medical studies.
- Zicam accounted for approximately 70 percent of Matrixx’s sales.
- Matrixx had previously told investors that revenues were going to rise 50 and then 80 percent despite information indicating a significant risk to its leading revenue-generating product.

Viewing these facts as a whole, the Court concluded that the respondents adequately
In 1999, the SEC Office of Chief Accountant issued Staff Accounting Bulletin (SAB) No. 99. SAB No. 99 discourages exclusive reliance on quantitative assessments of materiality:

Evaluation of materiality requires a registrant and its auditor to consider all the relevant circumstances, and the staff believes that there are numerous circumstances in which misstatements below 5% could well be material. . . .

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are –

• whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
• whether the misstatement masks a change in earnings or other trends
• whether the misstatement hides a failure to meet analysts’ consensus expectations for the enterprise
• whether the misstatement changes a loss into income or vice versa
• whether the misstatement concerns a segment or other portion of the registrant’s business that has been identified as playing a significant role in the registrant’s operations or profitability
• whether the misstatement affects the registrant’s compliance with regulatory requirements
• whether the misstatement affects the registrant’s compliance with loan covenants or other contractual requirements
• whether the misstatement has the effect of increasing management’s compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation
• whether the misstatement involves concealment of an unlawful transaction.

In Ganino v. Citizens Util. Co., 228 F.3d 154 (2d Cir. 2000), the court characterized SAB 99 as “thoroughly reasoned and consistent with existing law,” and rejected a determination of materiality relying exclusively on a single percentage benchmark. The court reversed a district court holding that fees characterized as 1.7 percent of 1996 total revenue were immaterial as a matter of law.

In Problem 12-2, Question (1)(a), a $10,000 embezzlement in a company with $100 million in net profits would be quantitatively immaterial, but would still be material under SAB 99 because it “involves concealment of an unlawful transaction.”

Question (1)(b) is more complicated. Marie Mega appears to be of such importance to HMM that an omission concerning her health would be material if it could be likened to omission of “a segment or other portion of the registrant’s business that has been identified as playing a significant role in the registrant’s operations or profitability.” Last year, she was responsible for a film that earned 50 percent of HMM’s net profits. If Marie Mega had died
or was diagnosed with a terminal illness soon to result in death, disclosure would most likely be required in light of her significance to HMM.

On the other hand, it seems unlikely a court would require a press release every time an executive takes a one-month vacation. If there is little likelihood that her health will prevent her from engaging in future work, it is unlikely a court would require disclosure.

Problem 12-2, Questions (2)–(4), involve the same type of premerger negotiations analyzed in Basic Inc. v. Levinson, 485 U. S. 224 (1988). In Basic, in September 1976, Combustion representatives met with Basic’s officers and directors to discuss a merger. On September 25, October 21, and November 6, Basic denied it was engaged in merger negotiations. On December 20, a merger with Combustion was announced.

The Supreme Court explicitly adopted the TSC Industries standard of materiality for Rule 10b-5 cases. It rejected an “agreement-in-principle” test for materiality of premerger negotiations on the basis that: (1) investors can analyze contingent information; (2) management is not required to disclose merger negotiations, it merely cannot mislead investors; and (3) data may be material to investors long before an agreement-in-principle is reached.

The Court held that a company will not always be liable if it falsely denies merger negotiations. Negotiations must be material. To determine if merger negotiations are material, the Court applied the Texas Gulf Sulfur test: Balance the indicated probability that the event will occur with the anticipated magnitude of the event. In assessing the probability of an event occurring, courts will review board resolutions, instructions to investment bankers, actual negotiations, and so on. The magnitude of a merger will typically be large for the target of an offer—e.g., 50 percent premiums are not uncommon.

A company can avoid liability if it does not wish to disclose merger negotiations. See n.17: Silence or a “no comment” statement is the equivalent of not making a statement.

At n.9: The Court stated it will not address earnings projections. Nonetheless, the Basic contingent event test has been applied to other forms of future events besides premerger negotiations.

In Problem 12-2, Question (2), an assertion by the officer that she has “absolutely” no information does not appear to be both material and false. Generally speaking, having dinner with a business school classmate portends so low a probability of a merger that it would not need to be disclosed. The analysis might be different if there were other reasons one company was actively seeking to merge with a firm similar to the other. But, even then, the probability is not enough to establish materiality unless both diners were, in fact, willing to consider a merger.

Would it be better to simply tell the NYSE representative “no comment”? That will depend on the circumstances, but many firms have a public relations policy to respond “no comment” to inquiries such as this one. The market, however, might regard this as an affirmation that something is going on. In that case, the NYSE may not accept this as an adequate response and halt (or threaten to halt) trading in the stock until a better answer is provided.
Question (3) is similar. If an offer has been rejected, then it is unlikely to still be material. Here, again, a policy of “no comment” may be the better course, rather than the public relations officer stating he “know[s] of absolutely nothing.” When the HMM public relations officer speaks, but omits information that makes the statement misleading (did he really “know of absolutely nothing”?), HMM may be liable for a material omission. However, this is a highly factual evaluation.

Question (4) involves a statement that is false. Is it material? It well might be. HMM may be a target of a tender offer with a large, likely premium. Even a small probability (say, 10 percent) with a large magnitude (say, a 50 percent premium) could be found to be material.

**Problem 12-3**

Tel-Cel is a corporation comprised of local telephone companies and cellular phone systems. The cellular phone business was hot, and the local telephone business cool. Tel-Cel’s board believed that the combination was unlovely to investors and that the firm’s assets would be worth more if the company was sold.

Rather than just seek out a possible purchaser and negotiate privately, Tel-Cel decided to organize an auction at which bidders could bid on the whole company or on parts of it as they wished. The auction was intimated in a public announcement by Tel-Cel on January 23 that it had hired two prominent investment banks to “explore strategic alternatives to maximize shareholder value, including the possible sale of the company.” On the day of the announcement, the price of Tel-Cel’s shares rose from $37 to almost $48.

On March 5, GTE, a potential bidder, announced that it would not participate in the auction. Although Tel-Cel responded by bravely claiming that “[w]e believe that this [GTE’s statement] has no impact on our process [and w]e continue to move along,” a week later it met with its investment bankers in private to consider the viability of a “survivor entity” consisting of those assets of Tel-Cel that would not fetch an attractive price at the auction. The conclusion (not publicly announced) of the participants at the meeting was that any such entity would “very clearly bear the taint of a nonsaleable Tel-Cel property which has been aggressively (and publicly) marketed to ‘the world.’ ”

On March 25, Pacific Telesis, one of the Baby Bells and a potential bidder for Tel-Cel’s Nevada properties, a major asset, announced that it also wouldn’t bid for them after all. Tel-Cel reacted with a public statement that “the bidding process continues to go very smoothly.” By this time, several other large potential purchasers had expressed a lack of interest as well. The price of Tel-Cel’s stock drifted lower than its peak on January 23, but it was still above $40.

April 16 was the deadline for the submission of bids. On April 13, Tel-Cel’s chief executive officer announced publicly that there was “widespread interest almost down to every [Tel-Cel telecommunications] exchange.”

The auction was held on April 16 as scheduled, but it was a bust. Only seven bids were submitted, none for the whole company. Although Tel-Cel kept mum, it accepted none of the bids. Instead, it approached Sprint hat in hand and quickly negotiated a sale of the entire company to Sprint at a price equivalent to $33.50 a share, which was $9 below the then current market price and roughly 10 percent below the market price before the auction was first intimated. As soon as the deal with Sprint was announced, on May 27, the value of Tel-Cel’s shares plummeted, from $42.50 to $32.

1. Did Tel-Cel make a material misstatement or omission in violation of Rule 10b-5?
2. What effect on liability would there be if Tel-Cel had added to its January 23rd announcement: “Of course we cannot guarantee that any strategic alternative will succeed or will generate an offer in excess of current market price”?

**ANALYSIS:**

Are statements of opinion, reason, or belief actionable, such as “[w]e believe that this [GTE's Statement] has no impact on our process” or the April 16th statement of Tel-Cel's C.E.O. that there was “widespread interest almost down to every [Tel-Cel telecommunications] exchange”?

The Supreme Court considered this question in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991). In *Virginia Bankshares*, VBI owned 85 percent of FABI; the remaining 15 percent was owned by 2,000 minority shareholders. In recommending a merger, the FABI directors stated that the price offered per share was “high” and “fair.” The Supreme Court held: Statements of opinion, reason, or belief can be misrepresented and material. As the Court explained, “Shareholders know that directors usually have knowledge and expertness far exceeding the normal investor's resources, and the directors’ perceived superiority is magnified even further by the common knowledge that state law customarily obliges them to exercise their judgment in the shareholders’ interest.” An executive’s off-the-cuff remark, however, that “sales of our new product will go through the roof” would not necessarily be viewed as material to investors. There are no similar indicia of the reliability of the executive's statement that would justify investor reliance on it. “Reasons for directors’ recommendations or statements of belief are, in contrast, characteristically matters of corporate record subject to documentation . . .”

The Court also explored half-truths: “If it would take a financial analyst to spot the tension between the [misleading statement] and [a true statement], whatever is misleading will remain materially so, and liability should follow.” Compare this statement in *Virginia Bankshares* with the bespeaks caution doctrine. Under this doctrine, a person making a material misstatement or omission in a forward-looking statement shall not be liable in a private action if the statement “is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.” See Section 27A(c)(1)(A) of the 1933 Act and Section 21E(c)(1)(A) of the 1934 Act. The bespeaks caution doctrine contains two important limitations: (1) the bespeaks caution doctrine is limited to forward-looking statements; and (2) vague or boilerplate disclosures do not suffice to mitigate the effect of a false statement. The bespeaks caution doctrine can be harmonized with *Virginia Bankshares*, as well as with the total mix concept in *TSC Industries*, as long as any cautionary statement does not automatically nullify a false statement.

**Question (1)** requires an analysis of each allegedly false statement. The statement with respect to GTE in the third paragraph appears to be false in light of the other facts in the third and fourth paragraphs. The statement, however, is somewhat tentative (“[w]e believe . . .”), and it is uncertain what, if any, impact the statement had on stock price, which would be a conventional measure of materiality in this context. If the GTE statement can be linked to a price decline from $48 on January 23 to $32 on May 27, it would be material. But to reach that conclusion, we would also need to consider overall market movements and whether other statements or events caused the decline.
The statements in paragraphs (4) and (5) that “the bidding process continues to go very smoothly” and that there is “widespread interest” also appear to be false. Could each of these statements be excused as “puffing”? Probably not. Puffing typically refers to a vague, forward-looking statement, self-evidently lacking in corroboration. These statements appear more like the statements in Virginia Bankshares, where outsiders could reasonably expect the corporate executives to have a basis for their statements.

Question (2) suggests a bespeaks caution defense. This defense will probably not succeed because it does not involve the “precise cautionary language” disclosing risks that Worlds of Wonder (excerpted in the casebook) found to be required. The disclaimer in Question (2) is far more general than the more specific statements in paragraphs (3), (4), and (5).

**PROBLEM 12-4**

(1) Rexford is the Chief Executive Officer of Hughes Gyros Inc. Bachman is the Chief Financial Officer. Earlier this year Rexford was criminally convicted for a scheme in which he secretly sold gyroscope parts from Hughes' inventory. The SEC has now commenced a civil action under Rule 10b-5 against Bachman.

Bachman argues that he did not act with the required culpability when he assisted Rexford and the others to purchase and resell inventory. He obtained cashier's checks with which to purchase the inventory but directed that his name not appear on these checks. The cashier's checks bore the names of a nominee account holder. Bachman transferred the proceeds of the sale among various noncorporate accounts held by Rexford, even though he concedes that these transactions had no apparent business purpose. Bachman has employed a Nuremberg defense by arguing that he simply did what he was told and was not in a position to question the orders given to him by his employer. What result?

(2) Hughes Gyros also published an earnings forecast in its latest Form 10-K annual report based on a linear extrapolation of prior year earnings, including those artificially inflated as a result of the secret inventory sales. What result if Bachman is sued and asserts § 21E of the Securities Exchange Act in defense?

**ANALYSIS:**

The Private Securities Litigation Reform Act of 1995 complicated proof of culpability under Rule 10b-5.

The Supreme Court addressed culpability with respect to historical facts in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976):

(1) Culpability cannot be established by pleading or proof of only negligence.

(2) An intent to deceive, manipulate, or defraud will suffice. “Section 10(b) was intended to proscribe knowing or intentional misconduct.”

(3) In n.12, the Court reserved the question whether recklessness is sufficient for civil liability under Section 10(b) and Rule 10b-5. As “Notes on the Required Culpability of the Defendant” documents, courts after Ernst & Ernst have held recklessness to be sufficient. In 1995, Section 27A of the 1933 Act and Section 21E of the 1934 Act were amended to create a safe harbor when a plaintiff alleges a fraudulent forward-looking statement, unless the
statement was made with “actual knowledge.” This means that plaintiffs can now only rely on a defendants’ recklessness in alleging claims concerning historical facts.

**Problem 12-4, Question (1),** poses the question of whether Bachman’s conduct was negligent or actionably reckless when he assisted Rexford in the inventory transactions. On the one hand, recklessness is only actionable when it involves “an extreme departure from the standards of ordinary care.” On the other hand, a chief financial officer can be expected to be particularly sensitive to transactions that could involve fraud. At the very least, it is difficult to accept that a CFO could defend otherwise inexcusable conduct on the ground that he was just following orders. As the senior financial officer of the company, the CFO has a duty to ensure compliance with such provisions as Section 13(b)(2) of the 1934 Act (which requires an issuer’s books, records, and accounts to “accurately and fairly reflect” the issuer’s transactions). He must also certify under Section 302 of the Sarbanes-Oxley Act that, based on his knowledge, the financial information in the company’s annual and quarterly reports are fairly presented in all material respects, and the company has established and maintained internal controls to ensure that material information regarding the issuer is made known to the CEO and CFO.

**Problem 12-4, Question (2),** can only be violated if Bachman had “actual knowledge” that the earnings forecast was false. Recklessness will not suffice.

**Problem 12-5**

Larry Abel, the Chief Executive Officer of Kain, Inc., a closely held corporation, recently had dinner with his business school classmate, Margaret Jones, Chief Executive Officer of Franklin Press, a thinly traded over-the-counter corporation. At the conclusion of dinner, they agreed to merge Kain, Inc. and Franklin Press. Three days later, a formal merger agreement was signed, and a press conference to make the announcement public was scheduled one week later.

The day after the merger agreement was signed, Afterman, a shareholder in Franklin Press, telephoned Franklin’s public relations officer, and asked about “rumors of an impending major event.” The public relations officer emphatically denied the rumors. Afterman promptly sold her Franklin stock at $20. After the merger was announced, Franklin’s stock rose to $30.

1. Can Afterman rely on the fraud-on-the-market presumption to prove reliance?
2. Could Afterman prove reliance if her stock sale order had been placed before the conversation with the public relations officer?
3. Would an earlier originated stock sale order be “in connection with” a stock sale that occurred after Franklin’s public relations officer made a material misrepresentation about Franklin’s future?
4. Suppose Afterman could satisfy the reliance and “in connection with” requirements. Could Afterman establish loss causation for the difference between her $20 sales price per Franklin share and the $30 price at which Franklin was quoted after the merger announcement if the relevant stock market index was up 25 percent?
5. Could Afterman establish loss causation if the Baucus Brothers decided the day after the merger agreement was signed to seek control of Franklin Press and their open market purchases pushed the trading price of Franklin to $25?
ANALYSIS:

Problem 12-5 includes an array of issues in the complex Rule 10b-5 law of reliance and causation.

(1) Reliance is a required element of a Rule 10b-5 case. See Basic Inc. v. Levinson, 485 U.S. 224 (1988). The Supreme Court, however, has permitted the fraud-on-the-market presumption to operate when securities are traded in an open and developed securities market. As the Court explained in Basic:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations. Peil v. Speiser, 806 F.2d 1154, 1160-1161 (C.A.3 1986).

Thินly-traded, over-the-counter securities have been held not to be traded in an efficient market that is required for the fraud-on-the-market presumption to operate.

(2)–(3) To establish that a violation of Rule 10b-5 is “in connection with the purchase or sale” of a security, an allegedly false statement must precede the purchase or sale. As the court wrote in Semerenko v. Cendant Corp., 223 F.3d 165 (3d Cir. 2000):

The purpose underlying § 10(b) and Rule 10b-5 is to ensure that investors obtain fair and full disclosure of material facts in connection with their decisions to purchase or sell securities. That purpose is best satisfied by a rule that recognizes the realistic causal effect that material misrepresentations, which raise the public's interest in particular securities, tend to have on the investment decisions of market participants who trade in those securities. . . . We therefore adopt the reasoning of the Second Circuit and the Ninth Circuit and hold that the Class may establish the “in connection with” element simply by showing that the misrepresentations in question were disseminated to the public in a medium upon which a reasonable investor would rely, and that they were material when disseminated.

(4) Loss causation limits damages to stock price changes caused by a false statement. Price movements as a result of market price changes or other causes are not actionable. See Semerenko.

Under Dura Pharmaceuticals, a plaintiff must prove more than that the market price on the date of purchase was inflated by the alleged misrepresentation. To meet their burden, the plaintiffs must prove their loss was caused by the misstatement, i.e., when the truth became known, it caused a decrease in the stock price that resulted in economic loss to the
plaintiffs. The *Halliburton* case (excerpted in the casebook) is helpful in further distinguishing between the concept of transactional causation and loss causation.

Assuming no other cause of the price changes, the maximum damages would be: $30 - $20 - (25% x ($30 - $20)) or $7.50 per share.

(5) Presumably, the Baucus Brothers’ purchase was made before the merger agreement was publicly announced. The Brothers caused the market price to rise to $25 after Afterman sold her shares at $20. The empirical question is whether the press relations officer made a false statement. If the officer knew or was reckless in not knowing about the Baucus Brothers’ plan to seek control, then loss causation could be established. Cf. *SEC v. Zandford*, 535 U.S. 813 (2002), describing a link between a deceptive practice and stock sales in another context. If, however, the press relations officer spoke the truth as it was known when she spoke, no loss causation would be established.
CHAPTER 13: INSIDER TRADING

PROBLEM 13-1

Wyoming was employed as Director of Fiduciary Services by the St. Louis law firm of Larsen & Gould. She controlled the selection of stockbrokers for the placing of securities trades on behalf of the trust accounts managed by Larsen & Gould. Murtagh was employed as a stockbroker by Morgan Merrill. Wyoming directed a large share of Larsen & Gould's business to Murtagh. Murtagh and Wyoming also shared a personal and financial relationship.

From December 7 until December 12, Larsen & Gould represented the Bank of St. Louis in connection with a potential merger with MoBanks. This was a highly confidential transaction. Though few lawyers at Larsen & Gould were involved in the transactions, Wyoming had daily contact with at least one, John Green. Green visited Wyoming’s office frequently to check stock prices and monitor his personal account. Computer records indicate that Wyoming opened Green’s account summary on Wyoming’s computer at 3:27 p.m. and 3:28 p.m. on December 12.

At 3:29 p.m., one minute after opening Green’s account summary, Wyoming placed a call to Murtagh. The call lasted one minute and twelve seconds. Immediately after Wyoming’s call, Murtagh called his trading assistant, Abby Lincoln, and entered orders to purchase approximately 11,000 shares of MoBanks stock, priced at $85 per share, for his own account, and those of other family members. Lincoln also purchased 400 shares of MoBanks stock for her own account. To her knowledge, Murtagh never had bought across all of his family accounts at once.

Lincoln on December 12th also telephoned her fiancé, Jim Washington, and said “buy MoBanks.” Washington instantly bought 1,000 shares.

After the market closed on December 12, Bank of St. Louis and MoBanks announced their merger. As a result of the merger, MoBanks stock price increased by $8 a share (or 28 percent) before the market opened on December 13.

Have (1) Wyoming, (2) Murtagh, (3) Lincoln, or (4) Washington violated Rule 10b-5? If so, why?

ANALYSIS:

The Supreme Court has addressed “insider” trading in three principal cases:

A. In Chiarella v. United States, 445 U.S. 222 (1980), the Supreme Court held that a plaintiff must prove that the defendant violated a duty to disclose material information by insider trading. The Court did not address two theories that were not argued at the trial court: (1) Whether there is a duty to an employer; and (2) Whether there is a duty not to misappropriate confidential information.

B. In Dirks v. SEC, 463 U.S. 646 (1983), the Supreme Court held that tippees who knowingly receive information in violation of the tipper’s duty can also be held liable. “[The test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.” Not only must the insider breach a duty, but the tippee must also know or be reckless in not knowing of the fiduciary duty breach. Dirks emphasized that the tippee’s liability is derived from the tipper. If the tipper did not violate a duty, the tippee could trade to her heart’s content.
The Supreme Court also noted in footnote 14 that certain outsiders, such as an underwriter, accountant, lawyer, or consultant, could be constructive insiders, with the same duties as an insider, when such persons: (1) acquired material nonpublic information; (2) entered into a special confidential relationship with the company and were given access to information solely for the company’s purposes; and (3) the company expected the outsider to keep the information confidential and the relationship at least implied such a duty.

C. In *United States v. O’Hagan*, 521 U.S. 642 (1997), the Supreme Court adopted a form of misappropriation duty initially proposed by Chief Justice Burger in his dissent in *Chiarella*. The Court also generalized about insider trading liability:

Under the “traditional” or “classical theory” of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a “deceptive device” under § 10(b), we have affirmed, because “a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.” *Chiarella v. United States*, 445 U.S. 222, 228, 100 S.Ct. 1108, 1114, 63 L.Ed.2d 348 (1980). That relationship, we recognized, “gives rise to a duty to disclose [or to abstain from trading] because of the necessity of preventing a corporate insider from . . . taking unfair advantage of . . . uninformed . . . stockholders.” *Id.*, at 228–229, 100 S.Ct., at 1115 (citation omitted). The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation. See *Dirks v. SEC*, 463 U.S. 646, 655, n. 14, 103 S.Ct. 3255, 3262, 77 L.Ed.2d 911 (1983).

The “misappropriation theory” holds that a person commits fraud “in connection with” a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. . . Under this theory, a fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company’s stock, the misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.

“Who Has a Duty to Disclose and SEC Regulations” summarizes the current grid of potential Rule 10b-5 liability for (1) insiders; (2) constructive or *Dirks* n.14 insiders; (3) tippers and tippees; and (4) misappropriators.

Problem 13-1 focuses on (i) tippers and tippees and (ii) misappropriators.
Question (1): Assuming the other elements of Rule 10b-5 can be established, did Wyoming violate Rule 10b-5? (We are not asked about Green.) It is not clear what (if anything) Green communicated to Wyoming. Presumably, Green’s frequent visits to Wyoming’s office were to check MoBanks’ stock price as part of the firm’s representation of the Bank of St. Louis. He used Wyoming’s computer (rather than calling an outside broker) to keep his inquiry confidential, all consistent with Green’s obligations to his firm and client. One might ask, however, why Green did not access the stock prices from his own computer; after all, market prices are accessible from virtually any laptop. The government might try to prove that Green alerted Wyoming to the impending acquisition with the intention that she (and her friends) could benefit. Could this involve a violation of a fiduciary duty by Green, as tipper, and Wyoming, as tippee?

In United States v. Martoma (excerpted in the casebook), the Second Circuit found objective evidence of an “intent to benefit,” without more (e.g., without requiring a “meaningfully close personal relationship” between the tipper and tippee, which some had understood as being required in a prior ruling), to be sufficient to find a fiduciary breach by a tipper:

... Because the existence of a breach “depends in large part on the purpose of the disclosure,” Dirks, 463 U.S. at 662, it makes perfect sense to permit the government to prove a personal benefit with objective evidence of the tipper’s intent, without requiring in every case some additional evidence of the tipper-tippee relationship. ... For example, suppose a tipper discloses inside information to a perfect stranger and says, in effect, you can make a lot of money by trading on this. Under the dissent’s approach, this plain evidence that the tipper intended to benefit the tippee would be insufficient to show a breach of the tipper’s fiduciary duty to the firm due to the lack of a personal relationship. Dirks and Warde do not demand such a result. Rather, the statement “you can make a lot of money by trading on this,” following the disclosure of material non-public information, suggests an intention to benefit the tippee in breach of the insider’s fiduciary duty.

... We are thus satisfied that the personal benefit element can be met by evidence that the tipper’s disclosure of inside information was intended to benefit the tippee. And as is clear from the purpose of the personal benefit element, the “broad definition of personal benefit set forth in Dirks,” and the variety of benefits we have upheld, the evidentiary “bar is not a high one.” Obus, 693 F.3d at 292.

... The central question in Newman was an issue of scienter on which our district courts had been split: whether a tippee must be aware, not only that the tipper breached a fiduciary duty in disclosing inside information, but also that the tipper received a personal benefit. Newman, 773 F.3d at 447–51. The Court persuasively explained that both were required. Id. at 449 (“[A] tippee’s knowledge of the insider’s breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit.”). This important teaching of Newman is not before us. ...
Newman’s second holding is the focus of this appeal. After resolving the scienter question, Newman considered the sufficiency of the personal benefit evidence for two tippers, where the government relied chiefly on evidence that they were friendly with their tippees.

The Newman panel rejected the government’s argument, holding that the personal benefit “standard, although permissive, does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature.” Id. . . . And in the sentence that forms the basis of Martoma’s argument on appeal, Newman stated as follows:

To the extent Dirks suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee’s trades ‘resemble trading by the insider himself followed by a gift of the profits to the recipient,’ we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship . . . .

Id. at 452 (citation omitted) (quoting Dirks, 463 U.S. at 664). . . .

The term “meaningfully close personal relationship” is new to our insider trading jurisprudence, and, viewed in isolation, it might admit multiple interpretations. But Newman provided substantial guidance. Immediately after introducing the “meaningfully close personal relationship” concept, Newman held that it “requires evidence of ‘a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].’” Newman, 773 F.3d at 452 (quoting Jiau, 734 31 F.3d at 153 (quoting Dirks, 463 U.S. at 664)). As explained above, each of these is an independently sufficient basis to infer a personal benefit under Dirks and its progeny. . . . In other words, Newman cabined the gift theory using two other freestanding personal benefits that have long been recognized by our case law. . . .

. . . Nor does our decision mean that a tipper who accidentally or unknowingly reveals inside information can be found guilty. See id. at 16. Such a tipper would be protected by the requirement that the tipper know (or is reckless in not knowing) that the information is material and non-public, see Obus, 693 F.3d at 286, or by the requirement that the tipper expect the tippee to trade, see United States v. Gansman, 657 F.3d 85, 92 (2d Cir. 2011).

A misappropriation case against Wyoming may be easier to prove. Wyoming’s actions can be likened to “deception of those who entrusted [her] with access to confidential information.” The question is whether she “misappropriate[d] confidential information for securities trading purposes, in breach of a duty owed to the source of the information” (in O’Hagan’s words). To the extent, for example, Green was checking MoBanks’ stock price as part of the firm’s representation of the Bank of St. Louis, her personal use of that information
would be a breach of duty to two sources: both the Bank of St. Louis and Larsen & Gould. The near-simultaneous telephone call by Wyoming to Murtagh should also satisfy the “in connection with the purchase or sale” requirement of Rule 10b-5 in light of the related stock purchases.

In Questions (2)–(4), we address the transactions by (2) Murtagh, (3) Lincoln, and (4) Washington. The starting point is whether Wyoming can be viewed as a tipper under Dirks, making Murtagh a tippee. It is unclear what Wyoming said to Murtagh, but the size of the purchases by Murtagh and Lincoln may be circumstantial evidence of a stock tip. There appears to be no corporate purpose for such a tip. Does this tip constitute a breach of Wyoming’s fiduciary duty? This will turn on whether Wyoming receives a personal advantage from communicating the tip to Murtagh. Has he favored her with other tips or perhaps allocations of “hot” stocks? Was this a “gift of confidential information to a . . . friend” (as described in Dirks)? Is there evidence that Wyoming’s disclosure of inside information was intended to benefit Murtagh?

Regarding Lincoln, there is a separate factual question about whether she knew the source of the information to buy MoBanks shares. If she did not know it was Wyoming, she can argue she is not a tippee since she did not know the information arose from the breach of a duty. Recall that Newman (described in Martoma) required a tippee to be aware, not only that the tipper breached a fiduciary duty in disclosing inside information, but also that the tipper received a personal benefit. Lincoln will, however, need to address her knowledge of Murtagh’s trading (that he had never before bought shares across all of his family accounts), which might suggest she had some knowledge (or was reckless in not knowing) of the source of the information.

Likewise, Washington may not have known the source of the information and, therefore, was not aware that the tipper breached a fiduciary duty or received a personal benefit. Lincoln told Washington to buy MoBank shares, and he did so. (“Hey Jim, MoBank is hot right now, something is going on, you should buy,” might have been the extent of the conversation.) There is nothing in the Problem suggesting Washington knew, or was reckless in not knowing, of Wyoming’s breach of a duty.

**Problem 13-2**

Former business school classmates, Mike Jones and Sara Sanchez, share a one room business office in Silicon Valley. Each operates a separate financial consulting firm.

Recently Jones overheard Sanchez discuss “the Incubator deal” with a client. Jones knows that Sanchez is on retainer to Incubator, Inc. Jones telephones his broker, Kelley Gunn, and asks for a research report on Incubator, a local biotech firm. Gunn telephones later that day with an upbeat report and Jones buys 1,000 shares of Incubator.

The next day Macrohard announced a friendly tender offer for Incubator at a 50 percent premium above the prior day’s stock market.

Has Sara Sanchez or Mike Jones violated Rule 10b-5?
Has Mike Jones violated Rule 14e-3?
ANALYSIS:

(1) Problem 13-2 initially involves a potential tipping and misappropriation problem, somewhat similar to Problem 13-1.

Jones learned of a potential tender offer not by design of a tipper (Sara Sanchez) or by his own design, but by accident. Given the arguable lack of culpability, he can claim there was no violation of Rule 10b-5.

Jones can also argue that Sanchez does not qualify as a tipper. Sanchez’s speaking openly about a confidential deal may have breached a duty (the duty of care), but the Problem does not indicate that Sanchez received a personal benefit, and absent that benefit, she would not qualify as a tipper. Of course, tips are easier to infer with trading friends or, presumably, co-tenants. What could be argued to be innocent could also be challenged by the SEC or Justice Department as involving reciprocal tips, in which case Sanchez could be found to have personally benefited—but the Problem does not indicate this to be the case.

The misappropriation case may also be weak. Jones does not appear to have misappropriated information or engaged in any deception to the source of the information. None of the enumerated duties of trust or confidence in Rule 10b5-2 appears to apply here.

(2) Rule 14e-3 was an SEC response to Chiarella, addressing insider trading before a tender offer was launched. The Rule was held to be validly adopted in O’Hagan, despite the lack of a fiduciary requirement.

Rule 14e-3 does have a culpability element. For Jones to be liable, he must be in possession of material information relating to a tender offer, which he knows or has reason to know was acquired directly or indirectly from one of the three types of persons specified in Rule 14e-3—(i) the offering person, (ii) the issuer of the securities sought or to be sought by such tender offer, or (iii) any officer, director, partner, or employee or any other person acting on behalf of the offering person or such issuer—unless, within a reasonable time prior to any purchase or sale, such information and its source are publicly disclosed by press release or otherwise.

Here, a case against Jones would fail unless it could be shown that (1) Jones had material information relating to the tender offer and (2) he knew or should have known that the information was acquired from one of the three types of persons listed above. Jones would argue that all he knew was: Sanchez worked for Incubator; there was a “deal,” but what type of deal and the timing of the deal was unknown; and his broker had given an upbeat report on Incubator. Jones’ protestations carry much less weight if he knew that Sanchez was a tender offer specialist, particularly if he knew that Sanchez was retained by Incubator as part of a takeover.

If (1) and (2) in the preceding paragraph could be demonstrated, Rule 14e-3 also requires that a substantial step be taken to commence the tender offer—very likely in this Problem since the tender offer was announced the next day.
PROBLEM 13-3

(1) If a person acquires 120,000 shares of a registered security, of which there are 1,000,000 shares outstanding, on May 1; purchases an additional 50,000 shares on July 1; sells 70,001 shares on September 1; and sells all of his remaining 99,999 shares on September 5; for which, if any, shares would the person be liable under Section 16(b)?

(2) Suppose that a corporation has a listed common stock outstanding and also a convertible preferred which is neither listed nor registered under Section 12(g) (because not held by more than 500 persons). A owns 90% of the preferred issue, which is convertible into more than 10% of the common, assuming complete conversion. The owner purchases and sells preferred within a period of six months. Under the Chemical Fund rationale, is the owner subject to liability under Section 16(b) as a 10% holder of a registered security?

ANALYSIS:

Section 16(b) provides in relevant part: “[A]ny profit realized [by any beneficial owner of more than 10 percent of any class of any equity security registered under the 1934 Act, or a director or officer of the issuer of such security] from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period less than six months . . . shall inure to and be recoverable by the issuer, irrespective of . . . intention . . . .”

This is the original insider trading section in the 1934 Act. There are five basic elements. Any profit realized by (1) a >10 percent beneficial owner, director, or officer from (2) any purchase and sale, or any sale and purchase, of any equity security of a public company (3) within any period less than six months (4) shall be recoverable by the issuer (5) irrespective of the insider’s intention.

A beneficial owner must own >10 percent both at the time of purchase and of sale. For example, if you own nothing, then buy 11 percent, and sell all 11 percent within six months, there is no liability. But if you own 10.01 percent, then buy 5 percent and sell it within six months, there is liability on the 5 percent. See “Ten Percent Holder.”

Accordingly, in Question (1), only 50,000 of the shares sold on September 1 are subject to Section 16(b). The first purchase is excluded by Foremost-McKesson, as a purchase before insider status had been acquired. The last 99,999 shares are not actionable under Reliance Electric because the seller owned less than 10 percent when the order was placed.

Question (2) is a permutation of Chemical Fund. This preferred stock satisfies the definition of equity security in Section 3(a)(11) (and Section 16(b)) of the 1934 Act. Under Chemical Fund, preferred stock convertible into more than 10 percent of common stock could trigger Section 16(b) liability for purchases and sales after crossing the 10 percent threshold.

Section 16 requires the subject class of equity security to be registered under the 1934 Act. Under Section 12(g), an issuer that is not a bank, bank holding company, or savings and loan holding company is required to register a class of equity securities under the Exchange Act if: (i) it has more than $10 million of total assets; and (ii) the securities are “held of record” by either 2,000 persons, or 500 persons who are not accredited investors. In this case, the preferred stock is neither listed nor held by more than 500 persons, and so it is not registered under the 1934 Act even though the common stock is. This difference in 1934 Act registration, between the preferred stock and common stock, is not addressed in Chemical Fund—but,
logically, that should not affect the core analysis that treats the preferred stock as equivalent to the common stock for purposes of Section 16(b) compliance.
CHAPTER 14: SEC ENFORCEMENT ACTIONS

PROBLEM 14-1

Last year, Hottentot, a securities broker licensed by the National Association of Securities Dealers, was affiliated with two companies, FCN Financial Services and Burnett Grey & Co. These companies were approached by the principals of a company called EDP to help create a market for EDP stock. The stock was not registered with the SEC. At the time, Hottentot was President of Burnett Grey, a broker-dealer firm, and Secretary of FCN, a company that advised clients on taking private companies public, meeting regulatory and compliance requirements relating to such undertakings, and promoting such companies to brokerage firms. In these capacities, she became involved in marketing EDP stock. Last year, Burnett Grey and FCN made four trades of unregistered EDP stock, in blocks ranging from 75 to 4,200 shares.

In marketing the stock, Hottentot did not ensure that EDP had registered its offering with the SEC. Hottentot relied on advice from Peterson, her personal attorney, who heard her oral description of EDP, then stated “this sounds like an exempt transaction to me.” Neither Hottentot nor Petersen learned that EDP was apparently a “sham” corporation, which had overstated the value of its assets and which had no real headquarters or employees.

Can the SEC permanently enjoin Hottentot from future violations of the securities laws?

ANALYSIS:

Until the cease and desist order became predominant, the injunction was the most common SEC remedy. Section 21(d) of the 1934 Act provides:

(d)(1) Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this title, the rules or regulations thereunder, . . . it may in its discretion bring an action . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. . . .

The Commission is not required to show the risk of irreparable injury or the unavailability of remedies at law. See SEC v. Unifund SAL, 910 F.2d 1028 (2d Cir. 1990). The Commission is subject to a “likelihood of success” standard in seeking a preliminary injunction. In essence, the Commission must (1) show a likelihood of success to prove both (2) a current violation and (3) the risk of repetition.

Consider this summary from the casebook of the factors courts consider when analyzing the risk of repetition:

(1) whether the defendant committed a past violation; (2) whether and to what degree scienter was present in the past violation; (3) whether the past violation can be properly characterized as an isolated occurrence; (4) whether the defendant has acknowledged the wrongfulness of the past conduct and given assurance that the violation will not be repeated; and (5) whether the defendant’s occupation puts him or her in a position to commit further violations.
A mere recitation of past violations is insufficient. In *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450 (2d Cir. 1996), the court concluded:

An injunction prohibiting a party from violating statutory provisions is appropriate where “there is a likelihood that, unless enjoined, the violations will continue.” . . . Such an injunction is particularly within the court’s discretion where a violation was “founded on systematic wrongdoing, rather than an isolated occurrence,” [citation omitted] and where the court views the defendant’s degree of culpability and continued protestations of innocence as indications that injunctive relief is warranted, since “persistent refusals to admit any wrongdoing make it rather dubious that [the offenders] are likely to avoid such violations of the securities laws in the future in the absence of an injunction.”

Problem 14-1 is a close case. Given the facts, the Commission should have little difficulty establishing a violation for failure to register. It is less certain the Commission will be able to show a likelihood of risk of repetition.

If the four trades can be likened to an isolated occurrence, the SEC’s case is weak. The defendant, however, is in a position to commit further violations. In some courts, acknowledgment of wrongfulness by the defendant and a lack of prior violations would be outcome determinative.

Consultation with a personal attorney, in all likelihood, is not helpful here. It is particularly unhelpful if the personal attorney has no background in securities law. As one court wrote: “A good faith reliance on the advice of counsel is not a defense to securities fraud. It is simply a means of demonstrating good faith and represents possible evidence of an absence of any intent to defraud.” *United States v. Peterson*, 101 F.3d 375, 381 (5th Cir. 1996). If Peterson, however, had a background in securities law and had been consulted before on securities law questions, the extent to which Hottentot could demonstrate good faith and the absence of an intent to defraud would be enhanced. Even then, the lack of any basis for legal advice other than an oral description of a transaction would probably dissuade a court from according much weight to Hottentot’s reliance on counsel.

**Problem 14-2**

June Lui, an associate of the major Wall Street firm of Smith & Folk (“S & F”), has been asked by partner Richard B. Ito to research the proper response to a “client problem.”

S & F’s largest client, World Bank, has hired S & F to complete due diligence on a $1.2 billion debt underwriting to be filed on the SEC’s abbreviated Form S-3.

Currently, interest rates are extremely favorable. World Bank would like Ito to complete his due diligence within three days.

Lui is concerned that World Bank has not produced Board of Directors Executive Committee Minutes for the previous year. She has repeatedly requested the Minutes and has repeatedly been informed, “They are in illegible handwritten form. There isn’t time to type them up. There is nothing of significance in them.”

Lui is aware of rumors that the Internal Revenue Service is conducting an investigation of World Bank, but has found no document to substantiate the rumors. World Bank’s Chief Financial Officer has specifically denied such an IRS investigation.
If Ito signs off on the World Bank underwriting without review of the Executive Committee Meeting Minutes, what risk is there of an S & F Rule 102(e) violation?

Assuming that World Bank refuses to produce the Minutes, what can Ito do that would be consistent with both applicable ABA Model Rules of Professional Conduct and the federal securities laws?

**ANALYSIS:**

(1) For purposes of Problem 14-2, only SEC Rules of Practice 102(e)(1)(ii) and 102(e)(1)(iii) are relevant. Rule 102(e)(1), as amended in 1998, provides in relevant part:

(e) Suspension and Disbarment. (1) Generally. The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter: . . . .

(ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or

(iii) To have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder. . . .

After the Checkosky cases (described in the casebook) raised questions about the Commission’s authority under Rule 102(e) to address negligent accounting, the SEC adopted Rule 102(e)(1)(iv). Because SEC Rule of Practice 102(e)(1)(iv) is limited to licensed accountants, it would not apply to Ito, although the Commission or a court might consider Rule 102(e)(1)(iv) by analogy in addressing the culpability of an attorney under Rule 102(e)(1)(ii).

Since its initial adoption in 1935, Rule 102(e) (before 1995, Rule 2(e)) has been the subject of considerable refinement and debate. After Section 602 of the Sarbanes-Oxley Act (Section 4C of the 1934 Act) was adopted, there was no longer any open question as to the SEC’s authority to adopt Rule 102(e).

In Carter v. Johnson, 47 SEC 471 (1981) (excerpted in the casebook), the Commission applied the aiding and abetting subsection, now Rule 102(e)(1)(iii), and concluded in relevant part:

The second element – substantial assistance – is generally satisfied in the context of a securities lawyer performing professional duties, for he is inevitably deeply involved in his client's disclosure activities and often participates in the drafting of the documents, as was the case with Carter. And he does so knowing that he is participating in the preparation of disclosure documents – that is his job.

In this connection, we do not distinguish between the professional advice of a lawyer given orally or in writing and similar advice which is embodied in drafting documents to be filed with the Commission. Liability in these circumstances should not turn on such artificial distinctions, particularly in light of the almost limitless range of forms which legal advice may take. Moreover, the opposite approach, which would permit a lawyer to avoid or
reduce his liability simply [by] avoiding participation in the drafting process, may well have the undesirable effect of reducing the quality of the disclosure by the many to protect against the defalcations of the few.

For these reasons, the crucial inquiry in a Rule 2(e) proceeding against a lawyer inevitably tends to focus on the awareness or the intent element of the offense of aiding and abetting. . . We do hold, however, that a finding of willful aiding and abetting within the meaning of Rule 2(e)(1)(iii) requires a showing that respondents were aware or knew that their role was part of an activity that was improper or illegal.

It is axiomatic that a lawyer will not be liable as an aider and abettor merely because his advice, followed by the client, is ultimately determined to be wrong. What is missing in that instance is a wrongful intent on the part of the lawyer. It is that element of intent which provides the basis for distinguishing between those professionals who may be appropriately considered as subjects of professional discipline and those who, acting in good faith, have merely made errors of judgment or have been careless.

Applying Rule 102(e)(1)(iii) to Ito, it seems likely that World Bank’s board would not be entitled to a due diligence defense under Section 11 of the 1933 Act if World Bank’s attorney did not review the Executive Committee Minutes. See Analysis to Problem 11-1. This would only be of consequence if World Bank includes a material misstatement or omission in its registration statement. Ito would be wise to insist on reviewing the Minutes to reduce this possibility.

If World Bank does publish a material misstatement or omission, Ito and his law firm will be found to have provided substantial assistance through their due diligence work. See Carter & Johnson.

Before the Dodd-Frank Act amendments, the decisive question was whether the substantial assistance involved “willful” aiding and abetting, which Carter & Johnson characterized as requiring awareness or knowledge that their role was part of an improper or illegal activity. That element seems unlikely to be established here. The Dodd-Frank Act, however, lowered the standard from “knowing and substantial” assistance to “knowing or reckless and substantial” assistance (see Section 929O of the Dodd-Frank Act, amending Section 20(e) of the 1934 Act). A case could be made that if Ito signs off on the due diligence—without reviewing the Executive Committee Minutes—his conduct will rise to the level of recklessness.

It is also worth noting, since Carter & Johnson, virtually all Rule 102(e) proceedings against attorneys have followed an earlier injunction or conviction based on a securities law violation.

(2) Carter & Johnson also addressed what is now Rule 102(e)(1)(ii) and concluded:

The Commission is of the view that a lawyer engages in “unethical or improper professional conduct” under the following circumstances: When a
lawyer with significant responsibilities in the effectuation of a company’s compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client’s noncompliance. The Commission has determined that this interpretation will be applicable only to conduct occurring after the date of this opinion.

We do not imply that a lawyer is obliged, at the risk of being held to have violated Rule 2(e), to seek to correct every isolated disclosure action or inaction which he believes to be at variance with applicable disclosure standards, although there may be isolated disclosure failures that are so serious that their correction becomes a matter of primary professional concern. It is also clear, however, that a lawyer is not privileged to unthinkingly permit himself to be co-opted into an ongoing fraud and cast as a dupe or a shield for a wrong-doing client.

Initially, counseling accurate disclosure is sufficient, even if his advice is not accepted. But there comes a point at which a reasonable lawyer must conclude that his advice is not being followed, or even sought in good faith, and that his client is involved in a continuing course of violating the securities laws. At this critical juncture, the lawyer must take further, more affirmative steps in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of non-disclosure.

The lawyer is in the best position to choose his next step. Resignation is one option, although we recognize that other considerations, including the protection of the client against foreseeable prejudice, must be taken into account in the case of withdrawal. A direct approach to the board of directors or one or more individual directors or officers may be appropriate; or he may choose to try to enlist the aid of other members of the firm’s management. What is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desires of a strong-willed, but misguided client.

Following *Carter & Johnson*, counseling would appear to be appropriate. There does not seem to have been “a substantial and continuing failure to satisfy . . . disclosure requirements” that would justify resignation or an approach to the board of directors under Rule 102(e).

In 2002, Section 307 of the Sarbanes-Oxley Act directed the SEC to adopt a rule requiring an attorney who appears and practices before the Commission “to report evidence of a material violation of securities law” to the company’s chief legal counsel or chief executive officer, and—in the absence of an appropriate response to the evidence—to the board’s audit committee, to another board committee comprised only of independent directors, or to the board. Section 307, and the SEC Standards of Professional Conduct for Attorneys (“SPCA”), clarify that lawyers representing issuers represent the entity, not an individual (see SPCA
Rule 3(a)). As a result, they have obligations to report “up” within the issuer and determine whether the issuer's response is sufficient (see SPCA Rules 3(b) and 3(c)). In addition, the Rule allows lawyers to report “out” to the SEC in certain circumstances (see SPCA Rule 3(d)).

The American Bar Association has long discouraged proceeding outside a company to report evidence of securities law violations as being inconsistent with a lawyer’s duty of confidentiality, now in Rule 1.6 (“Confidentiality of Information”) of the Model Rules of Professional Conduct.

**PROBLEM 14-3**

Finance Franchises (FF) is a registered broker-dealer that has adopted a series of cutting-edge approaches to supervision. Virtually all of its registered representatives are independent contractors, rather than employees. Most operate in single person offices. Much supervision is done by computer programs that review daily trading records.

Pam Backman, Chief of Compliance, recently became concerned that John Caviness, an FF independent contractor, may have been excessively trading six specific accounts. Should she:

1. Telephone Caviness and ask for an explanation?
2. Plan an unscheduled examination of his office?
3. Report the pattern of trading to Caviness’s line supervisor?
4. Report the trading pattern to Paul Gorgen, FF’s chief executive officer?
5. Review FF’s compliance procedures?
6. Seek to fire Caviness if he is found to have excessively traded?

**ANALYSIS:**

Supervision is always a hot topic for broker-dealers. In *John H. Gutfreund*, 51 SEC 93 (1992), the SEC focused on the senior officers of a major brokerage firm:

1. “A chief executive officer [of a brokerage firm] has ultimate affirmative responsibility, upon learning of serious wrongdoing within the firm as to any segment of the securities market, to ensure that steps are taken to prevent further violations of the securities law and determine the scope of wrongdoing.”

2. “Employees of brokerage firms who have legal or compliance responsibilities do not become ‘supervisors’ for purposes of Sections 15(b)(4)(E) and 15(b)(6) [of the 1934 Act] solely because they occupy those positions. Rather, determining if a particular person is a ‘supervisor’ depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.”

3. The chief legal officer of a brokerage firm who was informed by senior management of the serious misconduct of a senior firm official, and who was involved as part of management’s collective response to the problem, was a “supervisor” for purposes of Sections 15(b)(4)(E) and 15(b)(6). A legal officer in such
a position cannot be a mere bystander to the events that have occurred.

(4) Brokerage firm employees with legal or compliance duties who become involved in formulating management’s response to misconduct must take affirmative steps to ensure that appropriate action is taken to address such misconduct. “If such a person takes appropriate steps but management fails to act and that person knows or has reason to know of that failure, he or she should consider what additional steps are appropriate to address the matter, [such as disclosure to the board of directors,] resignation from the firm, or disclosure to regulatory authorities.”

In Royal Alliance Assoc., Inc., SEC Release No. 38,174, 63 SEC Dock. 1606, 1610 (1997), a consent settlement, the Commission addressed supervision of branch offices that have only a single or a small number of representatives:

. . . Royal Alliance operates 1,500 offices with 2,700 registered representatives. Some 49 of these are one-person Offices. Here, Royal Alliance’s failure to scrutinize adequately the securities-related businesses of its registered representatives, which were conducted beyond the direct aegis of the firm, was a certain recipe for trouble. Further, Royal Alliance’s practice of conducting a pre-announced compliance examination only once a year was inadequate to satisfy its supervisor obligations. Indeed, we harbor grave doubts that this practice would necessarily discharge the supervisory obligations of any firm that incorporates a structure in which smaller branch offices are operated by only one or two representatives. See, e.g., In the Matter of Consolidated Investment Services, Exchange Act Release No. 36,687 (Jan. 5, 1996) (broker-dealer supervision of a small office run by a single registered representative inadequate without surprise inspections).

In Quest Capital Strategies, Inc., SEC Release No. 44,935, 76 SEC Dock. 102, 106 (2001), the Commission again highlighted the stringency of the supervision requirement:

The Securities Exchange Act empowers us to discipline supervisors on the basis of a failure “reasonably to supervise, with a view to preventing violations of the [securities laws]” by persons subject to their supervision who violate these laws. We have made it abundantly clear that supervisors must act decisively to detect and prevent violations of the securities laws when an indication of irregularity is brought to their attention. Moreover, once a supervisor learns that a registered representative has engaged in misconduct, the representative cannot be retained unless he or she is subjected to enhanced supervision. . . .

This record reveals a substantial abdication of supervisory responsibility. We have repeatedly stressed that supervisors cannot rely on the unverified representations of their subordinates, including responses to questionnaires like those employed by Quest . . . Respondents could have taken a number of steps to implement a heightened supervision of Nakoski. Quest could have conducted surprise inspections of Nakoski’s branch office. Respondents argue
that, since they had no proprietary or equity interest in the office, they had no right to conduct an inspection without Nakoski’s permission. In fact, Quest’s independent contractor’s agreement with Nakoski gave Respondents that right. In any event, securities firms are required to supervise their employees. A surprise inspection is a compliance tool that is necessarily available to every securities firm in carrying out its supervisory responsibilities. A firm cannot permit its ability to supervise effectively to be negated or impeded by an “independent contractor” whose right to engage in the securities business depends on affiliation with a registered firm charged with the duty to supervise.

Moreover, in 2004, the SEC Division of Market Regulation published a legal bulletin, available at http://www.sec.gov/interp/legal/mrslb17.htm#P57_12244, to remind brokers that small, remote offices require vigilant supervision. It also described certain tools it found were characteristic of good supervisory procedures, including the use of unannounced onsite inspections, and offsite monitoring of trading, handling of funds, and use of personal computers. The bulletin noted:

Some broker-dealer firms have geographically dispersed offices staffed by only a few people, and many are not subject to onsite supervision. Their distance from compliance and supervisory personnel can make it easier for registered representatives (representatives) and other employees in these offices to carry out and conceal violations of the securities laws. The supervision of small, remote offices, therefore, can be especially challenging. The Commission staff has examined branch offices and the Commission has brought numerous enforcement cases involving inadequate supervision of these small, remote offices. These cases address situations in remote offices where supervisory mechanisms failed to detect and prevent misconduct. These cases illustrate gaps in firms’ supervisory systems and provide insight into the steps that can help firms achieve effective remote office supervision.

Against this backdrop, Backman would want to carefully consider each of the six alternatives.

Alternatives (1)–(3): The SEC favors surprise inspections, but this does not preclude other supervisory techniques, when appropriate. Normally, a chief of compliance would ask the line supervisor to take the lead. In some circumstances, a direct telephone call, usually from the immediate supervisor, would be appropriate.

Alternative (4): Unless a potential or actual legal violation was particularly serious, it would be unusual before an investigation to involve a CEO in supervision. In contrast, if a serious violation or pattern of violations is established, the Gutfreund case indicates that CEO involvement may be necessary.

Alternative (5): Royal Alliance, Quest, and the 2004 bulletin indicate that single-person offices and offices with independent contractors have been a focus of the SEC. It may well be wise, regardless of Caviness’ conduct, and even though the 2004 bulletin is over a decade
old, to review FF’s compliance procedures to ensure they reflect current requirements and practices.

Alternative (6): If Caviness has excessively traded, firing is an option. Whether it would be appropriate turns on considerations such as culpability (Did he know he was excessively trading and intended to do so? Was he reckless?) and frequency of violations (Is this a first violation, where a warning may suffice, or have there been earlier violations with earlier warnings?). If he is not fired, FF should subject him to enhanced supervision for a probationary period.

PROBLEM 14-4

The SEC has filed a four-count complaint against Defendants Yun Soo Oh Park, a.k.a. Tokyo Joe (“Park”), and Tokyo Joe’s Societe Anonyme Corp. (collectively, the “Defendants”), as a result of Defendants’ conduct on their web site, which allegedly violates various SEC regulations.

In year three, Park incorporated Tokyo Joe’s Society Anonyme Corp. (hereinafter “Societe Anonyme”). Societe Anonyme was never registered under the Investment Advisers Act of 1940.

In year one, Park began posting messages on various public financial Internet bulletin boards, which allow people to electronically post and reply to messages regarding stocks, investing, and other financial subjects. During year two, Park posted thousands of messages under the names “Tokyo Joe” or “TokyoMex.” Early year two, individuals from these bulletin boards began directly contacting Park, soliciting further information about stock picks and trading. As a result, in March of year two, Park created an e-mail list and sent individuals on the list his stock picks.

In July of year two, Park set up Tokyo Joe’s Internet site, at tokyo-joe.com, which operated under Park’s control. From July to December of year two, Tokyo Joe’s consisted of two areas. One was a limited area of the web site accessible to the general public, and the other consisted of a more expanded area of the web site accessible only to fee-paying members. From about July to about November of year two, the fee was $299 per year to become a Societe Anonyme member. Members received, among other things, exclusive e-mails of Park’s daily stock picks and unlimited access to the members-only areas of Park’s web site. On or about December of year two, Park added a “chat room” to the members-only area of the web site. The chat room served as a forum in which Park conducted two-way electronic dialogues with Societe Anonyme members about Park’s stock picks and other investment advice. Between July of year two and May of year three, Societe Anonyme’s membership increased from about 200 to 3,800 subscribers.

The SEC brought suit, for among other reasons, Park’s failure to register under the Investment Advisers Act. Park moved to dismiss claiming that he is not subject to the Investment Advisers Act after Lowe.

What result should a court reach on Park’s motion?

ANALYSIS:

The definition of “investment adviser” and the exception for publishers are found in Section 202(a)(11) of the Investment Advisers Act of 1940, which provides in relevant part:

“Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or
writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include . . . (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; . . .

In Lowe v. SEC, 472 U.S. 181 (1985), the Court concluded:

Petitioners’ newsletters are distributed “for compensation and as part of a regular business” and they contain “analyses or reports concerning securities.” Thus, on its face, the basic definition applies to petitioners. The definition, however, is far from absolute. . . .

One of the statutory exclusions is for “the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation.” Although neither the text of the Act nor its legislative history defines the precise scope of this exclusion, two points seem tolerably clear. Congress did not intend to exclude publications that are distributed by investment advisers as a normal part of the business of servicing their clients. The legislative history plainly demonstrates that Congress was primarily interested in regulating the business of rendering personalized investment advice, including publishing activities that are a normal incident thereto. On the other hand, Congress, plainly sensitive to First Amendment concerns, wanted to make clear that it did not seek to regulate the press through the licensing of non-personalized publishing activities.

The Court notably added:

The language of the exclusion, read literally, seems to describe petitioners’ newsletters. Petitioners are “publishers of any bona fide newspaper, news magazine or business or financial publication.” The only modifier that might arguably disqualify the newsletters are the words “bona fide.” Notably, however, those words describe the publication rather than the character of the publisher; hence Lowe’s unsavory history does not prevent his newsletters from being “bona fide.” In light of the legislative history, this phrase translates best to “genuine;” petitioners’ publications meet this definition: they are published by those engaged solely in the publishing business and are not personal communications masquerading in the clothing of newspapers, news magazines, or financial publications. Moreover, there is no suggestion that they contained any false or misleading information, or that they were designed to tout any security in which petitioners had an interest. Further, petitioners’ publications are “of general and regular circulation.” Although the publications have not been “regular” in the sense of consistent circulation, the publications have been “regular” in the sense important to the securities market: there is no indication that they have been timed to specific market activity, or to events affecting or having the ability to affect the securities industry.
Problem 14-4 provides a counterexample. The Problem is based on SEC v. Park, 99 F.Supp.2d 889 (N.D. Ill. 2000), where the district court denied a motion to dismiss after finding:

... Defendants meet the basic definition of an “investment adviser” in that over the Internet they “for compensation, engage in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issue or promulgate analyses or reports concerning securities.” Thus, Defendants must fall within an exclusion in order to not be considered an “investment adviser.” Moreover, in order to avail themselves of the publishers exception, Defendants’ publications over the Internet web site must be both “bona fide” and have a “general and regular” circulation. ...

Defendants’ publications may not be “bona fide” or of “general and regular” circulation. As discussed above, a “bona fide” publication is one that is genuine in that it would contain disinterested commentary and analysis and not be promotional material disseminated by a “tout.” ... On the web site, Defendants persuaded subscribers to purchase, sell, or hold specific stocks using several methods, including posting effusive testimonials and misleading performance results, urging subscribers to hold stocks until they reached certain target numbers, and falsely stating Societe Anonyme’s intentions to purchase certain stocks. Further, the SEC maintains that in certain instances, Defendants were acting as “touts,” by promoting stocks in which they either had an interest or for which they were being paid to recommend without revealing their interests.

Moreover, although Defendants claim that they never provided individualized advice to any clients, it is unclear whether they provided advice that may be viewed as personalized for purposes of the Advisers Act. Defendants allegedly sent e-mails directly to individual e-mail accounts, advising subscribers individually through their e-mail accounts of stock picks. In addition, on the web site, Defendants answered individual questions posed by subscribers in Defendants’ chat room. ...

Defendants’ publications may also not have a “general and regular” circulation. In Lowe, the Supreme Court found that a publication with a “general and regular” circulation would not include “people who send out bulletins from time to time on the advisability of buying and selling stocks.” ... Also, the court found that a “regular” circulation, more importantly, would not be “timed to specific market activity, or to events affecting or having the ability to affect the securities industry.” ... Defendants claim that they posted stock picks and information regularly throughout the business day. Although Defendants may have made postings on a daily basis, it is unclear whether Defendants did not time their advice to “specific market activity, or to events affecting or having the ability to affect the securities industry.” The SEC has alleged that Defendants sporadically disseminated their advice each
day so as to take advantage of certain prices and inflate them or to sell or purchase their own shares of a particular stock profitably. If those allegations prove to be true, there will not be anything “general and regular” about the Defendants’ publications.

Id. at 895-896.

The approach taken in the Park case was not appealed and, for now, is the last word on this type of case.

**Problem 14-5**

A commentator on a financial news TV show made highly laudatory statements about Zweig, Inc., the day after purchasing 5000 shares of Zweig’s stock. The next day the Zweig stock rose 15 percent. Has the commentator violated the Investment Advisers Act? Has the commentator violated Rule 10b-5 of the Securities Exchange Act? In either case, is it a defense that every statement made was believed to be true?

**Analysis:**

The type of misconduct described in Problem 14-5, variously called scalping or frontrunning, was also at issue in SEC v. Capital Gains Research Bur., Inc., 375 U.S. 180 (1963). Nonetheless, it is unlikely that Section 206, the antifraud provision of the Advisers Act, would apply to a television news commentator who presumably is not an investment adviser. See Section 202(a)(11)(D) of the Advisers Act.

The leading Rule 10b-5 scalping case before Chiarella v. United States, 445 U.S. 222 (1980), was Zweig v. Hearst, 594 F.2d 1261 (9th Cir. 1979). The Zweig case involved a newspaper columnist who published a highly favorable description of a business corporation. The newspaper allegedly contained material misrepresentations made to the columnist by firm insiders. The column was published after the columnist had purchased 5,000 shares of the firm’s stock at a substantial discount from the market price. After the column appeared, the price of the firm’s stock rose swiftly.

Focusing on the columnist’s alleged omissions of material nonpublic information, the decision considered whether Rule 10b-5 required the columnist to inform readers of his existing stock interest in the firm when the column was printed. The Ninth Circuit held that the columnist’s “relationship to the public was not a fiduciary one under common law, but that is not dispositive of the Rule 10b-5 claim.” Id. at 1269. To justify this result, the court analogized the columnist to a “quasi-insider,” a concept defined by The American Law Institute Federal Securities Code to include persons, such as judges’ clerks, who trade on information in unpublished opinions. Id. at 1267 n.9.

This analogy may not be persuasive after Chiarella. By definition, “quasi-insiders” in the ALI formulation are not subject to a fiduciary duty, but rather represent a “new category” of people who, on policy grounds, the ALI believes should be liable. Because Chiarella requires specification of a “fiduciary or other similar relation of trust,” 445 U.S. at 228, the analogy to a case that did not purport to identify a fiduciary duty appears unpersuasive. The SEC, however, has argued that Chiarella did not overrule Zweig because a columnist’s Rule 10b-5 disclosure obligation is premised on a fiduciary relationship of trust and confidence between
the columnist and her readers. In *SEC v. Park* (described in Problem 14-4), the court considered this argument and concluded, “Zweig still seems to be good law.” *Park*, 99 F.Supp.2d at 899.

Alternatively, the misappropriation theory may be applicable here. Under the logic of *United States v. O’Hagan*, 521 U.S. 642 (1997), the question becomes whether there was a deceptive breach of a duty to the source of the information. (One can argue that the broadcaster’s decision to promote Zweig is an asset of the TV company. Buying Zweig on the basis of the forthcoming report, without notifying the TV company, would involve the broadcaster’s use of a company asset for personal gain. In that regard, consider *Carpenter v. United States*, 484 U.S. 19 (1987), regarding defendant Foster-Winans, who co-wrote the “Heard on the Street Column” for the Wall Street Journal from 1982 to 1984, and was convicted of insider trading and mail fraud for leaking advance word of the contents of his columns to a stockbroker. The Court noted that the Journal had a “property” right in keeping confidential and making exclusive use, prior to publication, of the schedule and contents of Foster-Winans’ columns.) Of course, if the statements were simply fabrications, Rule 10b-5 can be pled without regard to a duty. In either case, the plaintiff would need to demonstrate that the Zweig trades were in connection with the statements.

Under *Capital Gains*, truth is not a defense to scalping. Presumably, this would apply equally to Rule 10b-5.

Note that, under FINRA Rule 2241, a research analyst at a member firm must disclose in her research report “if the research analyst or a member of the research analyst’s household has a financial interest in the debt or equity securities of the subject company (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), and the nature of such interest.” Although this Rule does not apply to the TV company, it may set a “best practices” standard for the TV company to adopt.
CHAPTER 15: CRIMINAL ENFORCEMENT OF THE FEDERAL SECURITIES LAWS

PROBLEM 15-1

You are assisting the general counsel of FINRA in formulating a policy regarding the sharing of the results of FINRA investigations with investigators from the SEC and with the FBI. Write down a list of pros and cons of a policy of open collaboration, in which FINRA’s Department of Enforcement routinely shares data, testimony, and findings of FINRA investigations with government investigators.

ANALYSIS:

Pros:

- Allows government to defray costs of investigations, since industry members support the FINRA budget
- FINRA may have better talent and better incentives, since they are not subject to civil service rules
- FINRA may have better expertise, since it is composed of industry insiders with better access to information
- FINRA may have greater cooperation with targets of investigations
- FINRA may have better access to technology in light of how it is funded
- Constitutional limitations do not apply (e.g., no Fourth or Fifth Amendment rights)
- Two heads may be better than one (e.g., different cultures may breed different approaches to investigations that help reduce errors)

Cons:

- To the extent FINRA is captured by the industry, its investigatory choices will be distorted (e.g., away from large firms; toward shading facts to find no violations)
- Likewise, FINRA investigators may not have the same public-minded motives as government investigators
- Arguments about access to information and trust are out of equilibrium—once the industry realizes this, it will treat FINRA more like the government
- The lack of constitutional constraints is also out of equilibrium, but the risk is even greater in a criminal case that is most likely to lead to a challenge over FINRA’s status as a non-governmental actor; if FINRA is deemed to be a governmental actor, it may lose the benefits of self-regulation entirely
CHAPTER 16: INTERNATIONAL ENFORCEMENT

PROBLEM 16-1

The sole business of Southeast Asian and European Overseas Traders (SAED), a Panamanian corporation, is to invest in securities. It is wholly owned by Allen Truck, a citizen of Canada. While vacationing in Florida, Truck made offers by telephone and e-mail, and closed a transaction with a French bank, located in Paris, to sell SAED securities.

(1) Would such conduct be sufficient to establish jurisdiction in a private action under the Securities Exchange Act?

(2) Assuming all facts are the same, but the SEC decided to bring an enforcement action, would they be able to establish jurisdiction?

ANALYSIS:

(1) In *Morrison v. National Australian Bank Ltd.*, the Supreme Court held that Section 10(b) of the 1934 Act applies only to “transactions in securities listed on domestic exchanges and domestic transactions in other securities.” A bright-line test focused on the location of the transaction. Based on the facts in this Problem, the issue is whether Truck’s conduct in the United States (offers by telephone and e-mail, and closing a transaction with a French bank) gives rise to a “domestic transaction.”

The Second Circuit in *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 2012 WL 661771 (2d Cir. 2012), under *Morrison*, held that “to sufficiently allege the existence of a ‘domestic transaction in other securities,’ plaintiffs must allege facts indicating that irrevocable liability was incurred or that title was transferred within the United States.” Subsequently, in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, 763 F.3d 198 (2d Cir. 2014), the Second Circuit held that Section 10(b) does not reach foreign squared transactions involving “securities-based swap agreements based on the price movements of foreign securities,” where the claim is based on “largely foreign conduct” and the “foreign defendants [had] no alleged involvement in plaintiffs’ transactions.” Plaintiffs relied on “various manipulative actions to deny and conceal Porsche’s intention to take over [Volkswagen AG]” when making U.S.-based swap agreements and suffered large losses when Porsche’s intentions became public. The court held that “while *[Morrison]* unmistakably made a domestic securities transaction (or transaction in a domestically listed security) necessary to a properly domestic invocation of § 10(b) of the Securities Exchange Act of 1934, such a transaction is not alone sufficient to state a properly domestic claim under the statute.” The Ninth Circuit rejected *Parkcentral’s* “necessary but not sufficient” test in *Stoyas v. Toshiba Corp.*, 896 F.3d 933 (9th Cir. 2018), holding that “*Parkcentral’s* analysis relies heavily on the foreign location of the allegedly deceptive conduct, which *Morrison* held to be irrelevant to the Exchange Act’s applicability, given Section 10(b)’s exclusive focus on transactions.” Thus, in *Stoyas*, the court determined that the presence of a domestic transaction is sufficient, and whether liability applies should be decided under the “in connection with” requirement.

In Circuits following the Second Circuit, allegations that the transactions were negotiated and closed in the United States would be sufficient to establish jurisdiction, even
under Parkcentral. Pursuant to Stoyas, the presence of a domestic transaction alone would be sufficient in the Ninth Circuit. Problem 16-1 would appear to satisfy both Circuits.

You may want to ask the students what the analysis would be if, instead of what is described in the Problem, the transactions involved options arranged by Truck (who, in this example, has no ties to SAED) that were bought domestically by a U.S. purchaser from a U.S. seller and whose value is tied to changes in SAED’s stock price. SAED made false statements to European investors (where the SAED shares are traded) that were picked up by the global press corps and published in the United States. Later, when accurate statements were made public, the resulting effect on the SAED stock price caused U.S. options-holders to lose hundreds of millions of dollars. What would the analysis be then? This fact pattern looks much more like Parkcentral, where there were domestic transactions, but all other significant aspects occurred offshore. Jurisdiction becomes less clear in the Second Circuit, although the presence of a domestic transaction is sufficient under Stoyas in the Ninth Circuit.

(2) In considering whether the SEC would be able to establish jurisdiction, the threshold question is whether the court would find that the Dodd-Frank Act restored the “conduct and/or effects test” to SEC enforcement actions. Section 929P(b) of the Dodd-Frank Act adds a phrase to Section 22 of the 1933 Act and Section 27 of 1934 Act that grants U.S. district courts jurisdiction over SEC or DOJ actions when “conduct within the United States . . . constitutes significant steps in furtherance of the violation” (even if the securities are not traded in the United States)—exactly the result Morrison rejected for private litigants. The legislative history makes clear that Congress intended for Section 929P(b) to rebut the presumption against extraterritoriality and reinstate the “conduct and/or effects” test to SEC and DOJ enforcement actions. If it does not, the analysis is the same as that for a private plaintiff in Question (1).

In IIT v. Vencap, Ltd., 519 F.2d 1001 (2d Cir. 1975), the Second Circuit focused on certain actions essential to the consummation of the fraud taking place in the New York City offices of the defendant’s attorneys. It then explained why this conduct was sufficient to support subject matter jurisdiction:

We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners. This country would surely look askance if one of our neighbors stood by silently and permitted misrepresented securities to be poured into the United States. By the same token, it is hard to believe Congress meant to prohibit the SEC from policing similar activities within this country. . . . If there would be subject matter jurisdiction over a suit by the SEC to prevent the concoction of securities frauds in the United States for export, there would also seem to be jurisdiction over a suit for damages or rescission by a defrauded foreign individual. Our ruling on this basis of jurisdiction is limited to the perpetration of fraudulent acts themselves and does not extend to mere preparatory activities or the failure to prevent fraudulent acts where the bulk of the activity was performed in foreign countries, such as in Bersch. Admittedly the distinction is a fine one. But the position we are taking here itself extends the application of the securities laws to transnational transactions beyond prior decisions, and the line has to be drawn somewhere
if the securities laws are not to apply in every instance where something has happened in the United States, however large the gap between the something and a consummated fraud and however negligible the effect in the United States or on its citizens.

In Problem 16-1, the question would likely focus on whether the fraud took place in the United States during Truck’s solicitation efforts or the closing of the transaction in the United States. If it did, it would appear to be sufficient under the conduct and/or effects test for the SEC to establish jurisdiction.