

Federal Securities Law

Second Edition

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Preface

This monograph provides an introduction to and overview of the complexities of litigation involving the federal securities laws, with an emphasis on the issues that are most likely to arise in litigation: basic registration, disclosure, and antifraud provisions. Because of space limitations, the monograph does not address the securities laws governing securities professionals and the operation of the securities markets, or the regulation of investment companies and investment advisers. At the end of the monograph there is a list of selected references for further reading.

Codification of the securities laws is extremely confusing. Of the seven federal securities statutes, the acts referred to most frequently in this monograph are the Securities Act of 1933 and the Securities Exchange Act of 1934. As is the case with all of the federal securities laws, the section numbers of the acts do not coincide with the U.S. Code cites; citations in the text are to the sections of the respective act and are not footnoted. The appendix contains conversion charts to help locate the correlative section of the U.S. Code. The 1933 and 1934 Acts, like other securities statutes, are evolving laws. For example, in 1968 Congress added the Williams Act amendments, which introduced federal regulation of tender offers, and in 1975 there were significant amendments to the 1934 Act's market regulation provisions. In 1995 and 1998 litigation reform provisions were added to the securities laws. Most recently, in 2002, the Sarbanes-Oxley Act introduced a number of corporate governance reforms and enhanced criminal penalties.

The SEC's rules are found in Part 17 of the Code of Federal Regulations. Rules under the 1933 Act are found in 17 C.F.R. §§ 230.100–230.904 (2002) and are numbered from 100 to 904. The 1934 Act rules are found in 17 C.F.R. §§ 240.01–240.31.1 (2002) and are numbered according to the section of the Act (e.g., Rule 10b-5 is promulgated under section 10(b)).

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I. Introduction

A. *The Federal Securities Laws*

Shortly after the Wall Street crash of 1929, Congress entered the securities regulatory arena with the Securities Act of 1933. When Franklin Roosevelt signed that act into law, he announced that securities law was to be changed from a system of *caveat emptor* to one of *caveat vendor*. As such, the Securities Act was the first federal consumer protection statute relating to securities.¹ Currently, there are seven statutes in this area: the Securities Act of 1933,² the Securities Exchange Act of 1934,³ the Public Utility Holding Company Act of 1935,⁴ the Trust Indenture Act of 1939,⁵ the Investment Company Act of 1940,⁶ the

1. S. Rep. No. 73-47, at 6–7 (1933) (ch. 38, Title I, § 1, 48 Stat. 74).

2. 15 U.S.C. §§ 77a–77z (2000 & Supp. 2001) (referred to alternatively as the “1933 Act” and the “Securities Act”).

3. 15 U.S.C. §§ 78a–78ll (2000 & Supp. 2001) (referred to alternatively as the “1934 Act” and the “Exchange Act”).

4. 15 U.S.C. §§ 79 to 79z-6 (2000 & Supp. 2001). The Public Utility Holding Company Act of 1935 was enacted to correct abuses in financing and operating public utilities. Most of the SEC’s work in this area has been completed.

5. 15 U.S.C. §§ 77aaa–77bbbb (2000 & Supp. 2001). The Trust Indenture Act of 1939 deals with debt financing of public issue companies in excess of a specified amount (currently \$5 million). It imposes standards of independence and responsibility on the indenture trustee for the protection of the security holders.

6. 15 U.S.C. §§ 80a-1 to 80a-64 (2000 & Supp. 2001). The Investment Company Act of 1940 regulates publicly owned companies that are engaged primarily in the business of investing and trading in securities. It regulates investment company management composition, capital structure, advisory contracts, and investment policy modifications, and it requires SEC approval for transactions by such companies with directors, officers, or affiliates. The Act was amended in 1970 to impose additional controls on management compensation and sales charges. The Act also subjects investment companies to the disclosure requirements of the 1933 Act when offering their securities publicly and to the reporting, proxy solicitation, and insider-trading provisions of the 1934 Act.

Investment Advisers Act of 1940,⁷ and the Securities Investor Protection Act of 1970.⁸

The 1933 Act was, and still is, directed primarily at public offerings of securities. Subject to certain exemptions, the 1933 Act requires the registration of all securities when first made publicly available. Many states had already adopted their own securities laws (so-called “blue sky” laws), which contained a merit approach under which the state securities commissioner could examine the merits of the investment and then decide if the securities were suitable for a public offering. After considerable debate, Congress decided not to adopt the merit regulatory approach of the state acts, opting instead for a system of full disclosure. The theory behind the federal regulatory framework is that investors are adequately protected if all aspects of the securities being marketed are fully and fairly disclosed, leaving no need for the more time-consuming merit analysis. The 1933 Act contains a number of private remedies for investors who are injured because of violations of the Act. There are also antifraud provisions that bar material omissions and misrepresentations in connection with the sale of securities. However, the scope of the 1933 Act is limited. The 1933 Act covers only distributions⁹ (both primary and secondary) of securities,

7. 15 U.S.C. §§ 80b-1 to 80b-21 (2000 & Supp. 2001). The Investment Advisers Act of 1940, as amended in 1960, established a scheme of registration and regulation of investment advisers comparable to that in section 15 of the 1934 Act with respect to broker-dealers (discussed in detail later).

8. 15 U.S.C. §§ 78aaa–78lll (2000). The Securities Investor Protection Act of 1970 established the Securities Investor Protection Corporation (SIPC) to aid securities firms in financial difficulty. The SIPC is involved in insolvent firms’ liquidation and payment of claims asserted by customers. The SIPC is funded by monetary assessments on its members and a \$1 billion line of credit from the U.S. Treasury. If the SIPC determines that a member firm is in danger of failing, it may apply to a court both for a decree that the firm’s customers need the protection of the Act and for the appointment of a trustee to liquidate the firm. If the firm’s assets are insufficient to pay all legitimate customer claims, the SIPC must advance to the trustee sufficient funds to satisfy all such claims up to a \$100,000 maximum for each customer (but with respect to claims for cash, not more than \$40,000).

9. *Distribution* is the term used to describe a large infusion of shares into the public markets. As described by Rule 100 of the SEC’s Regulation M, “Distribution means an offering of securities, whether or not subject to registration under the Securities

whereas the 1934 Act addresses all types of securities transactions. Additionally, the 1933 Act's investor protection extends only to purchasers (not sellers) of securities.¹⁰

The essence of registration under the 1933 Act is an initial disclosure document, known as the registration statement. The registration statement is created by a team consisting of lawyers, accountants, the issuer's management, and underwriters. The portion of the registration statement distributed to potential investors is known as the prospectus. The registration statement and prospectus must be filed before any public sale of securities can take place. After the registration statement is filed with the SEC, there is a waiting period during which the SEC reviews the filing for completeness, but not for accuracy. Publicly traded securities are also subject to the registration requirements of the 1934 Act, which impose periodic reporting requirements upon public companies.

Congress enacted the Securities Exchange Act of 1934, extending further regulation over a wider range of participants and transactions in the securities industry. Since the 1934 Act greatly increased the required administrative responsibility, Congress established the Securities and Exchange Commission.¹¹ The 1934 Act regulates all aspects of public trading of securities. It covers sellers as well as purchasers of securities and imposes disclosure, reporting, and other duties on pub-

Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." 17 C.F.R. § 242.100. Difficult questions can arise as to how large an offering is required to trigger the concept of a distribution—as compared with an ordinary secondary transaction in the market. *See, e.g.,* United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969); *In re Ira Haupt & Co.*, 23 S.E.C. 589 (SEC 1946).

10. As discussed more fully in subsequent sections, the 1933 Act imposes disclosure obligations and other restrictions on sellers but not on purchasers of securities. The Act has this focus, since it was aimed at the distribution process. In contrast, the 1934 Act, which addresses transactions generally, imposes obligations on purchasers as well as sellers.

11. *See generally* SEC, A Twenty-Five Year Summary of the Activities of the Securities and Exchange Commission 1934–1959 (1961); Joel Seligman, *The Transformation of Wall Street—A History of the Securities and Exchange Commission and Modern Corporate Finance* (1982).

licly held corporations. It also deals with stock manipulation, insider trading, manipulative or deceptive devices or contrivances in connection with the purchase or sale of stock, misstatements in documents filed with the SEC, and a myriad of other actions affecting securities sales, sellers, and purchasers. The 1934 Act was substantially amended in 1975, largely to increase the SEC's authority over national securities exchanges and the structure of the market system. It has been amended many other times as well.

B. The Securities and Exchange Commission

The federal securities laws are administered by the Securities and Exchange Commission (referred to alternatively as the SEC or the Commission). The SEC is a true “superagency” and exercises most administrative powers, with one exception: It cannot adjudicate disputes between private parties.

Section 4 of the 1934 Act provides that the SEC have five commissioners—appointed by the President of the United States with the advice and consent of the Senate—no more than three of whom can be from the same political party. The main SEC office is in Washington, D.C., and is composed of a number of divisions.¹² There are five regional offices,¹³ and there are district offices within the regions.

The SEC's role in administering the securities laws takes two basic forms: direct SEC regulation through rules, orders, and enforcement; and an elaborate system of industry self-regulation carried out under

12. The key divisions relevant to securities litigation are (1) Corporation Finance (which is often referred to as “Corp. Fin.”), with primary responsibility for examining all registration documents for compliance with the disclosure requirements of the securities laws and preparation of disclosure guides promulgated by the agency; (2) Enforcement, responsible for the investigation of all suspected securities laws violations; (3) Market Regulation, which oversees regulatory practices and policies relating to the exchanges, the over-the-counter markets, and broker-dealers; (4) Investment Management, which administers the Investment Company and Investment Advisers Acts of 1940 and the Public Utility Holding Company Act of 1935; and (5) Office of the General Counsel. Most lawyers contacting the SEC deal with staff members who give informal advice.

13. Regional offices are located in New York, Miami, Chicago, Denver, and Los Angeles.

SEC supervision and oversight. The self-regulatory organizations (SROs) include the securities exchanges, such as the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD), and the Municipal Securities Rulemaking Board, which establishes rules governing municipal securities dealers. Self-regulatory organizations have their own membership criteria, rules of operation, and disciplinary procedures, all of which are subject to SEC review.

Much of the SEC's rule-making power derives from sections of the securities laws that specifically empower the SEC to promulgate rules that have the force of statutory provisions. Rule making by direct legislative delegation necessarily has the effect of law so long as it is carried out according to statute. The SEC has also promulgated a number of interpretive or "safe harbor" rules¹⁴ designed to aid corporate planners and attorneys in complying with the statutes' requirements. Unlike the rules promulgated pursuant to statutory delegation, interpretive rules do not carry the force of law.

Supplementing the rules are the SEC's forms for the various statements and reports that issuers, broker-dealers, and others are required to file under the securities laws. These forms, which have the legal force of administrative rules, play an important part in defining the extent of disclosure obligations in the regulatory scheme.¹⁵

The SEC also engages in a substantial amount of "informal rule making" by setting forth its views on questions of current concern, but not as legal requirements imposed pursuant to formal procedures mandated by the Administrative Procedure Act.¹⁶ The SEC disseminates unsolicited advisory opinions in the form of "releases," which may include guidelines or suggested interpretations of statutory provi-

14. See *infra* text accompanying notes 89–94.

15. SEC Regulations S-K and S-X provide detailed guides for disclosure. Regulation S-K, 17 C.F.R. §§ 229.10 *et seq.* (2002). Regulation S-B is a parallel set of disclosure guides for small businesses. 17 C.F.R. §§ 228.10 *et seq.* (2002). A small business issuer is a United States or Canadian company with annual revenues of less than \$25 million. If the company is a majority-owned subsidiary then the parent must also be a small business issuer in order to qualify. Investment companies do not qualify as small business issuers. Reg. S-B, Item 10(a)(1); Regulation S-X, 17 C.F.R. §§ 210.1-01 *et seq.* (2002).

16. 5 U.S.C. §§ 551–559 (1994).

sions and rules. These releases necessarily provide less precedential and predictive value than rules promulgated under the more formal interpretative rule-making process. One step below interpretive releases are “no-action” letters, which are the SEC’s responses to private requests from individuals, entities, or their attorneys seeking an indication of whether certain contemplated conduct is in compliance with statutory provisions and rules. No-action responses take the form of recommendations from SEC staff members that the Commission take no enforcement action. Although technically not bound by a staff member’s no-action response, the Commission almost invariably follows it.

Broker–dealers (other than those conducting business on a totally intrastate basis) must register with the SEC pursuant to section 15(a) of the Exchange Act of 1934. Registration entails an initial disclosure document plus periodic reporting. Registration subjects broker–dealers to SEC adjudicatory proceedings for imposition of disciplinary sanctions. Although the registration requirements apply only to broker–dealer firms, the SEC has the authority to discipline “associated persons” of broker–dealers, including sales personnel.

Section 15(b)(8) makes it unlawful for any registered broker–dealer to engage in business unless the broker–dealer is a member of a national securities association or effects transactions solely on a national exchange on which the broker–dealer is a member. The NASD and exchange membership requirements, rules, market surveillance, and disciplinary procedures are all subject to SEC oversight and review.

C. Sources of Litigation

The judicial case law involving securities emanates from several types of proceedings. In addition to its administrative proceedings, the SEC itself may proceed by initiating a civil action in federal court if it discovers what it believes to be a violation of the law.

Private parties can bring suit under the federal securities laws. In addition to remedies for private parties, the securities laws vest the SEC with enforcement powers. For example, if the alleged violator is a broker–dealer or investment adviser required to register with the SEC, the SEC may initiate an administrative proceeding to revoke or suspend the firm’s registration or take other disciplinary action. If the al-

leged violator is an issuer seeking to sell securities under a 1933 Act registration statement, the SEC can initiate administrative proceedings to suspend the effectiveness of the statement. In either case, the hearing is first held within the SEC, with the SEC making the final decision after initial findings by an administrative law judge. Decisions can be appealed to the U.S. court of appeals in the District of Columbia or in the circuit where the registrant's principal place of business is located.

If the alleged violator is neither an issuer making a registered offering nor a person registered with the SEC, the Commission must go to court to obtain relief. The SEC may seek an injunction against future violations and, in particularly egregious situations, may refer the matter to the Department of Justice for prosecution as a criminal violation of the securities laws.

D. Self-Regulation

National securities associations must register with the SEC pursuant to section 15A of the 1934 Act. The SEC Division of Market Regulation oversees these self-regulatory organizations, which include the stock exchanges¹⁷ as well as the National Association of Securities Dealers (NASD). The exchanges have listing requirements for securities, and the NASD has similar listing requirements for its national market system.

Although the NASD operates much like an exchange, the NASD national market system is not a registered national securities exchange. The securities traded using the National Association of Securities Dealers' Automated Quotation System (NASDAQ) are considered over-the-counter (OTC) securities and thus are not subject to section 9 prohibitions on manipulation. Instead, NASDAQ securities are regulated by section 15(c) of the 1934 Act. Over-the-counter markets

17. In addition to the NASD, there are registered securities exchanges under section 6 of the 1934 Act: They include the New York Stock Exchange, American Stock Exchange, Chicago Board Options Exchange, Midwest Stock Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, Boston Stock Exchange, Cincinnati Stock Exchange, and the Intermountain Stock Exchange. The Intermountain Stock Exchange, in Spokane, Wash., closed in 1991.

are distinguished from exchanges in two principal ways: (1) there is no central facility comparable to an exchange floor (although the NASD's introduction in 1971 of an electronic automated quotation system, NASDAQ, and more recently its national market system, have made this distinction less important); and (2) the function of a firm representing an individual buyer is different (in an exchange, the firm acts as a "broker" and the only "dealer" is the registered "specialist" in that stock; in the over-the-counter market, any number of firms may act as dealers or "market makers" in a particular stock).

Broker-dealers registered with the SEC must also register with the NASD. Additionally, their sales personnel must register with the NASD as "registered representatives."¹⁸ Fitness standards for registered representatives operate to disqualify individuals who have engaged in fraudulent conduct or have been convicted of specified crimes. In addition, registered representatives must pass an exam administered by the NASD.¹⁹

The NASD is the only registered securities association for broker-dealers effectuating transactions in private-sector securities. Section 15B of the 1934 Act addresses the regulation of municipal securities (i.e., state and municipal government obligations) and sets forth the authority for the Municipal Securities Rulemaking Board, which is the self-regulatory organization for municipal securities dealers. Section 15C deals with government securities dealers. Government securities are those issued by the federal government or a federal agency. Section 6 of the 1934 Act provides for the registration of national securities exchanges, and all exchange rules, procedures, and disciplinary sanctions are subject to SEC oversight and review. Section 11 of the 1934 Act regulates exchange trading. Section 11A deals with the national market system. Section 17A of the 1934 Act addresses registration of clearing agents and stock transfer agents. Sections 7 and 8 implement margin regulations governing the extension of credit using

18. Many states have parallel registration requirements for broker-dealers and their registered representatives.

19. See the National Association of Securities Dealers Regulation (NASDR) Web site (www.NASDR.com) for a description of the qualification requirements and the various levels of registration.

securities as collateral. The margin rules are set by the Federal Reserve Board but are enforced by the SEC (and the self-regulatory organizations).

E. Private Remedies

Persons who believe they were injured by a violation of the securities laws can bring a civil action for damages. A number of sections of the 1933 and 1934 Acts provide for express private rights of action. Perhaps the most significant civil liability exists under various “implied” rights of action under provisions prohibiting certain activities.

II. Scope and Reach of the Securities Laws

A. Definition of Security

The federal securities laws provide jurisdiction over securities. The term *security* is broadly defined by the statutes. Section 2(a)(1) of the Securities Act of 1933 is representative:

The term “security” means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, reorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.²⁰

The statutory phrase “investment contract” captures the generic concept of what a security is, and interpretation of this phrase has provided basic guidelines for defining a security. In such determinations, courts have always been mindful that the bottom-line issue is whether the particular investment or instrument calls for investor protection under the federal securities laws.²¹

20. 15 U.S.C. § 77b(a)(1) (2000 & Supp. 2001). In 2000, the definition was amended to exclude security-based swap agreements but also to provide that such agreements, although not securities, are subject to the securities laws’ antifraud provisions. See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

21. *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (bank-issued certificate of deposit is not a security subject to federal securities laws, since it is already federally insured and purchasers therefore do not need that extra layer of protection the laws afford).

The landmark case on the definition of an investment contract is *SEC v. W.J. Howey Co.*²² The defendants in *Howey* were promoters who were selling orange groves. The promoters also marketed an “optional” service agreement, under which a company affiliated with the promoters would handle all management of trees bought by the investor. In reality, however, the promoters were selling a security interest in the trees and their fruit. Buyers were not expected to come to the field and tend their own trees; in fact, that would have been nearly impossible, given that there was no physical access or right of access to the individual plots. As such, it was virtually impossible for any single buyer to manage a plot individually, or even use a competitor’s services. Moreover, based on the small size of the plots, only a common enterprise and the resultant economies of scale would make the plots economically feasible. Thus, although not tied by contract, in economic reality the services offered by the promoters were tied to the property, creating a security.

Under the test developed in *Howey*, a contract, transaction, or scheme is an investment contract if “a person (1) invests his money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of the promoter or a third party.”²³ The fourth prong of this test was later modified to require only that the profits come “primarily” or “substantially” from the efforts of others.²⁴ In determining whether the *Howey* test is satisfied, the focus is on the “economic reality” surrounding the investment package as a whole, not exclusively on any single factor.

The definition of *security* is not limited to investment contracts. For example, stock is explicitly included in the statutory definition. There is a strong presumption that stock is a security. Nevertheless, under the economic reality test, some transfers of stock instruments are *not* transfers of securities. In *United Housing Foundation, Inc. v. Forman*,²⁵ the U.S. Supreme Court rejected the argument that merely denomi-

22. 328 U.S. 293 (1946).

23. *Id.* at 298–99.

24. See, e.g., *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (holding that pyramid sales arrangement is a security).

25. 421 U.S. 837 (1975).

nating an interest as stock necessarily makes it a security. In that case, the stock was in a government-subsidized residential housing cooperative. Sale of the stock was tied to leasing an apartment in the cooperative. The stock yielded no dividends, provided no rights to appreciation, and was nontransferable. Furthermore, the voting rights were not set by the number of shares of stock held but by the leasehold interest held. The Court, placing substance over form, focused on the economic reality of the venture and found that the shares of stock did not fall within the 1933 Securities Act's definition.

Following this economic reality approach, many courts of appeals recognized a "sale of business" exception to treating stock as a security: Namely, when an entire business (or in some cases, a "controlling interest" in a business) was sold, the transfer of stock was merely an "incident" of the business and thus did not fall under the Securities Act.²⁶ When the Supreme Court faced the issue, however, it took a literal approach. Finding that the stock involved had all the incidents of "stock," it held that even the sale of all the stock of a company is a sale of securities subject to securities laws.²⁷

The impact of the demise of the "sale of business" doctrine has implications beyond the sale of closely held businesses. The *Landreth* decision rejects the application of *Howey* as the exclusive test of what is a security. Although *Howey* is no longer the exclusive test for defining a security, it is still good law. Other investment instruments,

26. See, e.g., *Christy v. Cambron*, 710 F.2d 669 (10th Cir. 1983); *King v. Winkler*, 673 F.2d 342 (11th Cir. 1982); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981). See generally Thomas L. Hazen, *Taking Stock of Stock and the Sale of Closely Held Corporations: When Is Stock Not a Security?*, 61 N.C. L. Rev. 393 (1983); Irving Seldin, *When Stock Is Not a Security: The Sale of Business Doctrine Under the Federal Securities Laws*, 37 Bus. Law. 637 (1982).

27. *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). See generally John O'Brien & John Moye, *The Sale of Business Doctrine: Landreth Adds New Life to the Anti-Fraud Provisions of the Securities Acts*, 11 Vt. L. Rev. 1 (1986).

There is still some question as to whether the "sale of business" doctrine can be used under state securities laws to find the absence of a security. Compare *Jabend, Inc. v. Four-Phase Sys., Inc.*, 631 F. Supp. 1339, 1345 (W.D. Wash. 1986) (indicating that the doctrine may be applicable under California law) with *Specialized Tours, Inc. v. Hagen*, 392 N.W.2d 520 (D. Minn. 1986) (rejecting the doctrine).

such as stock and notes expressly included in the statute, are analyzed differently; they are presumptively considered to be securities, but the presumption can be overcome.

Although under both the 1933 and 1934 Acts “any note” is a security, the phrase has been modified by both the statutes themselves and the courts. Special provisions of the Acts limit the applicability of the federal securities laws to short-term notes. Section 3(a)(10) of the 1934 Act, for example, *excludes* from the definition of security any “note . . . aris[ing] out of a current transaction” with a maturity not exceeding nine months. Section 3(a)(3) of the 1933 Act *exempts* such notes from registration (but not from liability imposed by antifraud provisions of the Act).²⁸ In *Reves v. Ernst & Young*, the Supreme Court declared that the phrase “any note” “must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts.”²⁹ The Court adopted the “family resemblance” test for determining whether a note is a security. Using this approach, the starting point is a rebuttable presumption that the note is a security. Based on a court-created list of notes that fall outside the definition of security,³⁰ the presumption may be rebutted by showing that the note in question fits in a category on the list; bears a strong “family resemblance” to a category on the list; or belongs to another category that should be on the list.

The *Reves* factors for determining whether a note is a security are as follows: (1) the motivations/expectations of the parties involved in the note transaction; (2) the investment or commercial nature of the transaction; (3) the reasonable expectations of the public; and (4) the existence or nonexistence of other regulatory schemes to control the transaction.³¹ These factors incorporate the early “commercial versus

28. The Act further exempts all renewals thereof that are “likewise limited.”

29. 494 U.S. 56, 63 (1990).

30. *See, e.g.*, *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984); *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976).

31. The Court described the factors:

If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a “se-

investment” approach,³² which rests on the view that many transactions regulated in more specific ways do not need the protection of the federal securities laws.³³ The *Reves* approach further incorporates other considerations to ensure that only notes that resemble the type of securities transactions the acts were designed to regulate are included in the definition of *note*.

B. Jurisdictional Provisions

The Securities Act of 1933 and Securities Exchange Act of 1934 have different jurisdictional reach with respect to companies issuing securities. The 1934 Act governs offerings or issuers with sufficient interstate contact to support federal regulation.³⁴ In contrast, section 5 of

curity.” If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller’s cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a “security.” . . . Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be “securities” on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not “securities” as used in that transaction. Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

Reves v. Ernst & Young, 494 U.S. 56, 66–67 (1990) (citations omitted).

32. See, e.g., *Smith Int’l, Inc. v. Tex. Commerce Bank*, 844 F.2d 52 (5th Cir. 1988); *Union Nat’l Bank v. Farmers Bank*, 786 F.2d 881 (8th Cir. 1986).

33. See, e.g., *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (federally insured certificate of deposit issued by bank not subject to securities laws); *Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co.*, 577 F. Supp. 1281 (D. Mass. 1983); *Tafflin v. Levitt*, 865 F.2d 595 (4th Cir. 1989), *aff’d*, 493 U.S. 455 (1990) (certificate of deposit issued by savings and loan association not a security).

34. As to offerings, section 12(a) makes it unlawful for any broker or dealer to effect any transaction in a security on a national exchange unless a 1934 Act registration has been effected for the security. The registration requirement is set forth in section 12(g). See Donald Scott, *Checklist for Registration of Securities Under Section 12(g) of the Securities Exchange Act of 1934*, 25 Bus. Law. 1631 (1970).

As to issuers, for example, all issuers having more than \$5 million in assets and 500 or more holders of a class of equity securities, and issuers having issued securities under a 1933 Act registration statement with more than 300 holders of such securities, are subject to 1934 Act requirements. Sections 12(a), 12(g), & 15(d).

the 1933 Act asserts jurisdiction requiring registration for nonexempt offers or sales of securities through an instrumentality of interstate commerce. Although jurisdiction would otherwise exist, there is an exemption from registration for offerings taking place within a single state.³⁵

Federal courts have taken a broad view of the jurisdictional reach of the antifraud provisions contained in the 1933 and 1934 Acts, applying them generally to all securities, whether or not the securities are exempt from registration and periodic reporting requirements. Typically, these antifraud provisions are triggered by the use of an instrumentality of interstate commerce.³⁶ Under this expansive view of jurisdiction, even a face-to-face conversation may be subject to the broadest antifraud provision—SEC Rule 10b-5—if the conversation is part of a transaction that uses some instrumentality of interstate commerce.³⁷ The universally accepted rule appears to be that a misrepresentation need not be communicated through an instrumentality of interstate commerce, provided there is a connection between the fraud and the use of interstate commerce.³⁸ A broad reading of the securities

35. Section 3(a)(11) of the 1933 Act.

36. *E.g.*, 1933 Act § 12 (rendering unlawful offers and sales “mak[ing] use of any means or instrumentality of transportation or communication in interstate commerce or of the mails to sell such security” unless the security is registered or exempt); 1934 Act § 10(b) (“by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange”).

37. *E.g.*, *Franklin Sav. Bank of N.Y. v. Levy*, 551 F.2d 521, 524 (2d Cir. 1977) (jurisdiction found for claim based on section 12(a)(2) of the 1933 Act; “[T]he sales here consisted primarily of the manual delivery of the note and the receipt of payment, neither of which occasioned the use of the mails. After delivery of the note and receipt of the payment, however, [defendant] mailed a letter to [plaintiff] confirming the sale.”); *Leitner v. Kuntz*, 655 F. Supp. 725 (D. Utah 1987) (mailing of financial statement plus use of telephone to change date of face-to-face meeting were sufficient for jurisdictional purposes).

38. *E.g.*, *Kline v. Henrie*, 679 F. Supp. 464 (M.D. Pa. 1988); *United States v. Pray*, 452 F. Supp. 788 (M.D. Pa. 1978); *Harrison v. Equitable Life Assurance Soc’y*, 435 F. Supp. 281 (W.D. Mich. 1977); *Levin v. Marder*, 343 F. Supp. 1050 (W.D. Pa. 1972).

laws' jurisdictional requirements appears further warranted by a 1987 Supreme Court decision involving federal mail and wire fraud.³⁹

The jurisdictional scope of the 1934 Act's regulatory provisions varies. A few provisions apply only to exchange-listed securities and not to over-the-counter securities. Section 9, for example, prohibits manipulative activity only in connection with securities that are traded on a national securities exchange. In contrast, section 15(c) gives the SEC the power to promulgate rules prohibiting brokers and dealers from participating in manipulative, deceptive, or fraudulent acts or practices in connection with sales or attempts to induce sales, and is not limited to securities traded on the registered national exchanges.

C. SEC Enforcement Powers

The SEC is empowered to investigate suspected violations of the securities laws. Most investigations are conducted with a view toward initiation of SEC administrative proceedings, initiation of SEC enforcement actions brought in federal court, or referral to the Department of Justice for criminal prosecution. In addition to a normal investigation, which can lead to criminal prosecution, civil litigation, or administrative action under section 21(a) of the 1934 Act, the SEC is empowered to issue public reports of its findings. This power is rarely invoked and from time to time has raised considerable controversy.⁴⁰

The SEC has direct prosecutorial authority to enforce the 1934 Act in court with civil suits for injunctions and ancillary relief against alleged violators. Should a criminal violation exist, the SEC Division of Enforcement refers it to the Department of Justice for criminal prosecution. Where appropriate, the SEC may choose to address a securities law violation with administrative sanctions. With regard to market

39. In *Carpenter v. United States*, 484 U.S. 19 (1987), the Supreme Court found a violation of the mail fraud statute where the defendants did not themselves use the requisite instrumentality but the scheme was dependent on someone else using the mail. The defendants were convicted of trading on advance knowledge of columns that were to appear in the *Wall Street Journal*; the mailing of the *Journal* was held to satisfy the jurisdictional means.

40. For an example of criticism of the publication of investigations, see *In re Spartek, Inc.*, Exchange Act Release No. 34-15567 (Feb. 14, 1979) (Karmel, dissenting).

professionals (broker–dealers, investment bankers, investment companies, and investment advisers), the SEC can initiate adjudicatory proceedings that lead to possible sanctions ranging from censure to suspension or revocation of the right to act as a securities professional.

The SEC has “cease and desist” power, conferred by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. A cease and desist order may be appealed to the full Commission or directly to a federal court. The 1990 legislation also added section 21(d)(2) to the 1934 Act (and parallel provisions of the other securities laws), which empowers the SEC to obtain a court order barring a person from serving as an officer or director if that person’s conduct demonstrates “substantial unfitness.” It also gave the SEC power to issue civil penalties and, in administrative proceedings, to require disgorgement of ill-gotten profits resulting from securities law violations. It requires additional disclosures by dealers in certain low-priced stocks, frequently referred to as penny stocks.⁴¹

41. Penny stocks are securities that are generally unlisted, over-the-counter stocks not traded on a national exchange or through an automated quotation system. They are sold at under \$5 a share. They are frequently subject to abuse because (1) they can be sold in large volume, frequently to unsophisticated investors, generating enormous profits for unscrupulous broker–dealers; (2) they are usually issued by smaller, little-known companies that attract little attention outside that generated by the offering broker–dealer; and (3) there is no reliable quotation system for the non-NASDAQ OTC market, providing an opportunity for decreased supervision and increased abuse. See Exchange Act Release No. 27,160 (Aug. 22, 1989).

Additional disclosures are now required about both the market value of penny stocks and the people selling the stocks. Furthermore, the SEC is directed to adopt rules limiting the use of the proceeds of penny stock sales, providing a right of rescission to purchasers, and facilitating development of a quotation system providing volume and last sale information. See also Rules 15g-1 through 15g-8, which contain the SEC’s penny stock rules. These rules replaced Rule 15c2-6, an antifraud provision designed to combat the “unscrupulous, high pressure sales tactics of certain broker–dealers by imposing objective and readily reviewable requirements that condition the process by which new customers are induced to purchase low-priced stocks.” Exchange Act Release No. 27,160 (Aug. 22, 1989).

The SEC does not have jurisdiction to adjudicate disputes between private parties.⁴² However, it can order disgorgement of profits in administrative proceedings and has adjudicatory responsibility with regard to regulation of market professionals.⁴³

D. Relation to Other Federal Laws

In addition to the seven federal securities acts, a number of related statutes may supplement the federal securities laws: the Foreign Corrupt Practices Act of 1977,⁴⁴ enacted in response to widespread concern over the activities of domestic companies in their dealings abroad; the Racketeer Influenced and Corrupt Organizations Act (RICO), enacted to facilitate efficient law enforcement with regard to organized crime and racketeering activities; and the federal Mail Fraud and Wire Fraud Acts.⁴⁵ The SEC is involved in the administration of some of these laws when they involve securities regulation.

For certain regulated industries, the securities of issuers may be subject to regulation by other federal administrative agencies, either in addition to or sometimes in place of SEC regulation. The latter situation occurs where the federal securities laws have created an exemption for securities and/or issuers subject to regulation by both the SEC and another government agency. The rationale behind these exemptions is to avoid “double regulation,” especially where the regulation provided by the other agency is more subject-specific than that of the SEC. The Comptroller of the Currency, for example, has jurisdiction

42. Cf. the Commodity Futures Trading Commission’s reparations proceedings. Commodity Exchange Act § 14, 7 U.S.C. § 18 (1988).

43. Pursuant to Rule 102(e) of its Rules of Practice, the SEC can institute proceedings to suspend or otherwise discipline individuals admitted to practice before it. Rule 102(e) has been used on several occasions against lawyers and accountants. Section 307 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (July 30, 2002), requires the SEC to promulgate rules defining what constitutes proper legal representation of a public company, including defining when a lawyer having evidence of corporate wrongdoing must report that to the board of directors.

44. 15 U.S.C. §§ 78m(b)(2), 78dd-1, 78dd-2 (1988).

45. 18 U.S.C. §§ 1341, 1343 (1988 & Supp. 2001).

over the distribution of securities issued by national banks.⁴⁶ A similar arrangement exists with regard to securities of savings and loan associations, which are subject to regulation by the Federal Home Loan Bank Board.⁴⁷ Other examples include securities of common carriers, regulated by the Interstate Commerce Commission, and securities of eleemosynary organizations, governed by regulations of the Internal Revenue Service.

Banks and securities firms compete directly in a number of areas, including providing financing for corporations and managing pooled investment funds.⁴⁸ Banks and the federal banking agencies generally take an “entity regulation” approach under which anything a bank does is subject to regulation only by banking agencies. Securities firms and the SEC generally take a “functional regulation” approach under which any entity that engages in securities dealings is subject to regulation by the SEC. There has been a great deal of litigation on this issue.

Because securities are included in the definition of *commodity* in the Commodity Exchange Act, “futures contracts” on individual securities

46. 12 U.S.C. §§ 51–51c (1988); see also the 1933 Act § 3(a)(2), which provides an exemption from registration.

47. 12 U.S.C. §§ 1461–1470 (1988 & Supp. 2001); see also the 1933 Act § 3(a)(5), which provides an exemption from registration.

48. With the enactment of the Gramm-Leach-Bliley Act of 1999 (Pub. L. No. 106-102, 1999 U.S.C.C.A.N. (113 Stat.) 1338), Congress repealed the Glass-Steagall Act and its “Maginot line” between investment and commercial banking. Adopted in 1933, the Glass-Steagall Act, 12 U.S.C. §§ 24 & 378, was enacted to bar commercial banks from the investment banking business and securities firms from the commercial banking business. During the last three decades of the twentieth century, the prohibitions were continually eroded by administrative interpretation. Gramm-Leach-Bliley permits integrated financial services companies that previously were prohibited by Glass-Steagall. It provides for functional regulation with oversight by the Federal Reserve Board. This means, for example, that the SEC regulates securities activities; the Office of the Comptroller of the Currency or appropriate state banking agency regulates banking activities; and state insurance commissioners will continue to regulate insurance-related activities. Gramm-Leach-Bliley permits bank holding companies to engage in increased securities and insurance activities. It also creates a new category known as a financial holding company, which can engage in a wide variety of financial activities, including investment banking, commercial banking, and insurance.

and stock market and other financial indexes are regulated by the Commodity Futures Trading Commission rather than the SEC.⁴⁹ Options trading on outstanding securities, which has mushroomed in recent years following the development of organized option exchanges, is fully subject to SEC regulation. Contracts for future delivery of securities, however, were developed by, and are traded on, commodity exchanges rather than securities exchanges.

E. Relation to State Laws

The broad reach of the federal securities laws often brings them into contact, or conflict, with provisions of state laws, other federal laws, and foreign laws. State securities laws, commonly known as “blue sky” laws, generally provide for registration of broker–dealers, registration of securities to be offered or traded in the state, and sanctions against fraudulent activities. States’ securities laws are still characterized by great diversity of language and interpretation.

Prior to 1996,⁵⁰ federal securities laws specifically preserved the jurisdiction of state commissions to regulate securities transactions, so long as their regulation did not conflict with federal law. However, in that year Congress preempted state regulation in a number of important areas.⁵¹ States are now barred from regulating offerings of securi-

49. For an opinion analyzing the often-difficult question of whether a novel financial instrument should be considered a futures contract or a security, see *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537 (7th Cir. 1989). See also *Bd. of Trade v. SEC*, 187 F.3d 713 (7th Cir. 1999). In 2000 the Commodities Exchange Act was amended to permit, for the first time, futures on individual equity securities. See *Commodity Futures Modernization Act of 2000*, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). Prior to that Act the only individual securities (as opposed to indexes or baskets of securities) that could form the basis of futures contracts were federal government securities such as treasury bonds.

50. The enactment of the National Securities Markets Improvement Act (NSMIA) in 1996 preempted a significant portion of state regulation of securities offerings.

In 2002, the National Conference of Commissioners on Uniform State Laws approved a new Uniform Securities Act (USA) designed to bring uniformity to state regulation of securities. Originally promulgated in 1956 and then substantially revised in 1985, the USA relates to the registration of broker–dealers, agents, advisers, and securities, and has been substantially or partially adopted in more than thirty states.

51. Section 18 of the 1933 Act, 15 U.S.C. § 77r (2000 & Supp. 2001).

ties listed on major stock exchanges or the National Association of Securities Dealers' national market system, securities issued by investment companies, securities sold to "qualified purchasers" (as defined by the SEC), and securities sold in certain types of transactions exempted from registration under the Securities Act of 1933, sections 3 and 4. States remain free to bring antifraud proceedings, require filing of notices, and collect fees with respect to such transactions. Section 15(h) of the Securities Exchange Act of 1934⁵² now preempts state regulation of capital, custody, margin, financial responsibility, and record keeping of registered broker-dealers, as well as certain qualification requirements for associated persons. Investment advisers with more than \$25 million of assets under management that are registered with the SEC are now exempt from state regulation.⁵³ Investment advisers with less than \$25 million under management and regulated by their home states are now exempt from SEC regulation.

The internal affairs of corporations, the rights of their shareholders, and the liabilities of their officers and directors are generally governed by the law of the state of incorporation. However, certain provisions of federal securities law create liabilities that interact or overlap with provisions of state corporation law. Examples from the 1934 Act are section 14,⁵⁴ which regulates the solicitation of proxies in connection with shareholder meetings; section 16,⁵⁵ which imposes liability on officers, directors, and large shareholders for their profits on short-swing trading in the corporation's shares; and section 10(b), which imposes liability for a variety of "fraudulent or deceptive" acts.⁵⁶ Another example is SEC Rule 10b-5,⁵⁷ which also imposes liability for "fraudulent or deceptive" acts.

A number of state laws regulate corporate takeovers, generally imposing greater obstacles to such takeovers than are found in the fed-

52. 15 U.S.C. § 78o (2000 & Supp. 2001).

53. See Investment Advisers Act § 203A, 15 U.S.C. § 80b-3a (2000 & Supp. 2001).

54. 15 U.S.C. § 78n (2000 & Supp. 2001).

55. 15 U.S.C. § 78p (2000 & Supp. 2001). See *infra* text accompanying note 370.

56. 15 U.S.C. § 78j(b) (2000 & Supp. 2001).

57. 17 C.F.R. § 240.10b-5 (2002).

II. Scope and Reach of the Securities Laws

eral Williams Act.⁵⁸ The validity of such laws under the Supremacy Clause and the Commerce Clause of the United States Constitution has been considered in a number of cases.⁵⁹ The state takeover laws that have passed constitutional scrutiny are those that are part of the corporate law, focusing on corporate governance issues.

Insurance companies are regulated only by state law, and life insurance policies and annuities are specifically exempted from the registration provisions (but not the antifraud provisions) of the federal securities laws.⁶⁰ It is unlikely that traditional insurance policies and annuities would be deemed to be securities even in the absence of such exemption. However, the Supreme Court has held that when insurance companies issue “variable” annuities or insurance policies in which the rate of return varies with the profitability of an investment portfolio, such instruments are securities subject to the provisions of the federal securities laws.⁶¹

58. Codified in sections 13(d), 13(e), 14(d), 14(e), and 14(f) of the 1934 Act.

59. *See, e.g.*, *CTS v. Dynamics*, 481 U.S. 69 (1987); *Edgar v. MITE*, 457 U.S. 624 (1982); *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989).

60. Section 3(a)(8) of the 1933 Act, section 3(a)(10) of the 1934 Act, 15 U.S.C. §§ 77c(a)(8) & 78c(a)(10) (2000).

61. *See SEC v. VALIC*, 359 U.S. 65 (1959); *SEC v. United Benefit*, 387 U.S. 202 (1967). In 1987, the SEC adopted Securities Act Rule 151, a safe-harbor rule specifying the characteristics that would cause annuity contracts to be classified as exempt securities within the meaning of section 3(a)(8) of the 1933 Act.

III. Regulating the Distribution of Securities—The Securities Act of 1933

A. Structure of the 1933 Act

The Securities Act of 1933 regulates the distribution of securities. There are two basic ways that securities can be distributed. The first is by a primary offering (or distribution): Stock is sold from the issuer to the stockholder, usually for the purpose of raising capital. The second type is a secondary distribution: A shareholder or group of shareholders owning a large number of shares sells stock to someone else. In this case, the proceeds go not to the corporation (or other primary issuer), but to the selling shareholder. The 1933 Act regulates both primary and secondary distributors, since it covers distributions of securities by issuers, underwriters, and sellers.

If a transaction is covered by the 1933 Act, registration is required as a precondition to offers and sales. There is a basic “road map” for determining whether a transaction falls under the statute. First, section 2(a)(1) defines a security. If the interest or instrument in question is a security, the next step is to determine whether the security qualifies for one of the exemptions from registration found in section 3. Section 4 lists certain transactions that are exempt, even if the security itself does not qualify for a section 3 exemption. In addition, pursuant to section 28, the SEC has general exemptive authority to supplement the statutory exemptions. If the security or transaction at issue does not fall under one of these three provisions, registration is required under section 5, which also establishes limitations on offers and sales. Sections 6 and 8 set forth the procedure for registration; sections 7 and 10 list the disclosure requirements. If any of these sections are violated, there are civil liabilities under sections 11 and 12. Additionally, there is a general antifraud provision regulating these transactions in section 17, violation of which may result in SEC or criminal prosecution.

B. Registration Process Under the 1933 Act

Section 5 of the 1933 Act breaks down the registration process into three periods, based on the filing and effective dates of the registration statement. The “prefiling” period begins months before the filing of the registration statement and lasts until the filing date. The “waiting” period runs from the filing date until the effective date.⁶² The “post-effective” period starts at the effective date of the registration statement.

Pursuant to section 8, the registration statement becomes effective twenty days from the date of the original filing or the filing of the most recent amendment, whichever is last.

Section 5 limits the type of selling efforts that may be used and places various restrictions on the dissemination of information throughout the registration process.⁶³ No offer to buy or sell may be made before the registration statement is filed. Once the registration statement is filed, any offers to buy and sell (as well as confirmation sales) must meet certain requirements. No sales may take place until after the registration statement becomes effective.

1. Prefiling Period

Section 5(c) prohibits all offers to sell and buy securities prior to filing the registration statement; it remains in effect only during the prefiling period. An offer to sell is any communication reasonably calculated to

62. The waiting period can be several months or longer. In terms of actual practice, the waiting period is usually much longer than the statutory twenty days for first-time issuers and for complicated offerings because of SEC review practices. Under section 8, the effective date of deficient registration statements can be delayed by a stop order or refusal order. Formal section 8 orders are the exception, since the SEC will generally respond to deficient registration statements with a letter of comment suggesting changes. The letter of comment will frequently be followed by a delaying amendment filed by the prospective issuer, putting off the effective date until the deficiencies are corrected. When appropriate, the effective date can be accelerated (see SEC Rule 461).

63. By virtue of sections 4(1) and 4(4) of the 1933 Act, section 5 does not apply to persons other than issuers, underwriters, and dealers. Nor does it apply to unsolicited brokers' transactions.

generate a buying interest.⁶⁴ Section 5(c) applies to oral as well as written offers and is meant to prevent companies from “jumping the gun” in announcing offerings before the registration statement is filed.

Balanced against the desire to prevent “gun jumping” as expressed by the prohibitions of section 5(c) is the underlying purpose of federal securities regulation: affirmative disclosure. Broker–dealers, investment advisers, and other financial analysts generate a great deal of public information concerning securities.⁶⁵ Therefore, there are various exemptions from section 5(c)’s prohibitions in the pre-filing period. For example, SEC Rules 137, 138, and 139 (which also apply during the waiting and post-effective periods) provide exemptions from gun-jumping prohibitions for certain broker–dealer recommendations with regard to securities of 1934 Act reporting companies.⁶⁶ Recognizing that many investment bankers have research analysts who are separate from the underwriting department, these rules permit the research department to continue with its regular business without violating the prohibitions of section 5 of the 1933 Act. These exemptions are conditioned on certain protective requirements, including

64. *In re Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. 843 (1959), is generally considered the leading precedent for determining the scope of the definition of *offer to sell*. In *Loeb*, the company at issue was planning to go public. It had made a preliminary agreement with a group of underwriters. The lead underwriter issued a press release providing many specific details about the forthcoming offering. The SEC, while recognizing that a pre-filing press release may be a legitimate publicity device, ruled that this release was too explicit and was in fact designed to arouse buying interest in violation of section 5(c). Subsequently, the SEC, recognizing the informational tensions at issue, amended one of its rules to address pre-filing publicity by an issuer. See SEC Rule 135. There remains a question as to whether Rule 135, which speaks only of *issuers* releasing information, is the exclusive list of permissible information or is simply a safe harbor.

65. For discussion of the impact of the Internet on the offering process and other disclosure issues, see *Use of Electronic Media*, Securities Act Release No. 33-7856, 72 SEC Docket 753 (Apr. 28, 2000); *Use of Electronic Media for Delivery Purposes*, Securities Act Release No. 33-7234, 60 SEC Docket 1107 (Oct. 6, 1995).

66. Sections 13 and 15(d) of the 1934 Act provide for periodic reporting of (1) issuers whose securities are traded on a national exchange, (2) securities that have been subject to a 1933 Act registration, or (3) issuers with more than \$3 million in assets and more than 500 holders of a class of equity securities.

that the issuer of the recommended securities be sufficiently large and subject to reporting requirements (which ensure that there is sufficient public information already available). At the same time, any broker's or dealer's recommendation to purchase a security that does not fall within the scope of these rules would clearly violate section 5 unless, of course, some other exemption could be found.

The definition of *offer to sell* under section 2(a)(3) of the 1933 Act has been construed broadly: It is not limited to contract law doctrine, but rather includes any communication calculated to arouse investor interest in the securities to be offered.⁶⁷ Thus press releases and other announcements about a company or its securities can violate section 5(c)'s gun-jumping prohibitions. SEC Rule 135 sets forth a safe harbor for prefiling publicity about an upcoming securities offering so that it will not be treated as an illegal offer to sell. The purpose of Rule 135 and the SEC's position generally is to allow permissible prefiling publicity about a company and its financing plans that does not unduly precondition the market and investors for the upcoming offering.⁶⁸

To permit the formation of the underwriting agreement, section 2(a)(3)'s definitions of the terms *sale* and *offer to sell* exclude preliminary negotiations and agreements between the issuer and the underwriter, as well as among underwriters in privity with the issuer. When issuers of securities initiate prefiling activity designed to form the underwriting group, contacting too many potential underwriters or potential members of the retail "selling group" may be viewed as improperly preconditioning the market, and therefore may result in a finding of illegally jumping the gun. Section 2(a)(3)'s exclusion balances the need for formation of the underwriting group against the desire not to have premature widespread generation of a buying interest. It should be noted that the final underwriting agreement is usually not executed until the eve of the offering, and generally only a letter of intent is signed at the prefiling stage.

67. *In re Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. 843 (1959) (discussed *supra* note 64). See also, e.g., *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569 (2d Cir. 1970); Securities Act Release No. 33-5180, 1971 WL 120474 (Aug. 16, 1971).

68. See Securities Act Release No. 33-5180, 1971 WL 120474 (Aug. 16, 1971).

Section 5(a) prohibits sales prior to the effective date and thus operates during both the prefiling and waiting periods: Subsection (a)(1) prohibits the sale (or confirmation of a sale) prior to the effective date; and subsection (a)(2) prohibits taking steps toward the sale or delivery of securities pursuant to a sale through instrumentalities of interstate commerce prior to the effective date.

2. Waiting Period

The waiting period begins once the registration statement has been filed and ends when the registration statement becomes effective. While section 5(c)'s prohibitions on offers to sell and buy no longer apply after the prefiling period, section 5(a)'s prohibitions on sales of securities continue through the waiting period. In addition, section 5(b) "prospectus" requirements control the types of written offers to sell that may be made during both the waiting and post-effective periods.

A *prospectus*, as defined by section 2(a)(10), is any written or other permanent or widely disseminated offer to sell. For example, a telephone communication is not a prospectus, but a television or radio advertisement is. Most Internet communications qualify as prospectuses.⁶⁹ A written confirmation of a sale is expressly included in the statutory definition of a prospectus.⁷⁰

A combination of statutory provisions limits the variety of permissible written offers to sell that may be used during the waiting period (and the post-effective period as well). While section 5 permits offers during the waiting period, section 5(b)(1) makes it unlawful to transmit any prospectus after the filing of the registration statement unless the prospectus meets the disclosure requirements of section 10. The information called for by section 10, however, may not be available until the underwriting agreements have been signed and the offering

69. Information in E-mails and on Web sites clearly is subject to prospectus requirements. See Use of Electronic Media, Securities Act Release No. 33-7856, 72 SEC Docket 753 (Apr. 28, 2000). Live Internet simulcasts (also referred to as Internet road shows) may, under limited circumstances, be treated in much the same manner as oral communications and thus not be subject to the prospectus requirements. *Id.*

70. Rule 10b-10 of the 1934 Act requires that all sales by broker-dealers be confirmed in writing.

price set. The 1933 Act solves this problem by exempting from this path two types of written offering material: a type of identifying statement known as a “tombstone ad”,⁷¹ and the preliminary prospectus (discussed below).

Although offers to buy are permissible (since section 5(c) does not apply during the waiting period), an offer to buy that leads to a premature or otherwise illegal sale violates section 5(a). By virtue of section 10(b), which permits certain prospectuses during the waiting period, and section 2(a)(10), which excludes certain communications from the definition of prospectus, there are four types of permissible offers to sell during the waiting period.

First, all oral communications are permitted, provided that no sale is consummated (lest there be a violation of section 5(a)).⁷² Since an oral communication is not “permanent,” it is excluded from the section 2(a)(10) definition of prospectus.

Second, an identifying statement, as defined in section 2(a)(10)(b) and Rule 134, is permissible during the waiting period. This is a relatively narrow category because the type of information that may be included is severely limited. Section 2(a)(10)(b) expressly excludes these communications from the definition of prospectus as long as the requirements of Rule 134 are met. Inclusion of any information not specifically permitted by Rule 134 renders the rule unavailable and thus may result in a prospectus that fails to comply with section 10’s requirements. This, in turn, can result in a violation of section 5.

Third, a preliminary (or red herring) prospectus, as defined in Rule 430, is permissible during the waiting period. It must contain the information required in a full-blown statutory prospectus, except that price and some other terms may be omitted. Furthermore, there must be a legend explaining that it is a preliminary prospectus. This pre-

71. A tombstone ad is the industry term for an identifying statement that simply announces the offering and lists the underwriter.

72. The only prohibition is on written offers to sell, thus any (including written) offers to buy are permissible, provided the sale is not consummated. While there are no section 5 implications, oral offers to sell are, of course, subject to the securities acts’ general antifraud provisions.

liminary prospectus may be used only during the waiting period; it may not be used after the effective date.

Finally, a preliminary summary prospectus, as defined in Rule 431, may be used by certain experienced issuers during the waiting period. A summary prospectus is a short-form prospectus that may be used by qualifying issuers under some circumstances. The summary prospectus may also be used after the effective date and, like the preliminary version, is available only for an issuer who is a registered reporting company under the 1934 Act. The Rule 431 summary prospectus must contain all of the information specified in the official SEC form accompanying the applicable registration statement form as well as a caption stating that a more complete prospectus will be available from designated broker-dealers. The summary prospectus may not include any information not permitted in the registration statement or a tombstone ad as spelled out in Rule 134(a). A Rule 431 prospectus only satisfies section 5(b)(1);⁷³ it does not satisfy section 5(b)(2).⁷⁴ Thus, when a Rule 431 prospectus is used, a “full-blown” (or “statutory”) section 10(a) prospectus must still be delivered to all purchasers. This necessarily increases the record-keeping and monitoring activities of the underwriters.

3. Post-Effective Period

Once the registration statement becomes effective, section 5(a)'s prohibitions cease to apply and sales are permitted. Both of section 5(b)'s prospectus requirements apply. Section 5(b)(1) requires that all written or otherwise permanent offers to sell or confirmations of sales must be qualifying prospectuses (i.e., a section 10(a) full-blown statutory prospectus or a qualifying section 10(b) prospectus). Section 5(b)(2) provides that no security may be delivered for sale unless accompanied or preceded by a statutory section 10(a) prospectus. In the case of securities held for a customer's account by a broker or other

73. Section 5(b)(1) requires any written offer or confirmation to comply with section 10; a summary prospectus is valid for this purpose under section 10(b).

74. Section 5(b)(2), which applies only during the post-effective period, requires every person who purchases a security in the offering to receive a section 10(a) “full-blown” prospectus prior to delivery of that security.

custodian, the customer must still receive the prospectus before delivery.

Under section 2(a)(10), “free writing” is permitted in the post-effective period. Thus, supplemental sales information may be sent to prospective purchasers provided that it is preceded or accompanied by a prospectus that meets the requirements of section 10(a). In such a case, free writing is limited only by the antifraud provisions of the securities laws.⁷⁵

4. Shelf Registration (Rule 415)

Originally, it was assumed that effective registration meant that the covered shares were immediately on sale.⁷⁶ However, as offerings became more sophisticated, it became clear that there were offerings that should be delayed⁷⁷ or would be made on a continuous basis, making the existing registration system inadequate. Therefore, the SEC adopted Rule 415, permitting “shelf registration.” Under this rule, a corporation that over a period of time has been eligible to use Form S-3 may register securities for sale from time to time over a period of up to two years. For the registration statement to remain effective, however, there is an ongoing duty to regularly update information in it.

C. Disclosure Requirements in Securities Offerings

1. Registration Forms

The primary purpose of the Securities Act of 1933 is to promote disclosure of information to potential investors so that they can make informed decisions. The registration statement is the basic disclosure document that issuers must file with the SEC for 1933 Act registration. A number of alternative disclosure forms may be available to issuers for registration, depending on the nature of the issuer, the cir-

75. See also Rules 137, 138, and 139, which deal with broker–dealer recommendations of securities during the registration process.

76. In fact, holding the shares off the market could be deemed a manipulative practice.

77. Such offerings include debt offerings in times of fluctuating interest rates where the effective date may not fall in the best climate in which to attempt to sell the covered securities.

cumstances surrounding the offering, and the type(s) of securities offered. All registration forms are divided into two principal sections. The information contained in the first portion of the registration statement is the same information in the prospectus as required by section 10(a) of the 1933 Act and Schedule A. The Schedule A or statutory prospectus must be delivered before the consummation of any sale pursuant to a registered offering. Schedule A provides only a minimal outline of the types of disclosures required. The second part of the registration statement, not discussed in detail here, consists of additional information and exhibits that are not sent out in the prospectus but are available in the SEC files for public inspection. The specific disclosure requirements are found in the SEC's registration forms and in SEC Regulations S-K, S-B, and S-X. Regulation S-K describes in detail the ways in which the relevant information should be set forth. Regulation S-B provides simplified disclosures for use, in certain instances, by small business issuers. Regulation S-X addresses accounting matters in significant detail. In analyzing the sufficiency of disclosures in a registered offering (or any disclosure requirements for that matter), it is necessary to consult not only the applicable registration form but also Regulations S-K and S-X.

The SEC uses an integrated disclosure system⁷⁸ for registration of securities under the 1933 Act. The three-tiered system of registration and prospectus disclosure of registrant-oriented information⁷⁹ is based on the registrant's reporting history and market following. Three registration forms—S-1, S-2, and S-3⁸⁰—provide the basic framework for this system.

78. Prior to 1982, the SEC administered two parallel but uncoordinated disclosure systems: one for registration of public offerings under the 1933 Act and the other for periodic reporting requirements under the 1934 Act. This resulted in duplicative filings and unnecessary paperwork. The SEC adopted the integrated disclosure system in 1982.

79. The transaction-specific matters (information specific to the securities issuance) should always be disclosed in the registration statement and prospectus.

80. Other registration forms are tailored to specific types of transactions, such as Form S-4 for certain mergers and other business combinations involving public companies.

Form S-1 is the basic long-form registration generally available to issuers that do not qualify for one of the other forms. It requires all the information on the registrant and transaction to be provided in the prospectus. As a practical matter, Form S-1 is used primarily for large offerings by first-time issuers and by companies with publicly held securities but only a limited number of shareholders.

Form S-2 requires less detailed disclosure. It may be used by any issuer that has been filing reports under the 1934 Exchange Act for at least three years. Information that the issuer has reported on Form 10-K of the 1934 Act is incorporated by reference into the prospectus. Along with the description of the offering in the prospectus, the registrant need only provide an annual report or comparable information in the prospectus itself.

Form S-3 requires the least detailed level of disclosure to investors by allowing for the fullest possible incorporation by reference to Exchange Act reporting. No registrant-oriented information is required; only the transaction-specific description of the offering need be disclosed in the prospectus. Form S-3 may be used only by issuers that have been reporting under the 1934 Act for at least one year. Furthermore, the form may only be used for certain kinds of offerings, secondary offerings, or where the registrant passes the “market following” test.⁸¹

In addition to the basic framework for registration established by forms S-1, S-2, and S-3, there are some additional and more specialized forms geared toward certain situations. For example, a simplified Form SB-2 is available for small business issuers.⁸² Also, the SEC has

81. Until 1993, the market following test contained the alternative standards of a \$150 million minimum value of voting stock held by nonaffiliates (the “float”), or a \$100 million float and an annual trading volume of at least three million shares. See Special Report, 1982 Integrated Disclosure Adoptions, Fed. Sec. L. Rep. (CCH) No. 956 at 23–30 (Mar. 11, 1982). In 1993, the market following test was reduced to a \$75 million float regardless of annual trading volume. The theory behind the market following test is that such widely held securities have a sufficiently large informed market following, making more detailed disclosure unnecessary.

82. Other registration forms available for special situations include Form S-4, for mergers and acquisitions; Form S-6, for registration of securities or units in

adopted Form SB-1 to replace rescinded Form S-18, which was a short-form registration statement used for small issues. Form SB-1 may be used for offerings when the aggregate offering price does not exceed \$10 million dollars and the securities are to be sold for cash. Form S-18 was not available to issuers subject to the 1934 Act reporting requirements; nor was it available to a majority-owned subsidiary of a 1934 Act reporting company.⁸³ Form SB-1 is available to many more issuers than its predecessor.

In examining completed registration statements, the SEC has pinpointed a number of areas particularly susceptible to inadequate or misleading disclosures.⁸⁴ For example, shortcomings in management's statements have led to requirements⁸⁵ seeking more detailed information with respect to the following: the company's plan of operations (in the case of companies going public for the first time); competitive conditions in the company's industry; and dilution resulting from the disparity between the prices paid for the company's securities by public investors and those paid by "insiders."

2. Adequacy of Registration Statement Disclosures

The registration statement must include all material facts. For the purposes of a 1933 Act registration statement, Rule 405 defines "material" as "matters to which there is a substantial likelihood that a rea-

certain investment trusts; Form S-8, for employee stock purchase plans; and Form S-11, for securities issued by certain real estate investment companies.

83. Thus, as a practical matter, it was available only for a first-time public offering.

84. See, e.g., *In re Universal Camera Corp.*, 19 S.E.C. 648 (1945). In this case, the SEC identified six common problems in the first-time registration made by the defendant: (1) failure to adequately explain the issuer's prior adverse trends in sales and income; (2) failure to divide into *product lines* information about past performance and to explain whether past performance is a reasonable guide to the future; (3) failure to give a detailed description of the use of the proceeds from the offering at issue; (4) failure to disclose and explain transactions involving management and/or affiliated entities (including underwriting discounts, loans to officers, and other potential conflicts of interest); (5) failure to use charts and graphs to explain the disclosures and make the prospectus more readable for potential investors; and (6) insufficient introduction to the registration statement (note that the SEC will also challenge an introduction that is overly verbose).

85. See Items 101(a)(2), 101(c)(x), and 506 of Regulation S-K.

sonable investor would attach importance in determining whether to purchase the security registered.” This definition encompasses, but is not limited to, financial information.⁸⁶ Under section 8 of the 1933 Act, the SEC may issue a stop order to prevent the issuance of an offering if it believes the registration statement misstates or omits a material fact. Moreover, civil liability may arise when a security is sold under a registration statement that misstates or omits a material fact.

There has been controversy over the inclusion in registration statements of “soft” information, such as projections, predictions, and opinions. Since the late 1970s, SEC policy has been to encourage disclosure,⁸⁷ as evidenced by Rule 175’s safe-harbor rule for “forward-looking statements.” Under Rule 175 (and in the courts generally), the issuer is under no duty to provide soft information, but if it chooses to do so the information is presumed nonfraudulent and the burden is on the challenger to show either that there was no reasonable basis for the statement or that it was not made in good faith. The Seventh Circuit has held that the issuer may, but need not, disclose the underlying assumptions behind a challenged projection, increasing further the burden on the challenger.⁸⁸

Section 27A of the 1933 Act⁸⁹ and section 21E of the 1934 Act⁹⁰ codify the earlier case law and provide a safe harbor for forward-looking statements and the “bespeaks caution” doctrine created by the

86. For example, “material” has been construed to include the professional and personal integrity of management. See, respectively, *SEC v. Jos. Schlitz Brewing Co.*, 452 F. Supp. 824 (E.D. Wis. 1978), and *Franchard Corp.*, 42 S.E.C. 163 (1964). But see *Gaines v. Houghton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982) (holding that materiality does not extend to corporate bad judgment or corruption).

87. Originally, the SEC took the position that only “hard” information (i.e., provable, demonstrable facts) should be contained in the registration statement. For discussions of this position, see, e.g., Harry Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 Bus. Law. 300 (1961); Homer Kripke, *The SEC, the Accountants, Some Myths and Realities*, 45 N.Y.U. L. Rev. 1151 (1970).

88. *Wielgos v. Commonwealth Edison*, 892 F.2d 509 (7th Cir. 1989). See also, e.g., *Roots P’ship v. Land’s End, Inc.*, 965 F.2d 1411 (7th Cir. 1992).

89. 15 U.S.C. § 77z-2 (Supp. 2001).

90. 15 U.S.C.A. § 78u-5(c) (Supp. 2001).

federal courts. The safe harbor allows corporate management to disclose forward-looking information and projections to investors with a presumption that there was a reasonable basis⁹¹ for the projections.⁹² The bespeaks caution doctrine provides that specific cautionary language can render inaccurate projections not actionable.⁹³ In addition to the encouragement of forward-looking information and the bespeaks caution doctrine, the SEC requires that management discuss and analyze known trends and uncertainties that could have a material impact on the company's operations.⁹⁴

91. See, e.g. *In re* 2The Mart.com, Inc. Sec. Litig., [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,037 (C.D. Cal. 2000) (projections that on-line auction site would soon be operational lacked reasonable basis where there were no agreements to design or construct the site).

92. See SEC Rules 175 and 3b–6, 17 C.F.R. §§ 230.175, 240.3b–6. The Reform Act does not present an insurmountable obstacle to actions based on projections. See, e.g., *In re* N2K Inc. Sec. Litig., 202 F.3d 81 (2d Cir. 2000), *affg* 82 F. Supp. 2d 204 (S.D.N.Y. 1999) (cautionary language in prospectus concerning likelihood of continued losses was sufficient); *Cherednichenko v. Quarterdeck Corp.*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,108 (C.D. Cal. 1997) (plaintiffs adequately alleged the existence of facts contradicting optimistic projections); Erin M. Hardtke, Comment, *What's Wrong With the Safe Harbor for Forward-Looking Statements? A Call to the Securities and Exchange Commission to Reconsider Codification of the Bespeaks Caution Doctrine*, 81 Marq. L. Rev. 133 (1997).

See also, e.g., *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 47 F. Supp. 2d 546 (D.N.J. 1999) (forward-looking statements concerning desire to complete a merger were covered by the Act's safe-harbor provisions).

93. See *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407 (9th Cir. 1994); *Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480 (3d Cir. 1994); *Rubinstein v. Collins*, 20 F.3d 160 (5th Cir. 1994); *In re* Donald J. Trump Casino, 7 F.3d 357 (3d Cir. 1993); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037 (6th Cir. 1991); *I. Meyer Pincus & Assoc. v. Oppenheimer & Co.*, 936 F.2d 759 (2d Cir. 1991); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *Luce v. Edelstein*, 802 F.2d 49 (2d Cir. 1986); see also Committee on Securities Regulation, *A Study of Current Practices: Forward-Looking Statements and Cautionary Language After the 1995 Private Securities Litigation Reform Act*, 53 Record 725 (1998); Thomas W. Kellerman et al., *Update on Forward-Looking Statements and the Reform Act Safe Harbor*, 32 Rev. Sec. & Commod. Reg. 129 (June 23, 1999). Cf. *In re* N2K Inc. Sec. Litig., 202 F.3d 81 (2d Cir. 2000), *affg* 82 F. Supp. 2d 204 (S.D.N.Y. 1999) (sufficient cautionary language that financial performance might fall below analysts' expectations).

94. Item 303 of Regulation S-K (management discussion and analysis).

These safe harbors were designed to encourage companies to make projections and disclose future plans without undue worry about lawsuits if things happen to turn out differently than planned.

D. Exemptions from Registration Under the 1933 Act

Section 5 of the 1933 Act applies to *any* offer or sale of *any* security unless an exemption exists. Exemptions under the 1933 Act are based on the type of security involved or on the type of transaction. “Security” exemptions are generally covered by section 3, while “transaction” exemptions are generally covered by section 4 and various SEC rules promulgated thereunder.⁹⁵ Both types of exemptions are exemptions from registration, *not* from the antifraud provisions.

The burden of establishing an exemption falls on the claimant; exemptions are strictly construed. Thus, transactions must be carefully structured and documented to qualify for an exemption. As a general proposition, a single violation in the course of a planned exempt transaction can destroy the entire exemption.⁹⁶ The consequences of losing an exemption are dire, ranging from section 12(a)(1) liability for rescission of any sale to possible criminal liability.

1. Exempt Securities

Section 3 of the 1933 Act authorizes exemptions from section 5’s registration requirements based on the nature of the security involved. Section 3(a)(2) exempts bank securities, insurance policies, and government securities because they are already regulated by some other agency more focused on the specific needs of the industry, and/or they are considered less risky to investors.

95. Section 28 of the 1933 Act gives the SEC broader exemptive power than is found in sections 3 or 4 of the Act. Specifically, the SEC can exempt by rule or regulation any person, security, or transaction that it finds to be in the public interest and consistent with investor protection. As of the writing of this monograph, the SEC has relied on this broad exemptive power only once—Rule 701’s exemption for certain offerings by nonpublic companies to their employees.

96. But see SEC Rule 508, which provides that insignificant deviations from a term, condition, or requirement of Regulation D will not destroy the exemption for a transaction structured in good faith.

Section 3(a)(3) exempts short-term commercial paper from registration. This provision was enacted to exempt “short term paper of the type available for discount at a Federal Reserve bank and of a type which is rarely bought by private investors.”⁹⁷ While these, like other exempt securities, are subject to the 1933 Act’s antifraud provisions, short-term commercial paper is excluded from the 1934 Act definition and thus is not subject to the 1934 Act’s antifraud provisions. Virtually all other securities exempt from 1933 Act registration remain subject to the 1934 Act’s antifraud provisions.

Securities of nonprofit issuers are exempt from registration under section 3(a)(4). Generally, availability of this exemption depends on the ruling of the IRS regarding whether a contribution to the particular issuing institution is a proper charitable deduction. These issuers are exempt because they are already regulated and supervised by another agency. Section 3(a)(5) exempts securities issued by building and loan associations and similar associations, again because they are regulated more closely by another agency. Case law has narrowly defined this exemption: Substantially all of the issuer’s business must entail making loans to its members.⁹⁸

A rather narrow category—interests in railroad equipment trusts—is also exempt from 1933 Act registration by virtue of section 3(a)(6). Another exemption of relatively narrow applicability is found in section 3(a)(7), exempting trustees’ certificates issued in bankruptcy, provided they have been issued with court approval. Congress saw little reason for securities law supervision of a receiver already under court supervision—beyond the antifraud provisions, of course.

Section 3(a)(8) exempts insurance policies and annuities from 1933 Act registration. This provision does not exempt insurance company stock or other securities apart from such policies and annuities contracts. Further, certain annuity contracts (such as variable fund annuities) may *not* be exempt in light of the leading case decided by the Supreme Court under the Act’s definition of *security*.⁹⁹

97. H.R. Rep. No. 73-85, at 15 (1933).

98. *See, e.g., SEC v. Am. Int’l Sav. & Loan Ass’n*, 199 F. Supp. 341 (D. Md. 1961).

99. *See, e.g., SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959).

Although the following five section 3 exemptions—sections 3(a)(9), 3(a)(10), 3(a)(11), 3(b), and 3(c)—are labeled security exemptions, they operate more like transaction exemptions when viewed functionally. Therefore, absent another exemption, all later transactions or “downstream” public resales of these securities by persons having acquired them under this exemption must be registered. In these instances, the real rationale for the exemptions is the characteristics of the offers, not the characteristics of the securities.

a. Exemptions for Certain Exchanges of Securities: Sections 3(a)(9) and 3(a)(10)

Certain voluntary exchanges between an issuer and its existing security holders are exempt from registration under section 3(a)(9), although this exemption is relatively narrow in scope. To qualify, no remuneration may be paid or given to any underwriter or any other person soliciting the exchange; the issuer of both the securities to be issued and the securities to be exchanged must be the same; and no part of the offering may be made to persons other than existing security holders. The rationale behind this exemption is that the offerees are already shareholders, and presumably in possession of adequate information about the issuer, so no new information need be given.

Judicially or administratively approved exchanges of securities are also exempt from 1933 Act registration by virtue of section 3(a)(10), again because the transaction is already supervised in a proceeding where the fairness of the exchange is considered.

b. The Intrastate Exemption: Section 3(a)(11)

Section 3(a)(11), the intrastate exemption, exempts from registration the issuance of securities where the offering is solely within the confines of a single state and other conditions are also met. This exemption focuses on the nature of the transaction rather than the securities themselves; its availability depends not only on the attributes of the security or issuer but also on the form, scope, and extent of the transactions consummated pursuant to the offering. However, unlike most of the true transaction exemptions discussed below, with a section 3(a)(11) exemption there are no limitations on (1) the aggregate dollar amount of the securities to be offered; (2) the number or nature of offerees or purchasers so long as all offerees are residents of the state

of the offering; (3) the manner of offering,¹⁰⁰ or (4) resale so long as the securities have “come to rest” within the state, or in other words, provided there have been no out-of-state “downstream” resales.¹⁰¹ The exemption is relatively narrow since all aspects of the entire offering must take place within a single state.

Section 3(a)(11) is not drafted in a precise and detailed manner, and prior to 1974 relatively little judicial precedent and few SEC interpretive releases and rules were available. Most guidance was found in SEC no-action letters, which by their nature are expressly confined to the facts as given. Statutory construction made clear, however, that certain requirements must be met for section 3(a)(11) to be applicable. The issuer must be a resident of the state. If the issuer is a corporation, it must be incorporated under the laws of the state in addition to having its principal place of business there. In addition, courts read the exemption so narrowly as to require that a corporate issuer derive substantially all of its income from operations within the state and use substantially all of the proceeds of the offering within the state.¹⁰² Furthermore, to retain the exemption, case law requires that the issue come to rest in the hands of state residents.¹⁰³

In 1974, the SEC promulgated 1933 Act Rule 147 as a “safe harbor” in an attempt to provide certainty for those hoping to utilize the intrastate exemption. Rule 147 is available only to issuers, although the statute is not so limited and could be applied to secondary transactions as well. In other respects, Rule 147 provides a good guideline to the elements of the statutory exemption. Its availability requires compliance with every element of the rule. The issuer must be a resident of and doing business within the state of the offering. If the issuer is a corporation, it must be incorporated in the state of the offering, and it must make and use 80% of its profits within the state. All offerees and

100. A general solicitation may, however, trigger state securities law registration requirements.

101. Certain out-of-state downstream resales (i.e., before the securities have “come to rest”) may destroy the intrastate exemption. See 1 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 4.12 (4th ed. 2002).

102. See, e.g., *SEC v. McDonald Inv. Co.*, 343 F. Supp. 343 (D. Minn. 1972).

103. See, e.g., *Busch v. Carpenter*, 827 F.2d 653 (10th Cir. 1987).

purchasers must be residents of the state of the offering. There are limitations on resales for a period of nine months after the last sale that is “part of an issue.” “Part of an issue” is defined in subsection (b) of Rule 147 and is the rule’s counterpart to the “integration doctrine” for telescoping multiple transactions into one. Rule 147 is only a safe harbor, and thus noncompliance raises no inference as to the unavailability of the intrastate exemption.

Even a limited number of resales to nonresidents before the issue has come to rest will render the exemption inapplicable to the entire offering.¹⁰⁴ In such a case, the resident purchasers can claim that the securities they purchased were sold in violation of section 5, thus giving them a right of rescission under section 12(a)(1) of the Act.¹⁰⁵ Whether the issue has come to rest within a single state is a highly fact-specific determination when there have been subsequent out-of-state resales. Certainly, time is a factor. Rule 147 prohibits resales to nonresidents until nine months from the date of the last sale by the issuer of a security of the type for which the exemption is sought. Of course, because this is only a safe-harbor rule, nine months may not be necessary. The Tenth Circuit held that resale to nonresidents within seven months of the initial offering did not violate the coming to rest requirement based on the facts of that case.¹⁰⁶ On the other hand, mere technical compliance with the safe-harbor period of nine months is not sufficient if it is a sham merely to avoid registration. While certainly all purchasers will not be required to hold their securities for an infinite amount of time, the courts have held that evidence of investment intent (or lack thereof) on the part of the resident purchasers is a relevant consideration.

c. Small-Issue Exemptions: Sections 3(b) and 3(c)

Section 3(b) of the 1933 Act empowers the SEC to provide additional small-issue exemptions by promulgating appropriate rules. This section is not self-executing: It requires “enabling rules” developed and promulgated by the SEC. Thus, the SEC has the freedom to create the

104. See, e.g., *Hillsborough Inv. Corp. v. SEC*, 276 F.2d 665 (1st Cir. 1960).

105. Securities Act Release No. 33-4434 (Dec. 6, 1961).

106. *Busch v. Carpenter*, 827 F.2d 653, 657 (10th Cir. 1987).

exemptions it believes necessary or appropriate in light of policy considerations. Currently, such exemptions are limited to offerings of \$5 million or less. The exemptions emanating from section 3(b) include those found in Regulation A, as well as Rules 504 and 505 of Regulation D.¹⁰⁷ The SEC had proposed legislation to raise section 3(b)'s ceiling to \$10 million, but the proposal became moot when Congress enacted section 28's general exemptive authority, which does not place a dollar limit on exemptions. The SEC has raised the \$5 million ceiling only with respect to Rule 701's exemption for certain offerings by nonpublic companies to its employees.

Section 3(c) authorizes the SEC to exempt securities issued by small business investment companies organized under the Small Business Investment Act of 1958, provided that enforcement of the 1933 Act "with respect to such securities is not necessary in the public interest and for the protection of investors." The SEC has exercised this power by promulgating Regulation E.¹⁰⁸ By definition, the section 3(c) exemption is not available to the vast majority of public issuers of securities.

2. Exempt Transactions

a. Transactions Not Involving an Issuer, Underwriter, or Dealer: Section 4(1)

Section 4 of the 1933 Act describes the types of transactions that are exempt from the registration requirements of section 5. Transaction exemptions rise and fall with both the form and substance of the transaction and the nature of the participants. These exemptions, once available, can be destroyed when purchasers under the exemption resell the securities. Downstream sales have the potential to eradicate an existing exemption.

Section 4(1) provides a transaction exemption for persons other than an issuer, underwriter, or dealer. *Issuer* and *dealer* are defined in

107. 17 C.F.R. §§ 230.501–230.508 (2002).

108. Regulation E provides an exemption for small business investment companies.

the 1933 Act¹⁰⁹ and have been interpreted as ordinary parlance, not terms of art. *Underwriter*, by contrast, has become a term of art subject to significant SEC and judicial construction.

Section 2(a)(11) of the 1933 Act defines an underwriter as

any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking. . . . As used in this paragraph the term “issuer” shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

Determining who is included in this definition has required substantial interpretation. Underwriter status is not dependent on a formal underwriting agreement or even compensation for serving as an underwriter. Any intermediary between the issuer and the investor that is an essential cog in the distribution process may be a statutory underwriter.¹¹⁰ By definition, underwriters include participants in relatively large transactions who may unwittingly become “underwriters” and thus subject to the proscriptions of section 5.¹¹¹ The Act’s definition encompasses persons who purchase or otherwise obtain a large amount of securities directly from the issuer (or a control person¹¹²) and then resell the securities.¹¹³

109. *Issuer* is defined in section 2(a)(4) as “every person who issues or proposes to issue any security.” *Dealer* is defined in section 2(a)(12) as “any person who engages either for all or part of his time, directly or indirectly . . . in the business of offering, buying, selling, or otherwise dealing or trading in Securities issued by another person.”

110. *See, e.g.*, *SEC v. Chinese Consol. Benevolent Ass’n*, 120 F.2d 738 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941) (holding that even though the Chinese Benevolent Association had no formal agreement or contract with the government of China and received no remuneration, it was nevertheless deemed an underwriter because it was engaged in the systematic, continuous solicitation, collection, and remission of funds to purchase bonds, the securities at issue in the case).

111. *See, e.g.*, *In re Ira Haupt & Co.*, 23 S.E.C. 589 (1946).

112. *See infra* text accompanying notes 213–16 (1933 Act) and note 424 (1934 Act).

113. *See, e.g.*, *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969) (defendant purchased the securities from the issuer); *SEC v.*

Initially, guidelines for the definition of underwriter arose from judicial and SEC interpretations and tended to be subjective. In determining whether a person is a statutory underwriter, a key question was whether the would-be underwriter had sufficient investment intent at the time of purchase to qualify as an investor. Purchasers frequently drafted letters of “investment intent” at the time of their purchase in an attempt to avoid underwriter status, but these letters were deemed mere evidence of intent and not determinative, especially when the stock was held for a short period of time.¹¹⁴

Over time, more objective guidelines developed. Determining investment intent has become in large part a question of how long the securities are held before resale. The consensus has been that holding the securities for two to three years or more is ordinarily sufficient to show investment intent.¹¹⁵

However, passage of time alone may not be enough to prevent underwriter status. Section 2(a)(11) speaks in terms of taking the securities with the intent to distribute. Courts and the SEC also look at the circumstances surrounding the downstream sale. Transaction planners believed this could be used to shorten the necessary holding period. By proving an unforeseen change in circumstances for the would-be underwriter, planners thought the holding period should be shortened. Although the SEC consistently refused to issue no-action letters based on this “change of circumstances” defense, planners frequently relied on it in permitting transactions without registration.¹¹⁶ The

Guild Films Co., 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960) (defendant bank accepted stock as collateral, knowing there was a substantial likelihood that the loan recipient would default and the bank would foreclose and sell the stock).

114. Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959) (although investment letter existed, ten-month holding period was insufficient to show investment intent).

115. *See, e.g.*, United States v. Sherwood, 175 F. Supp. 480, 483 (S.D.N.Y. 1959) (defendant held the stock for two years; this showed investment intent). *Cf., e.g.*, Gilligan, Will & Co. (ten-month holding period held insufficient).

116. *See generally* 1 Louis Loss, Securities Regulation 665–73 (2d ed. 1961); Malcolm Fooshe & Edward McCabe, *Private Placements—Resale of Securities: The Crowell–Collier Case*, 15 Bus. Law. 72 (1959).

availability of this defense and others was uncertain, and the case-by-case analysis led to a subjective morass.

The resultant need for predictability led the SEC in 1972 to promulgate Rule 144, a safe-harbor rule. Rule 144 applies to all sales by control persons, all sales by affiliates of the issuer,¹¹⁷ and all resales of restricted securities (generally restricted to preserve the original exemption) by nonaffiliates.

There are five basic requirements for satisfying the provisions of Rule 144. First, the issuer must make publicly available accurate, current information such as that contained in the reporting requirements of the Securities Exchange Act of 1934.

Second, the seller of the “restricted securities” must have beneficially owned them for at least one year.¹¹⁸ The one-year holding period begins to run from the latest date the securities were purchased from the issuer or affiliates: Thus, nonaffiliates are permitted to “tack” holding periods. Rule 144(d)(3) provides eight special rules for computing the holding period for certain types of transactions.¹¹⁹ The full purchase price must be paid for at least one year prior to the sale. The “change in circumstances” defense¹²⁰ is not available for anyone choosing to rely on Rule 144. Since Rule 144 is nonexclusive, the change-in-circumstances defense arguably survives for those not choosing to rely solely on the safe harbor. However, the SEC has taken the position that the change-in-circumstances defense has been abolished for all cases.¹²¹

The third requirement is that all sales of the issuer’s securities by the Rule 144 seller and other specified related individuals comply with prescribed volume limitations. Specifically, sales by these persons

117. Rule 144(a)(1) defines *affiliate* as “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.”

118. Formerly the holding period was two years.

119. Specifically, these rules apply to stock dividends, splits, and recapitalizations; conversions; contingent issuance of securities; pledged securities; gifts of securities; trusts; estates; and Rule 145(a) transactions.

120. *See, e.g., Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959).

121. Securities Act Release No. 33-5223 (Jan. 11, 1972).

within the preceding three months may not exceed the greater of the average weekly trading volume during the preceding four weeks or 1% of the issuer's outstanding shares of that class. Nonaffiliates need only comply with this limitation within two years of purchase from the issuer or affiliate. Sales by affiliates must always comply with the volume limitations. Furthermore, all sales of securities of the issuer, restricted or not, are counted together: If the aggregate exceeds the Rule 144(e) limitation, the sales are not exempt.

The fourth requirement for a Rule 144 exemption is that the sales must be section 4(4) unsolicited brokers' transactions, executed in the usual and customary manner, without special commissions or solicitations.

Fifth, notice must be transmitted to the SEC of the Rule 144 sales unless the number of shares to be sold is less than 500 *and* their market value is less than \$10,000.

b. Transactions by an Issuer Not Involving a Public Offering: Section 4(2) Section 4(2) exempts private placements and other "transactions by an issuer not involving any public offering." This exemption was enacted to permit offerings by issuers for isolated sales to particularly sophisticated persons wherein there is no need for the Act's protections. Although the statutory language is somewhat vague, after years of SEC decisions, interpretive releases,¹²² and judicial scrutiny, four key factors have been isolated by the Supreme Court.¹²³

First, the number of offerees is an important factor: the fewer the offerees, the greater likelihood that a section 4(2) exemption applies.¹²⁴ Likewise, the size of the offering is a factor: The smaller the offering, the greater the chance for an exemption. Second, each offeree should have access to the type of information that would be disclosed should the issuer be required to undertake a full-fledged registration. Third, each offeree should be sophisticated with respect to business

122. See, e.g., Securities Act Release No. 33-285 (Jan. 24, 1935).

123. See also, e.g., SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Securities Act Release No. 33-5487 (Jan. 23, 1974).

124. See *Ralston Purina*, 346 U.S. at 125. The Court expressly refused to adopt a "numbers test" as determinative, however.

and financial matters, as well as with respect to the particular investment being offered.¹²⁵ Fourth, the manner of the offering should be limited to those who have a privately expressed interest rather than be a general solicitation. Other case law suggests that each offeree must be provided an opportunity to ask questions and verify information through access to the issuer's books and in face-to-face meetings.¹²⁶

Like the section 2(a)(11) underwriter definition and the resultant problems with section 4(1) exemptions, the subjective nature of reviewing a vague provision led to much uncertainty and variance among the courts faced with defining the scope of the section 4(2) exemption. As a result, the SEC again responded with a safe-harbor rule. The first safe-harbor rule adopted was former Rule 146; however, because it was extremely complex and technical, few issuers chose to rely on it. The rule was repealed in 1982. In its stead, the SEC adopted Rule 506, which is part of Regulation D and, as discussed below, provides an exemption for certain offers to a limited number of offerees.

c. The "Section 4(1½)" Exemption

Section 4(2)'s nonpublic offering exemption is limited by its terms to transactions by an issuer. Conceptually, a sale by a person other than an issuer that meets the requirements of section 4(2) should be similarly exempt. However, sometimes it is difficult to point to the statutory provision that would provide the equivalent exemption. For example, where the security has not been held for two years, the Rule 144 exemption is not available. Furthermore, if it is a large block of stock, the section 4(1) exemption may not be available.

Although not formally codified by the SEC, what has become known as the "section 4(1½)" exemption finds support in SEC no-

125. See also *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893 (5th Cir. 1977).

126. *Hill York Corp. v. Am. Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971). Several eminent commentators have suggested that as a safety device each offeree should receive an offering circular containing full disclosure.

action letters,¹²⁷ interpretive releases,¹²⁸ judicial decisions,¹²⁹ and commentators' writings.¹³⁰ Unfortunately, the SEC no-action letters do not provide a consistent statement of what is necessary to satisfy the exemption.¹³¹ A reading of the applicable no-action letters reveals five main considerations in the creation of a section 4(1½) exemption. First, each purchaser must have access to information similar to that which would be made available through a registration statement. Second, each purchaser must meet the section 4(2) qualifications, such as sophistication of the investor or investor's representative. Third, any general solicitation of purchasers destroys the exemption. Fourth, too many section 4(1½) sales within a given time frame could be found to be a distribution, which would destroy the exemption. Fifth, the seller must make clear that the proceeds are going to the selling shareholder, not the issuer.

In 1992 the SEC promulgated Rule 144A, helping to create a secondary market for institutional investors wanting to trade privately placed securities. The rule, a relatively narrow exemption, operates more as an experimental adoption of the concept behind the section 4(1½) exemption than as a meaningful safe harbor. Rule 144A applies only to sales of securities of a class not publicly traded in the United

127. See, e.g., Sidney Stahl, SEC No-Action Letter, 1981 WL 24892 (Apr. 23, 1981); Illinois Capital Inv. Corp., SEC No-Action Letter, 1975 WL 10071 (Apr. 14, 1975); Elwill Dev., Ltd., SEC No-Action Letter, 1974 WL 11054 (Dec. 5, 1974).

128. See, e.g., Securities Act Release No. 33-6188 n.178, 1 Fed. Sec. L. Rep. (CCH) ¶ 1051, 19 SEC Docket 465 (Feb. 1, 1980); Securities Act Release No. 33-5452, Fed. Sec. L. Rep. (CCH) ¶ 79,633, at 83,698, 3 SEC Docket 449 (Feb. 1, 1974).

129. See, e.g., Ackerberg v. Johnson, 892 F.2d 132 (8th Cir. 1989); Stoppelman v. Owens, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,208 (D.D.C. 1984); Neuwirth Inv. Fund, Ltd. v. Swanton, 422 F. Supp. 1187 (S.D.N.Y. 1975); Value Line Income Fund, Inc. v. Marcus, Fed. Sec. L. Rep. (CCH) ¶ 91,523 (S.D.N.Y. 1965).

130. See, e.g., ABA Committee on Federal Regulation of Securities, *The Section "4(1½)" Phenomenon: Private Resales of Restricted Securities*, 34 Bus. Law. 1961 (1971); Christopher Olander & Margaret Jacks, *The Section 4(1½) Exemption—Reading Between the Lines of the Securities Act of 1933*, 15 Sec. Reg. L.J. 339 (1988); Carl Schneider, *Section 4(1½)—Private Resales of Restricted or Control Securities*, 49 Ohio St. L.J. 501 (1988).

131. Olander & Jacks, *supra* note 130, at 353.

States.¹³² Rule 144A permits unlimited resales of securities that have never been registered under the 1933 Act as long as all such sales are made to “qualified institutional buyers.”¹³³ Simultaneously with its adoption of Rule 144A, the SEC approved the establishment of the computerized PORTAL¹³⁴ system to facilitate trading and provide a more liquid market for Rule 144A securities.

d. Exemption for Certain Dealer Transactions: Section 4(3)

Section 4(3) provides an exemption from the prospectus delivery requirements for certain transactions by dealers.¹³⁵ This exemption is directed generally to the aftermarket, after primary distribution has occurred. Section 4(3)(A) exempts dealer transactions taking place more than forty days after the first date on which the securities were bona fide offered to the public.¹³⁶ If a registration statement has been filed, section 4(3)(B) provides that the exemption applies during the first forty days¹³⁷ after (1) the securities were offered to the public or (2) the effective date, whichever is later.¹³⁸ Since the vast majority of day-to-day transactions occur more than forty (or ninety) days after the securities have been offered to the public, section 4(3) covers most transactions. While section 4(3) is available to underwriters no longer

132. This class of securities includes small companies, nonconvertible preferred stock, and foreign companies that cannot or will not comply with federal securities laws but seek a U.S. market.

133. Additionally, there are informational requirements unless the issuer is either a reporting company or a foreign issuer. Rule 144A(d)(4)(i).

134. Private Offerings, Resales, and Trading through Automated Linkages.

135. In this context, *dealer* may be understood to include underwriters no longer acting as underwriters (those who have sold their entire allotment).

136. This was intended to cover unregistered offerings and to protect nonparticipating dealers with regard to subsequent transactions, for it permits dealers to trade in a security illegally offered to the public without registration after a lapse of forty days from the time the offering was made. *Kubik v. Goldfield*, 479 F.2d 472 (3d Cir. 1973).

137. If the registration statement pertains to the issuer's first registered offering, the period is ninety days.

138. Since section 4(3)'s exemption is limited to the prospectus delivery requirements and comes into existence some time after the effective date (or bona fide offering date), it has no bearing on the following: prefling gun-jumping violations of section 5(c); section 5(a)'s prohibitions against sales prior to the effective date; or section 5(b)(1)'s prospectus delivery requirements during the waiting period.

acting as such, section 4(3)(c) makes clear that there is no exemption for transactions in securities that constitute all or part of an unsold allotment or subscription by a dealer who is a participant in the distribution.

SEC Rule 174 provides further exemptions under section 4(3) for nonparticipating dealers under certain circumstances by shortening or eliminating the period during which a prospectus need be delivered.¹³⁹ Additionally, Rule 174(d) shortens to twenty-five days the “quiet period,” where stock is listed on a national securities exchange or qualifies for inclusion on the National Association of Securities Dealers Automated Quotation system (NASDAQ).

e. Exemption for Unsolicited Brokers' Transactions: Section 4(4)

Section 4(4) of the Act exempts unsolicited brokers' transactions. There is no explicit definition of *broker* in either the 1933 Act or the rules promulgated thereunder; however, the Act's definition of *dealer* clearly includes brokers. Thus, unless exempted under section 4(3), and in the absence of section 4(4), brokers' transactions would come within section 5's purview by virtue of the operation of section 4(1). The section 4(4) exemption is limited to unsolicited customer orders and is designed to apply to day-to-day transactions where there is no potential for section 5 abuse. The exemption does not apply, however, to transactions so large that they are susceptible to characterization as a distribution,¹⁴⁰ in which case a registration statement would be required unless another exemption is available.

f. Exemption for Certain Small and Limited Offerings: Regulation D

Regulation D consists of three separate private-offering and small-offering exemptions: Rules 504 and 505, exclusive harbors; and Rule 506, a safe harbor.¹⁴¹ Rules 504 and 505 are section 3(b) exemptions,

139. Under Rule 174, a prospectus need not be delivered to offerees or purchasers (1) if the registration statement is on Form F-6 (for foreign issuers); (2) if the company was a public reporting company before the registration statement was filed and is current in its 1934 Act reporting; or (3) in the case of most offerings based on Rule 415 shelf registration.

140. See, e.g., *In re Ira Haupt & Co.*, 23 S.E.C. 589 (1946).

141. Because Rule 506 is a safe harbor, a transaction that does not meet the requirements of Rule 506 may nevertheless be exempt under the statutory section 4(2)

while Rule 506 is promulgated under section 4(2)'s nonpublic offering exemption. These three exemptions are all governed by Rules 501, 502, 503, 507, and 508. The exemptions are, of course, exemptions only from registration, not from the antifraud or civil liability sections of the federal securities laws; nor do the exemptions relieve the issuer of the necessity to comply with state securities laws. Regulation D exemptions are available only to the issuer of securities, not to affiliates or purchasers of securities initially acquired under Regulation D offerings.

Rule 501 defines the terms used in Regulation D. Particularly important is the definition of *accredited investor*.¹⁴² Rule 501(e) provides rules for computation of the number of purchasers.¹⁴³

Rule 502 provides general conditions that must be met in order to qualify for the exemptions provided by Rules 504, 505, and 506. Rule 502(a) provides an integration safe harbor to prevent other offerings from being integrated into the initial offering and thereby destroying the exemption (e.g., by exceeding the offering price ceiling).¹⁴⁴ Rule 502(b) sets forth informational requirements that must be met for exemptions relying on Rules 505 and 506.¹⁴⁵ In general, the larger the

exemption. In contrast, Rules 504 and 505 are dependent on strict compliance with their terms, as there is no statutory exemption to fall back on.

142. 17 C.F.R. § 230.501(a) (2002). There are eight categories that investors may fall within to be an accredited investor. Generally, the categories include institutional investors; individuals with a net worth (or joint net worth) of more than \$1 million; individuals with annual income in excess of \$200,000 (or \$300,000 joint income with spouse) in each of the two most recent years; and directors, executive officers, and general partners of the issuer. See also 1933 Act § 2(15), Rule 215 for other definitions of accredited investor.

143. This provision is only relevant to Rules 505 and 506 (which are limited to thirty-five purchasers), as Rule 504 has no purchaser limit. Rule 501(e) excludes accredited investors and most related purchasers from the number of purchasers counted.

144. Under Rule 502(a), offers made more than six months before or after the offering at issue may be excluded from integration with Regulation D transactions. (Rules 504 and 505, however, extend this period to twelve months before the offering if the other offering is reliant on an exemption under section 3(b) or illegally offered without registration in violation of section 5(a)).

145. No information is required under Rule 504 unless state law requires it.

offering, the more information that must be furnished. Rule 502(b) states that the required information must be provided to all unaccredited investors. Formerly, the SEC required that such information be furnished to all investors if there were any unaccredited offerees; this practice is still recommended by the SEC. Rule 502(c) prohibits the offer or sale of securities by general solicitation or general advertising.¹⁴⁶ Finally, Rule 502(d) sets forth limitations on the resale of securities acquired in a Regulation D transaction.¹⁴⁷ Since these exemptions are only transaction exemptions, any securities acquired pursuant to Regulation D cannot be resold unless the resale is registered or has an independent exemption. The issuer is required by Rule 502(d) to exercise reasonable care to ensure that the purchasers do not unwittingly become underwriters as defined by section 2(a)(11).¹⁴⁸

Rule 508 provides that insignificant deviations from a term, condition, or requirement of Regulation D will not destroy the exemption for a good-faith transaction. This is not designed as a new method of compliance, but rather as a defense in a suit where noncompliance was *de minimus*. To qualify for this defense, the issuer must show (1) that the failure to comply did not affect the complainant; (2) that it was an insignificant violation with respect to the offering as a whole; and (3) that a reasonable good-faith attempt to comply was made.

Rule 503 provides that Regulation D requires filing of notices of sales with the SEC. Moreover, Rule 507, added by the SEC in 1989, provides that Regulation D is not available to persons who have been enjoined from violating Rule 503's notice of sales requirement. The SEC may, however, waive this provision in an individual case upon a showing of good cause.

146. General solicitation includes, but is not limited to, advertising, general meetings, general letters, and circulars. In the limited situation where the exemption being relied on is Rule 504 and all sales are pursuant to state registration in states that require delivery of a disclosure document, general solicitation is permitted.

147. Again, in the limited situation where the transaction is relying on Rule 504 for exemption and all sales are pursuant to registration in a state (or states) requiring delivery of a disclosure document, resales need not be restricted.

148. Rule 502(d) contains examples of the requisite reasonable care, such as placing an appropriate legend on the stock certificate.

Offerings up to \$1 million—Rule 504. Under Rule 504, an issuer that is not an investment company or a 1934 Act reporting company may have an exemption for small offerings. Offerings with an aggregate price over \$1 million do not qualify for this exemption.¹⁴⁹ All securities offered within the past twelve months under a section 3(b) exemption and all securities offered in violation of section 5 within the past twelve months are included in calculating the aggregate offering price.¹⁵⁰ General solicitations of purchasers are permitted and no resale restrictions are required, but only if the offering is registered under applicable state securities (or blue sky) law provisions.

Offerings up to \$5 million—Rule 505. Rule 505, which is also a section 3(b) exemption, exempts certain offerings up to \$5 million by issuers that are not investment companies.¹⁵¹ The offering must be limited to thirty-five purchasers, but related purchasers and accredited investors do not count in the limit. No general solicitation is permitted. There are no limitations on the nature of the purchasers; however, there are informational requirements if any of the offerees are not accredited. As with Regulation A offerings, Rule 505 offerings are subject to the “bad boy” disqualification provisions of Rule 262 (see *infra* text accompanying note 158). Resales of the securities relying on this exemption are subject to restrictions.¹⁵²

Safe harbor for nonpublic offerings by issuers—Rule 506. Rule 506, the final exemption in Regulation D, is a safe harbor for a section 4(2)

149. Currently, only \$500,000 of the securities may be attributable to offers and sales of securities not registered under state securities laws. However, the SEC has proposed allowing up to \$1 million regardless of state registration.

150. This makes the planning and timing of offerings very important. For example, an issuer cannot have a \$500,000 Rule 504 offering following within one year of a \$1 million Regulation A offering, since Rule 504 puts a \$1 million ceiling on section 3(b) offerings within the preceding twelve months. On the other hand, an issuer can have a \$500,000 Rule 504 offering *followed by* a \$1 million Regulation A offering, since Rule 254 would permit it as within Regulation A’s \$1.5 million ceiling on section 3(b) offerings within twelve months.

151. The method of calculation is similar to Rule 504 and Regulation A: include all securities offered within the past twelve months under a section 3(b) exemption (i.e., Regulation A or Rule 504) plus those offered in violation of section 5.

152. Rule 502(d) requires that resales be made in compliance with Rule 144.

exemption. There is no limit on the dollar amount of an offering under Rule 506. General solicitation of purchasers is not permitted, and the offering is limited to thirty-five unaccredited purchasers.¹⁵³ Moreover, all of the unaccredited purchasers must be knowledgeable, sophisticated, and able to evaluate and bear the risks of the prospective investment.¹⁵⁴ Additionally, the purchasers must have access to the information as required by Rule 502(b), and the issuer must affirmatively disclose such information if there are any unaccredited purchasers. Rule 506, like Rule 505, is subject to the limitations on resale imposed by Rule 502(d), and downstream sales are similarly governed by Rule 144.

g. Other Exemptions

Rule 701 provides not merely a safe harbor, but an exclusive harbor for employee and consultant compensation plans. It is available only to issuers, and the issuer may not be a 1934 Act reporting company or an investment company. This exemption may be used for stock purchase plans, option plans, bonus plans, stock appreciation rights, profit sharing, thrift plans, incentive plans, or similar plans. However, the plan must be written, and it may not be used to compensate underwriters or most promoters. There is a limitation on the dollar amount of the compensation; the limitation varies depending on the size and assets of the company and the stock outstanding.¹⁵⁵ There are restrictions on resale; thus any downstream sales must be in accordance with Rule 144. Notice of sales relying on this exemption must

153. Related purchasers and accredited investors are excluded from the calculation of the number of purchasers.

154. Rule 146, the former safe-harbor rule for section 4(2), used to require this qualification for each offeree. Although this requirement is not specifically stated in Rule 506, disputes over whether a prohibited general solicitation has taken place frequently arise when this qualification is not met. *See, e.g., Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893 (5th Cir. 1977).

155. Any nonpublic issuer may rely on the Rule 701 exemption for offerings of at least \$1 million. The ceiling on the offering is the greater of \$1 million per year or 15% of the issuer's total assets or 15% of the aggregate value of the outstanding shares of the securities to be offered in the Rule 701 offering.

be filed with the SEC. Failure to comply may disqualify the issuer from using the exemption.

Regulation S contains two safe-harbor exemptions from registration for certain offshore offers and sales. It is relatively complex and requires not only that the offering process take place outside the United States but also that the securities so offered remain offshore.¹⁵⁶

Section 4(5) is of relatively narrow utility, exempting from registration certain real estate mortgage notes secured by a first lien on a single parcel of real estate consisting of land and either a residential or commercial structure.

Section 4(6) exempts offerings made solely to accredited investors where the aggregate amount of securities sold does not exceed the dollar limit of section 3(b) (currently \$5 million). Accredited investors, as defined in section 2(a)(15) of the 1933 Act, include institutional investors and individuals with a large net worth. The SEC in 1982 exercised its rule-making powers granted in section 2(a)(15) by promulgating Rule 215, which expands the definition of accredited investor to include other individuals who are considered sophisticated, who have access to information concerning the issuer, or who are sufficiently affluent to not require the Act's protection in the transaction. Sales under this exemption must be made only to accredited investors, there must be no public advertising or solicitation, and appropriate notice of reliance on the exemption (currently Form D) must be filed with the SEC.

Under the authority of section 3(b) of the 1933 Act, the SEC promulgated Regulation A¹⁵⁷ to exempt certain small issues. Regulation A is limited to issuers in the United States or Canada that are not investment companies, and it applies to issues with an aggregate offering price of \$5 million or less within a one-year period for issuer transactions and \$1.5 million for secondary transactions. Regulation A contains "bad boy" disqualification provisions that render the exemption unavailable in most cases if a participant in the offering has been sub-

156. Rules 901–904. See 3 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 17.4 (4th ed. 2002).

157. Rules 251–264.

ject to SEC disciplinary proceedings or convicted of a violation of relevant laws in the last five years.¹⁵⁸

Regulation A is not a complete exemption, but rather is conditioned on what is comparable to a “mini” registration. The issuer must file offering circulars with the SEC. Offers to sell can be made only by way of this offering circular. Copies of all sales materials must be filed with the SEC. Finally, the issuer must file reports of all sales with the SEC regional office (Form 2-a). In general, the advantages of a Regulation A filing are that the information disclosed may be less detailed, it does not require audited financial statements, and it does not subject the issuer to periodic reporting requirements.

3. General Exemptive Authority

In 1996, Congress enacted a broader exemptive authority not linked to the nature of the securities or the nature of the transaction. A new section 28 of the 1933 Act provides that the SEC may exempt transactions, securities, and persons if in the public interest and consistent with investor protection.¹⁵⁹ This virtually unlimited exemptive power frees the SEC from the more rigid parameters of the specific exemptions set forth in sections 3 and 4 of the Act.¹⁶⁰

4. Integration of Transactions

The integration doctrine permits the telescoping of two or more purportedly separate transactions into one transaction. Under the integra-

158. Rule 262.

159. The SEC may exercise this exemptive authority by rule or regulation, and the exemption may extend to any person, security, or transaction and may be subject to whatever conditions the SEC imposes so long as the exemption is considered necessary or appropriate in the public interest and is consistent with the protection of investors. 15 U.S.C. § 77z-3 (Supp. 2000). In contrast to its general exemptive authority under the 1933 Act, in the parallel provision of the 1934 Act the SEC was given the authority to provide an exemption by administrative order in addition to providing for an exemption in its rules and regulations. *See* section 36 of the 1934 Act, 15 U.S.C. § 78mm(a) (Supp. 2000).

160. The SEC has been proceeding cautiously. In 1998, it proposed eliminating the \$5 million ceiling on Rule 701 benefit plan offerings. Securities Act Release No. 33-7511, 63 Fed. Reg. 10785 (Mar. 5, 1998).

tion doctrine,¹⁶¹ the SEC and the courts examine multiple offerings to determine whether they should be treated as a single transaction. The integration doctrine can also be used to integrate a would-be exempt offering with a registered offering where some of the offers or sales in the registered offering would destroy the availability of the exemption.¹⁶² It is possible that two or more exempt offerings, when combined, will lose the attributes that entitled them to protection.

The SEC has made it clear that integration applies to the transaction exemptions under section 4 and, in particular, the section 4(2) exemption for transactions not involving a public offering. The SEC has developed the following five-factor test¹⁶³ to determine whether the integration doctrine should be applied to two or more transactions:

1. Are the sales part of a single plan of financing?
2. Do the sales involve issuance of the same class of securities?
3. Were the sales made at or about the same time?
4. Is the same type of consideration received?
5. Are the sales made for the same general purpose?

The SEC has not given much guidance on how these factors should be weighted. Accordingly, it would appear that in a particular case any one or more of the five factors could be determinative.¹⁶⁴

The integration doctrine essentially depends on the facts and nuances of each situation. Therefore, it is often difficult to glean any knowledge from the sparse precedent that exists. Much of the relevant

161. The integration doctrine first emerged in connection with the intrastate offering exemption in the context of determining which transactions constitute “part of an issue” (emphasis added). The “part of an issue” concept applies to section 3(b) exemptions, such as Regulation A. Similarly, the issue concept has been carried over to the section 3(a)(9) exemption for exchanges of securities exclusively with existing securities holders. The integration doctrine has also been applied to the section 3(a)(10) exemption for administratively approved reorganizations.

162. SEC Rule 155 sets forth safe harbors from integration for an abandoned public offering followed by an exempt private offering and for an abandoned private offering followed by a registered public offering.

163. Securities Act Release No. 33-4434 (Dec. 6, 1961).

164. Thus, for example, the absence of a prearranged single plan of financing has been held to preclude integration.

precedent is based on no-action letters, which by their nature are persuasive but not binding.¹⁶⁵ To decrease the uncertainty in some situations, the SEC has developed integration safe-harbor rules, such as Rule 502(a) for Regulation D offerings and Rule 147(b)(2) for offerings relying on the intrastate exemption.

E. Liabilities Under the 1933 Act

Under the 1933 Act, deficiencies in registration materials can result in administrative action by the SEC, criminal sanctions, injunctive relief, and, in some cases, private remedies.

1. SEC Administrative Remedies

In order to prevent a deficient registration statement from becoming effective, the SEC can institute formal proceedings for issuing a refusal order. Refusal-order proceedings must be instituted within ten days of the registration statement's filing, and the order may be issued only after the registrant has been given notice and an opportunity for a hearing. Alternatively, when faced with material deficiencies in the registration statement, the SEC may commence formal stop-order proceedings at any time.¹⁶⁶ Again, the order can be issued only after formal notice and an opportunity for a hearing. However, both of these formal proceedings are rather drastic measures and not a part of the normal process for dealing with deficient registration materials. Instead, the normal process generally involves the use of deficiency letters¹⁶⁷ and other communications between the issuer and the SEC staff, as well as amendments voluntarily delaying the proposed effective date by the issuer until the deficiencies are corrected. In addition to section 8 proceedings, section 8A gives the SEC the authority to issue cease and desist orders.

165. In 1979 the Commission suspended its practice of rendering no-action advice on integration questions but resumed the practice in 1985.

166. See 1 Hazen, *supra* note 101, § 2.2; William McLucas, *Stop Order Proceedings Under the Securities Act of 1933: A Current Assessment*, 40 Bus. Law. 515 (1985).

167. This is a letter from the SEC staff advising the issuer that the Commission would like to see certain changes in the registration statement. For greater detail, see generally 1 Hazen, *supra* note 101, § 3.7[1]; Richard Jennings & Harold Marsh, *Securities Regulation 174-75* (5th ed. 1982).

2. Private Rights of Action

The 1933 Act has three sections prohibiting fraud and misstatements: sections 11, 12, and 17. Sections 11 and 12 create private rights of action, while section 17(a) is a more generalized antifraud provision used primarily by the SEC and by the Department of Justice in criminal actions. Each of the private rights of action under the 1933 Act must be examined in conjunction with Rule 10b-5 of the 1934 Act and its general antifraud remedy for fraud in connection with the purchase or sale of a security.¹⁶⁸ Most state securities class actions are federally preempted by the Private Securities Litigation Reform Act.¹⁶⁹

Any material deficiencies in the registration statement that carry over to the prospectus will result in violations of the section 5(b) prospectus delivery requirements, which call for an accurate and up-to-date prospectus.¹⁷⁰ Any violation of section 5 gives rise to possible criminal sanctions as well as judicially secured SEC equitable sanctions. Furthermore, private remedies may exist for aggrieved persons under sections 11 and 12 of the 1933 Act. Purported waivers of 1933 Act claims are invalid, except in connection with settlement of threat-

168. 17 C.F.R. § 240.10b-5. The implied private right of action under 1934 Act Rule 10b-5 is cumulative with the express remedies set forth in the 1933 Act. *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). Although Rule 10b-5 is broader than the 1933 remedies, it imposes a higher standard of culpability than the 1933 Act by requiring a showing of scienter. Rule 10b-5 is discussed more fully *infra* text accompanying notes 451–82.

169. The PSLRA is discussed more fully *infra* text accompanying notes 225–57 and 382–85; and nn.379–80. The preemption applies to any class action involving misrepresentations, omissions, deception, or manipulation in connection with the purchase or sale of a publicly traded security. 1933 Act § 16(b), 15 U.S.C. § 77p(b) (Supp. 2001); 1934 Act § 28(f)(1), 15 U.S.C.A. § 78bb(f)(1) (2000 & Supp. 2001). The 1934 Act includes enhanced pleading requirements applicable to fraud actions. 1934 Act § 21D(b), 15 U.S.C. § 78u-4(b) (Supp. 2001). The litigation reform legislation also included some substantive amendments, including those relating to apportionment of damages and liability for forward-looking statements. *See* 1933 Act §§ 11(f), 12(b), 27A, 15 U.S.C. §§ 77k(f), 77l(b), 77z-2 (Supp. 2001).

170. *See, e.g., SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082 (2d Cir. 1972) (holding that delivery of an uncorrected prospectus, which was not an accurate statement as of the date of delivery, was a violation of section 5(b)(2), subjecting the dealer who delivered the prospectus to liability under section 12(a)(1)).

ened or pending litigation.¹⁷¹ The applicable statutes of limitations for private remedies under the 1933 Act are set forth in section 13.¹⁷²

a. Misrepresentations and Omissions in Registration Statements:
Section 11

Section 11 imposes express civil liability on persons preparing and signing materially misleading registration statements. Section 11 is the only liability provision expressly limited to registered public offerings.¹⁷³ It imposes broader liability than other antifraud provisions because the aggrieved purchaser need only show that he or she bought the security and there was a material misrepresentation in the registration statement.¹⁷⁴ There is no requirement under section 11 that pur-

171. 1933 Act § 14. See *Meyers v. C & M Petroleum Producers, Inc.*, 476 F.2d 427 (5th Cir.), *cert denied*, 414 U.S. 829 (1973).

172. Actions under sections 11 and 12(a)(2) must be brought within one year of discovery of the misstatement or omission. Notwithstanding a longer delay in discovery, actions under these sections must be brought within three years after the security was first offered to the public. An action under section 12(a)(1) must be brought within one year of discovery of the registration violation and within three years of the sale. In 2002 Congress added 15 U.S.C. § 1658, which provides that in actions for securities fraud the applicable limitations period is two years from the discovery of the facts constituting the violation but in no event more than five years after the violation. Since the remedies provided in sections 11 and 12 of the 1933 Act do not speak in terms of fraud, it is doubtful that these longer periods prevail over the one-year/three-year periods mentioned in section 13 of the 1933 act.

173. Although not expressly contained in the statute, the Supreme Court has “read” a public offering limitation into actions under section 12(a)(2). *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995). Although the Court has thus limited section 12(a)(2) to public offerings, it is not limited to registered offerings.

174. Section 11 does not require scienter and has been held by most courts not to implicate the enhanced pleading requirements that apply to fraud actions. *Lone Star Ladies Inv. Club v. Schlotzsky’s Inc.*, 238 F.3d 363 (5th Cir. 2001) (Rule 9(b)’s particularity requirements do not apply in actions under either section 11 or 12 of the 1933 Act); *In re CBT Group PLC Sec. Litig.*, [2000–2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,317, 2000 U.S. Dist. LEXIS 19214 (N.D. Cal. Dec. 29, 2000) (enhanced pleading requirements did not apply to section 11 claims); *In re Ultrafem, Inc. Sec. Litig.*, 91 F. Supp. 2d 678 (S.D.N.Y. 2000) (particularity requirements did not apply to either section 11 or section 12(a) claims); *In re Sirrom Capital Corp. Sec. Litig.*, 84 F. Supp. 2d 933, 938–39 (M.D. Tenn. 2000) (section 11 claim did not have to be pleaded with particularity); *In re Ziff-Davis, Inc. Sec. Litig.*, [1999–2000 Transfer

chasers show that they *relied* on the misstatement. However, there are two standards of liability imposed by section 11. The first is on the issuer, who generally is strictly liable once the plaintiff has proved that he or she bought the stock and that there was a material misstatement in the registration statement. The only “affirmative” defenses for the issuer are (1) to show that the person acquiring the security knew of the untruth or omission in the registration statement at the time of the

Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,006 (S.D.N.Y. 2000) (particularity not required); Griffin v. PaineWebber Inc., [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,762 (S.D.N.Y. 2000) (particularity requirements do not apply to section 11 claims); Yuan v. Bayard Drilling Techs., Inc., 96 F. Supp. 2d 1259 (W.D. Okla. 1999) (particularity requirements do not apply to either section 11 or section 12(a)(2) claims); *In re Thortec Sec. Litig.* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,330, 1989 WL 67429 (N.D. Cal. 1989) (pleading upheld); Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 973 (E.D.N.Y. 1988) (upholding section 11 claim); Quantum Overseas, N.V. v. Touche Ross & Co., 663 F. Supp. 658 (S.D.N.Y. 1987) (upholding section 11 claim but dismissing Exchange Act claim for failing to plead with sufficient particularity); *In re Lilco Sec. Litig.*, 625 F. Supp. 1500 (E.D.N.Y. 1986). *See also, e.g., In re Jiffy Lube Sec. Litig.*, 772 F. Supp. 258, 260–61 (D. Md. 1991); Steiner v. Southmark Corp., 734 F. Supp. 269 (N.D. Tex. 1990). *See generally* Note, *Pleading Under Section 11 of the Securities Act of 1933*, 98 Mich. L. Rev. 2395 (2000). *But see, e.g., Shaw v. Digital Equip. Corp.*, 82 F.3d 1194 (1st Cir. 1996); Shapiro v. UJB Fin. Corp., 964 F.2d 272, 288 (3d Cir.), *cert. denied*, 506 U.S. 934 (1992) (when section 11 and section 12 claims are grounded in fraud rather than negligence, the particularity requirements apply); Castlerock Mgmt. Ltd. v. Ultralife Batteries, Inc., 68 F. Supp. 2d 480 (D.N.J. 1999); Rhodes v. Omega Research Inc., 38 F. Supp. 2d 1353 (S.D. Fla. 1999) (claims under sections 11 and 12 of the 1933 Act sounded in fraud and not negligence, hence particularity requirements applied); *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096 (D. Nev. 1998) (claims under sections 11 and 12(a)(2) of the Securities Act of 1933 sound in fraud and thus must be pled with particularity). *See also, e.g., Sheldon v. Vermonty*, 31 F. Supp. 2d 1287, 1293–94 (D. Kan. 1998) (section 11 claim requires allegations of the required elements—that plaintiff purchased securities in a registered offering with a materially misleading registration statement). The propriety of this view is bolstered by the fact that the enhanced pleading requirements appear in the 1934 Act version of the Reform Act but not in the 1933 Act’s provisions. *See* 1934 Act § 21D(b), 15 U.S.C. § 78u-4(b) (Supp. 2001).

acquisition,¹⁷⁵ (2) lack of materiality, or (3) expiration of the statute of limitations.

The second standard of liability applies to nonissuers who may raise defenses not available to issuers. For all persons other than the issuer,¹⁷⁶ section 11(b) provides three additional possible affirmative defenses. The first two defenses relate to someone who discovers the material misstatement or omission and takes appropriate steps to prevent the violation. A potential section 11 defendant may be relieved of liability by resigning or taking steps toward resignation, and informing the SEC and the issuer in writing that he or she has taken such action and disclaims all responsibility for the relevant sections of the registration statement. Alternatively, if the registration statement becomes effective without the defendant's knowledge, upon becoming aware of the effectiveness the potential section 11 defendant may be relieved of liability by taking appropriate steps toward resignation, informing the SEC as above, and giving reasonable public notice that the registration statement became effective without the defendant's knowledge.

The third defense, contained in section 11(b)(3), is the most frequently used. It absolves defendants from liability if they had reasonable grounds for believing, and did in fact believe, that there was no omission or material misstatement. Since assertions of actual belief are generally difficult to disprove, the test for this defense centers on what are "reasonable grounds" for believing that no violation occurred. Section 11(c) establishes the appropriate standard of care: "[T]he standard of reasonableness shall be that required of a prudent man in the management of his own property." Thus, this defense is often described as the "due diligence" (although that phrase does not appear in the statute) and reasonable investigation defense.

175. Remember that reliance is not required, so an offer of proof that the plaintiff never heard or read the misstatement is irrelevant.

176. Persons liable include all signers of the registration statement (which must include the principal executive and financial officers, the issuer, and a majority of the directors), all directors (including people not yet directors but agreeing to be named as about to become directors), experts (e.g., the certifying accountant), and underwriters. See sections 11(a)(1)–(5) for a list of these persons.

The courts have not articulated a bright-line test as to what satisfies the due diligence and reasonable investigation standard of care.¹⁷⁷ What has emerged, however, is a sliding scale of culpability depending on the defendant's knowledge, expertise, and status with regard to the issuer, its affiliates, or its underwriters, as well as the degree of the defendant's actual participation in the registration process and in preparing registration materials.¹⁷⁸ In an effort to clarify its position, the SEC promulgated Rule 176, which sets forth factors to be considered, reinforces the judicial sliding scale of culpability, and further provides for the necessity of a case-by-case, highly fact-specific analysis. Rule 176 provides the following:

In determining whether or not the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in section 11(c), relevant circumstances include, with respect to a person other than the issuer:

- (a) the type of issuer;
- (b) the type of security;
- (c) the type of person;
- (d) the office held when the person is an officer;
- (e) the presence or absence of another relationship to the issuer when the person is a director or proposed director;
- (f) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing);
- (g) when the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter, and the availability of information with respect to the registrant; and
- (h) whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

177. See, e.g., *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968); *Feit v. Leaseco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *In re Flight Transp. Corp. Sec. Litig.*, 593 F. Supp. 612 (D. Minn. 1984); *Draney v. Wilson, Morton, Assaf & McElligott*, 592 F. Supp. 9 (D. Ariz. 1984); *In re Fortune Sys. Sec. Litig.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,390 (N.D. Cal. 1987).

178. For more detail, see 1 Hazen, *supra* note 101, § 7.4.

It is appropriate to consider not only the positions held but also any special expertise the person might have.

Damages under section 11 depend on whether or not the security is sold prior to judgment. The critical dates are the date of sale (if the security has been sold prior to the lawsuit), the date the lawsuit is filed, and the date of the judgment. If the security is sold before the suit is filed, damages are based on the amount paid less the amount for which the security sold. If the security is sold between the date the suit is filed and the date of judgment, the plaintiff is entitled to the lesser of (1) the amount paid less the price for which the security sold or (2) the amount paid less the value of the security at the time the suit was filed. If the security is held until the date of the judgment, the plaintiff is entitled to the amount paid less the value of the security at the time the suit was filed. Furthermore, defendants are liable only for damages caused by the misleading statement; they have the right to attempt to reduce the damages they must pay by attempting to prove that the decrease in value is the result of something other than their misleading statement. However, section 11 gives the court discretion to award the plaintiff costs and attorneys' fees as part of the damage award. Liability under section 11 is joint and several¹⁷⁹ subject to two exceptions. First, underwriters of the public offering are not liable under section 11 beyond their proportionate participation in the offering.¹⁸⁰ Second, outside directors may seek contribution from more culpable section 11 defendants.¹⁸¹

b. Securities Sold in Violation of Section 5 and Securities That Contain Material Misstatements or Omissions: Section 12

Section 12 of the 1933 Act imposes liability in two contexts: when a person sells a security in violation of section 5 (failure to register or meet an exemption) and when a security is sold by means of a prospectus or oral communication that contains a material misstatement

179. Section 11(e), 15 U.S.C. § 77k(e) (2000).

180. *Id.*

181. Section 11(f), 15 U.S.C. § 77k(f) (2000 & Supp. 2001). The Supreme Court has also recognized an implied right of contribution for damages based on 1934 Act Rule 10b-5. *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286 (1993).

or omission. Unlike section 11, section 12 by its terms applies to any transaction, whether or not it is subject to the registration provisions of the 1933 Act.¹⁸² A major issue in many section 12 cases is whether the defendant is a permissible one—that is, whether he or she is a “seller” for purposes of section 12. Issuers and underwriters generally are not sellers within the meaning of section 12 unless they actively participate in the negotiations with the plaintiff/purchaser.¹⁸³ Similarly, an attorney’s having worked on the offering circular will not make him or her a seller.¹⁸⁴ On the other hand, a broker who deals directly with the plaintiff is a section 12 seller.¹⁸⁵

Section 12 appears to require privity between the plaintiff and the defendant.¹⁸⁶ Traditional agency principles that would give rise to a finding of privity in a normal contract situation apply with equal force in the securities context.¹⁸⁷ The Supreme Court has delineated two factors that should be considered in identifying a seller under section 12:

182. For a violation of the federal securities law to occur, some means or instrument of interstate commerce must be used. The Supreme Court held that a section 12(a)(2) action cannot be brought in connection with an isolated sale but can apply only in the context of a public offering. *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995). This reading of the statute does not seem justified either by the language of the Act or by its legislative history. See 1 Hazen, *supra* note 101, § 7.6.

183. See *Foster v. Jesup & Lamont Sec. Co., Inc.*, 759 F.2d 838 (11th Cir. 1985). See also *Pinter v. Dahl*, 486 U.S. 622 (1988) (holding that to be a seller in an action under section 12(a)(1), the defendant must have been both an immediate and direct seller; substantial participation alone will not suffice).

184. E.g., *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988), *cert. denied*, 492 U.S. 918 (1989); *Stokes v. Lokken*, 644 F.2d 779 (8th Cir. 1981).

185. E.g., *Quincy Co-operative Bank v. A.G. Edwards & Sons, Inc.*, 655 F. Supp. 78 (D. Mass. 1986).

186. The seller “shall be liable to the person purchasing such security from him . . .” (emphasis added). See, e.g., *Pinter*, 486 U.S. 622; *Collins v. Signetics Corp.*, 443 F. Supp. 552 (E.D. Pa. 1977), *aff’d*, 605 F.2d 110 (3d Cir. 1979); *Unicorn Field, Inc. v. Cannon Group, Inc.*, 60 F.R.D. 217 (S.D.N.Y. 1973). While there has been some suggestion that the *Pinter* decision may dispense with the privity requirement, the correct view is that it does not. E.g., *In re Craftmatic Sec. Litig.*, 703 F. Supp. 1175, 1183 (E.D. Pa.), *modified on other grounds*, 890 F.2d 628 (3d Cir. 1989). *But see Scotch v. Moseley, Hallgarten, Eastabrook & Weeden, Inc.*, 709 F. Supp. 95 (M.D. Pa. 1988) (privity not required under section 12(a)(2) with regard to open-market transaction).

187. See *Buchholtz v. Renard*, 188 F. Supp. 888 (S.D.N.Y. 1960).

whether the defendant received direct remuneration or benefit as a result of the sale, and whether the defendant's role in the solicitation and purchase was intended to benefit the seller (or owner) of the security.¹⁸⁸

Civil liability for sales in violation of section 5—section 12(a)(1). Anyone who offers or sells a security in violation of section 5 is liable in a civil action under section 12(a)(1) to the person “purchasing such security from him.” In order to recover under this section, the plaintiff need only show that the defendant sold the security to the plaintiff and that the security was unregistered. The defendant then must either show that an exemption existed or establish the *in pari delicto* (or equal fault) defense. While initially it was believed that the *in pari delicto* defense was unavailable in an action under section 12(a)(1) (since liability imposed under this section is “strict liability”), the Supreme Court has held that the defense is available in private actions under any provision of the federal securities laws.¹⁸⁹ Relying on an earlier Court decision,¹⁹⁰ the Court laid out the two-prong test for the *in pari delicto* defense: First, the plaintiff must be at least equally at fault for the underlying illegality; and second, preclusion of the suit must not offend the “underlying statutory policies.”¹⁹¹ Applying the test to section 12(a)(1) violations (i.e., securities sold in violation of section 5), the Court held that “the *in pari delicto* defense may defeat recovery in a section 12(a)(1) action only where the plaintiff's role in the offering or sale of nonexempted, unregistered securities is more as a promoter than as an investor.”¹⁹²

Under section 12(a)(1), the successful plaintiff is entitled to rescission and return of purchase price. If the security has already been sold, damages under section 12(a)(1) are based on the loss comprising the difference between the plaintiff's purchase price and sale price. Since section 12(a)(1) does not require a causal connection between

188. *Pinter*, 486 U.S. 622.

189. *Id.*

190. *Bateman, Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985).

191. *Pinter*, 486 U.S. at 638.

192. *Id.* at 639. See also Mark Klock, *Promoter Liability and In Pari Delicto Under Section 12(1)*, 17 Sec. Reg. L.J. 53 (1989).

the violation and any decline in price, a successful plaintiff is entitled to rescission even when the price of the security drops as a result of a change in the issuer's circumstances or market factors wholly unrelated to the section 5 action.¹⁹³ Also, at least one court has held that even where a violation of the section 5(b)(1) prospectus delivery requirement is followed by the purchaser's receipt of a complete statutory prospectus prior to the delivery of the security, the legal sale does not cure the illegal offer, and the purchaser is entitled to maintain an action under section 12(a)(1).¹⁹⁴

Liability of sellers for material misstatements or omissions—section 12(a)(2). Section 12(a)(2) of the 1933 Act creates an express private remedy for a purchaser against the seller of a security for material misstatements or omissions¹⁹⁵ in connection with the offer and sale. As is the case with section 12(a)(1), section 12(a)(2) is limited to liability of sellers and thus imposes a privity requirement. Once the privity requirement is satisfied, the plaintiff must establish only that there was a material misstatement or omission in the prospectus or oral communication. There is no requirement that the plaintiff prove

193. This is in contrast to sections 11 and 12(a)(2), which require a causal connection between the misstatement and the plaintiff's loss. 1933 Act §§ 11(e), 12(b). Similarly, 1934 Act Rule 10b-5 imposes a causation requirement.

194. *Diskin v. Lomasney & Co.*, 452 F.2d 871 (2d Cir. 1971).

195. Some courts have held that section 12 does not require scienter; most courts have held that section 12 does not implicate the enhanced pleading requirements that apply to fraud actions. *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363 (5th Cir. 2001); *In re Ultrafem, Inc. Sec. Litig.*, 91 F. Supp. 2d 678 (S.D.N.Y. 2000); *Yuan v. Bayard Drilling Techs., Inc.*, 96 F. Supp. 2d 1259 (W.D. Okla. 1999) (particularity requirements do not apply to either section 11 or section 12(a)(2) claims). These enhanced pleading requirements appear in the 1934 Act but not in the 1933 Act. See 1934 Act § 21D(b), 15 U.S.C. § 78u-4(b) (Supp. 2001). A number of courts have, however, applied the enhanced pleading standards to section 12(a)(2) claims. *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 288 (3d Cir.), cert. denied, 506 U.S. 934 (1992); *Sears v. Likens*, 912 F.2d 889 (7th Cir. 1990); *Castlerock Mgmt. Ltd. v. Ultralife Batteries, Inc.*, 68 F. Supp. 2d 480 (D.N.J. 1999); *Rhodes v. Omega Research Inc.*, 38 F. Supp. 2d 1353 (S.D. Fla. 1999); *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096 (D. Nev. 1998).

reliance; it will be presumed.¹⁹⁶ The plaintiff also need not have read the misstatement in question.¹⁹⁷ However, if the plaintiff *knew* of the untruth or omission prior to purchase, the section 12(a)(2) claim should be dismissed.¹⁹⁸

The defendant may also be absolved of liability if “he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.”¹⁹⁹ It is clear that the section 12(a)(2) reasonable care requirement imparts some sort of negligence standard and that it is not necessary for the purchaser to show any type of scienter on the seller’s part.²⁰⁰ Indeed, the section 12(a)(2) standard of reasonable care may impose a duty to investigate in some circumstances.²⁰¹ Certain factors can be used to determine whether the defendant exercised reasonable care: (1) the quantum of decisional and facilitative participation, such as designing the deal and contacting and attempting to persuade potential investors; (2) access to source material against which the truth of the representations could be tested; (3) relative skill in “ferreting out the truth”; (4) pecuniary interest in the transaction’s completion; and (5) the existence of a relationship of trust between the investor and the alleged seller.²⁰²

As with section 12(a)(1), but unlike section 11 or the implied remedy under 1934 Act Rule 10b-5, damages under section 12(a)(2) are limited to either rescission and return of purchase price or, if the purchaser no longer owns the security, damages based on the difference between the purchase price and sale price. As is the case with section 11 damages, damages under section 12(a)(2) will not include any de-

196. *Currie v. Cayman Res. Corp.*, 835 F.2d 780 (11th Cir. 1988); *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982); *In re Conner Bonds Litig.*, [1988–1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,969 (E.D.N.C. 1988).

197. *Sanders v. John Nuveen & Co.*, 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).

198. *See Mayer v. Oil Field Sys. Corp.*, 803 F.2d 749 (2d Cir. 1986).

199. *Id.* at 755 (quoting 15 U.S.C. § 776(2)).

200. *See, e.g., Wigand v. Flo-Tek*, 609 F.2d 1028 (2d Cir. 1979).

201. *Sanders v. John Nuveen & Co.*, 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).

202. *Davis v. Avco Fin. Servs., Inc.*, 739 F.2d 1057 (6th Cir. 1984), *cert. denied*, 472 U.S. 1012 (1985).

cline in the value of the security that can be attributed to factors other than the material misrepresentation or omission in question.²⁰³

3. SEC Actions and Criminal Prosecutions: Section 17

Section 17(a) of the 1933 Act prohibits fraud, material misstatements, and omissions of fact in connection with the offer or sale of securities.²⁰⁴ It applies regardless of whether the securities are registered or exempt from registration under section 3. However, unlike its 1934 Act counterpart (Rule 10b-5), section 17(a) applies only to sales of and offers to sell securities.²⁰⁵ It covers activities of the offeror or seller, but not fraud by the purchaser. The Supreme Court has held that scienter must be shown to establish a violation of section 17(a)(1), but not for either section 17(a)(2) (the language of which was found “devoid of any suggestion whatsoever of a scienter requirement”) or section 17(a)(3) (which “focuses upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible”).²⁰⁶ The vast majority of decisions hold that private plaintiffs do not have an implied remedy under section 17(a) of the 1933 Act.

Section 17(b) prohibits disseminating information about a security without disclosing any consideration received or to be received, directly or indirectly, in connection with sales of the security. Like section 17(a), section 17(b) applies to securities whether registered or

203. Section 12(b), 15 U.S.C. § 77l(b) (2000 & Supp. 2001).

204. Section 17(a) provides that:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

205. Furthermore, also unlike Rule 10b-5, the overwhelming majority of decisions hold that there is no implied private right of action for violations of section 17(a) of the 1933 Act. See 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* § 12.22 (4th ed. 2002).

206. *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

exempt under section 3. Section 17(b) is designed to prevent the misleading impression of impartiality in certain recommendations. Section 17(b) has been held applicable even to periodicals receiving compensation for favorable recommendations, notwithstanding a challenge that such regulation violates First Amendment rights of free speech.²⁰⁷ It has also been held that section 17(b) is not limited to securities distributions but applies both to new and outstanding securities.²⁰⁸

Violations of section 17 may result in both criminal sanctions and an SEC civil suit. A majority of the earlier federal securities cases recognized an implied right of action under section 17(a).²⁰⁹ But although a few decisions continued to recognize the remedy,²¹⁰ the overwhelming majority of decisions do not.²¹¹ In fact, the nonexistence of an implied right under section 17(a) is so clear in some circuits as to justify the imposition of sanctions under Federal Rule of Civil Procedure 11 for claims brought under such a theory.²¹²

207. *SEC v. Wall St. Publ'g Inst., Inc.*, 851 F.2d 365 (D.C. Cir. 1988), *cert. denied*, 489 U.S. 1066 (1989).

208. *Id.* (relying on S. Rep. No. 73-47, at 4 (1933) and H.R. Rep. No. 73-85, at 6 (1933)).

209. *See Crookham v. Crookham*, 914 F.2d 1027 (8th Cir. 1990) (upholding Rule 11 sanctions); *Landry v. All Am. Assurance Co.*, 688 F.2d 381 (5th Cir. 1982); *Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086 (1978); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967). *See also* 2 *Hazen*, *supra* note 205, § 12.22.

210. *See, e.g., Letizia v. Prudential Bache Sec., Inc.*, 802 F.2d 1185 (9th Cir. 1986); *Gaff v. FDIC*, 814 F.2d 311 (6th Cir. 1987) (but denying standing to an offeree who did not purchase).

211. *See, e.g., Schlifke v. Seafirst Corp.*, 866 F.2d 935 (7th Cir. 1989); *Newcome v. Esrey*, 862 F.2d 1099 (4th Cir. 1988); *Krause v. Perryman*, 827 F.2d 346 (8th Cir. 1987); *Landry v. All Am. Assurance Co.*, 688 F.2d 381 (5th Cir. 1982). Additional cases are collected in 2 *Hazen*, *supra* note 205, § 12.22.

212. *Crookham*, 914 F.2d 1027 (\$10,000 sanction for bringing suit under section 17(a) of the 1933 Act).

4. Secondary Liability Under the 1933 Act

a. Controlling-Person Liability

Both the 1933 and 1934 Acts provide for controlling-person liability. Section 15 of the 1933 Act imposes joint and several liability on controlling persons for the actions of persons under their control. The term *control* (including the terms *controlling*, *controlled by*, and *under common control with*) means “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.”²¹³ A controlling person is sometimes referred to as an affiliate.²¹⁴ Controlling-person liability will not be imposed if “the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.” However, this “lack of knowledge” exception is generally narrowly construed and limited to the basic facts underlying the course of business; lack of knowledge of the particular transaction does not preclude controlling-person liability.²¹⁵ Some courts have held that the broader common-law rules of *respondeat superior* do not apply in light of the statutory provisions dealing with controlling-person liability. However, the clear majority of the federal courts of appeals hold that statutorily imposed controlling-person liability does not preclude application of either the com-

213. 17 C.F.R. § 230.405 (2002). See, e.g., *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969).

214. “An affiliate of, or person affiliated with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.” 17 C.F.R. § 230.405 (2002).

215. S.F.—Okla. *Petroleum Exploration Corp. v. Carstan Oil Co.*, 765 F.2d 962 (10th Cir. 1985). Likewise, controlling-person liability does not require the controlling person’s participation in the wrongful conduct. See, e.g., *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945 (5th Cir. 1981); *Underhill v. Royal*, 769 F.2d 1426 (9th Cir. 1985); *Steinberg v. Ill. Co.*, 659 F. Supp. 58 (N.D. Ill. 1987). *But see* *Durham v. Kelly*, 810 F.2d 1500 (9th Cir. 1987) (corporate president’s wife exercised some control but was not held liable, since she did not induce the misstatements in question); *Buhler v. Audio Leasing Corp.*, 807 F.2d 833 (9th Cir. 1987) (broker–dealer not liable for failure to supervise off-book sales).

mon-law principle of *respondeat superior* or the agency concepts of actual or apparent authority.²¹⁶

b. Aiding and Abetting Liability

Aside from the provisions on controlling-person liability, neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 expressly imposes liability on secondary participants in securities violations. The courts nevertheless applied common-law principles of aiding and abetting to reach many such offenders. Although there is scattered authority to the contrary, the vast majority of cases have held that aiding and abetting principles do not apply to broaden the range of defendants in private actions under sections 11 and 12 of the 1933 Act. The Supreme Court has made it clear that there is no private remedy against aiders and abettors;²¹⁷ however, every court of appeals that has faced the issue has recognized aiding and abetting as a proper basis for liability under the generalized antifraud provisions, which can give rise to SEC actions and criminal prosecutions under section 17(a).²¹⁸

There is broad agreement among the circuits on the elements necessary to establish aider and abettor liability. First, the court must find

216. See, e.g., *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991); *Henricksen v. Henricksen*, 640 F.2d 880 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Paul F. Newton & Co. v. Tex. Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980); *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980), *cert. denied*, 449 U.S. 1011 (1981); *Commerford v. Olson*, 794 F.2d 1319 (8th Cir. 1986) (decided under 1934 Act § 20, the equivalent controlling-person liability provision under the Exchange Act); *In re Atlantic Fin. Mgmt., Inc.*, 784 F.2d 29 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987) (also decided under 1934 Act § 20). A different rule applies, however, to actions complaining of insider trading. See 1934 Act § 21A(b)(1), discussed *infra* text accompanying note 427.

217. *Central Bank of Denver v. First Interstate Bank of Denver*, 508 U.S. 959 (1993).

218. See, e.g., *Cleary v. Perfectune*, 700 F.2d 774 (1st Cir. 1983); *Armstrong v. McAlpin*, 699 F.2d 79 (2d Cir. 1983); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Hochfelder v. Midwest Stock Exch.*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974).

a primary violation of the securities laws.²¹⁹ Second, the aider and abettor must be found to have a “general awareness” that his or her role was part of an overall plan of wrongdoing.²²⁰ Finally, the aider and abettor must have given knowing and substantial assistance to the person perpetrating the primary violation.²²¹

The courts are split on whether a person can be held liable as an aider and abettor when his or her sole assistance was through silence and inaction. Some courts have held that aider and abettor liability can arise when the person remained silent with the conscious intent of furthering the fraud.²²² Other courts have found aider and abettor liability for silence and inaction only where the person had an independent duty to disclose the securities violation.²²³ Alternatively, the Fifth Circuit has found aider and abettor liability when the aider and abettor either acted with the specific intention of furthering the fraud or had an independent duty to disclose the facts underlying the violation.²²⁴

219. *SEC v. Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). *But see* *Kaliski v. Hunt Int'l Res. Corp.*, 609 F. Supp. 649 (N.D. Ill. 1985) (although “lulling” activities can constitute a primary violation of the securities laws, they are not sufficient to establish aiding and abetting liability).

220. *See, e.g., Coffey*, 493 F.2d at 1314. *See also* *Buffo v. Graddick*, 742 F.2d 592 (11th Cir. 1984); *In re Gas Reclamation, Inc. Sec. Litig.*, 659 F. Supp. 493 (S.D.N.Y. 1987); *Antinore v. Alexander & Alexander Serv., Inc.*, 597 F. Supp. 1353 (D. Minn. 1984).

221. *See, e.g., Coffey*, 493 F.2d at 1314. *See also* *Kilmartin v. H.C. Wainwright & Co.*, 580 F. Supp. 604 (D. Mass. 1984); *SEC v. Rogers*, 790 F.2d 1450 (9th Cir. 1986); *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987); *Mishkin v. Peat, Marwick, Mitchell & Co.*, 658 F. Supp. 271 (S.D.N.Y. 1987).

222. *See, e.g., IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Rochez Bros. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975); *Martin v. Pepsi-Cola Bottling Co.*, 639 F. Supp. 931 (D. Md. 1986).

223. *See, e.g., Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731 (10th Cir. 1974); *Quintel Corp., N.V. v. Citibank, N.A.*, 589 F. Supp. 1235 (S.D.N.Y. 1984); *Dahl v. Gardner*, 583 F. Supp. 1262 (D. Utah 1984); *SEC v. Nat'l Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978).

224. *See, e.g., Woodward v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975).

F. Securities Class Actions

In 1995 and again in 1998, Congress amended the Securities Act of 1933 and Securities Exchange Act of 1934, in part to curb abusive securities litigation. These amendments introduced new requirements and procedures relating to the conduct of securities class-action litigation.

I. Private Securities Litigation Reform Act

The Private Securities Litigation Reform Act of 1995 (PSLRA)²²⁵ implemented substantive changes relating to pleading, discovery, liability, and the awarding of fees and expenses in cases brought under the federal securities laws. The PSLRA reforms are an attempt to decrease frivolous securities class action lawsuits in federal courts by making it more difficult for shareholders to bring derivative suits based merely on allegations that subsequent stock prices were lower than predicted.

The PSLRA imposes qualifications on lead plaintiffs beyond those imposed for federal class actions generally. In particular, it creates a presumption in favor of the shareholder with the largest financial interest as lead plaintiff; this is designed to encourage the appointment of institutional investors as lead plaintiffs. Section 27 of the 1933 Act and section 21D of the 1934 Act²²⁶ require that a “lead plaintiff” be appointed as the representative party in all class-action suits, presumably to encourage substantial investors (and institutional investors in particular²²⁷) to gain control of suits and discourage lawyer-driven suits.²²⁸ The lead plaintiff must file a sworn certification with the com-

225. Pub. L. No. 104-67, 109 Stat. 737 (H.R. 1058, 104th Cong. (1995)).

226. 15 U.S.C. § 78u-4 (Supp. 2001). *See also* section 27 of the Securities Act of 1933. 15 U.S.C. § 77z-1 (Supp. 2001).

227. The preference for institutional investors as plaintiffs does not mean, however, that they will always prevail in their quest to act as lead plaintiff. *See Netsky v. Capstead Mortgage Corp.*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,020 (N.D. Tex. 2000) (appointing group of investors rather than one of two institutional investors as lead plaintiff).

228. S. Rep. No. 104–98, at 11 (1995) (stating that “[t]he Committee intends to increase the likelihood that institutional investors will serve as lead plaintiffs” and that “increasing the role of institutional investors in class actions will ultimately benefit the class and assist the courts”). *See also* H.R. Conf. Rep. No. 104–369, at 33 (1995) (stat-

plaint stating that he or she (1) has reviewed the complaint; (2) did not purchase the securities to participate in the lawsuit or at the instruction of an attorney; (3) is willing to serve as the class representative; (4) has provided information on all personal transactions in the security that is the subject of complaint; (5) has identified all other securities actions within the past three years in which he or she has served as representative party; and (6) will not accept any payment beyond his or her pro rata share in the suit.²²⁹ The lead plaintiff is prohibited from serving in a lead plaintiff capacity more than five times in three years.²³⁰ The trial court's order appointing a lead plaintiff cannot be appealed on an interlocutory basis by disappointed would-be lead plaintiffs.²³¹

A plaintiff filing a class action asserting a securities claim under the 1934 Act is required to provide notice to potential class members in a widely circulated business publication or wire service within twenty days of filing a complaint.²³² The notice must provide information about the claim and inform any potential class members that they may move to serve as lead plaintiff within sixty days of the publication of

ing that the amendments were intended to “effectively discourage the use of professional plaintiffs”); S. Rep. No. 104–98, at 10 (1995) (“One way of addressing this problem is to restore lawyers and clients to their traditional roles by making it harder for lawyers to invent a suit and then attach a plaintiff.” (quoting testimony of Mark E. Lackritz)).

229. The lead plaintiff's share of any recovery is to be determined on a pro rata basis of the final judgment or settlement.

230. However, it has been held that the limit of five cases was not intended to apply to institutional investors, since the purpose of the Act was to encourage institutional investors to act as plaintiffs in securities class actions. *See, e.g., In re McKesson HBOC, Inc. Sec. Litig.*, 97 F. Supp. 2d 993 (N.D. Cal. 1999) (selecting between one of two institutional investors seeking to become lead plaintiff); *Blaich v. Employee Solutions, Inc.*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,109, 1997 WL 842417 (D. Ariz. Nov. 21, 1997).

231. *Z-Seven Fund, Inc. v. Motocar Parts & Accessories*, 231 F.3d 1215 (9th Cir. 2000); *Fla. State Bd. of Admin. v. Brick*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,758, 2000 WL 178416 (6th Cir. 2000) (unpublished opinion).

232. *See Burke v. Rutenberg*, 102 F. Supp. 2d 1280 (N.D. Ala. 2000) (notice was inadequate). Failure to give the required notice can result in disqualification as lead counsel. *King v. Livent*, 36 F. Supp. 2d 187 (S.D.N.Y. 1999).

the notice. Not later than ninety days after the publication of the notice, the court must appoint a lead plaintiff based on factors that include (1) whether the plaintiff filed the complaint or made a motion in response to the notice; (2) which plaintiff has the largest financial interest in the suit; and (3) whether the plaintiff otherwise complies with Federal Rule of Civil Procedure 23 concerning class representation. Most courts permit multiple lead plaintiffs when appropriate.²³³

The PSLRA expressly permits courts to classify a number of individual plaintiffs as a “group” for the purposes of determining the largest shareholder for lead plaintiff status.²³⁴ Although the appointment of a group may not be commonplace, it is appropriate when the identity of interests required by the statute exists.²³⁵ Courts have held that an overly liberal interpretation of the group concept is contrary to the

233. See, e.g., *Baffa v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 222 F.3d 52 (2d Cir. 2000); *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285 (2d Cir. 1992). See also, e.g., *In re Conesco, Inc. Sec. Litig.*, [2000–2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,234 (S.D. Ind. 2000) (appointing two municipal retirement funds as lead plaintiffs but rejecting investment management fund as lead plaintiff because it engaged in arbitrage strategies that were not representative of the class); *Saddleback Partners, Ltd. v. Hiatt*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,051, 2000 WL 1182793 (S.D.N.Y. 2000) (sophistication of plaintiff did not render him an atypical class representative; fact that plaintiff gave conflicting testimony in two depositions did not render him an inadequate class representative).

234. See, e.g., *In re Tyco Int'l Ltd. Sec. Litig.*, No. 00-MD-1335-B, 2000 WL 1513772 (D.N.H. Aug. 17, 2000). See also, e.g., *Local 144 Nursing Home Pension Fund v. Honeywell Int'l, Inc.*, [2000–2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,261, 2000 U.S. Dist. LEXIS 16712 (D.N.J. 2000) (appointing group of five largest institutional investors as lead plaintiff).

235. *In re Telxon Corp. Sec. Litig.*, 67 F. Supp. 2d 803 (N.D. Ohio 1999) (rejecting two groups but accepting third group as lead plaintiffs). Where there are multiple plaintiffs but different groups allege different securities law claims, the appointment of separate groups is appropriate. *In re Nanophase Techs. Sec. Litig.*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,686, 1999 WL 965468 (N.D. Ill. 1999). Alternatively, the court may decide to accept the group that represents the largest aggregate losses from the alleged violations in question. *In re Ribozyme Pharms., Inc. Sec. Litig.*, 192 F.R.D. 656 (D. Colo. 2000) (two competing groups were both qualified to serve as lead plaintiff; the court selected the group with the larger aggregate loss).

intent of the PSLRA in limiting lead plaintiffs.²³⁶ Accordingly, courts will not recognize a group as the largest shareholder for lead plaintiff purposes if the members of the group do not truly have an identity of interests.²³⁷ Where a member of a group is atypical of most class members, the entire group may be disqualified for certification as lead plaintiff.²³⁸

Issues also arise as to how to select the most appropriate lead counsel.²³⁹ The PSLRA provides that “[t]he most adequate lead plaintiff

236. *Telxon*, 67 F. Supp. 2d 803. *See also, e.g.*, *Bowman v. Legato Sys., Inc.*, 195 F.R.D. 655 (N.D. Cal. 2000) (subset of plaintiffs selected by lawyer did not qualify as a group appropriate to act as lead plaintiff); *Wenderhold v. Cylink Corp.*, 188 F.R.D. 577 (N.D. Cal. 1999) (refusing to aggregate plaintiffs into a group); *In re Nice Sys., Ltd. Sec. Litig.*, 188 F.R.D. 206 (D.N.J. 1999) (unpublished opinion) (rejecting appointment of nine lead plaintiffs but certifying five lead plaintiffs as a group); *Switzenbaum v. Orbital Sciences Corp.*, 187 F.R.D. 246 (E.D. Va. 1999) (group of investors did not satisfy the requirements for appointment as a group to serve as lead plaintiff); *In re Baan Co. Sec. Litig.*, 186 F.R.D. 214 (D.D.C. 1999) (agreeing with SEC’s contention that a triumvirate of lead plaintiffs is a good way to deal with unrelated investors but refusing to appoint a group of twenty investors); *Tumolo v. Cymer, Inc.*, No. 98-CV-1599TW, 1999 U.S. Dist. LEXIS 22105 (S.D. Cal. Jan. 22, 1999) (refusing to appoint 339 investors as lead plaintiffs).

237. *Sakhrani v. Brightpoint, Inc.*, 78 F. Supp. 2d 845 (S.D. Ind. 1999). *See also, e.g.*, *Tyco*, 2000 WL 1513772 (appointing group of three substantial shareholders as lead plaintiffs); *Burke v. Rutenberg*, 102 F. Supp. 2d 1280 (N.D. Ala. 2000) (group of 300 unrelated investors could not serve as lead plaintiff under the PSLRA, but court appointed a committee consisting of state pension fund’s investment manager and three individual investors as lead plaintiff); *Takeda v. Turbodyne Techs., Inc.*, 67 F. Supp. 2d 1129 (C.D. Cal. 1999) (group of unrelated individuals was not an appropriate group; instead the court appointed a bona fide investor group as lead plaintiffs).

238. *Seamans v. Aid Auto Stores, Inc.*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,902 (E.D.N.Y. 2000) (one of three members of group was a market maker and was not a typical class representative).

239. For example, a conflict of interest will disqualify an attorney from serving as lead counsel. A lawyer may not be able to represent two different classes suing the same defendant but may represent two different classes in two different actions where each action is naming different defendants. *See Dietrich v. Bauer*, 192 F.R.D. 119 (S.D.N.Y. 2000). Also, misconduct by lead counsel can result in disqualification. *Cf. Stearns v. Navigant Consulting Corp.*, 89 F. Supp. 2d 1014 (N.D. Ill. 2000) (co-lead counsel who contacted class members of another lead counsel “narrowly” avoided being disqualified).

shall, subject to the approval of the court, select and retain counsel to represent the class.”²⁴⁰ The court is thus given considerable discretion in determining whether the lead plaintiff’s choice of representative best suits the needs of the class.²⁴¹ In exercising this discretion, courts should consider both the quality and the cost²⁴² of the legal representation. As one court explained, “[i]t is reasonable to assume that given the opportunity, absent class members would try to secure the most qualified representation at the lowest cost.”²⁴³ Courts may also take into account a firm’s experience, size, and financial resources.²⁴⁴ In what may be an emerging trend, some courts in securities class actions have relied on a “free market” approach to counsel selection and have conducted an auction, soliciting bids from attorneys seeking to act as lead counsel.²⁴⁵

240. 15 U.S.C. § 78u-4(a)(2)(A)(v) (Supp. 2001). *See also* 15 U.S.C. § 77z-1(a)(3)(B)(v) (Supp. 2001).

241. *See, e.g., Griffin v. GK Intelligent Sys., Inc.*, 196 F.R.D. 298 (S.D. Tex. 2000) (denying certification, since petitioning lead plaintiffs were neither typical nor representative of the class); *In re Cendant Corp. Litig.*, 182 F.R.D. 144, 149 (D.N.J. 1998) (where “in contrast to the strictly defined procedures and considerations that prescribe the determination of lead plaintiff, here the Court’s approval is subject to the discretionary judgment that lead plaintiff’s choice of representative best suits the needs of the class”). *Accord, Sherleigh Assocs., LLC v. Windmere–Durable Holdings, Inc.*, 186 F.R.D. 669 (S.D. Fla. 1999). *See also, e.g., Koppel v. 4987 Corp.*, 191 F.R.D. 360 (S.D.N.Y. 2000) (partial recall of lead plaintiff was not sufficient to render him inadequate; nor was he disqualified because of alleged animosity with one of the defendants); *Miller v. Material Sciences Corp.*, 31 Sec. Reg. & L. Rep. (BNA) 1007 (N.D. Ill. 1999) (fact that plaintiff purchased shares from her husband did not make her atypical so as to disqualify her as class-action plaintiff); Geoffrey P. Miller, *Overlapping Class Actions*, 71 N.Y.U. L. Rev. 514 (1996).

242. *See, e.g., Tarica v. McDermott Int’l, Inc.*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,946, 2000 WL 377817 (E.D. La. 2000) (appointing co-lead counsel plus a third firm as liaison counsel provided that this arrangement did not result in higher legal fees).

243. *Cendant Corp.*, 182 F.R.D. at 149. *See also, e.g., Raftery v. Mercury Fin. Co.*, No. 97C624, 1997 WL 529553 (N.D. Ill. Aug. 7, 1997).

244. *See, e.g., Wenderhold v. Cylink Corp.*, 191 F.R.D. 600 (N.D. Cal. 2000).

245. *E.g., In re Lucent Techs., Inc. Sec. Litig.*, 194 F.R.D. 137 (D.N.J. 2000); *In re Cendant Corp. Prides Litig.*, 98 F. Supp. 2d 602 (D.N.J. 2000); *Wenderhold v. Cylink Corp.*, 188 F.R.D. 577 (N.D. Cal. 1999); *Sherleigh Assocs.*, 186 F.R.D. 669; *Cendant*

Section 21D(a)(6) of the Securities Act of 1934²⁴⁶ states that attorneys' fees in class-action cases are limited to a reasonable amount, and that discretion in determining what is reasonable is left to the courts. Class-action settlements are subject to court approval, as is the allocation of attorneys' fees out of the settlement fund. The PSLRA does not mandate a particular method of calculating attorneys' fees.²⁴⁷ Attorneys' fees may be calculated according to the lodestar approach—multiplying an attorney's hours by a reasonable fee and increasing the amount for any risk or other relevant factors.²⁴⁸

Section 21D(b)(3) of the 1934 Act²⁴⁹ provides that discovery be stayed during the pendency of a motion to dismiss or motion for summary judgment in order to alleviate discovery expenses of defen-

Corp., 182 F.R.D. 144; *In re Wells Fargo Sec. Litig.*, 156 F.R.D. 223 (N.D. Cal. 1994). See also, e.g., *In re Amino Acid Lysine Antitrust Litig.*, 918 F. Supp. 1190 (N.D. Ill. 1996). See generally Andrew K. Niebler, *In Search of Bargained-for Fees for Class Action Plaintiffs' Lawyers: The Promise and Pitfalls of Auctioning the Position of Lead Counsel*, 54 Bus. Law. 763 (1999) and Laural L. Hooper & Marie Leary, *Auctioning the Role of Class Counsel in Class Action Cases: A Descriptive Study* (Federal Judicial Center 2001) (at <http://www.fjc.gov> and on the courts' intranet at jnet.fjc.dcn).

246. 15 U.S.C. § 78u-4(a)(6) (Supp. 2001). See also 15 U.S.C. § 77z-1(a)(6) (Supp. 2001).

247. *Powers v. Eichen*, 229 F.3d 1249 (9th Cir. 2000) (section 21D of the 1934 Act does not mandate that fees be based on net recovery rather than the gross amount).

248. See, e.g., *Williams v. MGM-Pathe Communications Co.*, 129 F.3d 1026 (9th Cir. 1997) (attorneys' fees out of settlement fund should be based on the entire settlement fund or on the lodestar rather than the class members' claims against the fund); *In re F & M Distributions, Inc. Sec. Litig.*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,621 (E.D. Mich. 1999) (approving fee award of \$6,075,000 as 30% of settlement fund in light of "excellent performance" of attorneys). See also, e.g., *In re Cendant Corp. Prides Litig.*, 51 F. Supp. 2d 537 (D.N.J. 1999) (awarding law firm 5.7% of stock acquisition rights available to the class). Cf. *Wininger v. SI Mgmt., L.P.*, 33 F. Supp. 2d 838, 846–47 (N.D. Cal. 1998) (attorney's advancing client costs of proxy solicitation to counteract alleged misleading proxy solicitation by defendant was not a part of attorneys' fees within the meaning of the PSLRA).

249. 15 U.S.C.A. § 78u-4(b)(3) (Supp. 2001).

dants.²⁵⁰ The stay is mandatory.²⁵¹ However, the mandatory discovery stay does not apply to certification of the class.²⁵² The certification issue must be resolved before a motion to dismiss that would trigger the stay provision. During a stay of discovery, the court may impose sanctions on defendants who willfully destroy evidence. Additionally, by virtue of section 21D(d), in suits for money damages where the plaintiff must establish that the defendant acted with a particular state of mind, the defendant may ask that written interrogatories be submitted to the jury as to each defendant's state of mind at the time of the violation.²⁵³

Notice of final or proposed settlement agreements in class actions must be provided to class members.²⁵⁴ A summary of the agreement must appear on the cover page of the notice. The notice must also include the following: the average amount of damages per share that will be recovered; an explanation of attorneys' fees and costs; the name, address, and telephone number of the lead counsel; and a statement outlining the reasons for settlement. As with class actions generally, courts will review settlements to determine fairness to class members.²⁵⁵

250. S. Rep. No. 104–98, at 14 (1995) (finding that discovery costs often force defendants to settle securities class-action suits). The discovery stay is subject to two statutory exceptions: when particularized discovery is necessary to either preserve evidence or prevent undue prejudice to the moving party. 1934 Act § 21D(b)(3)(B).

251. *SG Cowen Sec. Corp. v. U.S. Dist. Ct.*, 31 Sec. Reg. & L. Rep. (BNA) 1199 (9th Cir. 1999) (limited discovery order was improper in light of mandatory stay of all discovery).

252. *In re Diamond Multimedia Sys., Inc. Sec. Litig.*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,561, 1997 WL 773733 (N.D. Cal. 1997).

253. 15 U.S.C. § 78u-4(d) (Supp. 2001).

254. *See, e.g., Krangel v. Golden Rule Res., Inc.*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,025 (E.D. Pa. 2000) (notice was adequate).

255. *See, e.g., In re Mego Fin. Corp. Sec. Litig.*, 213 F.3d 454 (9th Cir. 2000) (approving class-action settlement); *Neuberger v. Shapiro*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,061 (E.D. Pa. 2000) (approving settlement as reasonable); *Krangel* (approving settlement); *In re Blech Sec. Litig.*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,978, 2000 WL 661680 (S.D.N.Y. 2000) (approving class-action settlement); *In re Ikon Office Solutions, Inc. Sec. Litig.*, [1999–2000

In private suits involving class-action claims, courts may require an undertaking from the attorneys for the plaintiff or defendant, the parties themselves, or both. Equitable principles may be used to ascertain whether to require an undertaking and to determine the relevant proportions.

In order to dissuade abusive litigation, section 21D(b)(1) of the 1934 Act²⁵⁶ directs courts to perform a mandatory review at the final adjudication of the action to determine whether any party or attorney violated Federal Rule of Civil Procedure 11(b). If review reveals any violation by an attorney or party, the Act directs the court to impose Rule 11 sanctions on the attorney or party unless the violator can establish a proper basis for not imposing the sanctions. The court must give the attorney or party notice and an opportunity to respond.

In the event that the court finds a plaintiff or attorney has violated Rule 11 in filing a complaint, there is a rebuttable presumption in favor of awarding all attorneys' fees and costs incurred in the action to the defendant. Similarly, when a party's responsive pleading or dispositive motion violates Rule 11(b), there is a rebuttable presumption in favor of awarding attorneys' fees and costs incurred as a direct result of the violation to the prevailing party. Once a Rule 11 violation has been found and the statutory presumptions come into play, the 1934 Act requires that the court give the violator an opportunity to offer rebuttal evidence in order to show that an award of attorneys' fees and costs is unreasonable or that the Rule 11 violation was *de minimis*. If the rebuttal evidence is not persuasive, sanctions are to be imposed pursuant to the standards set forth in Rule 11. In order to warrant the imposition of sanctions, the complaint must have been frivolous.²⁵⁷

Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,972 (E.D. Pa. 2000) (approving settlement).

256. 15 U.S.C. § 78u-4(b)(1) (Supp. 2001).

257. *See, e.g., Richter v. Achs*, 174 F.R.D. 316 (S.D.N.Y. 1997) (sanctions denied under PSLRA even though plaintiff failed to identify any instance in which defendant allegedly violated securities laws; while the claims were unconvincing, they were not frivolous). *Compare, e.g., Inter-County Res., Inc. v. Medical Res., Inc.*, 49 F. Supp. 2d 682 (S.D.N.Y. 1999) (Rule 10b-5 damage claim brought by person who was neither a purchaser nor seller was frivolous and thus supported sanctions), *with Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group, Inc.*, 186 F.3d 157 (2d Cir. 1999) (claim

Once a party moves for the imposition of Rule 11 sanctions, by virtue of the PSLRA a court cannot deny the motion without making explicit findings regarding compliance with Rule 11(b).

2. Securities Litigation Uniform Standards Act

Plaintiffs seeking to avoid the stricter federal standards of the PSLRA began to file class-action securities lawsuits in state courts. As a result, Congress passed the Securities Litigation Uniform Standards Act of 1998 (Uniform Standards Act or SLUSA),²⁵⁸ which mandates that class actions involving publicly traded securities be brought in federal court.²⁵⁹

The preemptive provisions of SLUSA apply only to covered class actions involving “covered” securities under the 1934 Act.²⁶⁰ Covered securities under the Act are securities registered with the SEC and traded on the New York Stock Exchange, American Stock Exchange, the NASD National Market System, or other national markets designated by the SEC, as well as securities issued by investment companies registered under the Investment Company Act of 1940.²⁶¹ The preemption applies to any class action involving misrepresentations,

for injunctive relief by plaintiff who was neither a purchaser nor seller was not frivolous, but Rule 10b-13 claim was).

258. Pub. L. No. 105-353, 112 Stat. 3227 (1998).

259. 15 U.S.C. § 78bb(f) (Supp. 2001). 1933 Act § 16(f), 15 U.S.C.A. § 77p(f) (Supp. 2001). *See, e.g.*, David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1988: The Sun Sets on California’s Blue Sky Laws*, 54 Bus. Law. 1 (1998); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 Cornell L. Rev. 1 (1998).

260. 1934 Act § 27, 15 U.S.C. § 77aa (2000). While jurisdiction over 1934 Act claims is exclusively federal, private actions under sections 11 and 12 of the 1933 Act can be brought in either federal or state court. 1933 Act § 22(a), 15 U.S.C. § 77v(a) (2000).

261. 1934 Act § 28(f)(5)(E), 15 U.S.C.A. § 78bb(f)(5)(E) (Supp. 2001); 1933 Act § 16(f)(3), 15 U.S.C.A. § 77p(f)(3) (2000 & Supp. 2001). This definition in turn refers to section 18 of the 1933 Act, 15 U.S.C.A. § 77r (2000 & Supp. 2001), which preempts those securities from state registration requirements.

omissions, deception, or manipulation in connection with the purchase or sale of a covered security.²⁶²

SLUSA contains its own definition of a covered class action: a single lawsuit or group of joined or consolidated lawsuits for damages brought on behalf of more than fifty persons.²⁶³ SLUSA thus does not preclude individual actions, derivative suits,²⁶⁴ or suits on behalf of fifty or fewer persons from being brought in state court. Class actions by states or their political subdivisions, as well as class actions by state pension plans, are not subject to SLUSA's preemptive effect.²⁶⁵ This exclusion requires that all class members fit within one of these categories so as to prevent private parties from circumventing the Act. Furthermore, SLUSA does not apply to investigations and enforcement actions by state securities administrators; and it does not apply to class actions seeking to enforce a contractual agreement under a trust indenture for a debt security.²⁶⁶

SLUSA preempts class actions based on state law causes of action for misrepresentation or fraud.²⁶⁷ The preemption also applies to cov-

262. 1934 Act § 28(f)(1), 15 U.S.C.A. § 78bb(f)(1) (2000 & Supp. 2001) (defining a class action or constructive class action as brought "by any private party alleging an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security, or . . . that the defendant employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security"). *Accord* 1933 Act § 16(b), 15 U.S.C. § 77p(b) (Supp. 2001).

263. 1934 Act § 28(f)(5)(B), 15 U.S.C. § 78bb(f)(5)(B) (Supp. 2001); 1933 Act § 16(f)(2), 15 U.S.C. § 77p(f)(2) (Supp. 2001). Derivative actions are expressly excluded from the category of covered class actions. 1934 Act § 28(f)(5)(C), 15 U.S.C. § 78bb(f)(5)(C) (Supp. 2001); 1933 Act § 16(f)(3), 15 U.S.C. § 77p(f)(3) (Supp. 2001).

264. Derivative actions are expressly excluded from the category of covered class actions. 1934 Act § 28(f)(5)(C), 15 U.S.C. § 78bb(f)(5)(C) (Supp. 2001); 1933 Act § 16(f)(3), 15 U.S.C. § 77p(f)(3) (Supp. 2001).

265. 1934 Act § 28(f)(3)(B), 15 U.S.C. § 78pp(f)(3)(B) (Supp. 2001); 1933 Act § 16(d)(2), 15 U.S.C. § 77p(d)(2) (Supp. 2001).

266. 1934 Act §§ 28(f)(3)(B), (C); 15 U.S.C. §§ 78pp(f)(3)(B), (C) (Supp. 2001); 1933 Act §§ 16(d)(2), (3), 15 U.S.C. §§ 77p(d)(2), (3) (Supp. 2001).

267. 1933 Act § 27(b)(4), 15 U.S.C. § 77z-1(b)(4) (Supp. 2001); 1934 Act § 21D(b)(3), 15 U.S.C. § 78u-4(b)(3) (Supp. 2001).

ered class actions involving any liability under the 1933 Act²⁶⁸ (provided the class action involves fifty or more plaintiffs). Presumably simple breach of contract²⁶⁹ or conversion²⁷⁰ actions can be brought under state law. Of course, class actions involving securities that are not publicly traded may remain in state court.²⁷¹

SLUSA preserves state court actions brought in the issuer's state of incorporation by shareholders challenging management's statements or recommendations in connection with corporate transactions, claiming a breach of fiduciary duty, or asserting statutory appraisal rights.²⁷² Referred to as the "Delaware carve out"—although not expressly limited to Delaware—it is designed to preserve remedies under state laws governing breaches of fiduciary duty and disclosures to existing shareholders in corporate transactions.

Any covered class action involving a covered security brought in state court is removable to federal court.²⁷³ The action will be remanded to state court only if it is determined that SLUSA's preemptive provisions do not apply.²⁷⁴ The Act empowers a federal court to stay

268. 1933 Act § 22(a), 15 U.S.C. § 77v(a) (Supp. 2001).

269. *Green v. Ameritrade, Inc.*, 120 F. Supp. 795 (D. Neb. 2000) (breach of contract claim not preempted). In fact the Uniform Standards Act explicitly excludes covered class actions brought to enforce a contractual agreement between the issuer and an indenture trustee. 1933 Act § 16(d)(3), 15 U.S.C.A. § 77p(d)(3) (2000); 1934 Act § 28(f)(3)(C), 15 U.S.C.A. § 78u-4(f)(3)(C) (2000).

270. *Burns v. Prudential Sec.*, 116 F. Supp. 2d 917 (D. Ohio 2000).

271. See, e.g., Comment, *Uncharted Waters: Securities Class Actions in Texas After the Securities Litigation Uniform Standards Act of 1998*, 31 St. Mary's L.J. 143 (1999).

272. 1934 Act § 28(f)(3)(A), 15 U.S.C. § 78pp(f)(3)(A) (Supp. 2001); 1933 Act § 16(d)(1), 15 U.S.C. § 77p(d)(1) (Supp. 2001).

273. 1934 Act § 28(f)(2), 15 U.S.C. § 78pp(f)(2) (Supp. 2001); 1933 Act § 16(c), 15 U.S.C.A. § 77p(c) (Supp. 2001).

274. 1934 Act § 28(f)(4)(D), 15 U.S.C. § 78pp(f)(4)(D) (Supp. 2001); 1933 Act § 16(d)(4), 15 U.S.C. § 77p(d)(4) (Supp. 2001). See, e.g., *In re Lutheran Bhd. Variable Ins. Prods. Co.*, 105 F. Supp. 2d 1037 (D. Minn. 2000) (variable annuities were covered securities; McCarran-Ferguson Act, which prevents federal law from interfering with state insurance regulation, did not alter this fact and thus claims were removed to federal court without remand to state court).

discovery in any state court action if deemed to aid in the federal court's jurisdiction.²⁷⁵

275. 1934 Act § 21D-(3), 15 U.S.C.A. § 78u-4(b)(3) (2000); 1933 Act § 27(b)(4), 15 U.S.C.A. § 77z-1(b)(4). *See, e.g., In re Bankamerica Corp. Sec. Litig.*, 95 F. Supp. 2d 1044 (D. Mo. 2000) (staying state court class action that “threatened the orderly conduct of the federal case,” which represented more than twenty-six times the dollar amount in claims than the state court proceeding that was stayed).

IV. Regulating Issuers, Securities Professionals, and the Securities Markets— The Securities Exchange Act of 1934

A. Scope of the 1934 Act

The Securities Exchange Act of 1934 presents a broad umbrella of regulation. In addition to market and financial regulation, it imposes disclosure and other obligations on issuers of securities. The three principal targets of the 1934 Act are issuers, markets, and market professionals. Oversight of the securities markets and market professionals is accomplished not only directly by the SEC but also by systems of self-regulation overseen by the SEC.

The 1934 Act has a much broader scope than the 1933 Act in its regulation of securities distributions, including the regulation of day-to-day trading. The 1934 Act has an issuer registration requirement apart from the one found in the 1933 Act. Registration of securities is not triggered by a particular transaction (such as a public offering) but rather applies to virtually all publicly traded securities in the United States. The 1934 Act also regulates proxy solicitations, tender offers, other control-related transactions, and insider transactions involving companies that are registered under the Act. Registration under the 1934 Act in turn triggers periodic reporting requirements. There are some instances in which issuers who do not have to register securities under the 1934 Act will nevertheless be subject to its periodic reporting provisions. While most of the 1934 Act's regulation applies only to registered and reporting companies, there are two important provisions that are not so limited: (1) the general antifraud provisions of section 10(b) and, in particular, SEC Rule 10b-5; and (2) the tender offer antifraud provision found in section 14(e).

There are two jurisdictional bases for regulation of securities and their issuers under the 1934 Act. The first basis of jurisdiction is triggered by use of an instrumentality of interstate commerce—this is the basis for jurisdiction under SEC Rule 10b-5 and section 14(e) of the 1934 Act. The second basis for jurisdiction is found in the registration

provisions of section 12 and the periodic reporting provisions of sections 13 and 15(d).

Section 12 of the 1934 Act requires registration of most publicly traded securities. Under section 12(a), any security that is traded on a national exchange must be registered under the 1934 Act.²⁷⁶ Section 12(a) thus covers exchange-traded equity securities (stock and securities convertible into stock), exchange-traded options (puts and calls),²⁷⁷ and exchange-traded debt securities (bonds). Section 12's registration provisions further apply to equity securities that are publicly traded in over-the-counter markets through the facilities of the National Association of Securities Dealers (NASD),²⁷⁸ rather than on an exchange. Section 12(g)(1) requires registration of certain equity securities that are not listed on a national securities exchange. It applies on its face to companies that have a class of equity securities held by 500 or more persons and more than \$1 million in assets. However, the SEC has narrowed the number of companies subject to 1934 Act registration. Rule 12g-1 exempts an issuer if the company has less than \$10 million in gross assets.²⁷⁹ The registration and consequent

276. The 1934 Act's registration requirement is set forth in section 12(g) and differs significantly from that of the 1933 Act. A corporation that has registered a class of securities under the 1934 Act will still have to register each particular offering of that class of securities under the 1933 Act.

277. Options are included in the definition of equity securities, because options are convertible into equity securities.

278. The NASD operates the over-the-counter market, distinguished originally from the exchanges in two principal ways: (1) there is no central facility comparable to an exchange floor (although the NASD's introduction in 1971 of an electronic automated quotation system, NASDAQ, and more recently its "national market system" have made this distinction less important); and (2) the function of a firm representing an individual buyer is different (in an exchange, the firm acts as a broker and the only dealer is the registered specialist in that stock; in the over-the-counter market, any number of firms may act as dealers or market makers in a particular stock).

279. There is an exemption from 1934 Act registration for securities of foreign issuers, over-the-counter American Depositary Shares, and American Depositary Receipts representing such securities. 1934 Act § 12(g)(3) and SEC Rule 12g3-2. The exemption requires the issuer to annually furnish the SEC with all information that must be disclosed according to the laws of the issuer's domicile. This exemption was

periodic reporting obligations cease if on the last day of each of the issuer's last three fiscal years the issuer (1) has had fewer than 300 shareholders of record of that class of securities or (2) has had assets not exceeding \$10 million.²⁸⁰ In such cases, the issuer may withdraw its registration.

Registration under the 1934 Act brings with it periodic disclosure obligations. Section 13 of the 1934 Act sets forth the periodic reporting requirements. The basic reports that must be filed with the SEC are Form 10-K, an annual report; Form 10-Q, a quarterly report; and Form 8-K, an interim "current report." Form 8-K's mandated interim reporting requirements are quite limited,²⁸¹ and, as a general rule, companies are not under an affirmative duty to disclose information until the next quarterly report. As a result of the Sarbanes-Oxley Act of 2002, the SEC is expanding the types of events that trigger interim reporting on Form 8K.

B. Prohibition of Manipulative Activities

Section 9(a) prohibits transactions entered into simultaneously where the purpose is to create a "misleading appearance of active trading."²⁸²

modified in 1983 and is no longer available for NASDAQ-listed securities; however, securities qualifying prior to the modification retain their exempt status.

280. Rule 12h-3.

281. The following items must be disclosed on Form 8-K: (1) changes in control of the registrant (within fifteen calendar days of the change); (2) acquisition or disposition of a significant amount of assets, not in the ordinary course of business, by the issuer or any of its majority-owned subsidiaries (within fifteen calendar days of the event); (3) bankruptcy or receivership (within fifteen calendar days of the event); (4) change of certifying accountant (within five days of the event); (5) any other events not called for by this form but which the registrant deems important; (6) resignation of directors (within five days of the event); and (7) change in fiscal year (within fifteen calendar days of the decision). Companies frequently use Form 8-K for voluntary interim filings.

282. A "wash" sale is a fictitious sale where there is no change in beneficial ownership: It is a transaction without the usual profit motive and is designed to give the false impression of market activity when in fact there is none.

A "matched" order occurs when orders are entered simultaneously to buy and sell the same security. The mere fact that a broker crosses trades or enters into matched orders does not violate the 1934 Act. In fact, cross-trades can actually benefit the

It also prohibits any exchange-based transactions that give the artificial impression of active trading,²⁸³ as well as transactions entered into for the purpose of depressing or raising the price of the securities.²⁸⁴ Furthermore, section 9(a)(6) empowers the SEC to promulgate rules prohibiting “pegging, fixing, or stabilizing” securities prices.²⁸⁵

Another type of manipulation covered by section 9 involves exchange-traded options, or put and call options.²⁸⁶ Section 9(b) gives the SEC rule-making power over options transactions where there is no intent to follow through with the rights and obligations of the option with respect to the underlying security. The SEC has not imposed any substantive prohibitions, but rather has elected to deal with put

firm’s customers if the savings on commissions are passed on to the customers. However, the cross-trades become problematic when the cost savings are not passed on to the customer.

283. Wash sales and other manipulative acts create the appearance of liquidity that makes a stock more attractive.

284. Prearranged trades can be used in order to set an artificially high price.

285. The problem of stabilization has been addressed by the SEC in Regulation M, 17 C.F.R. §§ 241.100–240.105. See *Anti-Manipulation Rules Concerning Securities Offerings*, Securities Act Release Nos. 33–7375 and 34–38067; IC–22412, 62 Fed. Reg. 520 (Jan. 3, 1997).

286. Note that the provisions relating to options do not apply to warrants (options issued by the issuer). Furthermore, the provisions are limited to options with regard to securities, not to be confused with futures contracts or options relating to commodities, which are regulated by the Commodities Futures Trading Commission. A call option is a contract between a seller (the option writer) and a buyer under which the option buyer has the right to exercise the option and thereby purchase the underlying security at an agreed-on price (the “strike” or “exercise” price). The option will expire unexercised (and hence valueless) unless it is exercised within a specified time period, the last day of which is the expiration date. A put option, conversely, gives the option’s buyer the right to exercise the option by selling the underlying security. The put-option seller must purchase the underlying security at the agreed-on price if the option is exercised on or before the expiration date. If the strike price is “out of the money” in comparison with the price of the underlying security, so that it would not make economic sense to exercise the option, the option will simply expire unexercised. Option contracts can be used either for speculation or to hedge existing securities positions. See generally, 1 Hazen, *supra* note 101, § 1.7; Thomas L. Hazen, *Rational Investment, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effects on the Underlying Capital Markets*, 86 Nw. U. L. Rev. 987, 989–90 (1992).

and call options for securities by requiring an adequate disclosure document for purchasers and sellers.

C. Shareholder Voting: Federal Regulation of Proxies and Proxy Solicitation

In addition to periodic reporting requirements, 1934 Act registrants are subject to the federal proxy rules established under section 14 of the Act. Although state corporate law governs shareholder voting rights generally, federal securities law regulates the proxy machinery of publicly held companies. There are four primary aspects of SEC proxy regulation. First, by virtue of section 14(a), there must be full and fair disclosure of all material facts with regard to any management-submitted proposals that will be subject to a shareholder vote. Second, material misstatements, omissions, and fraud in connection with the solicitation of proxies are prohibited, and the courts have recognized implied private remedies for injured investors.²⁸⁷ Third, the federal proxy regulation facilitates shareholder solicitation of proxies, since by virtue of Rule 14a-8 management is required not only to submit relevant shareholders' proposals in its own proxy statements but also to allow the proponents to explain their position in the face of any management opposition. Fourth, the proxy rules mandate full disclosure in nonmanagement proxy materials and thus are significant in control struggles and contested takeover attempts.

Under section 14 of the 1934 Act, whenever there is a proxy solicitation with regard to shareholder votes (or a consent to action) for holders of securities subject to section 12's registration requirements, the solicitation must be in line with SEC disclosure requirements. Section 14(a) is limited to proxy solicitation materials and procedures. Accordingly, it does not apply if shareholder votes or consents by proxy are not solicited. When there is no proxy solicitation made by the issuer's management, section 14(c) nevertheless requires management to mail a statement containing information similar to that re-

287. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

quired for a proxy solicitation to the shareholders in advance of any shareholders' meeting.²⁸⁸

The proxy rules govern disclosure but not voting mechanics or substantive voting rights.²⁸⁹ In Rules 14a-3 through 14a-12, the SEC sets forth the types of information that must be disclosed in proxy solicitations subject to the Act. The SEC distinguishes between the proxy²⁹⁰ and solicitation²⁹¹ materials. All solicitations must be accompanied or preceded by a written proxy statement containing the information required by Schedule 14A.²⁹² Required disclosures include information about the person making the solicitation and details relating to the transactions in question. If the solicitation is made on the issuer's behalf, the proxy statement must be accompanied or preceded by an annual report to security holders.²⁹³ The annual report must contain financial information as well as management's analysis of operations.

The federal proxy rules also provide for shareholder access to information.²⁹⁴ Rule 14a-8, the shareholder proposal rule, tells manage-

288. 15 U.S.C. § 78n(c) (2000). These informational requirements are set out in Regulation 14C, 17 C.F.R. §§ 240.14c-1 to 240.14c-7 (2002), and Schedule 14C, 17 C.F.R. § 240.14c-101 (2002).

289. The mechanics of shareholder voting and the identification of proper matters for shareholder consideration are determined by state law.

290. *Proxy* is defined in Rule 14a-1(f) to include any shareholder's consent or authorization regarding the casting of that shareholder's vote. Requirements for the appropriate form of the proxy itself can be found in Rule 14a-4.

291. *Solicitation*, as defined in Rule 14a-1(l), includes the following: any request for a proxy; any request to execute or not to execute, or to revoke, a proxy; or any communication to shareholders reasonably calculated to result in the procurement, withholding, or revocation of a proxy. Rule 14a-2 lists the types of solicitations exempt from the proxy rules. Rule 14a-3 sets forth the types of information that must be included in proxy solicitations.

292. Rule 14a-3. Five preliminary copies of the proxy statement, form of proxy, and any soliciting material must be filed with the SEC at least ten calendar days prior to the date definitive copies are sent or distributed to security holders. Rule 14a-6.

293. Rule 14a-3(b). See also Regulation 14C, which requires dissemination of the annual report in years when the registrant does not engage in a proxy solicitation.

294. See Rule 14a-7, designed for nonmanagement persons intending to make a solicitation. Upon request, management must either supply a list of security holders or offer to mail the solicitation materials at a reasonable cost to the requesting party. The Seventh Circuit has held that violations of Rule 14a-7 mailing requirements can give

ment which shareholder proposals must be included in the proxy statement. In essence, any shareholder proposal that is proper for consideration under state law must be included in management's proxy statement (along with a brief explanation of the shareholder's reason for supporting the proposal's adoption), provided the proposal is submitted to the issuer in a timely fashion. For one's proposal to be included, a proponent must have owned, for at least one year, at least 1% of the company's securities or \$1,000 worth of the market value of such securities, and must continue to be a security holder through the date on which the shareholders' meeting is held. The proposal submission must be timely under the requirements of Rule 14a-8(a)(3). Furthermore, a shareholder may submit only one proposal per year that qualifies for mandatory inclusion in management's proxy statement. In addition to the proposal itself, the proponent may provide a supporting statement, subject to length limitations. The issuer may exclude certain proposals, even those filed properly and timely. However, if a proposal is valid under state law and is properly excludable, it must nevertheless be described in the issuer's proxy statement.²⁹⁵

Rule 14a-9 embodies the general antifraud proscriptions applicable to proxy solicitations. The Supreme Court has repeatedly recognized an implied remedy for private parties seeking redress for violations of Rule 14a-9's antifraud provisions.²⁹⁶ In addition, other issues are litigated in the context of Rule 14a-9 actions, including standing, materiality, causation, the proper standard of liability, and damages.

Based solely on the language of Rule 14a-9 in order to establish standing to sue, all a private plaintiff needs to show in a Rule 14a-9 action is that he or she was injured in connection with a proxy solicitation covered by the Exchange Act's regulation.²⁹⁷ Courts have held

rise to private rights of action. *Haas v. Wieboldt Stores, Inc.*, 725 F.2d 71 (7th Cir. 1984).

295. Schedule 14A, item 21.

296. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

297. See, e.g., *Palumbo v. Deposit Bank*, 758 F.2d 113 (3d Cir. 1985) (director has standing to bring suit under the proxy rules); *Ameribanc Investors Group v. Zwart*, 706 F. Supp. 1248 (E.D. Va. 1989) (even the issuer or target corporation has standing

that a shareholder has standing to challenge a misleading proxy statement by alleging direct injury notwithstanding the absence of his or her alleging actual reliance.²⁹⁸ All that is necessary is that the reliance of some shareholders on the statement was likely to have affected the outcome of their votes.

A basic element of a claim based on one of the securities laws' antifraud provisions is that the misstatements or omissions were "material" to the transaction. The Supreme Court found the determination of "materiality" to be a mixed question of law and fact and declared that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."²⁹⁹ This definition appears to have stood the test of time, having been adopted again by the Court in determining materiality in the context of a Rule 10b-5 action,³⁰⁰ and it was echoed in an SEC rule pertaining to materiality in the context of 1934 Act registration and reporting.³⁰¹ This same materiality test is also applied to 1933 Act disclosure obligations (as well as to disclosures required under the other securities laws that are not discussed herein).

It is difficult to generalize with regard to issues of materiality, since the decisions are highly fact-specific. However, the cases do in large part reflect the common law of misrepresentation, which states that opinions, predictions, intentions, and mere statements of value are

to sue under the proxy rules); District 65, *UAW v. Harper & Row Publishers*, 576 F. Supp. 1468 (S.D.N.Y. 1983) (plaintiff must be a shareholder at the time of the proxy solicitation).

298. See, e.g., *Bradshaw v. Jenkins*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,645 (W.D. Wash. 1984). But cf. *Atkins v. Tony Lama Co.*, 624 F. Supp. 250 (S.D. Ind. 1985) (dismissing claim because allegations negated any possibility of reliance, a necessary element of a fraud claim).

299. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

300. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

301. Rule 12b-2.

generally not actionable.³⁰² Predictions, opinions, and projections will not be actionable unless they constitute a misrepresentation of fact.³⁰³ Complicating matters are the disclosures required in Management Discussion and Analysis concerning the significant trends management foresees for the company.³⁰⁴

Nondisclosure or inadequate disclosure of conflicts of interest frequently constitute material misrepresentations.³⁰⁵ However, in some contexts, nondisclosure of the directors' motivations for supporting or opposing a particular transaction has been held not material so long as there was full disclosure of all relevant facts surrounding the transaction.³⁰⁶

In addition to materiality, establishing an actionable violation of the proxy rules requires the private plaintiff to establish causation. Causation under the proxy rules' private right of action has been a somewhat elusive concept. A showing of cause in fact is the first step in establishing a sufficient causal nexus between the defendant's conduct and the plaintiff's injury.³⁰⁷ Once cause in fact has been established, it must be shown that the causal connection is sufficiently proximate in

302. See, e.g., *Mendell v. Greenberg*, 612 F. Supp. 1543 (S.D.N.Y. 1985), *aff'd in part and rev'd in part*, 927 F.2d 667 (2d Cir. 1991) (mere opinion is not actionable); *Nutis v. Penn Merch. Corp.*, 610 F. Supp. 1573 (E.D. Pa. 1985), *aff'd*, 791 F.2d 919 (3d Cir. 1986) (failure to disclose that terms of proposed merger were "grossly unfair" held not actionable); *Hahn v. Breed*, 587 F. Supp. 1369 (S.D.N.Y. 1984) (expressions of opinions of future prospects held not actionable).

303. See, e.g., *Krauth v. Executive Telecard, Ltd.*, 890 F. Supp. 269 (S.D.N.Y. 1995). The "bespeaks caution" doctrine, discussed *supra* text accompanying notes 89–94, will preclude liability for forward-looking statements made in good faith. 15 U.S.C. § 77z-2 (Supp. 2001). See, e.g., *Wielgos v. Commonwealth Edison*, 892 F.2d 509 (7th Cir. 1989). See also, e.g., *Roots P'ship v. Land's End, Inc.*, 965 F.2d 1411 (7th Cir. 1992).

304. Reg. S-K, Item 303, 17 C.F.R. § 229.303.

305. See, e.g., *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987 (2d Cir. 1988).

306. See, e.g., *Kademian v. Ladish Co.*, 792 F.2d 614 (7th Cir. 1986); *Morrissey v. County Tower Corp.*, 717 F.2d 1227 (8th Cir. 1983); *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214 (9th Cir. 1980); *Warner Communications v. Murdoch*, 581 F. Supp. 1482 (D. Del. 1984).

307. See, e.g., *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972) (decided under Rule 10b-5).

order to warrant recovery. In securities law, as with common-law fraud, there must be a direct causal connection between the act and the injury; collateral breaches of fiduciary duties will not be sufficient to state a claim.³⁰⁸ The Supreme Court stated that the proper test of causation in a Rule 14a-9 action is whether upon full and fair disclosure a reasonable shareholder's voting decision would likely have been affected.³⁰⁹ Alleged misstatements in connection with a shareholder vote that was not required to effectuate the transaction in question cannot form the basis of a private damage action.³¹⁰

Another issue in proxy rule litigation is the degree of culpability required to establish a defendant's violation. Two courts of appeals have upheld private Rule 14a-9 claims based on negligence.³¹¹ Although a few courts have indicated that scienter is required in actions under Rule 14a-9,³¹² the Supreme Court's ruling in *Aaron v. SEC*,³¹³ though decided under section 17(a) of the 1933 Act, seems to mandate that a showing of negligent conduct would suffice.

Material misstatements and omissions in connection with a proxy solicitation can result in civil liability to shareholders who can show injury. In an appropriate case, a court may enjoin a shareholder meeting or any action voted on at that meeting when there have been significant violations of the proxy disclosure and filing require-

308. See, e.g., *Ketchum v. Green*, 557 F.2d 1022 (3d Cir.), *cert. denied*, 434 U.S. 940 (1977) (insufficient connection); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) (sufficient connection); *In re Tenneco Sec. Litig.*, 449 F. Supp. 528 (S.D. Tex. 1978) (insufficient connection); *Superintendent of Ins. v. Freedman*, 443 F. Supp. 628 (S.D.N.Y. 1977), *aff'd*, 594 F.2d 852 (2d Cir. 1978) (insufficient connection).

309. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970). See also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

310. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991).

311. *Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054 (1989); *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987 (2d Cir. 1988). *Accord Gillette Co. v. RB Partners*, 693 F. Supp. 1266 (D. Mass. 1988); *Fradkin v. Ernst*, 571 F. Supp. 829 (N.D. Ohio 1983).

312. See, e.g., *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir.), *cert. denied*, 449 U.S. 1067 (1980).

313. 446 U.S. 680 (1980).

ments.³¹⁴ Injunctive relief may also be secured in an SEC enforcement action,³¹⁵ and in an appropriate case the SEC can refer the matter for criminal prosecution.³¹⁶ However, it is difficult to unscramble eggs—because of the practical difficulties involved and hardships placed on innocent third parties, only rarely will a court set aside a transaction that has already been completed. In many cases, the inability of an aggrieved shareholder to secure injunctive relief makes the damage action the plaintiff's only meaningful remedy. Calculation of damages in the proxy context is a much more amorphous process,³¹⁷ since proxy rule violations do not always result in a sale of securities or some other readily identifiable reference point for computing damages. This, coupled with the paucity of cases on point,³¹⁸ means that there is little guidance for assessing the prospects of a claim for damages in a proxy area not based on a transaction in shares or corporate assets (where dollar amounts may be more readily identifiable).

Full disclosure regarding shareholder election of directors is part of the federal proxy regime. For example, all sources of financing behind the solicitation must be disclosed. Schedule 14A and Schedule 14B contain one of the more significant director election disclosure requirements—disclosure of the nominee's experience in office. Schedule 14B applies to solicitations made by persons other than the issuer. Nondisclosure of a director's conduct in office may be a material omis-

314. See, e.g., *Condec Corp. v. Farley*, 573 F. Supp. 1382 (S.D.N.Y. 1983) (no showing of irreparable injury; preliminary injunction denied); *Citizens First Bancorp, Inc. v. Harreld*, 559 F. Supp. 867 (W.D. Ky. 1982) (although plaintiff stated a claim, preliminary injunction was denied because of plaintiff's failure to show that otherwise there would be irreparable injury).

315. See, e.g., *SEC v. May*, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956) (preliminary injunction granted in an action against shareholders waging a proxy battle).

316. See, e.g., *United States v. Matthews*, 787 F.2d 38 (2d Cir. 1986).

317. See, e.g., *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977).

318. The absence of much guidance from the courts results from the fact that in most cases the plaintiff either has been unsuccessful or has settled prior to a judgment on the merits.

sion with respect to a shareholder's decision on how to cast his or her vote.³¹⁹ As is the case with disclosures generally, the pertinent information relating to the composition of the board of directors³²⁰ and the directors' conduct must be disclosed clearly and conspicuously.

D. Tender Offers and Takeover Bids: The Williams Act

Tender offers are publicly announced offers to purchase the shares of a target company. During the 1960s the securities markets witnessed a substantial increase in the use of tender offers in lieu of the more conventional statutory merger as a means of effecting corporate combinations. The increased use of tender offers resulted in part from the fact that target companies subject to the Exchange Act's reporting requirements were required to hold a shareholder vote and to comply with the Act's proxy rules when participating in a statutory merger. The competitive atmosphere and vociferousness with which such takeover battles were waged became extreme in terms of both public and private ramifications. This climate led to the 1968 Williams Act, amendments to the 1934 Act that were enacted to regulate these tender offers and takeover bids. The Williams Act is codified in sections 13(d), 13(e), 14(d), 14(e), and 14(f) of the 1934 Act.

Section 13(d) performs an important early warning function by putting investors and the target company's management on notice of a possible impending takeover attempt. It requires the filing of a disclosure statement on Schedule 13D by any person (or group), other than the issuer, who directly or indirectly acquires beneficial ownership of 5% or more of a class of equity securities registered pursuant to section 12.³²¹ Once a person has reached this 5% threshold, he or she has

319. *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979).

320. *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62 (D.C. Cir.), *cert. denied*, 449 U.S. 1012 (1980) (proxy solicitation defective where the fact that proxies sought by management for approval of a stock sale would in effect transfer control of a corporation to a third party was buried in pages of minute print).

321. That disclosure must include (1) the background and identity of the person(s); (2) the source and amount of funds used to make the purchases; (3) the purpose of the purchases; (4) the number of shares beneficially owned; and (5) any contracts, arrangements, or understandings involving securities of the issuer. Some institutional investors may qualify for the short-form Schedule 13G. An issuer's purchases

ten days in which to file the Schedule 13D.³²² After the Schedule 13D filing, there is a ten-day moratorium on additional purchases.

As defined by section 13(d)(3), a *person* includes a “partnership, limited partnership, syndicate, or other group.” Accordingly, a Schedule 13D must be filed when members of a group aggregately acquire 5% of a class of equity securities subject to the 1934 Act’s reporting requirements. The Second Circuit has held that the determinative factor is whether a group holding securities has been established pursuant to an express or implied agreement, thus presenting the *potential* for a shift in control; no agreement to purchase further securities is necessary.³²³ In contrast, the Seventh Circuit requires more explicit

of its own shares, directly or through an affiliate, are subject to similar disclosure requirements under section 13(e).

322. While initially intended to prevent accidental violations of the securities laws, the ten-day window frequently is used for additional undisclosed acquisitions of the target company’s stock; there have been attempts to close this window. *See, e.g.*, 15 Sec. Reg. & L. Rep. (BNA) 1156 (June 17, 1983) (a panel commissioned by the SEC recommended that the Schedule 13D filing be due in advance of the purchases); 16 Sec. Reg. & L. Rep. (BNA) 793 (May 11, 1984) (legislative proposals by the SEC to close the ten-day window); *D’Amato Introduces Comprehensive Proposal for Tender Offer Reform*, 19 Sec. Reg. & L. Rep. (BNA) 84 (Jan. 24, 1987).

323. *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972). *Accord* *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,534, 1999 WL 544708 (S.D.N.Y. 1999) (sufficient allegations that a number of investors constituted a group); *Strauss v. Am. Holdings, Inc.*, 902 F. Supp. 475 (S.D.N.Y. 1995) (allegation that one person was president and chief executive officer of one firm that was a shareholder and the sole general partner of another was sufficient to allege a group); *Staley Cont’l, Inc. v. Drexel Burnham Lambert, Inc.*, [1987–1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,698 (D.D.C. 1988); *Fin. Gen. Bankshares v. Lance*, [1978–1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,403 (D.D.C. 1978). *See also* *K-N Energy, Inc. v. Gulf Interstate Co.*, 607 F. Supp. 756 (D. Colo. 1983). *Cf.* *SEC v. First City Fin. Corp.*, 688 F. Supp. 705 (D.D.C. 1988), *aff’d*, 890 F.2d 1215 (D.C. Cir. 1989) (beneficial ownership based on relationship and understandings in the absence of a formal agreement). *But see* *Advanced Computer Techniques Corp. v. Lecht*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,795 (S.D.N.Y. 1982).

The Second Circuit has held that the member’s agreement to acquire control is established by purchase of the 5% threshold. *Corenco Corp. v. Schiavone & Sons, Inc.*, 488 F.2d 207 (2d Cir. 1973). However, discussions by various persons of the

evidence of a concerted effort to form a group. Under the Seventh Circuit's approach, the group must have an agreement not only to exert control but also to acquire additional shares for the purpose of exerting control.³²⁴

A group may be deemed to exist when individual parties agree to act in concert to purchase additional shares, regardless of the absence of a common plan with respect to the target corporation beyond the additional share acquisitions.³²⁵ Formation of a group via an agreement among existing shareholders owning in the aggregate more than 5% of a class of equity securities will trigger the section 13(d) filing requirement even though no additional shares are to be purchased. Whether a failure in the Schedule 13D to disclose the existence of a group constitutes a material misstatement or omission depends on the facts of the case.³²⁶

Rule 13d-3 sets forth the SEC's standards for determining who is a beneficial owner for purposes of section 13(d) and section 13(g)³²⁷ filing requirements. Section 13(d)(4) addresses the computation of the 5% threshold.

Section 13(d)(6) exempts certain acquisitions from the filing requirements of sections 13(d) and 13(g). The terms of section 13(d)(6) give the SEC the power to provide additional exemptions through rule making.³²⁸

possibility of entering into an agreement alone do not establish the formation of a group. *Lane Bryant, Inc. v. Hatleigh Corp.*, 517 F. Supp. 1196 (S.D.N.Y. 1981).

324. *Bath Indus. v. Blot*, 427 F.2d 97 (7th Cir. 1970).

325. *Mid-Continent Bancshares, Inc. v. O'Brien*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,734 (E.D. Mo. 1981).

326. Compare *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979), with *Treadway Co. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980).

327. See, e.g., *Stichting Phillips Pensionbonds A and B*, SEC No-Action Letter, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,668 (Jan. 12, 1988) (foreign pension fund investing in regular course of its business and not with a view toward affecting control of target company qualified for Schedule 13G).

328. Rule 13d-6 exempts a purchase whereby the purchaser becomes more than a 5% beneficial owner if the acquisition is made pursuant to preemptive subscription rights, provided that (1) an offering is made to all holders of securities of the same class; (2) the person acquiring securities does not acquire any additional securities

Section 13(d)'s filing requirements are aimed at creeping acquisitions and open-market or privately negotiated large-block purchases. In contrast, section 14(d)'s filing requirements, section 14(e)'s general antifraud proscriptions, and section 14(f)'s disclosure requirements relating to new directors are all triggered by a tender offer. The term *tender offer* is not defined in the Williams Act. Both the courts and the SEC have construed the term broadly, providing a flexible definition. The SEC has suggested an eight-factor test to determine whether a tender offer exists:

1. whether there is active and widespread solicitation of public shareholders;
2. whether there is solicitation for a substantial percentage of the issuer's stock;
3. whether the offer to purchase is made at a premium over prevailing market price;
4. whether the terms of the offer are firm rather than negotiable;
5. whether the offer is contingent on the tender of a fixed minimum number of shares;
6. whether the offer is open only for a limited period of time;
7. whether the offerees are subject to pressure to sell their stock; and
8. whether public announcements of a purchasing program precede or accompany a rapid accumulation of stock.³²⁹

These are only broad guidelines. Hence, any predictability must be gleaned from the cases and SEC rulings.³³⁰ Cases involving both open-

other than through the pro rata share offering of preemptive rights; and (3) the acquisition is duly reported, if required, pursuant to section 16(a).

329. The eight-factor test, which is not contained in an official SEC release, has evolved over a period of time and is discussed in *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979); *Hoover Co. v. Fuqua Indus., Inc.*, [1979–1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,107 (N.D. Ohio 1979).

330. See, e.g., *Holstein v. UAL Corp.*, 662 F. Supp. 153 (N.D. Ill. 1987) (holding that a poison-pill plan involving distribution of rights was not a tender offer); *Beaumont v. Am. Can Co.*, 621 F. Supp. 484 (S.D.N.Y. 1984), *aff'd*, 797 F.2d 79 (2d Cir. 1986) (cash option portion of a merger with a cash election feature is not a tender offer); *In re Pain Webber, Jackson & Curtis, Inc.*, 15 Sec. Reg. L. Rep. (BNA) 131 (SEC

market and privately negotiated stock purchases seem to turn on whether or not the “pressure-creating characteristics of a tender offer”³³¹ accompany the transactions.³³² Although the cases conflict, a number of decisions have held that most privately negotiated transactions are susceptible to categorization as tender offers. However, most privately negotiated purchases are not tender offers unless they subject the seller to undue pressure.³³³ The theme that emerges from the cases is that when a privately negotiated attempt to take control of a company raises problems that the Williams Act is designed to cover, a tender offer may exist.

Dec. 12, 1982) (block trade of 9.9% is a tender offer); *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985) (five privately negotiated purchases and one open-market purchase were not a tender offer; the transactions in question have been referred to as an “end run” because they were preceded by a tender offer that was withdrawn and then followed by a second tender offer); *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985) (issuer’s open-market purchase program in response to a third-party tender offer was not a tender offer subject to section 13(e)); *Dyer v. Eastern Trust Co.*, 336 F. Supp. 890 (N.D. Me. 1971) (holding that a large block purchase of shares made without the intent to obtain control was not a tender offer).

331. *Ludlow Corp. v. Tyco Labs., Inc.*, 529 F. Supp. 62, 68 (D. Mass. 1981).

332. *See also Zuckerman v. Franz*, 573 F. Supp. 351 (S.D. Fla. 1983) (highly publicized cash merger proposal at a premium above the market price constituted a tender offer); *S-G Sec., Inc. v. Fuqua Inv. Co.*, 466 F. Supp. 1114 (D. Mass. 1978) (publicly announced intention to acquire a substantial block of stock followed by rapid acquisition of 28% of shares of target company held a tender offer).

333. *See, e.g., Cattlemen’s Inv. Co. v. Fears*, 343 F. Supp. 1248 (W.D. Okla. 1972) (any privately negotiated purchase that interferes with a shareholder’s “unhurried investment decision” and “fair treatment” of investors defeats the protections of the Williams Act and is probably a tender offer); *In re G.L. Corp.*, [1979–1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,494 (Apr. 15, 1980) (offer for all or none purchase at a premium may be a tender offer); *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979) (secret offers to twenty-eight of target company’s largest shareholders, giving each of them only from half-an-hour to overnight to decide, constituted a tender offer). *Cf. Kennecott Copper Corp. v. Curtis-Wright Corp.*, 584 F.2d 1195 (2d Cir. 1978) (acquisition of nearly 10% of target company’s shares does not constitute a tender offer where tender offeror and solicited shareholder agree on secrecy and the private nature of the transaction, and no high-pressure tactics are used); *Energy Ventures, Inc. v. Appalachian Co.*, 587 F. Supp. 734 (D. Del. 1984) (series of privately negotiated transactions not involving high pressure did not constitute a tender offer).

Once an offer is deemed a tender offer, it is governed by various procedural provisions of the Williams Act. In general, section 13(e) and the rules promulgated thereunder regulate issuer tender offers, or “self tender offers,” and sections 14(d), (e), and (f) and the rules promulgated thereunder regulate tender offers by third parties. The rules governing third-party tender offers and issuer tender offers are basically the same. There are six important requirements placed on tender offers by the Williams Act: (1) disclosure requirements; (2) rules regulating shareholder withdrawal rights; (3) the “pro rata” rule; (4) the “all holders” rule; (5) the “best price” rule; and (6) rules governing the duration of the tender offer. Most of these apply only to offers for securities registered under the 1934 Act (sections 13(e) and 14(d) and applicable rules), but some of the federal tender offer regulations apply regardless of 1934 Act registration (section 14(e) and applicable rules).

Section 14(d)(1) of the 1934 Act requires that all “tender offer material” for equity securities subject to the registration requirements of section 12 must be filed with the SEC³³⁴ and accompanied by the appropriate disclosures. Section 14(d) requires disclosures of the type specified by Schedule 13D, in addition to other information the SEC may require. As with Schedule 13D, the section 14(d) filings must be updated to reflect material changes and developments.³³⁵ Section 14(d) does not apply to an issuer’s acquisition of its own shares—those transactions are covered by section 13(e), which, by virtue of SEC rule making, imposes regulations for issuer tender offers that are comparable³³⁶ to Regulation 14D’s rules for third-party offers.

Under the Williams Act, shareholders have the right at certain times to withdraw their tendered shares from a tender offer. Section 14(d)(5) provides that all securities deposited pursuant to a tender offer may be withdrawn during the first seven days of the tender offer

334. Schedule TO is the appropriate form for filing tender offers under section 14(d).

335. See, e.g., *In re Revlon, Inc.*, Exchange Act Release No. 34-23320 (June 16, 1986) (finding violations of Rule 14d-4 for failure to amend the Schedule 14D-9 to reflect defensive merger negotiations).

336. See, e.g., Rule 13e-1.

and at any time after sixty days from the date of the original tender offer. This has been extended by the SEC rules to permit tendered securities to be withdrawn at any time while the tender offer remains open.³³⁷ The rules also set out the proper form for notice of withdrawal.

The “pro rata” rule requires pro rata acceptance of shares tendered where the tender offer by its terms does not obligate the tender offeror to accept all shares tendered. This takes pressure off the target company’s shareholders who would otherwise have to make a quick decision should acceptance be on a first-come basis.

The “all holders” rule prohibits discriminatory tender offers that exclude one or more shareholders from participating.³³⁸ There is an exception to the all holders requirement when the tender offer is in compliance with a constitutionally valid state statute.³³⁹ Furthermore, in addition to reserving general exemptive power under the all holders rule,³⁴⁰ the SEC has promulgated a specific but limited exemption for “odd-lot tender offers” by issuers.³⁴¹

The “best price” rule states that the highest price paid to any tendering security holder must be paid to all tendering security holders.³⁴² This requirement applies only to shares purchased during a single tender offer. As such, unlike state “fair price” statutes,³⁴³ it does

337. Section 14(d)(6). The statutory period has been extended for the entire period of the tender offer by Rule 14d-8 for third-party tender offers and Rule 13e-4(f)(3) for issuer tender offers.

338. Rule 14d-10(a)(1) for third-party tender offers; Rule 13e-4(f)(8)(i) for issuer tender offers. These rules were promulgated after (and perhaps in response to) a Delaware decision that upheld a tender offer by an issuer that excluded a hostile tender offeror. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (D. Del. 1985).

339. Rule 14d-10(b)(2) for third-party tender offers; Rule 13e-4(f)(9)(ii) for issuer tender offers.

340. Rule 14d-10(e); Rule 13e-4(g)(7).

341. Rule 13e-4(g)(5). An odd-lot offer is one limited to security holders owning less than a specified number of shares under 100. Within that group, however, both the “all holders” and “best price” requirements will apply to the terms of the odd-lot offer.

342. Rule 14d-10(a)(2) for third-party tender offers; Rule 13e-4(f)(8)(ii) for issuer tender offers.

343. *See, e.g.*, Md. Code Ann., Corps. & Ass’ns §§ 3-602, 3-603 (1993).

not regulate two-tiered offers consummated in two distinct steps. However, it can be important if a series of transactions are integrated and held to be parts of a single tender offer.³⁴⁴ The SEC best price rule does not prohibit differentiation in types of consideration. The different consideration need not be substantially equivalent in value so long as the tender offer permits each tendering security holder to select among the types of consideration offered.³⁴⁵ As is the case with the all holders rule, the SEC has the power to grant exemptions from the best price requirement.³⁴⁶

The Williams Act also prescribes minimum lengths for the duration of tender offers. A tender offer must remain open for at least twenty business days. This requirement applies even for tender offers for securities of target companies not registered under the 1934 Act.³⁴⁷ Any increase or decrease in the consideration offered under the tender offer triggers the requirement that the tender offer be open for ten business days from the date of change in consideration.³⁴⁸ Furthermore, notice of any “material” change in the terms of the offer must be made in a manner reasonably designed to inform shareholders of that change.³⁴⁹

344. See, e.g., *Field v. Trump*, 850 F.2d 938 (2d Cir. 1988), *cert. denied*, 489 U.S. 1012 (1989) (upholding complaint that withdrawal of first tender offer was a sham). *But cf. Brill v. Burlington N., Inc.*, 590 F. Supp. 893 (D. Del. 1984) (December tender offer that was terminated and January tender offer addressed to same class of shareholders were two separate tender offers). See also section 14(d)(7) of the 1934 Act, which provides that whenever a person varies the terms of a tender offer or a request before the expiration thereof by increasing the consideration offered, the person making such an increase must pay to all persons tendering that same price whether or not the securities were tendered prior to the variation of the tender offer’s terms.

345. Rule 14d-10(c) for third-party tender offers; Rule 13e-4(f)(10) for issuer tender offers.

346. Rule 14d-10(e); Rule 13e-4(g)(7).

347. Rule 14e-1(a) for third-party tender offers; Rule 13e-4(f)(1)(i) for issuer tender offers.

348. Rule 14e-1(b) for third-party tender offers; Rule 13e-4(f)(1)(ii) for issuer tender offers.

349. Rule 14d-4(c) for third-party tender offers; Rule 13e-4(e)(2) for issuer tender offers. The SEC has interpreted this to mean that a material change would require holding the offer open for at least five days from the date of notice and for ten days

When a tender offer is made for equity securities subject to the 1934 Act's reporting requirements, section 14(f) requires full disclosure of any agreements concerning the designation of new directors, unless the designation is made through a formal vote at a meeting of the securities holders. Contemplated management turnover, including any arrangement regarding the makeup of the majority of directors, also must be disclosed.³⁵⁰ The purpose of section 14(f)'s disclosure requirements is to ensure that shareholders and other investors are aware of any changes in management control that are to take place without a shareholder vote. The required disclosures keep security holders apprised of all material information, including new directors' backgrounds and relationships with the issuer both in terms of employment contracts and stockholdings.

In *Schreiber v. Burlington Northern, Inc.*,³⁵¹ the Supreme Court limited the thrust of section 14(e). *Schreiber* involved a claim that the defendant target company's renegotiation of the terms of a tender offer was manipulative and therefore in violation of section 14(e). Rather than directly confront the issue of what constitutes "manipulative conduct," the Court held that "without misrepresentation or nondisclosure, section 14(e) has not been violated."³⁵² In a rather unusual review of the section's legislative history, the Court concluded that disclosure was the sole thrust of the section,³⁵³ in effect excising "manipulative conduct" from the terms of the statute. The ramifications of this decision, if overextended and literally applied, not only could eviscerate Regulation 14E as discussed below but also could carry over to section 10(b), on which section 14(e) is based. This could lead to the invalidation of a number of the section 10(b) rules dealing with

where the change is as significant as a change in consideration or the percentage of securities sought.

350. Rule 14d-4(c) for third-party tender offers; Rule 13e-4(e)(2) for issuer tender offers. *See also* Rule 14f-1.

351. 472 U.S. 1 (1985).

352. *Id.* at 12.

353. "Nowhere in the legislative history is there the slightest suggestion that Section 14(e) serves any purpose other than disclosure . . ." *Id.* at 11.

manipulative conduct. The courts, however, have been reluctant to give *Schreiber* such an unwarranted broad reading.³⁵⁴

Although it is clear that the SEC may investigate suspected violations and bring enforcement actions, it is not entirely clear whether the Williams Act authorizes implied rights of action. In general, the courts seem to favor the existence of at least a limited implied remedy (for material misstatements or omissions) under section 14(e)'s antifraud provision. The availability of an implied remedy under the Williams Act's filing requirements (sections 13(d), 13(e), and 14(d)) is also significant.³⁵⁵ The cases are in conflict, but a number of decisions have held that the relevant provisions of sections 13 and 14 themselves provide a basis for at least limited private relief. Courts seem more likely to grant injunctive relief³⁵⁶ than damages.³⁵⁷ The Su-

354. *Polaroid v. Disney*, 862 F.2d 987 (3d Cir. 1988) (upholding the validity of the all holders rule, which prohibits excluding shareholders from a tender offer).

355. Since these sections all apply to issuers subject to the 1934 Act's registration and reporting requirements, and involve mandatory filings with the SEC, other remedies for material misstatements may be available. For example, an investor injured by actual reliance on material misstatements in the mandatory filings may sue for damages under the express remedy provided in section 18(a) of the 1934 Act. Furthermore, any material misstatements or omissions that give rise to an injury in connection with the purchase or sale of a security will form the basis of a cause of action under Rule 10b-5. However, no private remedy appears to exist under Rule 10b-5 for mere delay in making the required filing. Thus it is important to determine if an implied remedy exists under the Williams Act filing requirements.

356. See, e.g., *Conagra, Inc. v. Tyson Foods, Inc.*, 708 F. Supp. 257 (D. Neb. 1989) (preliminary injunction granted); *Morrison Knudsen Corp. v. Heil*, 705 F. Supp. 497 (D. Idaho 1988) (exercise of control enjoined until deficiencies cured in section 13(d) filings); *Schnell v. Schnell*, 550 F. Supp. 650 (S.D.N.Y. 1982); *Berman v. Metzger*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,857 (D.D.C. 1981).

357. For a case holding that section 14(d)(7) can support a damage action, see *Field v. Trump*, 850 F.2d 938 (2d Cir. 1988), cert. denied, 489 U.S. 1012 (1989). See also, e.g., *Sanders v. Thrall Car Mfg. Co.*, 730 F.2d 910 (2d Cir. 1984), affg, 582 F. Supp. 945 (S.D.N.Y. 1983); *Dan River, Inc. v. Unitex Ltd.*, 624 F.2d 1216 (4th Cir. 1980), cert. denied, 449 U.S. 1101 (1981); *Chromalloy Am. Corp. v. Sun Chem. Corp.*, 611 F.2d 240 (8th Cir. 1979); *Liberty Nat'l Ins. Holding Co. v. Charter Co.*, 734 F.2d 545 (11th Cir. 1984). But see *Am. Bakeries Co. v. Pro-Met Trading Co.*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,925 (N.D. Ill. 1981); *Gateway Indus., Inc. v. Agency Rent A Car, Inc.*, 495 F. Supp. 92 (N.D. Ill. 1980).

preme Court has indicated *in dicta* that a target company may have standing to complain of delays by a purchaser in filing a Schedule 13D where the target company can show a resultant injury.³⁵⁸

E. Liabilities Under the 1934 Act

1. Wrongdoing Related to Tender Offers: Section 14(e)

Section 14(e) of the Exchange Act of 1934 prohibits material misstatements, omissions, and fraudulent practices in connection with tender offers regardless of whether the target company is subject to the Exchange Act's reporting requirements.³⁵⁹ It is not always necessary to disclose preliminary merger discussions; however, the Supreme Court has held that whether preliminary merger negotiations have crossed the materiality threshold is a question of fact³⁶⁰ depending on whether a reasonable investor would consider them significant in making an investment decision.³⁶¹

In *Piper v. Chris-Craft Industries, Inc.*,³⁶² the Supreme Court determined that there is no private remedy for a competing tender offeror. In so holding, the Court did not rule out any private remedy; in fact, the opinion held out much hope for the recognition of a section 14(e) private right of action in the hands of the target company or its shareholders. The Court in *Piper* reasoned that the purpose of the Williams Act was to further investor protection by serving the shareholders of the target company, not competing tender offerors, who, at best, were collateral beneficiaries of the tender offer provisions. Most lower courts have recognized a remedy in the hands of the target company or one of its shareholders,³⁶³ as well as the right of a competing tender

358. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975).

359. In contrast, the other provisions of the Williams Act are limited to securities of issuers subject to section 12's registration requirements.

360. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

361. *Id.*; see *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

362. 430 U.S. 1 (1977).

363. See, e.g., *Seaboard World Airlines, Inc. v. Tiger Int'l, Inc.*, 600 F.2d 355 (2d Cir. 1979) (recognizing section 14(e) remedy but finding no substantive violation). See also *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *H.K. Porter Co. v. Nicholson File Co.*, 482 F.2d 421 (1st Cir. 1973).

offeror to seek injunctive relief.³⁶⁴

A target company and its shareholders have standing to sue under section 14(e). The *Piper* decision indicates that a private right of action, if it exists at all, works in favor of the target company shareholders and, in an appropriate case, in favor of the target company. Again, most circuit and district court opinions dealing with the question have recognized a private right of action under section 14(e) by a target company or its shareholders. Target company shareholders, but not the target company management, may be able to assert claims under Regulation 14D.³⁶⁵

2. Manipulation of Exchange-Traded Securities: Section 9(e)

Section 9 of the 1934 Exchange Act outlaws manipulative practices in connection with the trading of exchange-listed securities. It also provides a private remedy for investors injured by such prohibited manipulative conduct. Section 9 does not apply to securities traded in the over-the-counter markets. Manipulation of nonexchange-traded securities is prohibited by sections 10(b) and 15(c), which do not contain an express private right of action. *Manipulation* is interpreted narrowly, not extending to many acts that effectively alter the price of a security. Although manipulation has the same meaning under each of the Exchange Act provisions, the Supreme Court has repeatedly stated that it is a “term of art” limited to certain types of transactions specifically designed to artificially affect the price of a security.³⁶⁶

Section 9(e) provides a private remedy in damages to any investor injured by conduct violating section 9 (conduct involving securities listed on a national exchange). In addition to costs and reasonable attorneys’ fees, the successful plaintiff is entitled to damages based on the difference between the actual value and the price as affected by the

364. See, e.g., *Humana, Inc. v. Am. Medicorp, Inc.*, 445 F. Supp. 613 (S.D.N.Y. 1977).

365. *Polaroid v. Disney*, 862 F.2d 987 (3d Cir. 1988).

366. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976); *Schreiber v. Burlington N., Inc.*, 472 U.S. 1 (1985).

manipulative conduct. Liability under section 9(e) is expressly limited to persons “willfully” participating in the manipulative conduct. The plaintiff must also prove manipulative intent.³⁶⁷

The section 9(e) remedy has been described as follows:

To show a violation of section 9(a)(2) in a private suit under section 9(e), a plaintiff must plead and prove that

(1) a series of transactions in a security creating actual or apparent trading in that security or raising or depressing the price of that security, (2) carried out with scienter (3) for the purpose of inducing the security’s sale or purchase by others, (4) was relied on by the plaintiff, (5) and affected the plaintiff’s purchase or selling price.³⁶⁸

Although the foregoing test indicates that plaintiffs must prove actual reliance and reliance on market price alone will not suffice, this limitation may be questionable in the face of the “fraud on the market” theory of reliance.³⁶⁹ The fraud-on-the-market doctrine, which applies to actively traded securities, presumes reliance and shifts the burden of nonreliance to the defendant. Nevertheless, it is patently clear that even without this element, the section 9(e) remedy is a rather limited one. Market manipulation and deceptive practices are also regulated by sections 10, 14(e), and 15(c).

3. Insider Reporting and Short-Swing Profits: Section 16

Section 16³⁷⁰ of the 1934 Act is intended to prevent corporate insiders from engaging in “short-swing” trading (i.e., using access to nonpublic information about important, impending corporate actions to trade short-term in the securities of a company for profit). Short-swing trading is short-term trading in the corporation’s stock (in the statute,

367. See Annotation, *What Constitutes Willfulness or Manipulative Purpose So As To Warrant Imposition of Liability in Private Civil Action Based on Price Manipulation Provisions of Securities Exchange Act (15 USCS §§ 78i(a)(2), 78i(e))*, 25 A.L.R. Fed. 623 (1975).

368. *Ray v. Lehman Bros. Kuhn Loeb, Inc.*, 624 F. Supp. 16, 19 (N.D. Ga. 1984) (quoting *Chemetron Corp. v. Business Funds, Inc.*, 682 F.2d 1149, 1164 (5th Cir. 1982), *vacated on other grounds*, 460 U.S. 1007 (1983), *reh’g granted*, 718 F.2d 725 (5th Cir.), *cert. denied*, 460 U.S. 1013 (1983)).

369. See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (upholding the fraud-on-the-market presumption of reliance in Rule 10b-5 actions).

370. See *infra* text accompanying notes 504–35.

a purchase then sale, or sale then purchase, occurring within six months). Section 16(a) requires every officer, director, and beneficial owner of more than 10% of any class of equity security registered under section 12 of the Act to file disclosure notices with the SEC. These notices must disclose all ownership interest in any of the issuer's equity securities. The notice must be filed within ten days of a person's becoming an officer, director, or beneficial owner of more than 10% of a class of securities, as well as within ten days of the end of every calendar month in which there has been a change in that person's holdings. These reports are then made available to the public at the SEC's office in Washington, D.C. The SEC also publishes monthly summaries of the reports.

4. False Filings

a. Section 18

Section 18 of the 1934 Act provides an express right of action for any investor injured by purchasing or selling securities in reliance on a materially misleading statement or omission in a document required to be filed³⁷¹ with the SEC. However, the usefulness of section 18 has been largely diminished by the courts' "eyeball" test: The plaintiff must have actual knowledge of and must have relied on the materials filed with the SEC (or a copy thereof). That the plaintiff saw similar information in other documents prepared by the issuer is not sufficient.³⁷² As a practical matter, civil liability for false SEC filings and false statements generally is more likely to be based on the implied remedy under SEC Rule 10b-5.

b. Rule 10b-5

The primary private remedy for fraud available under the 1934 Act is implied from SEC Rule 10b-5. No express provision in the securities laws prescribes civil liability for a violation of Rule 10b-5. However, as

371. The concept of a filed document is a narrow one. It is limited to forms such as the 10-K, the 10-Q quarterly report, 8-K filings, and Schedule TO for tender offers and does not include other required disclosure documents, such as the annual report to shareholders sent under the mandate of the proxy rules. See Rule 14a-3(b).

372. See, e.g., *Ross v. A.H. Robins Co.*, 607 F.2d 545, 552 (2d Cir. 1979); *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518, 525 (S.D.N.Y. 1977).

far back as 1946, the courts followed the normal tort rule that persons who violate a legislative enactment are liable in damages if they invade an interest of another person whom the legislation was intended to protect.³⁷³

Rule 10b-5 was promulgated under section 10(b), which gives the SEC power to make rules prohibiting the use of “manipulative or deceptive device[s] or contrivance[s] . . . in connection with the purchase or sale of any security”³⁷⁴ Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

Rule 10b-5 applies to any purchase or sale by any person of *any* security. The fact that a security is exempt from 1933 or 1934 Act registration does not affect the applicability of Rule 10b’s proscriptions. The rule applies regardless of whether the security is registered under the 1934 Act and regardless of whether the company is publicly held

373. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (recognizing private remedy under SEC Rule 10b-5). The first decision to recognize an implied remedy under section 17(a) of the 1933 Act was *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949). *But cf.* *Crookham v. Crookham*, 914 F.2d 1027 (8th Cir. 1990) (no section 17(a) remedy).

374. Other rules authorized under this section include Rule 10b-3, addressing manipulation; Rules 10b5-1 and 10b5-2, dealing with insider trading; Rule 10b-9, dealing with conditional offerings of securities; Rule 10b-10, dealing with broker–dealer confirmations of securities transactions; Rule 10b-16, addressing requisite disclosure in margin transactions; Rule 10b-17, dealing with the untimely announcement of record dates; and Rule 10b-18, dealing with a company’s purchases of its own shares. 17 C.F.R. §§ 240.10b-3, 240.10b5-1, 240.10b5-2, 240.10b-9, 240.10b-10, 240.10b-17, & 240.10b-18.

or closely held. It applies even to government and municipal securities and, in fact, to any kind of entity that issues something that can be called a security. Because of this broad scope, Rule 10b-5 can be invoked in many situations.

Of the three separate clauses in Rule 10b-5 (above), clause (c) is generally assumed to have the broadest scope. There are five principal elements of this type of Rule 10b-5 claim: the plaintiff must show (1) fraud or deceit (2) upon any person (3) in connection with (4) the purchase or sale (5) of any security.

One of the requirements for proving the element of fraud is scienter. In 1976, the Supreme Court held that a valid claim for damages under Rule 10b-5 must establish that the defendant acted with scienter.³⁷⁵ In 1980, the Court held that the scienter standard applies under Rule 10b-5 regardless of whether the action is a private damage action or an enforcement action brought by the SEC.³⁷⁶ In these cases, the Court did not decide whether a showing of reckless conduct would satisfy the scienter requirement.³⁷⁷ However, the majority of district and appellate court decisions have found that recklessness is sufficient to state a claim under Rule 10b-5.³⁷⁸ In suits involving money damages predicated on proof that a defendant acted with a certain state of mind, plaintiffs must plead with particularity that the defendant acted with such state of mind with respect to each act or omission.³⁷⁹ Plaintiffs also must provide facts that indicate a “strong inference” that a

375. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

376. *Aaron v. SEC*, 446 U.S. 680 (1980).

377. *Hochfelder*, 425 U.S. at 193–94 n.12; *Aaron*, 446 U.S. at 690–91.

378. *See, e.g., Van Dyke v. Coburn Enter.*, 873 F.2d 1094 (8th Cir. 1989); *Rankow v. First Chicago Corp.*, 870 F.2d 356 (7th Cir. 1989); *Stephenson v. Paine Webber, Jackson & Curtis, Inc.*, 839 F.2d 1095 (5th Cir.), *cert. denied*, 488 U.S. 926 (1988) (reckless/due diligence standard applied to plaintiff); *Hackbart v. Holmes*, 675 F.2d 1114 (10th Cir. 1982).

379. 1934 Act § 21D(b), 15 U.S.C. § 78u-4(b) (Supp. 2001). *See, e.g., Griffin v. GK Intelligent Sys., Inc.*, 87 F. Supp. 2d 684 (S.D. Tex. 1999); Note, *A Case-by-Case Approach to Pleading Scienter Under the Private Securities Litigation Reform Act of 1995*, 97 Mich. L. Rev. 2265 (1999). There is no parallel provision in the 1933 Act’s version of the PSLRA.

defendant acted with a particular state of mind.³⁸⁰ A “reasonable inference” of scienter is not sufficient.³⁸¹

In order to withstand the scrutiny imposed by the Private Securities Litigation Reform Act of 1995,³⁸² the inference of scienter must be both reasonable and strong.³⁸³ The circuits are split on the severity of the scienter pleading requirements imposed by the PSLRA: Some courts have held that allegations of motive and opportunity can satisfy the specificity requirement when pleading scienter.³⁸⁴ Other courts have held that motive and opportunity alone are not sufficient to establish scienter.³⁸⁵

380. There is evidence that Congress intended to strengthen the pleading standard for securities action and modeled the standard on Second Circuit case law. S. Rep. No. 104–98, at 15 (1995). *See, e.g.,* *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000) (the PSLRA did not heighten the Second Circuit requirement; it merely added a particularity requirement).

381. *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999). *See also, e.g., In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410 (3d Cir. 1997).

382. *See* discussion *supra* text accompanying notes 225–57.

383. *See, e.g., Novak*, 216 F.3d at 316; *Coates v. Heartland Wireless Communications, Inc.*, 100 F. Supp. 2d 417 (N.D. Tex. 2000).

384. *See, e.g., EP Medsystems, Inc. v. EchoCath, Inc.*, 255 F.3d 865 (3d Cir. 2000); *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000). *See also In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999) (upholding complaint alleging motive and opportunity); *Press v. Chem. Inv. Servs. Co.*, 166 F.3d 529 (2d Cir. 1999) (same); *Zishka v. Am. Pad & Paper Co.*, [2000–2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,208 (N.D. Tex. 2000); *In re Green Tree Fin. Corp. Stock Litig.*, 61 F. Supp. 2d 860 (D. Minn. 1999) (same); *McNamara v. Bre-X Minerals, Ltd.*, 57 F. Supp. 2d 396 (E.D. Tex. 1999) (same).

385. *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999) (particularity requirement means that plaintiff must allege severe recklessness; alleging motive and opportunity alone will not suffice); *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 988 (9th Cir. 1999), *affg* 970 F. Supp. 746 (N.D. Cal. 1997) (PSLRA requires deliberate recklessness; motive, opportunity, and nondeliberate recklessness may provide some evidence of intentional misconduct but standing alone are not sufficient). *See also Weber v. Contempo Colours, Inc.*, 105 F. Supp. 2d 769 (W.D. Mich. 2000) (scienter not established by allegations of motive and opportunity); *Dalarn Partners, Ltd. v. Sync Research, Inc.*, 103 F. Supp. 2d 1209 (C.D. Cal. 2000) (scienter was not adequately pleaded under *Silicon Graphics*); *In re Paracelsus Corp. Sec. Litig.*, 61 F. Supp. 2d 591 (S.D. Tex. 1998) (showing motive and opportunity alone is not suffi-

Any statement reasonably calculated to affect the investment decision of a reasonable investor will satisfy the rule's "in connection with" requirement.³⁸⁶ The Supreme Court has taken a broad view of what types of conduct can be characterized as in connection with the purchase or sale of a security.³⁸⁷

To have standing to sue, a Rule 10b-5 plaintiff in a private damages action must have been either a purchaser or seller of the securities that form the basis of the material omission, misstatement, or deceptive conduct.³⁸⁸ In *Blue Chip Stamps v. Manor Drug Stores*,³⁸⁹ the plaintiff had a right to purchase the securities in issue under an antitrust consent decree, but refrained on the basis of allegedly misleading statements made by the defendants. The Supreme Court held that this would-be purchaser could not state a Rule 10b-5 cause of action. It

cient). See Gregory A. Markel & Francis S. Chlapowski, *The PSLRA After Silicon Graphics*, 32 Sec. Reg. & L. Rep. (BNA) 219 (1999).

386. *Semerenko v. Candant Corp.*, 223 F.3d 165 (3d Cir. 2000); *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153 (2d Cir. 1998); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (misstatements in a corporate press release were made "in connection with" purchases and sales made by shareholders in the open market and violated Rule 10b-5, even though the corporation itself was not buying or selling shares); *Pelletier v. Stuart-James Co.*, 863 F.2d 1550 (11th Cir. 1989) (fraudulent scheme need not relate to "investment value" of security); *Ellis v. Merrill Lynch & Co.*, 664 F. Supp. 979 (E.D. Pa. 1987) (upholding Rule 10b-5 claim challenging broker's system for disbursing proceeds from sale); *Foltz v. U.S. News & World Report, Inc.*, 627 F. Supp. 1143 (D.D.C. 1986) (sufficient causal connection based on alleged misstatements dissuading employees from delaying retirement, which triggered a sale of stock under stock bonus plan).

387. In *SEC v. Zandford*, 122 S. Ct. 1899 (2002), a stockbroker embezzled the proceeds of a securities transaction. The Fourth Circuit held that this embezzlement was not in connection with the purchase or sale of securities simply because the cash that was taken represented the proceeds of a securities transaction. The Supreme Court reversed, finding a sufficient connection. This decision supports a continued expansive approach to the in connection with requirement. See also, e.g., *United States v. O'Hagan*, 521 U.S. 642 (1997) (finding a lawyer guilty of insider trading); *Carpenter v. United States*, 484 U.S. 19 (1987) (taking a broad view of the Mail Fraud Act).

388. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). See *Wharf (Holdings) Ltd. v. United Int'l Holdings*, 532 U.S. 588 (2001) (plaintiff could challenge oral option to purchase securities under Rule 10b-5).

389. 421 U.S. 723 (1975).

seems apparent that, likewise, mere “would-be” sellers cannot raise Rule 10b-5 claims.³⁹⁰ The courts have generally assumed that it is not necessary for the defendant to have been a purchaser or seller of securities in order to have violated Rule 10b-5.³⁹¹

Courts have broadly construed “purchase or sale.” Share exchanges or cash-out transactions pursuant to a corporate merger or other business combination will ordinarily constitute purchases and sales under Rule 10b-5.³⁹² Most courts also allow a remedy for a corporation for certain transactions, including corporate repurchases of its own shares at an inflated price or an additional issuance of corporate shares on an unfavorable basis³⁹³ (although a share exchange or merger with a shell company undertaken merely for “corporate restructuring” has been held not to constitute a purchase or sale under Rule 10b-5³⁹⁴). A corporation’s repurchase of its own shares or an additional issuance of its shares may also give rise to a shareholder derivative claim.³⁹⁵

390. In fact, this was the prevailing view even before *Blue Chip Stamps*. See, e.g., *Sargent v. Genesco, Inc.*, 492 F.2d 750 (5th Cir. 1974); *Greenstein v. Paul*, 400 F.2d 580 (2d Cir. 1968); *Jensen v. Voyles*, 393 F.2d 131 (10th Cir. 1968).

391. See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (upholding liability for misleading statement but not directly addressing whether defendant’s not being a purchaser or seller precluded liability); *Blue Chip Stamps*, 421 U.S. 723 (imposing a purchaser/seller standing requirement on the plaintiff).

392. *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Mader v. Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied*, 394 U.S. 930 (1969); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

393. See, e.g., *Ala. Farm Bureau Mut. Cas. Co. v. Am. Fid. Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980) (repurchase of shares); *Bailes v. Colonial Press, Inc.*, 444 F.2d 1241 (5th Cir. 1971) (issuance of shares); *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964) (issuance of shares); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (issuance of shares). *But cf.* *Smith v. Ayers*, 845 F.2d 1360 (5th Cir. 1988) (shareholder suing in individual capacity and complaining of corporation’s issuance of shares lacked Rule 10b-5 standing).

394. *In re Penn Cent. Sec. Litig.*, 494 F.2d 528 (3d Cir. 1974).

395. See *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988); *Blue Chip Stamps*, 421 U.S. 723.

A purchase or sale pursuant to a tender offer can form the basis of a Rule 10b-5 claim. A pledge of securities is generally held to be a sale subject to a Rule 10b-5 claim,³⁹⁶ although there is some disagreement on this point.³⁹⁷ A secured creditor who is injured because of a foreclosure sale of securities has been held to have standing to sue under Rule 10b-5.³⁹⁸

As noted earlier, for a misstatement or omission to be actionable under Rule 10b-5, it must be material. The Supreme Court has defined materiality in terms of the type of information that a reasonable investor would consider significant in making an investment decision.³⁹⁹ The materiality of a particular item is determined within the total mix of information that is publicly available. As materiality questions are highly fact-specific, summary judgment will rarely be appropriate.⁴⁰⁰

Following the common law of fraud, reliance is an element of any Rule 10b-5 claim. In a divided decision with only five justices in agreement, the Supreme Court recognized the fraud-on-the-market presumption of reliance⁴⁰¹ under which a showing that a material misstatement or omission that adversely affects the market price creates a presumption of reliance. However, the availability of the presumption is premised on the existence of a relatively liquid and, hence, efficient

396. *E.g.*, *Madison Consultants v. FDIC*, 710 F.2d 57 (2d Cir. 1983); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979). *See also* *Rubin v. United States*, 449 U.S. 424 (1981) (decided under section 17(a) of the 1933 Act).

397. *Lincoln Nat'l Bank v. Herber*, 604 F.2d 1038 (7th Cir. 1979); *Nat'l Bank v. All Am. Assurance Co.*, 583 F.2d 1295 (5th Cir. 1978).

398. *Falls v. Fickling*, 621 F.2d 1362 (5th Cir. 1980); *Bosse v. Crowell Collier & MacMillan*, 565 F.2d 602 (9th Cir. 1977).

399. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (decided under Rule 10b-5); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (decided under the proxy rules).

400. For examples of materiality in various contexts, see 2 Hazen, *supra* note 205, § 12.9.

401. *Basic*, 485 U.S. 224. *See, e.g.*, *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988). *See also* *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972) (applying presumption of reliance in face-to-face transaction).

market for the securities in question.⁴⁰² The defendant may rebut the presumption of reliance or show that reliance was unreasonable.

Causation is a key element of a Rule 10b-5 action. Many courts have divided causation into two subparts: transaction causation and loss causation. Transaction causation requires a showing that but for the violations in question, the transaction would not have occurred (at least in the form that it took). Loss causation requires a showing of a causal nexus between the transaction and the plaintiff's loss.⁴⁰³ Also, as is the case with any fraud claim, the plaintiff must be able to establish damages. In most Rule 10b-5 litigation, the appropriate measure of damages is the out-of-pocket loss caused by the material misstatement or omission.⁴⁰⁴ On occasion, disgorgement of ill-gotten profits or the benefits of the bargain might be a more appropriate measure of damages.⁴⁰⁵

Section 10(b) and Rule 10b-5 do not contain a statute of limitations for the implied remedy. Under the earlier decisions, the applicable statute of limitations for antifraud claims was generally the most analogous state statute of limitations.⁴⁰⁶ Many courts held this to be the blue sky limitations period.⁴⁰⁷ Regardless of the applicable statute of limitations, the earlier decisions held that federal equitable tolling principles were applicable, so that the statute of limitations did not begin to run until the time the violation was discovered or reasonably should have been discovered. In contrast, section 13 of the 1933 Act

402. See, e.g., *Freeman v. Laventhol & Horwath*, 915 F.2d 193 (6th Cir. 1990); *Greenberg v. Boettcher & Co.*, 755 F. Supp. 776 (N.D. Ill. 1991); *Sanders v. Robinson Humphrey/Am. Express, Inc.*, 634 F. Supp. 1048 (N.D. Ga. 1986), *modified on other grounds sub nom. Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718 (11th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988); *Reingold v. Deloitte Haskins & Sells*, 599 F. Supp. 1241 (S.D.N.Y. 1984).

403. See 2 *Hazen*, *supra* note 205, § 12.11.

404. E.g., *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433 (9th Cir. 1987); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986).

405. See *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335 (9th Cir. 1976). See also 2 *Hazen*, *supra* note 205, § 12.12.

406. See 2 *Hazen*, *supra* note 205, § 13.8.

407. *Id.* Especially in earlier decisions, some courts applied the longer common-law fraud limitations period. A blue sky law is a state securities act.

provides the statute of limitations applicable to private actions under the Act: one year from the date of discovery, with a three-year repose period. In other words, no claim can be brought more than three years after the sale or violation.⁴⁰⁸ A similar one-year/three-year limitations period applies to express remedies under sections 9(e) and 18(a) of the 1934 Act.⁴⁰⁹ The Supreme Court, in a splintered 5–4 decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,⁴¹⁰ held that the applicable limitations period was to be found in the most analogous federal (rather than state) statute.⁴¹¹ Accordingly, the Court applied the one-year-from-discovery/three-year repose period.⁴¹² In 2002, Congress added a new statute of limitations for actions based on fraud and deceptive conduct.⁴¹³ The limitations period for private fraud actions is now two years from discovery of the facts constituting the violation but in no event more than five years after the violation. This new statute clearly applies to actions under Rule 10b-5, but not to actions under provisions of the securities laws that are not based on fraud or deceit, in which cases the one-year/three-year periods referred to in *Lampf* remain applicable.

408. In an action under section 12(a)(2) of the 1933 Act, the three-year repose period runs from the sale; in an action under section 11 or section 12(a)(1), the three-year period begins from the time the securities were first bona fide offered to the public.

409. In contrast, an action for disgorgement of profits from insider short-swing transactions has a two-year limitations period. 1934 Act § 16(b).

410. 501 U.S. 350 (1991).

411. In so ruling, the Court followed its earlier decision in *Agency Holding Corp. v. Malley-Duff & Associates, Inc.*, 483 U.S. 143 (1987), holding that in a private RICO action the statute of limitations was to be taken from the federal antitrust laws rather than the most analogous state limitations period. The Court applied the new rule retroactively, but Congress legislatively overruled the Court by denying retroactive application of the *Lampf* decision. 1934 Act § 27A.

412. 501 U.S. 350 (1991). In *In re Data Access Systems*, 843 F.2d 1537 (3d Cir. 1988), the Third Circuit held that the *Agency Holding* rationale is equally applicable to the federal securities laws. As such, the court applied section 18(a)'s one-year/three-year limitations period. In contrast to the one-year/three-year statute, the new remedy for illegal insider trading contains a five-year limitations period that runs from the date of the transaction. 1934 Act § 20A(b)(4).

413. 28 U.S.C. § 1658.

Notwithstanding the application of the one-year/three-year limitations period to implied securities fraud actions, a number of questions remain unanswered. For example, does the three-year repose period start with the sale or the violation?⁴¹⁴ The answer would determine whether a continuing fraud could toll the statute beyond the three-year repose period.

In *Herman & MacLean v. Huddleston*,⁴¹⁵ the Supreme Court held that the remedies under section 11 of the 1933 Act for misstatements in registration materials and Rule 10b-5 are cumulative. Presumably, Rule 10b-5 remedies are cumulative with other express remedies as well.⁴¹⁶

c. Additional Implied Rights of Action

With the exception of Rules 10b-5 and 14a-9⁴¹⁷ and sections 14(e)⁴¹⁸ and 29(b),⁴¹⁹ recognition of additional implied private remedies under the federal securities laws seems unlikely. While the Supreme Court in the early 1970s repeatedly recognized an implied private right of action under Rule 10b-5,⁴²⁰ starting in the mid-1970s the Court showed

414. The three-year period in a section 9(e) action begins to run from the date of the violation; in an action under section 18(a), the three-year repose period runs from the time the cause of action “accrues.” In contrast, under the 1933 Act, the three-year period runs from the date of the sale or from the time the security is first bona fide offered to the public, depending on whether the claim is based on section 12(a)(2), 11, or 12(a)(1).

415. 459 U.S. 375 (1983).

416. Remedies under sections 12(a)(1) and 12(a)(2) of the 1933 Act, for example. The measure of damages under section 12 of the 1933 Act is based on rescission. See also the remedy under section 18(a) of the 1934 Act (misstatements in false filings). The new remedies under the Insider Trading and Securities Fraud Enforcement Act of 1988, codified in section 21A of the 1934 Act (disgorgement of profits in an action by contemporaneous traders), are expressly in addition to any other express or implied remedies.

417. Discussed *supra* text accompanying notes 296–312.

418. Discussed *supra* text accompanying notes 351–55, 359–65.

419. Section 29(b) of the 1934 Act provides that any contract in violation of the Act or any rule promulgated thereunder is void.

420. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). See also, e.g., *J.I. Case v. Borak*, 377 U.S. 426 (1964) (recognizing private right of action under proxy rules using tort theory of liability); *Blue Chip Stamps v. Manor Drug Stores*, 421

less willingness to recognize implied rights of action. In 1975, it set forth a restrictive test for determining when implied remedies should be recognized.⁴²¹ Subsequent decisions have made it clear that additional implied remedies are at best doubtful.⁴²² In addition, at least one court has awarded Rule 11 sanctions against claims based on other provisions where the implied remedy has been denied.⁴²³

Secondary liability under the 1934 Act. In addition to primary liability of persons who violate the securities laws, there can be secondary liability of collateral participants. There are three types of secondary liability: (1) controlling-person liability; (2) vicarious liability based on respondeat superior; and (3) liability for aiding and abetting a primary violator. To impose secondary liability on a collateral participant there must be a primary violation of the securities laws.

Controlling-person liability is found both in the 1934 Act (section 20(a)) and the 1933 Act (section 15). Although worded differently, the provisions are interpreted as similar.⁴²⁴ Control has been defined by the SEC as “the possession, direct or indirect, of the power to direct

U.S. 723 (1975); *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991); *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286 (1993).

421. In *Cort v. Ash*, 422 U.S. 66 (1975), the Supreme Court set forth a four-factor test for determining when to recognize an implied remedy: (1) Is the plaintiff one of the class for whose special benefit the statute is enacted? (2) Is there any evidence of legislative intent to create such a remedy or to deny one? (3) Is the recognition of an implied remedy consistent with the underlying purposes of the legislative scheme? (4) Is the area of law one that is traditionally relegated to the states?

Relying more heavily on legislative intent (factor 2) than on the other three factors, the Supreme Court recognized an implied right of action under the Commodity Exchange Act in *Curran v. Merrill Lynch Pierce Fenner & Smith*, 456 U.S. 353 (1982). The Court reasoned, *inter alia*, that the lower federal courts had recognized such an action for years while Congress sat by in silence.

422. See *Crookham v. Crookham*, 914 F.2d 1027 (8th Cir. 1990); *Landry v. All Am. Assurance Co.*, 688 F.2d 381 (5th Cir. 1982); 2 Hazen, *supra* note 205, § 12.22.

423. *Crookham*, 914 F.2d 1027 (\$10,000 sanction for bringing suit under section 17(a) of the 1933 Act). Other provisions that are unlikely to support an implied remedy include section 7 of the 1934 Act (margin violations), as well as violation of rules of self-regulatory organizations. See 3 Hazen, *supra* note 156, §§ 14.7, 14.26.

424. *Maher v. Durango Metals*, 144 F.3d 1302 (10th Cir. 1998). For the 1933 Act, see *supra* text accompanying notes 213–16.

or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”⁴²⁵ This liability requires that the defendant not only be a controlling person of the primary violator but also a culpable participant in the illegal activity. In an employment context, failure to supervise an employee may be deemed indirect participation by the controlling person, and thus the controlling person may be liable for any fraudulent schemes arising during the unsupervised period. Controlling-person liability is not limited to an employer–employee relationship.

Controlling-person liability is more restrictive than common-law agency theories in that it holds a controlling person liable only if that person (1) did not act in good faith or (2) induced or knowingly participated in the violation. Controlling-person liability is broader than *respondeat superior* in that it is not limited to employers. The question has arisen as to whether controlling-person liability is exclusive. Most courts of appeals have held that section 20(a) of the 1934 Act is not an exclusive remedy and thus can be supplemented by common-law principles of *respondeat superior*.⁴²⁶ In contrast to the prevailing rule as to controlling-person liability generally, section 21A(b)(2) denies *respondeat superior* liability in actions dealing with insider trading.⁴²⁷

425. Rule 405, 17 C.F.R. § 230.405 (2002). Courts have defined “control” as influence short of actual direction. *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761 (3d Cir. 1976).

426. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991); *In re Atlantic Fin. Mgmt., Inc.*, 784 F.2d 29 (1st Cir. 1986), *cert. denied*, 481 U.S. 1072 (1987); *Henricksen v. Henricksen*, 640 F.2d 880, 887 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Paul F. Newton & Co. v. Tex. Commerce Bank*, 630 F.2d 1111 (5th Cir. 1980); *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980). *But see Carpenter v. Harris, Upham & Co.*, 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979).

427. The Insider Trading and Securities Fraud Enforcement Act of 1988 provides that there is no controlling-person liability under the Insider Trading Sanctions Act of 1984 unless it is shown that the controlling person knew or recklessly disregarded the likelihood of illegal trading on inside information and failed to take precautions against the illegal conduct. 1934 Act § 21A(b). *See infra* text accompanying note 501.

Aiding and abetting liability⁴²⁸ for violations of the antifraud provisions of the 1934 Act is available in SEC enforcement actions⁴²⁹ and criminal prosecutions but not in private actions.⁴³⁰ Liability for aiding and abetting requires a showing of the following: the existence of a securities law violation by the primary party; “knowledge” of the violation on the part of the aider and abettor; and “substantial assistance” by the aider and abettor in the achievement of the primary violation.⁴³¹ The Supreme Court has recognized an implied right of contribution for damages based on 1934 Act Rule 10b-5.⁴³²

Most courts hold that, as a general proposition, the aider and abettor must have acted with at least the same degree of scienter as the primary violator.⁴³³ However, when the aider and abettor stands in a fiduciary relationship to the plaintiff, recklessness will satisfy the scienter requirement for imposing liability on the defendant for aiding and abetting.⁴³⁴

428. See 2 Hazen, *supra* note 205, § 12.25.

429. Section 20(f) of the 1934 Act gave the SEC the authority to pursue persons who knowingly provide substantial assistance to primary violators of the securities laws. 15 U.S.C. § 78t (Supp. 2001).

430. *Central Bank of Denver v. First Interstate Bank of Denver*, 508 U.S. 959 (1993).

431. See, e.g., *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

432. *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286 (1993).

433. See *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986) (“We take *Ernst & Ernst*, together with *Herman & Maclean*, as establishing that aiders, abettors, conspirators, and the like may be liable only if they have the same mental state required for primary liability.”).

434. The Sixth Circuit, in *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981), held that recklessness will satisfy the scienter requirement even in the absence of a fiduciary relationship. *But see, e.g., In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig.*, 676 F. Supp. 458 (S.D.N.Y. 1987) (actual knowledge is required where the alleged aider and abettor does not stand in a fiduciary or confidential relationship to the injured party). Brokers are frequently held to stand in a special fiduciary relationship to their customers. The existence of this fiduciary duty does not eliminate the scienter requirement; it merely affects the degree of scienter necessary to find one guilty of aiding and abetting. If no fiduciary duty exists, then the scienter standard will be stricter. See *Harmsen v. Smith*, 693 F.2d 932, 944 n.10 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983).

RICO in securities cases. The Racketeer Influenced and Corrupt Organizations Act (RICO), enacted in 1973,⁴³⁵ is drafted in general terms and thus has a broad reach. Among other things, it provides a treble damage remedy to anyone injured by a person associating with an “enterprise” and engaging in “a pattern of racketeering.” In response to the fear of abusive RICO litigation, Congress amended the statute to require that in order to be sued in a civil RICO action for securities fraud, the defendant must have already been criminally convicted of the underlying violation.⁴³⁶

An “enterprise” consists of any association, formal or informal⁴³⁷—it need not be a permanent association.⁴³⁸ The Supreme Court

435. 18 U.S.C. §§ 1961–1968 (1988 & Supp. 2001). Many states have enacted “little RICO” statutes.

436. 18 U.S.C. § 1964(c) (Supp. 2001). The conviction requirement applies to securities fraud actions but not expressly to other actions based on fraud. It would be a subversion of the congressional intent to permit a plaintiff to couch a RICO claim involving securities in common law or wire fraud in order to circumvent the conviction requirement. It has properly been held that if the conduct could be classified as securities fraud, then the conviction requirement applies even if the plaintiff tries to formulate the predicate act on alternative grounds. *Aries Aluminum Corp. v. King*, 1999 U.S. App. LEXIS 24827 (6th Cir. Sept. 30, 1999) (unpublished opinion) (RICO action predicated on sale of nonexistent securities could not be maintained); *Bald Eagle Area Sch. Dist. v. Keystone Fin., Inc.*, 189 F.3d 321 (3d Cir. 1999) (couching complaint in mail or wire fraud will not support RICO claim without underlying criminal conviction for action that could be classified as securities fraud). *But cf. Mezzonen, S.A. v. Wright*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,704, 1999 WL 1037866 (S.D.N.Y. Nov. 16, 1999) (alleged misappropriation of assets occurred after the securities transaction, and thus the misappropriation was not in connection with the purchase or sale of a security; RICO claim could proceed despite the Private Securities Litigation Reform Act).

437. 18 U.S.C. § 1961(4) (1988). According to the Supreme Court, the concept of enterprise connotes a group with a common purpose, a continuity of personnel, and an ongoing formal or informal organization. *United States v. Turkette*, 452 U.S. 576 (1981). *See also, e.g., Northern Ky. Bank & Trust v. Rhein*, [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,864 (E.D. Ky. 1984) (it is not necessary to delineate the structure of the enterprise at the pleading stage).

438. *See, e.g., United States v. Turkette*, 452 U.S. 576 (1981), where the Court applied the term to a band of hooligans who had a one-night rampage of murder and other acts covered by RICO.

has indicated that the enterprise requirement is a separate element from the “pattern of racketeering activity” even though the facts pertaining to each may coalesce.⁴³⁹

In addition to the enterprise requirement, a violation of RICO section 1962 requires a “pattern of racketeering activity.”⁴⁴⁰ A pattern of racketeering requires two or more underlying predicate acts, as defined by section 1961(1), occurring within ten years of each other.⁴⁴¹ Securities fraud is expressly included as one of the underlying predicate acts. As part of the PSLRA, RICO was amended to provide that civil liability under RICO for securities fraud now requires that the defendant has been convicted of the underlying securities law violation. Fraud and mail fraud are also included as predicate acts.⁴⁴² Thus, it is not necessary that a security be involved; fraud relating to other types of investments may be covered by RICO. The Supreme Court has held that RICO does not require multiple schemes to find a pattern of racketeering. Furthermore, in order to satisfy the pattern-of-racketeering requirement, the multiple predicate acts must be arranged or ordered either by the relationship they bear to one another or by the relationship they bear to some external organizing principle.⁴⁴³

The treble damage provision and availability of attorneys’ fees make RICO counts attractive in appropriate securities cases.⁴⁴⁴ A RICO ac-

439. *Turkette*, 452 U.S. 576. See also *Police Ret. Sys. v. Midwest Inv. Advisory Serv., Inc.*, 706 F. Supp. 708 (E.D. Mo. 1989) (enterprise requirement was satisfied but no pattern of racketeering activity shown).

440. 18 U.S.C. § 1962 (1988).

441. See 18 U.S.C. § 1961(5) (1988).

442. Congress did not explicitly extend the criminal conviction requirement to mail and wire fraud (or to fraud generally). However, if that conduct involves securities, it would seem that the criminal conviction requirement should apply. See *Cyber Media Group v. Island Mortgage Network*, 183 F. Supp.2d 559, 578–80 (E.D.N.Y. 2002); *Mezzonen, S.A. v. Wright*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,704, 1999 WL 1037866 *3 (S.D.N.Y. Nov. 16, 1999).

443. *H.J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229 (1989).

444. RICO also permits forfeiture of attorneys’ fees that were paid with money made by the client from racketeering activities. This provision has been used for drug dealers but presumably could also be used with securities laws violations.

tion can be brought in either federal or state court.⁴⁴⁵ RICO has been applied in securities cases, for example, where a broker–dealer (i.e., enterprise) engages in more than one fraudulent act.

Mail and wire fraud. Two federal acts—the Mail Fraud Act⁴⁴⁶ and the Wire Fraud Act⁴⁴⁷—can be potent weapons in the enforcement of securities law. The Supreme Court, in a unanimous opinion, held that trading securities on nonpublic information could support a mail fraud conviction.⁴⁴⁸ The Court’s opinion is striking, since, in the same case, the Court was equally divided as to whether the conviction on the securities fraud count should be sustained. A violation of the Mail or Wire Fraud Act requires only the use of the mails or wires to execute a scheme to defraud someone of his or her property rights, tangible or intangible.⁴⁴⁹ As long as the mails or wires are used, the Mail and Wire Fraud Acts “reach any scheme to deprive another of money or property by means of false or fraudulent pretenses, representations, or promises.”⁴⁵⁰ This may be relevant in both criminal and civil actions. Although there is no specific civil liability for violation of mail fraud and wire fraud statutes, such violations are predicate acts under RICO, which can lead to treble damages.

F. Insider Trading

1. Rule 10b-5

Perhaps the most common and widely known use of Rule 10b-5 of the 1934 Act is in the context of “insider trading,” or trading on the basis of nonpublic confidential or proprietary information. Trading on inside information destroys the integrity of the marketplace by giving an informational advantage to a select group of corporate insiders. Rule 10b-5 is the primary source of liability for improper trading on inside

445. *Yellow Freight Sys. v. Donnelly*, 494 U.S. 820 (1990).

446. 18 U.S.C. § 1341 (1988 & Supp. 2001).

447. 18 U.S.C. § 1343 (1988 & Supp. 2001).

448. *Carpenter v. United States*, 484 U.S. 19 (1987).

449. *Id.* at 25–28. The Court specifically declared that “[c]onfidential business information has long been recognized as property.” *Id.* at 26.

450. *Id.* at 27.

information.⁴⁵¹ There are essentially two varieties of improper trading on the basis of nonpublic information. One is a face-to-face transaction in which an insider fails to disclose material information to the buyer or seller. This not only involves a clear violation of Rule 10b-5⁴⁵² but also violates principles of common-law fraud.⁴⁵³ The second variety, which forms the basis of the overwhelming majority of litigation under the securities laws, involves open-market transactions by corporate insiders and others in possession of material nonpublic information.

As there is no statutory definition of what constitutes improper trading on nonpublic information, the 1934 Act's catchall provision in Rule 10b-5 is the primary source of the violation. Over time, there has been a change in the premise of insider trading liability under Rule 10b-5 from one of unfairness to investors⁴⁵⁴ to one of fiduciary duty and misappropriation.⁴⁵⁵ Rule 10b-5(c) makes it unlawful for "any

451. Promulgated by the SEC in 1942, Rule 10b-5 is patterned directly on section 17(a) of the 1933 Act. The primary difference is that Rule 10b-5 extends to misstatements or omissions occurring in connection with either a purchase or sale of securities, whereas section 17(a) is limited to fraudulent sales. The former assistant solicitor of the SEC, Milton Freeman, who formulated Rule 10b-5 in response to a fraudulent purchase of corporate securities by the company's president, describes the drafting and adoption of the rule in *Conference on Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 922 (1967) (remarks of Milton Freeman).

452. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

453. *See, e.g., Strong v. Repide*, 213 U.S. 419 (1909).

454. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). *See* 2 Hazen, *supra* note 205, § 12.17.

455. *See, e.g., United States v. O'Hagan*, 521 U.S. 642 (1997); *Chiarella v. United States*, 445 U.S. 222 (1980). In *Chiarella*, Justice Powell explained the development of Rule 10b-5:

In *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. The obligation to disclose or abstain derives from

"[a]n affirmative duty to disclose material information[, which] has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We, and the courts, have consistently held that insiders must disclose material facts which are known to them by virtue of their

person, directly or indirectly, by the use of any instrumentality of interstate commerce . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the sale or purchase of any security.” The violation is thus premised on fraud and the existence of some duty to speak honestly. Silence alone is not actionable; there must be a duty to speak. Possession of inside information without more does not create the duty to speak or abstain from trading under Rule 10b-5.⁴⁵⁶ Subsequent judicial treatment of this requirement has led to the misappropriation theory, and the concept of the “constructive” or “temporary” insider who, though not strictly speaking an insider, nevertheless owes some fiduciary duty to the person who discloses to him or her the material nonpublic information he or she “misappropriates.”

Beginning in 1961, the SEC broadened the application of Rule 10b-5 into a general prohibition on corporate officials trading on the basis of material nonpublic information, even on the open market.⁴⁵⁷ This

position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.” *Id.* at 911.

The Commission emphasized that the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure. *Id.* at 912, and n.15. . . . In its *Cady, Roberts* decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the “necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders.” *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (Del. 1951).

445 U.S. at 226–29.

456. *Chiarella*, 445 U.S. 222.

457. *Cady, Roberts*, 40 S.E.C. 907. *See also, e.g., In re Smith Barney, Harris, Upham & Co.*, Exchange Act Release No. 34-21242, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,656 (Aug. 15, 1984) (brokerage firm should give its customers time to digest research recommendations reflecting a material change in the firm’s position before the firm trades in securities for its own account). *But see Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984) (brokerage firm not held liable to open market seller). SEC Rule 14e-3 is another source of insider trading prohibitions, but its application is limited to tender offers.

expansion stemmed from the view that the harm the rule sought to protect against was unfairness to investors not privy to the inside information, so the potential trader possessing material nonpublic information had an alternative duty to disclose the information or to abstain from trading.⁴⁵⁸ In the first Supreme Court case on point, the Court held that in a face-to-face transaction, a purchaser possessing inside information about a company has a duty to disclose such information to the seller before consummating the transaction.⁴⁵⁹ More recently, however, the Court held that in order to find a violation of Rule 10b-5, the plaintiff must show that the defendant had material nonpublic information and a legal duty, based on a wrongful conversion or misappropriation of the information, to disclose it.⁴⁶⁰

In *Chiarella*,⁴⁶¹ the Supreme Court held that a Rule 10b-5 claim cannot be based solely on the defendant's knowingly trading to his or her advantage while in possession of material nonpublic information.⁴⁶² However, five of the justices apparently would have upheld a conviction based on a theory that the defendant was given information in a position of trust and then wrongfully misappropriated the information to his or her advantage. This misappropriation theory of liability was subsequently adopted by the Court in *United States v.*

458. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

459. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

460. *United States v. O'Hagan*, 521 U.S. 642 (1997); *Chiarella*, 445 U.S. 222.

461. 445 U.S. 222 (1980). The defendant was the employee of a printing company involved in the production of various tender offer documents. The target company's name was concealed in the galleys sent to the printer in an effort to maintain confidentiality. However, Chiarella was able to identify the company based on other information in the tender offer material, and with this knowledge, he traded in securities of the target company for profit. The Court reversed his conviction on the ground that he had no legal duty to speak.

462. Such a definition has been proposed to Congress but has not been adopted. However, following the *Chiarella* decision, the SEC adopted Rule 14e-3, which makes it unlawful for anyone other than the tender offeror who has knowledge of a planned tender offer to trade on that information.

O'Hagan.⁴⁶³ It remains difficult to define situations where there is a sufficient duty that gives rise to Rule 10b-5's "disclose or abstain from trading" obligation with regard to material nonpublic information.⁴⁶⁴

A Second Circuit decision is illustrative of the problem of defining insider trading. In *United States v. Chestman*,⁴⁶⁵ a stockbroker's customer relayed to the broker information about an impending takeover.⁴⁶⁶ The broker, armed with that knowledge, purchased shares in the target company and subsequently was indicted for violating Rules 14e-3 and 10b-5 and for mail fraud. The jury found the broker guilty on all counts. The broker appealed, and in three separate opinions, a panel of the Second Circuit reversed the broker's convictions on all

463. 521 U.S. 642 (1997). In *O'Hagan*, a partner in a law firm had traded on knowledge that a firm client was about to launch a takeover of another company. The defendant purchased stock in the shares of the target company.

464. The SEC adopted Rule 10b5-2 in order to provide a degree of certainty in identifying the types of relationships in which such a duty arises. 17 C.F.R. § 240.10b5-2. Under Rule 10b5-2 there are

three non-exclusive bases for determining that a duty of trust or confidence was owed by a person receiving information: (1) when the person agreed to keep information confidential; (2) when the persons involved in the communication had a history, pattern, or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; and (3) when the person who provided the information was a spouse, parent, child, or sibling of the person who received the information, unless it were shown affirmatively, based on the facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality.

Selective Disclosure and Insider Trading, Exchange Act Release No. 34-42259 (Dec. 20, 1999).

Thus, for example, family relationships can provide the basis for Rule 10b-5's disclose or abstain rule. See, e.g., *SEC v. Yun*, 148 F. Supp. 2d 1287 (M.D. Fla. 2001) (post-nuptial negotiations created confidential relationship so as to support insider trading liability based on a tip of information between husband and wife).

465. 704 F. Supp. 451 (S.D.N.Y. 1989), *rev'd*, 903 F.2d 75 (2d Cir. 1990), *reh'g en banc*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1759 (1992).

466. The customer, Mr. Loeb, was married to the granddaughter of Julia Waldbaum, a member of the board of directors of Waldbaum, Inc., a publicly traded company that owned a large supermarket chain. Furthermore, Mrs. Loeb's uncle, Ira Waldbaum, was president and controlling shareholder of Waldbaum, Inc. As a member of the Waldbaum family, Mr. Loeb learned nonpublic information concerning the impending sale of Waldbaum to the Great Atlantic & Pacific Tea Company, and relayed the information to a broker.

counts.⁴⁶⁷ The Second Circuit then agreed to rehear the case en banc,⁴⁶⁸ and the Rule 14e-3 convictions were affirmed while the Rule 10b-5 and mail fraud convictions were reversed. However, these decisions were reached as a result of many separate opinions.⁴⁶⁹ In affirming the broker's Rule 14e-3 convictions, ten of the eleven judges rejected the broker's arguments that (1) Rule 14e-3 was invalid,⁴⁷⁰ or that, if not, there was insufficient evidence to sustain the convictions; and that (2) his convictions violated the "fair notice" requirement of due process. However, the Rule 10b-5 convictions (as well as the mail fraud convictions) were reversed because six of the judges found that no fiduciary duty had been breached.⁴⁷¹ As a result, it appears in the Second Circuit that at least in the context of public tender offers, the SEC has filled the gap left by the decision in *Chiarella*, as no fiduciary duty is required for a conviction under Rule 14e-3.⁴⁷²

In *Dirks v. SEC*,⁴⁷³ the Supreme Court indicated that someone who receives information from an insider (or anyone else holding that information in trust) is not liable under Rule 10b-5 for trading on the information unless the insider passed on that information with a wrongful motive.⁴⁷⁴ Thus in the absence of some breach of fiduciary

467. 903 F.2d 75 (2d Cir. 1990).

468. 947 F.2d 551 (2d Cir. 1991).

469. Five judges voted to affirm the Rule 14e-3 convictions and reverse the Rule 10b-5 and mail fraud convictions (with one judge writing a special concurrence); five judges voted to affirm all convictions; and one judge voted to reverse all convictions.

470. Rule 14e-3 was also upheld in *O'Hagan*.

471. One case that shows the potential for liability under this view is *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990). A former CEO of Shearson and former president of American Express was considering becoming CEO of BankAmerica. He discussed these plans with his wife, who in turn discussed them with her psychiatrist in the course of her treatment. The psychiatrist traded in the marketplace on the basis of this material nonpublic information and profited as a result. On the basis of the breach of the fiduciary relationship between the psychiatrist and his patient, the court held that the psychiatrist had violated Rule 10b-5.

472. Rule 14e-3 was upheld by the Supreme Court in *United States v. O'Hagan*, 521 U.S. 642 (1997).

473. 463 U.S. 646 (1983).

474. In *Dirks*, the insiders were former employees of the company at issue. Their motivation in disclosing the information to Dirks, a security analyst, was a desire to

duty, or “misappropriation,” there is no violation of Rule 10b-5. The Court also suggested that for liability to attach, there must be “personal gain” by the wrongdoer.⁴⁷⁵ However, subsequent case law suggests that this may no longer be true. The misappropriation theory again reached the Supreme Court in 1987.⁴⁷⁶ The defendant was a financial columnist (writing the influential *Wall Street Journal*’s “Heard on the Street” column) who had tipped his friends in advance as to the contents of upcoming columns that would affect the price of certain stocks. The Second Circuit held that the information had been misappropriated from the defendant’s employer (Dow Jones), and thus, under the “disclose or abstain” rule, the columnist and his friends had violated Rule 10b-5.⁴⁷⁷ This decision was affirmed without opinion by an equally divided Supreme Court.⁴⁷⁸ It remains to be seen whether the Court was divided over the validity of the misappropriation theory in general or on some other issues raised by the case.⁴⁷⁹

Another question is whether it must be shown that the trader in fact used the information in question; namely, that he or she would not have traded but for the confidential information. The courts favored the view that it must be established that the defendant actually

expose the company’s fraud. While attempting to verify that a fraud had in fact occurred, Dirks disclosed the information to some of his institutional customers, who thereupon sold large quantities of stock in the company. The Court found that Dirks was not an insider and that he did not owe a duty to the insiders not to disclose the information (in fact, they wanted him to). Since the insiders who passed the information on to him did not have a wrongful motive, Dirks was not obligated to abstain from passing on the inside information disclosed to him.

475. *Dirks*, 463 U.S. at 660.

476. *Carpenter v. United States*, 484 U.S. 19 (1987).

477. *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986).

478. *Carpenter*, 484 U.S. 19. The decision to recognize the misappropriation theory also finds support in the legislative history of the 1988 Insider Trading and Securities Fraud Enforcement Act (ITSFEA), H.R. Rep. No. 100-910, at 10–11 (1988).

479. The Supreme Court may, for example, have been divided over whether Rule 10b-5’s “in connection with” requirement had been satisfied. In *Carpenter*, the reporter’s employer, from whom the information was allegedly misappropriated, was neither a purchaser nor a seller of securities. The SEC had argued that if the conviction were to be overturned it should be overturned on these grounds rather than on a wholesale rejection of the misappropriation theory.

used the information in deciding to make the trades in question, although use could be inferred from trades made while in possession of the information.⁴⁸⁰ The SEC adopted a rule requiring that the defendant used the information in making the challenged securities transactions.⁴⁸¹ Rule 10b5-1 also contains a presumption that someone who trades while in possession of the information has used the information in making the trade.⁴⁸²

2. Insider Trading Sanctions: SEC Actions

Willful violations of the federal securities laws may give rise to a criminal prosecution resulting in fines and imprisonment. Furthermore, violations may result in sanctions from the SEC. For example, the SEC may impose administrative sanctions: If the violator is a broker-dealer or other market professional, his or her broker-dealer license can be suspended or revoked. By virtue of section 21(d)(1) of the 1934 Act, the SEC is authorized to seek either temporary or permanent injunctive relief in the courts “whenever it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices which constitute or will constitute a violation.”

Although the statutory enabling provisions speak solely in terms of the SEC’s power to enjoin, the SEC and the courts have fashioned remedies ancillary to the traditional injunctive decree relying on “the general equitable powers of the federal courts.”⁴⁸³ Ancillary relief has taken many forms, ranging from disgorgement of ill-gotten profits to

480. *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998); *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998). *Compare, e.g., United States v. Teicher*, 987 F.2d 112 (2d Cir.), *cert. denied*, *Teicher v. United States*, 510 U.S. 976 (1993).

481. 17 C.F.R. § 240.10b5-1. The SEC originally adopted the possession test, but after reviewing the public comments the commission repropoed the rule to adopt the use requirement plus a presumption of use. *See Exchange Act Release No. 34-24259* (Dec. 20, 1999).

482. The presumption of use that follows from trading while in possession may be rebutted by a showing that the defendant (1) had a preexisting binding contract to enter into the transaction in question, (2) executed a prior instruction to a third party to execute the transaction in question, or (3) previously adopted a written plan specifying the transactions in question. 17 C.F.R. § 240.10b5-1.

483. *See, e.g., James Farrand, Ancillary Remedies in SEC Civil Enforcement Suits*, 89 *Harv. L. Rev.* 1779, 1781 (1976).

more imaginative corrective action. Among such imaginative remedies are the appointment of an independent majority on the board of directors,⁴⁸⁴ the appointment of a receiver,⁴⁸⁵ prohibitions against exercising voting control in a proxy battle,⁴⁸⁶ the appointment of “special professionals” to ensure compliance with securities laws,⁴⁸⁷ orders designed to protect remaining assets,⁴⁸⁸ and prohibitions on continued participation as an officer or director of any public company.⁴⁸⁹

In the wake of the *Chiarella*⁴⁹⁰ and *Dirks*⁴⁹¹ decisions, Congress enacted even stronger insider trading penalties available for use by the SEC. The Insider Trading Sanctions Act of 1984 (ITSA) increased civil and criminal penalties for trading while in possession of material non-public information. The SEC is authorized to seek disgorgement of profits and a civil penalty of up to three times the profits gained or the

484. See, e.g., *SEC v. Vesco*, 571 F.2d 129 (2d Cir. 1978); *SEC v. Mattel, Inc.*, [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,807 (D.D.C. 1974) (consent to sanctions).

485. See, e.g., *SEC v. United States Fin. Group, Inc.*, 474 F.2d 354 (9th Cir. 1973); *SEC v. Florida Bank Fund*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,707 (M.D. Fla. 1978). This power is expressly given to the SEC by section 42(e) of the Investment Company Act for violators of the Act’s registration requirements. 15 U.S.C. § 80a-41(e) (1988 & Supp. 2001).

486. See, e.g., *SEC v. Westgate-California Corp.*, Litig. Release No. 6142, 3 SEC Docket 30 (S.D. Cal. Nov. 9, 1973). Cf. *Chris-Craft Indus., Inc v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973) (defendant barred from voting for five years on shares obtained illegally).

487. See, e.g., *SEC v. Beisinger Indus. Corp.*, 552 F.2d 15 (1st Cir. 1977); *SEC v. First Jersey Sec., Inc.*, [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,923 (S.D.N.Y. 1985) (appointment of consultant to review broker–dealer’s practices, pursuant to permanent injunction entered by parties’ consent).

488. See, e.g., *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1105–06 (2d Cir. 1972); *SEC v. R.J. Allen & Assoc., Inc.*, 386 F. Supp. 866, 881 (S.D. Fla. 1974). See also *SEC v. Vaskevitch*, 657 F. Supp. 312 (S.D.N.Y. 1987) (freeze order in insider trading case); *SEC v. Am. Bd. of Trade, Inc.*, 830 F.2d 431 (2d Cir. 1987), cert. denied, 485 U.S. 938 (1988) (freeze order in illegal unregistered commercial paper investment program).

489. See, e.g., *SEC v. Cosmopolitan Inv. Funding Co.*, Litigation Release No. 7366 (SEC Apr. 23, 1976); 42 SEC Ann. Rep. 119 (1976).

490. 445 U.S. 222 (1980).

491. 463 U.S. 646 (1983).

loss avoided by the defendant, and the criminal penalty was increased from \$10,000 to \$100,000. However, while facially applicable to transactions involving misuse of nonpublic material information, ITSA does not define the scope of permissible conduct. Thus it does not alter the availability of a cause of action, merely the penalties that may be imposed. Nevertheless, ITSA has proven to be an effective enforcement weapon. Following its enactment, the SEC has been increasingly vigorous in enforcing insider trading prohibitions and has reached some lucrative settlements.⁴⁹²

The question arises whether SEC actions under ITSA and criminal prosecutions based on the same transactions violate the constitutional prohibition against double jeopardy. In *United States v. Halper*,⁴⁹³ the Supreme Court held that double jeopardy issues can arise when a criminal prosecution is followed by a government suit seeking to impose civil penalties. In 1997, the Supreme Court eased the double jeopardy concerns. In *Hudson v. United States*,⁴⁹⁴ the defendants had been sued by the Office of the Comptroller of the Currency and agreed to pay monetary assessments resulting from violating federal law. A subsequent criminal prosecution was challenged on the grounds of double jeopardy. The Supreme Court ruled that since the assessments in the first action were not punitive, there was no double jeopardy bar to the criminal prosecution. The Court ruled that the *Halper* test of whether a civil sanction is punitive proved “unworkable.” Instead, it referred to the test it had enunciated previously in *United States v. Ward*,⁴⁹⁵ to the effect that there is a strong presumption that Congress’s designation of a sanction as “civil” means that it is not punitive and that a court must find the “clearest proof” before the legislative

492. See, e.g., SEC v. Certain Unknown Purchasers of Common Stock & Call Options of Santa Fe Int’l Corp., [1985–1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,484 (S.D.N.Y. 1986) (consent order to disgorge \$7.8 million in alleged insider trading profits); SEC v. Boesky, [1986–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. 1986) (settlement of \$50 million disgorgement and \$50 million penalty); SEC v. Kidder Peabody & Co., 19 Sec. Reg. & L. Rep. (BNA) 811 (S.D.N.Y. 1987) (settlement of more than \$25 million).

493. 490 U.S. 435 (1989).

494. 522 U.S. 93 (1997).

495. 448 U.S. 242 (1980).

label of a civil sanction is disregarded. It has thus become increasingly unlikely that a civil penalty, such as the one imposed by the Insider Trading Sanctions Act, will be viewed as criminal in nature. Accordingly, double jeopardy issues should not be an issue with regard to successive SEC and criminal actions against insider trading.⁴⁹⁶

3. Private Rights of Action for Insider Trading

In a face-to-face transaction, an action will lie against someone who sells or purchases while in possession of material nonpublic information.⁴⁹⁷ However, in an open-market context, standing to sue could be more problematic. In a Ninth Circuit case,⁴⁹⁸ a financial columnist purchased stock prior to publishing his “buy” recommendation, which was based on an overly optimistic view of the company. The plaintiffs acquired the stock pursuant to a merger that was agreed to prior to the conduct in question. Despite the fact that the plaintiffs were “forced purchasers” who made no investment decision and thus did not rely on the column, the defendant was held liable. The court reasoned that the columnist’s failure to disclose his stock purchase defrauded the market by causing an artificially high price that the plaintiffs were forced to pay. This is the fraud-on-the-market theory.

The fraud-on-the-market theory, however, is far from unanimously accepted in the insider trading context. The Sixth Circuit has held that any duty that was breached was owed to the person from whom the information was appropriated, not to someone in a faceless market.⁴⁹⁹ Similarly, the Second Circuit held that a tippee of inside information who was convicted of having violated Rule 10b-5 was not liable in

496. *But cf.* United States v. Andrews, 146 F.3d 933 (D.C. Cir. 1998) (indicating that civil penalty could form the basis of double jeopardy, but the claim could not be raised in a criminal prosecution of a corporation’s CEO based on a civil penalty assessed against the corporation rather than the CEO himself).

497. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). Causation was not a problem because the purchaser dealt directly with the seller. Further, the Supreme Court held that reliance on the nondisclosure could be presumed from the materiality of the information.

498. *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979).

499. *Friedrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

damages to people who were selling their stock at the same time that the defendant was buying on inside information. To be held liable for damages, the court said, the “inside trader” must be a corporate official who owes an independent duty to the shareholders who trade on opposite sides of the insider’s transactions.⁵⁰⁰

The Insider Trading and Securities Fraud Enforcement Act (ITSFEA) of 1988 was designed by Congress to supplement any remedy that may exist under Rule 10b-5. The Act provides an express private right of action by contemporaneous traders against persons making improper use of material nonpublic information.⁵⁰¹ Damages in such an action are limited to the profit (or loss avoided) that is attributable to the defendant’s illegal conduct, reduced to the extent that the SEC has secured disgorgement (as opposed to penalty) under the 1984 Insider Trading Sanctions Act (ITSA).

ITSFEA also specifically addresses controlling-person liability.⁵⁰² Such liability in a private suit is still governed by section 20(a) of the 1934 Act. However, ITSFEA imposes a more specific provision for controlling-person liability in SEC actions under ITSA. Under ITSFEA, a court can impose ITSA’s treble damage penalties on a controlling person of a primary violator only if (1) the controlling person knew or acted in reckless disregard of the fact that the controlled person was likely to engage in illegal insider trading, and (2) the controlling person failed to take adequate precautions to prevent the prohibited conduct from taking place. The establishment of a “Chinese Wall” or “fire wall” to keep confidential information confined to the proper sectors of a multiservice firm may help protect against controlling-person liability.

500. *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

501. 1934 Act § 20A.

502. Controlling-person liability under the 1934 Exchange Act generally is governed by section 20(a) of the Act. In addition to the new controlling-person provision, the 1988 legislation was amended to make it clear that tippers and tippees are both primary violators, so plaintiffs need not rely on aiding and abetting principles. 1934 Act § 20A(c).

In a further attempt to provide incentive for private persons to expose illegal insider trading, ITSFEA also added a “bounty” provision. Section 21A(e) states that up to 10% of any civil penalty recovered by the SEC may, at the SEC’s discretion, be paid to the private individuals who provided information leading to the imposition of the penalty. Persons associated with the SEC, the Department of Justice, or the self-regulatory organizations are not eligible to receive a bounty reward.

With the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, amendments to the 1934 Act gave the SEC the power in an administrative proceeding to require disgorgement of illegal profits.⁵⁰³

4. Insider Transactions and Section 16

Section 16 of the Exchange Act regulates directors, officers, and 10% (or greater) beneficial owners of any class of equity securities subject to section 12 registration requirements. This provision is designed to discourage corporate insiders from taking advantage of their access to information by engaging in short-swing trading. Section 16(a) contains reporting requirements; section 16(b) imposes liability for short-swing profits; and section 16(c) prohibits insider short sales.

Persons falling within the scope of section 16 (i.e., an officer, director, or 10% beneficial owner⁵⁰⁴ of a class of equity securities⁵⁰⁵ subject

503. These amendments also require additional disclosures about penny stocks. *See supra* note 41 and accompanying text.

504. Beneficial ownership hinges on the direct or indirect pecuniary interest in the shares, and that interest may be the result of “any contract, arrangement, understanding, relationship, or otherwise.” Rule 16a-1(a)(2), 17 C.F.R. § 240.16a-1(a)(2). Thus when several persons get together for the purpose of exercising control, this group will be considered a single person for the purpose of computing the 10% beneficial ownership threshold. *See Morales v. Freund*, 163 F.3d 763 (2d Cir. 1999); *Strauss v. Kapp Inv. Advisors, Inc.*, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,666 (S.D.N.Y. 1999). *See also Rosenberg v. XM Ventures*, 129 F. Supp. 2d 681 (D. Del. 2001).

505. The owner of convertible securities becomes a 10% beneficial owner with regard to the underlying securities once his or her conversion rights would permit 10% ownership of the underlying securities. *Medtox Scientific, Inc. v. Morgan Capital*

to the 1934 Act reporting requirements) are required to file appropriate notice with the SEC, including disclosure of all ownership interest in any of the issuer's equity securities, within ten days of acquiring that status.⁵⁰⁶ Thereafter, whenever they acquire or dispose of any equity securities of the company, they must file notice thereof with the SEC within ten days of the end of the calendar month in which the change takes place.⁵⁰⁷

In addition to its reporting requirements, section 16(a) determines who is subject to section 16(b)'s provisions for disgorgement of insider short-swing profits. However, the Act does not precisely define *officer*, *director*, or *10% beneficial owner*. As a result, many questions have been raised as to the scope of section 16's coverage.

The courts and the SEC have both considered the scope of *officer*. SEC Rule 3b-2 provides that under the Act, generally "‘officer’ means a president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers." Although expressly refusing to pass on the validity of Rule 3b-2, the Second Circuit adopted a similar functional equivalency test under the terms of the statute.⁵⁰⁸ In 1991, the SEC completely revamped its interpretive rules under section 16. As part of this reform, for the purposes of section 16, *officer* is limited to high-

L.L.C., 50 F. Supp. 2d 896 (D. Minn. 1999). See also *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967).

506. 1934 Act § 16(a).

507. *Id.* Violations of the filing requirements do not give rise to a private remedy. *Scientex Corp. v. Kay*, 689 F.2d 879 (9th Cir. 1982); *C.R.A. Realty Corp. v. Goodyear Tire & Rubber Co.*, 705 F. Supp. 972 (S.D.N.Y.), *aff'd*, 888 F.2d 125 (2d Cir. 1989). However, they can result in criminal sanctions. See, e.g., *United States v. Guterma*, 281 F.2d 742 (2d Cir.), *cert. denied*, 364 U.S. 871 (1960).

508. *Colby v. Klune*, 178 F.2d 872, 875 (2d Cir. 1949):

["Officer"] includes, inter alia, a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions. It is immaterial how his functions are labeled or how defined in the by-laws, or that he does or does not act under the supervision of some other corporate representative.

Id. at 873.

ranking company officials in policy-making positions.⁵⁰⁹ Since Rule 16a-1 specifically addresses section 16 of the Act, in this respect its definition prevails over the more general definition in Rule 3b-2.

Another problem in determining who is subject to section 16(b) arises in the context of deputization. The Supreme Court has held that where a partnership profited from short-swing transactions in the corporation's stock and the partnership designated or deputized one of its partners to sit on that corporation's board of directors, the partnership would be deemed a "director" under the doctrine of deputization.⁵¹⁰ The Supreme Court appeared to require the plaintiff to prove an actual deputizing or agency relationship,⁵¹¹ but subsequent lower court decisions suggest that it may be enough to show that the potential for abuse was more than a mere possibility.⁵¹² Although it is clear that the mere presence of an interlocking directorate will not be sufficient to create a section 16 deputization,⁵¹³ each situation must be examined on its own facts.

Another issue to be considered under section 16 is the effect the timing of the transactions has regarding an officer's or director's assumption of office or resignation. In general, courts tend to find liability if either purchase or sale occurred while the defendant was an officer or director;⁵¹⁴ if both purchase and sale were before or after the defendant held the position, courts tend not to find liability.⁵¹⁵

509. Rule 16a-1(f), 17 C.F.R. § 240.16a-1(f) (2002).

510. *Blau v. Lehman*, 368 U.S. 403 (1962).

511. *Id.* at 411.

512. *See, e.g., Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

513. *See, e.g., Popkin v. Dingman*, 366 F. Supp. 534 (S.D.N.Y. 1973).

514. *See, e.g., Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970) (defendant purchased shares while a director, then sold them at a profit after resigning); *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959) (defendant purchased shares before becoming an officer, then sold them after assuming his position).

515. *See Lewis v. Mellon Bank*, 513 F.2d 921 (3d Cir. 1975) (officer who exercised stock option immediately after resigning then sold at a profit was not liable under section 16, since he was not an insider at time of purchase or sale); *Lewis v. Varnes*, 505 F.2d 785 (2d Cir. 1974). Since this result appears justified by the language of section 16, such conduct could be used to raise a presumption of reliance on inside

In contrast to cases dealing with officers and directors, section 16 provides that where insider status attaches by virtue of 10% beneficial equity ownership, the section applies only where such person was a beneficial owner “both at the time of purchase and sale, or the sale and purchase.” The Supreme Court has held that the threshold purchase that pushes the defendant over the 10% threshold does not qualify as a purchase subject to section 16 and that only purchases made after the threshold purchase will give rise to liability. Similarly, when a holder of more than 10% first sells enough to bring his or her holdings down to 9.9%, and on the next day liquidates the remaining holdings, the second sale cannot be subject to section 16, even if the two sales were parts of a single prearranged scheme.⁵¹⁶

Section 16(b) requires statutory insiders under section 16(a) to disgorge to the issuer any profit wrongfully realized as a result of a purchase and sale or sale and purchase of covered equity securities occurring within a six-month period. Congress saw section 16(b) as a “crude rule of thumb” or objective method of preventing “the unscrupulous employment of (corporate) inside information.”⁵¹⁷ Accordingly, in light of its broad remedial purpose, section 16(b) requires disgorgement of insider short-swing profits even in the absence of any wrongdoing.

Section 16 does not *prohibit* officers, directors, and 10% equity shareholders from short-term trading in the stock of their companies; it simply authorizes the company (or a shareholder suing on its behalf) to recover the profits realized from such trading. The SEC, therefore, has no enforcement responsibilities under section 16. It has, however, adopted rules and regulations exempting transactions from the liability provisions if it finds them to be “not comprehended within the purpose of” section 16(b).⁵¹⁸

information to find a possible violation of Rule 10b-5. See 2 Hazen, *supra* note 205, 12.10.

516. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972).

517. *Hearings on S. Res. 84, S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. pt. 15 at 6557 (1934).

518. 1934 Act § 16(b). The SEC has in fact adopted a number of rules exempting transactions: For example, it has exempted certain transactions by registered invest-

A section 16(b) action is not based on any injury to the plaintiff, but rather is a remedial provision designed to prevent certain types of insider trading abuses. Success in an action under section 16(b) is not dependent on the possession or use of inside information.⁵¹⁹

An action may be brought under section 16(b) by a shareholder after a demand has been made to and refused by the directors.⁵²⁰ Section 16(b) actions arise even though the SEC has no enforcement powers under section 16, corporate management is seldom interested in suing itself, and the financial stake for an individual shareholder is generally very small. The greatest incentive for bringing a section 16(b) action is that attorneys' fees will be awarded to the successful plaintiff's attorneys out of the fund created by the recovery.⁵²¹ Suit may be filed by a person who is, at the time of the suit, a shareholder of record, as long as that person continues to be a shareholder throughout the trial. The commonplace contemporaneous ownership rule, requiring a shareholder who brings suit to have been a shareholder at the time of the act complained of, does not apply in an action under section 16(b).⁵²² Thus people who purchase their shares after the transactions in question may bring suit. Notwithstanding the possible champerty implications,⁵²³ the courts have held that it is no

ment companies; certain large block transactions in connection with a distribution of securities; qualifying employee benefit plans; certain securities acquired in connection with a redemption of another security; certain option exercises and most conversions of convertible securities; and certain transactions involving share subscriptions. For details and a more complete list of exemptions, see SEC Rules 16b-1 through 16b-11.

519. *Hearings on S. Res. 84, S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. pt. 15 at 6557 (1934).

520. *Dottenheim v. Murchison*, 227 F.2d 737 (5th Cir. 1955), *cert. denied*, 351 U.S. 919 (1956); *Benisch v. Cameron*, 81 F. Supp. 882 (S.D.N.Y. 1948).

521. *See, e.g., Super Stores, Inc. v. Reiner*, 737 F.2d 962 (11th Cir. 1984).

522. *Dottenheim*, 227 F.2d 737; *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Portnoy v. Kawecki Berylco Indus., Inc.*, 607 F.2d 765 (7th Cir. 1979).

523. *Champerty* is the impermissible practice of a lawyer purchasing the right to bring a lawsuit or encouraging a client to bring suit so that the lawyer can recover attorneys' fees. Since section 16(b) does not have a contemporaneous ownership rule, it is possible to purchase the right to bring suit by purchasing or having a nominee purchase a share of the company's stock after the impermissible act.

defense to an action under section 16(b) that the suit was motivated primarily by an attorney's desire to obtain attorneys' fees. Courts generally reason that Congress must have accepted this price in order to achieve effective enforcement of the provision.⁵²⁴ An action under section 16(b) for disgorgement of profits may be brought in law or in equity.

If a person is found to fall within one of the categories covered by section 16, the next question is whether there has been a "purchase" and "sale." Where there is a "garden variety" cash-for-stock transaction, section 16(b)'s application will be determined by an objective test.⁵²⁵ However, the courts have also had to decide whether other transactions—so-called "unorthodox" transactions—fall within section 16(b)'s reach. The exercise of an option or a conversion privilege or the exchange of one security for another, either in a merger or a voluntary transaction, may or may not fall within the statute depending on the circumstances.

In *Kern County Land Co. v. Occidental Petroleum Corp.*,⁵²⁶ the Supreme Court addressed the applicability of section 16(b) to sales of the target company's shares by a defeated tender offeror. In finding that a section 16(b) "sale" had not occurred, the Court used a pragmatic analysis of the transaction:

In deciding whether borderline [unorthodox] transactions are within the reach of the statute, the courts have come to inquire whether the transaction may serve as a vehicle for the evil which

524. *Magida v. Continental Can Co., Inc.*, 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956).

525. *See, e.g., Arrow Distrib. Corp. v. Baumgartner*, 783 F.2d 1274 (6th Cir. 1986) (with respect to cash-for-stock transactions, plaintiff need only show that both transactions occurred within a period of less than six months). Other transactions have also been viewed as "orthodox" transactions, requiring the application of the objective test. *See, e.g., Gund v. First Fla. Banks, Inc.*, 726 F.2d 682 (11th Cir. 1984) (sale of convertible debentures followed by purchase of underlying stock; objective test applied); *Oliff v. Exchange Int'l Corp.*, 669 F.2d 1162 (7th Cir. 1980), *cert. denied*, 450 U.S. 915 (1981) (court found "orthodox" transaction even where "purchase" was a repurchase under compulsion of paying a 205% penalty to the IRS for self-dealing in the prior sale and the IRS called the repurchase a "rescission" of the prior sale).

526. 411 U.S. 582 (1973).

Congress sought to prevent—the realization of short-swing profits based upon access to inside information—thereby endeavoring to implement congressional objectives without extending the reach of the statute beyond its intended limits.⁵²⁷

This pragmatic approach was intended to take the place of the objective test for unorthodox transactions, such as “stock conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and dealings in options, rights, and warrants.”⁵²⁸ If there is no fear of or potential for section 16(b) abuse in the unorthodox transaction at issue, the pragmatic analysis should find no purchase or sale.⁵²⁹

There has also been significant debate over the method of computing a profit within the meaning of section 16(b). The apparent majority approach, when there has been a series of transactions within a six-month period, is to match the lowest purchase price against the highest sales price within that period.⁵³⁰ This method is the harshest of the alternative interpretations, since it catches a profit even in situations where an out-of-pocket loss may exist for all transactions entered into during the six-month period.⁵³¹ Furthermore, there is authority to the effect that dividends declared on shares sold at a profit will be considered part of the section 16(b) profit, provided that insider status applied at the time of declaration of the dividend.⁵³²

527. *Id.* at 594–95 (footnotes omitted). See also, e.g., *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 396 (2d Cir. 1998), *aff'g* 979 F. Supp. 263 (S.D.N.Y. 1997).

528. *Kern County Land Co.*, at 594 n.24.

529. See Thomas L. Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C. L. Rev. 1 (1975).

530. *Arrow Distrib. Corp. v. Baumgartner*, 783 F.2d 1274 (6th Cir. 1986); *Whittaker v. Whittaker Corp.*, 639 F.2d 516, 530–32 (9th Cir.), *cert. denied*, 454 U.S. 1031 (1981); *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

531. See *Smolowe*, 136 F.2d at 239.

532. *W. Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966). *But see*, e.g., *Morales v. Lukens, Inc.*, 593 F. Supp. 1209, 1214–15 (S.D.N.Y. 1984) (relying on *Blau v. Lamb*, 363 F.2d 507, 528 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) (dividends are excluded from section 16(b) computation absent evidence that the defendant manipulated the dividend)).

Section 16(c) prohibits certain speculative activities by insiders (10% beneficial owners, officers, and directors) who must file reports under section 16(a). Section 16(c) is aimed at two types of speculative transactions: (1) short sales,⁵³³ or selling the security of the issuer without owning the underlying security; and (2) sales against the box,⁵³⁴ when the seller delays in delivering the securities. In both instances, the investor's hope is that the price will decline from the time of sale, thus enabling the seller to cover at a lower price. Although these are legitimate speculating devices in certain instances, the practices of selling short and selling against the box are high-risk transactions subject to speculative abuse, particularly by insiders. Section 16(c) thus operates to make it unlawful to sell a security if the selling insider either (1) does not own the security or (2) owns the security but does not deliver it within twenty days or deposit it in the mail in five days.⁵³⁵

G. Regulation of the Marketplace and Securities Professionals

In addition to imposing disclosure requirements on issuers of publicly traded securities, the 1934 Act regulates the marketplace. Although the SEC has direct authority, a great deal of market regulation is carried out through its oversight of national exchanges and self-regulatory organizations. Market regulation includes the establishment of fair market practices and minimum-capital requirements for broker-dealers in order to minimize the risk of insolvency. A major goal of this regulation is to ensure orderly markets. There are also severe prohibitions against fraudulent and manipulative broker-dealer con-

533. A short sale takes place when a seller, believing the price of a stock will fall, borrows stock from a lender and sells it to a buyer. Later, the seller buys similar stock to pay back the lender, ideally at a lower price than he or she received on the sale to the buyer.

534. A sale against the box takes place when the seller, anticipating a decline in the price of stock he or she owns, sells it to a buyer at the present market price, but delivers it later, when (he or she hopes) the market price will have fallen below the sales price, thus creating a paper profit for the seller.

535. There is a good-faith exception provided within the statute. Furthermore, the SEC has exempted certain transactions deemed not to violate the policy of the provision. See Rules 16c-1, 16c-2, and 16c-3.

duct. Additionally, the SEC and Federal Reserve Board work together in regulating the extension of credit for securities transactions.

Section 15(a) of the 1934 Act requires registration with the SEC of all broker-dealers⁵³⁶ engaged in interstate business involving securities transactions.⁵³⁷ Section 15(b)(4) empowers the SEC to hold hearings and impose disciplinary sanctions ranging from censure to revocation of the registration of broker-dealers engaging in certain types of proscribed conduct.⁵³⁸ Section 15(b)(6) empowers the SEC to impose similar sanctions for the same types of conduct on persons who, although not themselves broker-dealers, are associated or seek to become associated with broker-dealers.

In addition to imposing sanctions arising out of the SEC's direct broker-dealer regulation, the SEC is charged with supervising a securities firm's structure and taking measures to ensure its solvency. Section 15(b)(7) requires broker-dealers to meet such operational and financial competence standards as the SEC may establish. The competence requirements include provisions for maintenance of adequate records and standards for supervisory and associated personnel. The SEC also has established financial responsibility requirements in its net capital rule, which sets out the minimum standards of broker-dealer solvency based on the balance sheet.⁵³⁹

536. See generally Jerry W. Markham & Thomas L. Hazen, *Broker-Dealer Operations Under Securities and Commodities Law: Financial Responsibilities, Credit Regulation, and Customer Protection* (2001 supp.).

537. The only exemption from the registration requirements is for a broker-dealer "whose business is exclusively intrastate and who does not make use of any facility of a national exchange."

538. For example, the SEC may impose sanctions after a hearing (1) when a broker-dealer makes false filings with the SEC; (2) when the broker-dealer, within the past ten years, has been convicted of certain crimes or misdemeanors involving moral turpitude or breach of fiduciary duty; (3) when the broker-dealer has willfully violated or aided in violating any federal securities law or rule; and (4) when the broker-dealer has been barred by the SEC or enjoined from being a broker-dealer. 1934 Act § 15(b)(4).

539. Rule 15c3-1, the net capital rule, is based on a complex balance sheet test for solvency. See, e.g., SEC Study on the Financing and Regulatory Capital Needs of the Securities Industry (Jan. 23, 1985).

Section 15(b)(8) requires that all broker–dealers be members of a qualifying self-regulatory organization (either a national exchange or registered securities association).⁵⁴⁰

Section 15(c) of the 1934 Act contains a series of antifraud provisions designed to prohibit securities broker–dealers from engaging in fraudulent practices and conduct. In addition to regulating broker–dealers’ financial responsibilities, this provision and others⁵⁴¹ are used most often by the SEC and courts to regulate (1) excessive prices for over-the-counter securities;⁵⁴² (2) activities of market makers who deal directly with individual customers;⁵⁴³ (3) generation of commissions by excessive trading in customers’ accounts (“churning”) and other fraudulent trading practices;⁵⁴⁴ and (4) undisclosed interests of investment advisers in the stocks they recommend.⁵⁴⁵

540. There are nine national exchanges registered under section 6 of the Act and one securities association registered under section 15A (the National Association of Securities Dealers).

541. Most notably section 17(a) of the 1933 Act and section 10(b) of the 1934 Act and rules promulgated thereunder.

542. *See, e.g., Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943) (violation of the securities laws where broker–dealer made high-pressure “cold calls,” convincing purchasers to pay an undisclosed 16%–40% markup over market value of securities).

543. *See, e.g., In re Alstead, Dempsey & Co.*, Exchange Act Release No. 20,825, 30 SEC Docket 211 (Apr. 5, 1984) (in over-the-counter market, where market maker’s customers hold 95.7% of the stock of the company at issue, and market maker controls the market, markups of 11%–20% over transactions in the independent inter-dealer market are excessive); *Chasins v. Smith, Barney*, 438 F.2d 1167 (2d Cir. 1970) (failure to disclose market-maker status is nondisclosure of a material fact in violation of the securities laws). *See also* SEC Rule 10b-10.

544. *See, e.g., Mihara v. Dean Witter*, 619 F.2d 814 (9th Cir. 1980) (where broker–dealer has control or de facto control of account, a high turnover rate, particularly of securities unsuitable to the complaining investors, generates excessive commissions in violation of the securities laws); *Nesbit v. McNeil*, 896 F.2d 380 (9th Cir. 1990) (in a churning case, a successful plaintiff is entitled to receive at his or her option as damages the decline in value of his or her portfolio, the amount of excess commissions generated by churning in the account, or both).

545. *See, e.g., SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (failure to disclose purchases of securities prior to making recommendation constituted a violation of Investment Advisers Act § 206).

Beyond the SEC rules and the additional requirements that may be imposed by the applicable self-regulatory organizations, broker-dealers are, of course, subject to common-law duties and fiduciary obligations. For example, a broker-dealer is prohibited from recommending a security unless he or she has actual knowledge of the characteristics and fundamental facts relevant to the security in question. Also, the recommendation must be reasonably supported by the facts.⁵⁴⁶

Furthermore, there are obligations imposed with regard to the broker-dealer's duty to "know the customer." This duty is frequently imposed by rules of self-regulatory organizations but also arises from general fiduciary duties between brokers and their customers. This duty requires that a broker be certain that the customer understands the risks of investment (or, in a discretionary account, that the broker understands the objectives of the customer, e.g., financial security as opposed to speculation). Although the fiduciary obligations are high, disciplinary actions have been few, and the overwhelming majority of cases have denied the existence of a private remedy by an injured investor based solely on the violation of an applicable rule of a self-regulatory organization.⁵⁴⁷ On the other hand, it is clear that if an injured customer can state the equivalent of a Rule 10b-5 violation, including showing the requisite scienter, materiality, reliance, causation,

546. This "know your security" requirement is an extension of the common-law doctrine of "holding out." The Second Circuit has held that to satisfy this requirement, a challenged broker-dealer must show that there was (1) an adequate and reasonable basis for the recommendation; (2) a reasonable independent investigation (the standards of which vary based on the nature of the security); (3) disclosure of essential information about the company to the investor; and (4) disclosure to the investor of any lack of information and the risks that may therein arise. *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969).

547. See, e.g., *Carrott v. Shearson Hayden Stone, Inc.*, 724 F.2d 821 (9th Cir. 1984); *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966); *Klock v. Lehman Bros. Kuhn Loeb, Inc.*, 584 F. Supp. 210 (S.D.N.Y. 1984). *Contra* *Buttry v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

damages, and deception, a violation of the know the customer rule will be actionable.⁵⁴⁸

Relatively few broker–customer disputes end up in the courts, especially because of the 1987 Supreme Court decision holding that predispute arbitration agreements are enforceable.⁵⁴⁹ Since that decision, predispute arbitration agreements have been increasingly popular. As is the case with arbitration generally, the scope of review is extremely limited, and the appropriate standard of review is “manifest disregard of the law.”⁵⁵⁰

548. *See, e.g.,* *Pelletier v. Stuart-James Co.*, 863 F.2d 1550 (11th Cir. 1989); *Lopez v. Dean Witter Reynolds, Inc.*, 591 F. Supp. 581 (N.D. Cal. 1984).

549. *Shearson Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

550. *E.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*, 808 F.2d 930, 933 (2d Cir. 1986).

Appendix: Statutory Conversion Charts

Securities Act of 1933

Act §	15 U.S.C. §	
1	77a	Short Title
2	77b	Definitions
3	77c	Exempted Securities
4	77d	Exempted Transactions
5	77e	Prohibitions Relating to Interstate Commerce and the Mails
6	77f	Registration of Securities and Signing of Registration Statement
7	77g	Information Required in Registration Statement
8	77h	Taking Effect of Registration Statements and Amendments Thereto
8A	77h-1	Cease and Desist Proceedings
9	77i	Court Review of Orders
10	77j	Information Required in Prospectus
11	77k	Civil Liabilities on Account of False Registration Statement
12	77l	Civil Liabilities Arising in Connection with Prospectuses and Communications
13	77m	Limitation of Actions
14	77n	Contrary Stipulations Void
15	77o	Liability of Controlling Persons
16	77p	Additional Remedies
17	77q	Fraudulent Interstate Transactions
18	77r	State Control of Securities
18A	77r-1	Preemption of State Law
19	77s	Special Powers of Commission
20	77t	Injunctions and Prosecution of Offenses
21	77u	Hearings by Commission
22	77v	Jurisdiction of Offenses and Suits
23	77w	Unlawful Representations
24	77x	Penalties
25	77y	Jurisdiction of Other Government Agencies over Securities

Federal Securities Law

Act §	15 U.S.C. §	
26	77z	Separability of Provisions
27	77z-1	Private Securities Litigation
27A	77z-2	Application of Safe Harbor for Forward-Looking Statements
28	77z-3	General Exemptive Authority

Securities Exchange Act of 1934

Act §	15 U.S.C. §	
1	78a	Short Title
2	78b	Necessity for Regulation
3	78c	Definitions and Applications
4	78d	Securities and Exchange Commission
4A	78d-1	Delegation of Functions by Commission
4B	78d-2	Transfer of Functions with Respect to Assignment of Personnel to Chairman
5	78e	Transactions on Unregistered Exchanges
6	78f	National Securities Exchanges
7	78g	Margin Requirements
8	78h	Restrictions on Borrowing and Lending by Members, Brokers, and Dealers
9	78i	Prohibition Against Manipulation of Security Prices
10	78j	Manipulative and Deceptive Devices
10A	78j-1	Audit Requirements
11	78k	Trading by Members of Exchanges, Brokers, and Dealers
11A	78k-1	National Market System for Securities; Securities Information Processors
12	78l	Registration Requirements for Securities
13	78m	Periodical and Other Reports
14	78n	Proxies
15	78o	Registration and Regulation of Brokers and Dealers
15A	78o-3	Registered Securities Associations
15B	78o-4	Municipal Securities
15C	78o-5	Government Securities Brokers and Dealers
16	78p	Directors, Officers, and Principal Stockholders
17	78q	Records and Reports
17A	78q-1	National System for Clearance and Settlement of Securities Transactions
17B	78q-2	Automated Quotation Systems for Penny Stocks
18	78r	Liability for Misleading Statements
19	78s	Registration, Responsibilities, and Oversight of Self-Regulatory Organizations

Federal Securities Law

Act §	15 U.S.C. §	
20	78t	Liability of Controlling Persons
20A	78t-1	Liability to Contemporaneous Traders for Insider Trading
21	78u	Investigations and Actions
21A	78u-1	Civil Penalties for Insider Trading
21B	78u-2	Civil Remedies in Administrative Proceedings
21C	78u-3	Cease and Desist Proceedings
21D	78u-4	Private Securities Litigation
21E	78u-5	Application of Safe Harbor for Forward-Looking Statements
22	78v	Hearings by Commission
23	78w	Rules, Regulations, and Orders; Annual Reports
24	78x	Public Availability of Information
25	78y	Court Review of Orders and Rules
26	78z	Unlawful Representations
27	78aa	Jurisdiction of Offenses and Suits
27A	78aa-1	Special Provision Relating to Statute of Limitations on Private Cause of Action
28	78bb	Effect on Existing Law
29	78cc	Validity of Contracts
30	78dd	Foreign Securities Exchanges
30A	78dd-1	Prohibited Foreign Trade Practices by Issuers
31	78ee	Transaction Fees
32	78ff	Penalties
33	78gg	Separability of Provision
34	78hh	Effective Date
35	78kk	Authorization of Appropriations
35A	78ll	Requirements for the EDGAR System
36	78mm	General Exemptive Authority

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