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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 anti-fraud provisions. This edition updates and revises the third edition.

Because of space limitations, this monograph does not address the details of the securities laws governing securities professionals and the operation of the securities markets, nor the regulation of investment companies and investment advisers. Appendix B lists selected references for further reading.

Codification of the securities laws is extremely confusing. Of the seven federal securities statutes, the acts discussed most frequently in this monograph are the Securities Act of 1933 (also referred to as the 1933 Act or the Securities Act) and the Securities Exchange Act of 1934 (also referred to as the 1934 Act or as the Exchange Act). As with all 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. Appendix A contains conversion charts to help locate the correlative section of the U.S. Code.

The Securities and Exchange Commission's rules are codified 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 and are numbered from 100 to 904. The 1934 Act rules are found in 17 C.F.R. §§ 240.01–240.31.1 and are numbered according to the section of the Act (e.g., Rule 10b-5 is promulgated under § 10(b)). With some exceptions, this monograph refers to the Securities and Exchange Commission as the SEC. The SEC has five Commissioners, twenty-one division directors, and many staff members.

This edition has been revised to include case law through the Supreme Court's October 2019 term. It includes district and appellate case law through July 30, 2021, and regulatory developments through February 24, 2022.

All cites to the U.S. Code are to the 2006 edition unless otherwise specified. All cites to the Code of Federal Regulations are to the 2010 edition unless otherwise specified.

Portions of this monograph were adapted from Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* (2d ed. West 1990; 3d ed. West 1995; 6th ed. 2009; 7th ed. Thomson Reuters 2016).

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Introduction

I.A

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 venditor*.¹ As such, the Securities Act was the first federal consumer protection statute relating to securities.² The federal securities laws do not focus on the merits of investments. Instead, the underlying premise of the federal securities laws is full disclosure to benefit investors by providing information upon which they can make informed investment decisions. The disclosure focus reflects the sage words of Louis Brandeis that sunlight is the best disinfectant.³

There are seven federal acts in this area,⁴ six of which are still in effect: the Securities Act of 1933 (1933 Act),⁵ the Securities Exchange Act of 1934 (1934

1. Message to Congress from President Franklin Roosevelt (March 29, 1933), as quoted in H.R. Rep. No. 73-85, 73d Cong. 1st Sess. (May 4, 1933) (“This proposal adds to the ancient rule of caveat emptor the further doctrine, ‘Let the seller also beware.’ It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.”).

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

3. Louis D. Brandeis, *Other People’s Money* ch. 5 (1914) (“sunlight is said to be the best of disinfectants; electric light the most efficient policeman”).

4. The Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (2000 & Supp. 2001), was enacted to correct abuses in financing and operating public utilities. Most of the Securities and Exchange Commission’s work in this area had been completed, and in 2005 the Act was repealed by the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005); Repeal of the Public Utility Holding Company Act of 1935 and Enactment of the Public Utility Holding Company Act of 2005, 70 Fed. Reg. 75592–01, 2005 WL 3464225 (FERC Dec. 8, 2005).

5. 15 U.S.C. §§ 77a–77z (referred to alternatively as the “1933 Act” and the “Securities Act”).

Act),⁶ the Trust Indenture Act of 1939,⁷ the Investment Company Act of 1940,⁸ the Investment Advisers Act of 1940,⁹ and the Securities Investor Protection Act of 1970.¹⁰ The discussion that follows focuses on the Securities Act of 1933 and the Securities Exchange Act of 1934.¹¹ The remaining securities laws are highly specialized and thus are not given significant coverage in this monograph.

The 1933 and 1934 Acts, like the other federal securities laws, are evolving laws and are amended periodically. 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. In 2002, the Sarbanes-Oxley Act ("SOX") introduced corporate governance reforms and enhanced criminal penalties, as well as protections for whistleblowers who report violations of securities laws. In 2010, Congress created massive

6. *Id.* §§ 78a–78l (referred to alternatively as the "1934 Act" and the "Exchange Act").

7. *Id.* §§ 77aaa–77bbb. 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.

8. *Id.* §§ 80a-1 to 80a-64. 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.

9. *Id.* §§ 80b-1 to 80b-21. The Investment Advisers Act of 1940, as amended in 1960, established a scheme of registration and regulation of investment advisers comparable to that in § 15 of the 1934 Act with respect to broker-dealers (discussed in detail later). The Investment Advisers Act treats advisers as fiduciaries. Broker-dealers have not been subject to comparable language, but as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Congress mandated that the SEC evaluate the discrepancies between adviser and broker-dealer regulation to determine if additional rule making is warranted. *Id.* § 913.

10. *Id.* §§ 78aaa–78lll. 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 as to claims for cash, not more than \$40,000).

11. For discussion of the other securities laws, see Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* (7th ed. 2016).

financial reform with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Dodd-Frank's amendments increased the SOX protection of whistleblowers in the financial services industry. Only a small portion of Dodd-Frank impacts the subject-matter of this monograph, and those changes are explained in the relevant sections throughout. The Jumpstart Our Business Startups Act (JOBS Act), adopted in 2012, relaxed some disclosure-and-reporting requirements for small businesses. The JOBS Act amendments are discussed in relevant portions of this monograph. On occasion, a securities law amendment will be folded into other legislation, as was the case in the FAST (Fixing America's Surface Transportation) Act of 2015¹² and the National Authorization Act for Fiscal Year 2021.¹³

I.A.1

Overview of 1933 Act

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 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.

12. Pub. L. No. 114-94, 129 Stat. 1312, 114th Cong. Sec. 76001(d) (Dec. 4, 2015) (adding 1933 Act § 4(a)(7)'s exemption for resales to accredited investors).

13. Pub. L. No. 116-283, Sec. 6501, 116th Cong. (Jan. 1, 2021) (expressly authorizing disgorgement as a remedy in SEC actions).

The 1933 Act applies its registration and disclosure requirements only to distributions¹⁴ (both primary and secondary) of 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 whereas the 1934 Act protects both purchasers and sellers.¹⁵

The essence of registration under the 1933 Act is an initial disclosure document, known as the registration statement. It is important to understand that neither securities nor the companies issuing securities are registered under the 1933 Act. Instead, the 1933 Act calls for the registration of transactions—namely, the public offering. Once the offering is complete the registration ceases to be effective. In reality, notwithstanding the statutory terminology, it thus is a mistake to talk of registered securities under the 1933 Act.¹⁶ In contrast, 1934 Act registration, which is discussed later, does in fact involve registration of securities.¹⁷

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 Securities and Exchange Commission (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 and other requirements upon public companies.

14. *Distribution* is the term used to describe a large infusion of shares into the public markets. As described by Rule 100 of the Securities and Exchange Commission's Regulation M, "Distribution means an offering of securities, whether or not subject to registration under the Securities 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 (1946).

15. 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. *Compare, e.g.,* 1933 Act § 17(a), 15 U.S.C. § 77q(a) (prohibiting material misstatements and fraud in connection with the offer or sale of securities), with SEC Rule 10b-5, 17 C.F.R. § 240.10b-5) (prohibiting material misstatements and fraud in connection with the purchase or sale of securities),

16. *But see* 1933 Act § 6, 15 U.S.C. § 77f(a) ("Any security may be registered with the Commission . . .").

17. *See* 1934 Act § 12, 15 U.S.C. § 78l.

I.A.2

Overview of 1934 Act

Congress enacted the 1934 Act, 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.¹⁸ 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 publicly 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.

I.B

**Securities and Exchange Commission
(and Self-Regulation)**

The federal securities laws are administered by the Securities and Exchange Commission (referred to alternatively as the “SEC” or “the Commission” throughout this monograph). In terms of function, although not in terms of size, 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

18. 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).

main SEC office is in Washington, D.C., and is composed of six divisions.¹⁹ There are eleven regional SEC offices.²⁰

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 SEC supervision and oversight. The self-regulatory organizations (SROs) include the securities exchanges. For many years the primary SROs were the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD),²¹ but in 2007 these self-regulators merged into the Financial Industry Regulatory Authority (FINRA). The Municipal Securities Rulemaking Board (MSRB), which establishes rules governing municipal securities dealers, is also an SRO. SROs 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. Rulemaking by direct legislative delegation necessarily has the effect of law so long as it is carried out according to statute and does not exceed the statute's scope. The SEC also promulgates interpretive rules, including "safe harbor" rules,²² 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 although they are entitled to significant deference.

19. The key divisions are *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; *Enforcement*, responsible for the investigation of all suspected securities laws violations; *Trading and Markets* (formerly Market Regulation), which oversees regulatory practices and policies relating to the exchanges, the over-the-counter markets, and broker-dealers; *Investment Management*, which administers the Investment Company and Investment Advisers Acts of 1940; *Examinations*, which conducts examination to monitor compliance; and *Economic and Risk Analysis*, which conducts economic, statistical, and analytical studies to inform the SEC. Most lawyers contacting the SEC deal with staff members who give informal advice. In addition to the six divisions, the SEC has nineteen "offices" including the Office of General Counsel, Office of the Chief Accountant, Office of Compliance and Inspections, and the Office of Administrative Law Judges. See <http://www.sec.gov/divisions.shtml>. For the SEC organizational chart, see <https://www.sec.gov/about/orgtext.htm>.

20. Regional offices are in Atlanta, Boston, Chicago, Denver, Fort Worth, Los Angeles, Miami, New York City, Philadelphia, Salt Lake City, and San Francisco.

21. When the NASD and NYSE demutualized, their self-regulatory arms were spun off as independent self-regulators (NASD Regulation—NASDR; and New York Stock Exchange Regulation—NYSER).

22. See, e.g., *infra* text accompanying notes 157–60 and 197–98.

Supplementing the SEC's rules and regulations are the SEC's forms for the various statements and reports that companies, 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.²³

The SEC 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.²⁴ The SEC disseminates unsolicited advisory opinions in the form of "releases," which may include guidelines or suggested interpretations of statutory provisions 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.

The SEC publishes Staff Legal Bulletins, Frequently Asked Questions (FAQs), and other interpretations. Although these bulletins and interpretations have less precedential effect than formal SEC Releases, they provide further insight into the SEC's approach to selected issues.²⁵

Broker-dealers (other than those conducting business on a totally intrastate basis) must register with the SEC pursuant to 1934 Act § 15(a).²⁶ Registration

23. SEC Regulations S-K and S-X provide detailed guides for disclosures. They put the meat on the bones provided by the applicable SEC forms and schedules. Regulation S-K contains the guidance for narrative disclosures, whereas Regulation S-X provides the guidance for financial statements and related disclosures. Regulation S-B was a parallel set of narrative disclosure guides for small businesses. 17 C.F.R. Part 228 (2006). However, in 2007 the SEC eliminated the specialized forms and Regulation S-B that formerly were available to small business issuers. At the same time, the SEC redefined the concept of small business issuers in order to enable more companies to qualify for the new "scaled disclosure requirements" available under both the 1933 and 1934 Acts for smaller reporting companies. Companies with less than \$75 million in public equity float now qualify for scaled disclosure requirements under Regulation S-K as amended and under the applicable 1933 and 1934 Act forms as amended. Companies that do not have a calculable public equity float qualify for scaled disclosure if their revenues were below \$50 million in the previous year.

24. 5 U.S.C. §§ 551-559.

25. SEC Staff Legal Bulletins and Interpretations are available at <http://sec.gov/>.

26. 15 U.S.C. § 78o(a).

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)²⁷ of the 1934 Act makes it unlawful for any registered broker-dealer to engage in business unless the broker-dealer is a member of a national securities association (i.e., FINRA) or effects transactions solely on a national exchange on which the broker-dealer is a member. FINRA and exchange membership requirements, rules, market surveillance, and disciplinary procedures are all subject to SEC oversight and review.

I.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 alleged 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

27. *Id.* § 78o(b)(8).

administrative law judge.²⁸ 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 (or a person associated with such an issuer), nor a securities professional 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.

I.D

Self-Regulation

National securities associations must register with the SEC pursuant to 1934 Act § 15A.²⁹ The SEC Division of Trading and Markets (formerly Market Regulation) oversees self-regulatory organizations, including the stock exchanges³⁰ and FINRA. The exchanges have listing requirements for securities, and the National Association of Securities Dealers' Automated Quotation system (Nasdaq) has similar listing requirements for its national stock market (formerly its market system).

Over the course of most of its history, the Nasdaq operated much like an exchange, but until 2006 the Nasdaq national market system was not a registered national securities exchange. In 2006, the SEC approved Nasdaq's application to make its national Stock Market a registered securities exchange. The securities that are not listed in the national stock market but are nevertheless traded using

28. SEC administrative law judges (ALJs) are constitutional officers who must be appointed by the SEC by a formal action of the commissioners. *Lucia v. SEC*, 138 S. Ct. 2044 (2018). Even after the Supreme Court's decision in *Lucia*, the challenges to the ALJs have continued. In *Cochran v. SEC*, 969 F.3d 507 (5th Cir. 2020), the respondents in an SEC proceeding claimed that ALJs had unconstitutional protection against removal. The challenge was based on the Supreme Court ruling, in *Seila Law LLC v. Consumer Financial Protection Bureau*, 140 S. Ct. 2183 (2020), that it was unconstitutional for the director of the Consumer Financial Protection Bureau (CFPB) not to be removable at will. But *Cochran* held that the D.C. Circuit was not the proper venue for this constitutional challenge, which should have been made to the SEC. *Seila* involved an agency – the CFPB – with one director appointed by the President with the Senate's advice and consent. The Court there held that not having the director removable at will by the President violated the Constitution's Separation of Powers clause. Whether the reasoning could be applied to the SEC's ALJs is not clear. It thus remains to be seen whether the non-removability of ALJs renders the process unconstitutional.

29. 15 U.S.C. § 78o-3.

30. A national securities exchange is defined by registration under § 6 or the 1934 Act. 15 U.S.C. § 78f.

the Nasdaq or on the Nasdaq electronic bulletin board (OTCBB) are considered “over the counter” (OTC) securities and formerly were not subject to 1934 Act § 9 prohibitions on manipulation. However, 1934 Act § 9 was amended to apply to all securities traded in interstate commerce and thus now includes the OTC markets. OTC securities are also regulated by 1934 Act § 15(c).³¹ OTC markets are distinguished from exchanges in two principal ways: 1) there is no central facility comparable to an exchange floor (although the National Association of Securities Dealers’ (NASD) 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” (now known as a designated market maker) in that stock; in the OTC 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 FINRA (formerly the NASD). Additionally, their sales personnel must register with FINRA as “registered representatives.”³² There are various categories of FINRA qualifications, depending on the functions to be performed by the brokerage employee in question. 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 FINRA.³³

FINRA is the only registered securities association for broker-dealers effectuating transactions in private-sector securities. Section 15B of the 1934 Act³⁴ 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 15C³⁵ deals with government securities dealers. Government securities are those issued by the federal government or a federal agency. Section 6 of the 1934 Act³⁶ provides for the registration of national securities exchanges, and all exchange rules, procedures, and disciplinary sanctions are

31. *Id.* § 78o(c).

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

33. See the Financial Industry Regulatory Authority website, <http://www.FINRA.org>, for a description of the qualification requirements and the various levels of registration.

34. 15 U.S.C. § 78o-4.

35. *Id.* § 78o-5.

36. *Id.* § 78f.

subject to SEC oversight and review. Section 11 of the 1934 Act³⁷ regulates exchange trading. Section 11A deals with the national market system. Section 17A of the 1934 Act³⁸ addresses registration of clearing agents and stock transfer agents. Sections 7 and 8 implement margin regulations governing the extension of credit using securities as collateral.³⁹ The margin rules are set by the Federal Reserve Board but are enforced by the SEC (and the self-regulatory organizations).

I.E

Private Remedies

Investors who believe they were injured by a violation of the securities laws can bring a civil action for damages. Several sections of the 1933 and 1934 Acts provide for express private rights of action.⁴⁰ Perhaps the most significant civil liability exists under various “implied” rights of action under provisions prohibiting certain activities.⁴¹ Especially when based on material misstatements and omissions, private securities suits are likely to be brought as class actions. Private remedies are discussed throughout this monograph.

37. *Id.* § 78k.

38. *Id.* § 78q-1.

39. *Id.* §§ 78g, 78h.

40. 1933 Act §§ 11, 12, 15 U.S.C. §§ 77k, 77l; 1934 Act §§ 9(f), 16(b), 18(a), 21A, 15 U.S.C. §§ 78i(f), 78p(b), 78r(a), 78t-1.

41. The most prominent implied remedies are based on Rule 10b-5 and Rule 14a-9, 17 C.F.R. §§ 240.10b-5, 240.14a-9.



Scope and Reach of Securities Laws

II.A

Definition of Security

The applicability of federal and state securities laws is dependent upon finding a transaction involving securities. When most people think of securities, they probably focus on stocks and bonds. The term *security* is defined much more broadly in 1933 Act § 2(a)(1). Section 3(a)(10) of the 1934 Act sets forth a substantially similar definition as do the other federal securities laws. In addition to stock, bonds, and “any interest or instrument commonly known as a security,” § 3(a)(10) includes, among other things, any “investment contract.” Comparable definitions are found in many state securities laws. These definitions have been liberally interpreted by the courts to apply to a wide range of money-raising schemes, particularly when the SEC or state regulators have sought injunctions against activities for which there was no prompt or effective relief available under other laws designed to protect the public.

As noted above, 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.⁴²

The definition thus contains a list of various types of investments in addition to the broader category of “investment contract.” 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.⁴³

The landmark—and still leading—case on the definition of an investment contract is *SEC v. W.J. Howey Co.*⁴⁴ 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 profits⁴⁵ (4) solely from the efforts of the promoter

42. 15 U.S.C. § 77b(a)(1) (2000 & Supp. 2001). In 2000, the 1933 Act was amended to explicitly exclude security-based swap agreements from the definition of security 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). 15 U.S.C. § 77b-1. Accord 1934 Act § 3A, 15 U.S.C. § 78c-1. The 1934 Act definition is substantially the same with the exception that certain short-term notes are excluded from the 1934 Act definition. 1934 Act § 3(a)(10), 15 U.S.C. § 78c(a)(10). In contrast, those notes are securities under the 1933 Act but are exempt from 1933 Act registration. 1933 Act § 3(a)(3), 15 U.S.C. § 77c(a)(3).

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

44. 328 U.S. 293 (1946).

45. A fixed (as opposed to variable) return can still qualify as a profit under the investment contract test. See *SEC v. Edwards*, 540 U.S. 389 (2004) (holding promise of fixed return from sale-leaseback arrangement satisfied *Howey*’s profit requirement).

or a third party.”⁴⁶ The fourth prong of this test was later modified to require only that the profits come “primarily” or “substantially” from the efforts of others.⁴⁷ 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. The statute contains a list of other types of investments that are explicitly included in the definition. 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*,⁴⁸ the Supreme Court rejected the argument that merely denominating 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 Act’s definition of *security*.

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 1933 Act.⁴⁹ When the Supreme Court faced the issue, however, it took a literal approach. In *Landreth Timber Co. v. Landreth*,⁵⁰ finding that the stock

46. *Howey*, 328 U.S. at 298–99.

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

48. 421 U.S. 837 (1975).

49. 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).

50. 471 U.S. 681 (1985). 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 doctrine may be applicable under California law) with *Specialized Tours, Inc. v. Hagen*, 392 N.W.2d 520, 536–37 (D. Minn. 1986) (rejecting doctrine).

involved had all the incidents of “stock,” the Court held that even the sale of all the stock of a company is a sale of securities subject to securities laws.

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 for interpreting the meaning of “investment contract.” Other investment instruments, 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,⁵¹ 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).⁵² 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.”⁵³ 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,⁵⁴ 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

51. 15 U.S.C. § 78c(a)(10).

52. The Act further exempts all renewals thereof that are “likewise limited.” *Id.*

53. 494 U.S. 56, 63 (1990).

54. 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).

schemes to control the transaction.⁵⁵ These factors incorporate the early “commercial versus investment” approach,⁵⁶ which rests on the view that many transactions regulated in more specific ways do not need the protection of the federal securities laws.⁵⁷ 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*.

II.B

Jurisdictional Provisions

The Securities Act of 1933 and Securities Exchange Act of 1934 have different jurisdictional reach over companies issuing securities. The 1934 Act governs

55. Here is how 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 “security.” 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, 494 U.S. at 66–67 (citations omitted).

56. See, e.g., *Smith Int'l, Inc. v. Texas Com. Bank*, 844 F.2d 1193 (5th Cir. 1988); *Union Nat'l Bank v. Farmers Bank*, 786 F.2d 881 (8th Cir. 1986).

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

offerings or issuers with sufficient interstate contact to support federal regulation.⁵⁸ In contrast, § 5 of the 1933 Act asserts jurisdiction requiring registration for nonexempt offers or sales of securities through an instrumentality of interstate commerce.⁵⁹ Although jurisdiction would otherwise exist, there is an exemption from registration for offerings taking place within a single state.⁶⁰

The federal securities laws provide a mosaic approach to jurisdiction. The Securities Act of 1933 and most of the other acts comprising the battery of securities laws provide for concurrent jurisdiction of federal and state courts, thus giving parties a choice of a federal or state forum⁶¹ in the context of private causes of action.⁶² The impact of concurrent jurisdiction was severely limited by the Securities Litigation Uniform Standards Act (SLUSA),⁶³ which preempts state courts from hearing most securities class actions.⁶⁴ The Supreme Court held that the

58. Section 12(a) of the 1934 Act 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. 15 U.S.C. § 78l(a). The registration requirement as it applies to non-exchange listed (over-the-counter) securities is set forth in § 12(g). 15 U.S.C. § 78l(g). Until April 2012, by virtue of § 12(g)(1) of the Exchange Act and former Rule 12g-1, 1934 Act registration was required for issuers having both a class of equity securities with 500 or more shareholders of record and more than \$10 million in total assets. In 2012 the JOBS Act amended § 12(g) to increase the threshold from 500 to 2,000 shareholders of record. However, the JOBS Act retained the lower 500 “shareholder of record” threshold with respect to unaccredited investors. As discussed *infra* text and accompanying note 435, there are thirteen categories of accredited investors. Rules 215, 501(a). 17 C.F.R. §§ 230.215, 230.501(a). Shareholders who receive shares as part of an employee compensation plan that is exempt from 1933 Act registration are excluded from the shareholder of record calculation. Section 12(g) was also amended to exclude from the shareholder calculation any holders of shares issued pursuant to an exempt crowdfunding offering.

1934 Act’s § 12 registration subjects companies to the Act’s periodic reporting requirements and other requirements, including proxy regulation, tender offer and other takeover regulation, and reporting of insider transactions in the company shares. Even for companies not registered under § 12, § 15(d) provides that issuers having issued securities under a 1933 Act registration statement with more than 300 record-holders of such securities are subject to 1934 Act requirements. 15 U.S.C. § 78o(d).

59. 15 U.S.C. § 77e.

60. 1933 Act § 3(a)(11), 15 U.S.C. § 77c(a)(11).

61. See generally Thomas L. Hazen, *Allocation of Jurisdiction Between the State and Federal Courts for Remedies Under the Federal Securities Laws*, 60 N.C. L. Rev. 707 (1982). Cf. *Sides v. Simmons*, No. 07-80347-CIV-Ryskamp/Vitunac, 2007 WL 3344405 (S.D. Fla. Nov. 7, 2007) (1933 Act claims remained in state court while 1934 Act Rule 10b-5 claim would proceed in federal court since court declined to invoke abstention doctrine for that claim).

62. The concurrent jurisdiction provisions apply only to private suits; they do not extend to enforcement actions by the SEC or criminal prosecutions.

63. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 105th Cong. (2d Sess. Nov. 3, 1998) (S. 1260).

64. See 1933 Act § 16(f), 15 U.S.C. § 77p(f); 1934 Act § 28(f), 15 U.S.C. § 78bb(f).

state courts' concurrent jurisdiction under the 1933 Act is not preempted by SLUSA.⁶⁵ The Court also clarified that SLUSA did not impact the rule that class actions alleging solely 1933 Act claims in state court are not subject to removal to federal court.⁶⁶

In contrast to the concurrent jurisdiction of the other securities laws, the Securities Exchange Act of 1934 provides that jurisdiction is exclusively federal, which means that all private suits must be brought in federal court. All criminal prosecutions under the securities laws and judicial enforcement actions by the Securities and Exchange Commission must be maintained only in federal court.⁶⁷ Similarly, jurisdiction over appeals from SEC administrative decisions is exclusively federal.⁶⁸ When dealing with private remedies, however, the six securities acts present three different approaches to jurisdictional allocation.

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,⁶⁹ 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.⁷⁰ Under this expansive view of jurisdiction, even a face-to-face conversation may be subject to the broadest antifraud provision—SEC Rule 10b-5⁷¹—if the conversation is

65. *Cyan, Inc. v. Beaver Cnty. Emps.' Ret. Fund*, 138 S. Ct. 1061 (2018).

66. *Id.*

67. Securities Act of 1933, § 22(a), 15 U.S.C. § 77v(a); Securities Exchange Act of 1934, § 27, 15 U.S.C. § 78aa; Public Utility Holding Company Act of 1935, § 25, 15 U.S.C. § 79y (repealed in 2005); Trust Indenture Act of 1939, § 322(b), 15 U.S.C. § 77vvv(b); Investment Company Act of 1940, § 44, 15 U.S.C. § 80a-43; Investment Advisers Act of 1940, § 214, 15 U.S.C. § 80b-14.

68. Securities Act of 1933, § 9, 15 U.S.C. § 77i; Securities Exchange Act of 1934, § 25, 15 U.S.C. § 78y; Public Utility Holding Company Act of 1935, § 24, 15 U.S.C. § 79x (repealed in 2005); Trust Indenture Act of 1939, § 322(a), 15 U.S.C. § 77vvv(a); Investment Company Act of 1940, § 43, 15 U.S.C. § 80a-42; Investment Advisers Act of 1940, § 213, 15 U.S.C. § 80b-13.

A state court does not have the power to interfere with SEC proceedings. *First Jersey Sec., Inc. v. SEC*, 476 A.2d 861 (N.J. 1984), *appeal dismissed*, 501 A.2d 893 (1985).

69. The securities laws' antifraud provisions (as amended in 2000) also extend to security-based swap agreements. See 1933 Act § 17(a), 1934 Act § 10(b), 15 U.S.C. §§ 77q(a), 78j(b).

70. *E.g.*, 1933 Act § 12, 15 U.S.C. § 77l (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), 15 U.S.C. § 78j(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").

71. 17 C.F.R. § 240.10b-5.

part of a transaction that uses some instrumentality of interstate commerce.⁷² 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.⁷³ The Supreme Court's decision in *Carpenter v. United States*⁷⁴ reinforces a broad interpretation of the securities laws' jurisdictional requirements. In *Carpenter*, the 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.

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 traded in interstate commerce.⁷⁵ 1934 Act § 15(c)⁷⁶ 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.

II.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

72. *E.g.*, *Franklin Sav. Bank of N.Y. v. Levy*, 551 F.2d 521, 524 (2d Cir. 1977) (jurisdiction found for claim based on § 12(a)(2) of 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).

73. *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).

74. 484 U.S. 19 (1987).

75. 15 U.S.C. § 78i. 1934 Act § 9 formerly was limited to manipulation of exchange-traded securities.

76. *Id.* § 78o(c).

litigation, or administrative action under § 21(a) of the 1934 Act, the SEC is empowered to issue public reports of its findings.⁷⁷ This power is rarely invoked and from time to time has raised considerable controversy.⁷⁸

When the SEC brings a civil enforcement action in court, it generally is seeking injunctive relief.⁷⁹ In addition, the SEC may seek ancillary relief such as disgorgement of the wrongdoer's profits.⁸⁰ In *Liu v. SEC*,⁸¹ the Supreme Court upheld the SEC's ability to go to court to seek disgorgement of profits as ancillary relief to an SEC injunction so long as the proceeds from the disgorgement are distributed to investors. In its decision, the Court noted that disgorgement is not available as an equitable remedy unless the defendant was a wrongdoer. But the Court indicated that joint wrongdoers acting as "partners engaged in concerted wrongdoing" could be held jointly and severally accountable under common law and that this could be applied in an action for disgorgement.⁸²

In an earlier case,⁸³ the Supreme Court held that the five-year statute of limitations applicable to civil penalties governs SEC enforcement actions seeking disgorgement.⁸⁴ In 2021 Congress amended 1934 Act § 21(d) making it clear that the SEC has authority to seek disgorgement "of any unjust enrichment by the person who received such unjust enrichment as a result of [a] violation"⁸⁵ in injunctive actions.

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 the case to the Department of Justice for criminal prosecution. Where appropriate, the SEC may choose to address a securities law violation with administrative sanctions. As for market professionals (broker-dealers, investment bankers, investment companies, and investment advisers), the SEC can initiate administrative adjudicatory proceedings that lead to possible sanctions, ranging from censure to suspension or revocation of the right to act as a securities professional.

77. *Id.* § 78u.

78. For an example of criticism of the publication of investigations, see *In re Spartek, Inc.*, Sec. Exchange Act Release No. 34-15567, 1979 WL 173653 (Feb. 14, 1979) (Karmel, dissenting).

79. See Hazen, *supra* note 11, § 16:8 (discussing SEC's authority to seek injunctive relief).

80. See *id.* § 16:17 (discussing the varieties of injunctive relief).

81. 140 S. Ct. 1936 (2020).

82. *Id.* at 1938-39.

83. 18 U.S.C. § 2462.

84. *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

85. 15 U.S.C. § 78u(d)(1). See National Defense Authorization Act for Fiscal Year 2021, Pub. L. No. 116-283, Sec. 6501, 116th Cong. (Jan. 1, 2021).

The SEC has “cease and desist” power, conferred by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.⁸⁶ A cease and desist order may be appealed to the full Commission or directly to a federal court. The 1990 legislation also added § 21(d)(2) to the 1934 Act⁸⁷ (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.” The legislation also gives 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, referred to as penny stocks. Penny stocks are securities that are generally unlisted—OTC stocks not traded on a national exchange or through an automated quotation system. Penny stocks are sold at under \$5 a share. They are subject to abuse because 1) they can be sold in large volume, often 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.⁸⁸ Additional disclosures are required about both the market value of penny stocks and the people selling the stocks. Furthermore, the SEC was 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.⁸⁹

Notwithstanding its broad range of enforcement authority, the SEC does not have jurisdiction to adjudicate disputes between private parties.⁹⁰ The SEC can,

86. Pub. L. No. 101-429 (1990). See H.R. Rep. No. 101-617, 101st Cong. (1990).

87. 15 U.S.C. § 78u(d)(2).

88. See Exchange Act Release No. 27,160 (Aug. 22, 1989).

89. See also Rules 15g-1 through 15g-8. These penny stock rules replaced Rule 15c2-6, an anti-fraud 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).

90. Cf. The Commodity Futures Trading Commission’s reparations proceedings. Commodity Exchange Act § 14, 7 U.S.C. § 18.

however, order disgorgement of profits in administrative proceedings and has adjudicatory responsibility for regulation of market professionals.⁹¹

II.D

Relation to Other Federal Laws

A number of related statutes may supplement the federal securities laws: the Foreign Corrupt Practices Act of 1977,⁹² 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.⁹³ 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 over the distribution of securities issued by national banks.⁹⁴ A similar arrangement exists with securities of savings and loan associations, which are subject to regulation by the Federal Home Loan Bank Board.⁹⁵ Another example is securities of charitable organizations, which are governed by regulations of the Internal Revenue Service.

91. 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.

92. 15 U.S.C. §§ 78m(b)(2), 78dd-1, 78dd-2.

93. 18 U.S.C. §§ 1341, 1343.

94. 12 U.S.C. §§ 51–51c. *See also* 1933 Act § 3(a)(2), which provides an exemption from registration.

95. 12 U.S.C. §§ 1461–1470. *See also* 1933 Act § 3(a)(5), which provides an exemption from registration.

Banks and securities firms compete directly in some areas, including providing financing for corporations and managing pooled investment funds.⁹⁶ 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.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act introduced significant reforms.⁹⁷ It imposed many changes on the operation of financial institutions, including the so-called “Volcker Rule,”⁹⁸ which limits certain activities that are “high-risk or which create significant conflicts of interest between these institutions and their customers.”⁹⁹ For example, with specified exemptions, including one for activities outside the United States, the Dodd-Frank Act amended the Bank Holding Company Act to outlaw proprietary trading by banks and nonbank financial institutions.¹⁰⁰ Granting the same exemptions, the Dodd-Frank Act also prohibits banks and nonbank financial companies from

96. With the enactment of the Gramm-Leach-Bliley Act of 1999 (Pub. L. No. 106-102, 1999 U.S.C.A.N. (113 Stat.) 1338), Congress repealed the Glass-Steagall Act and its “Meginot line” between investment and commercial banking. The Glass-Steagall Act, 12 U.S.C. §§ 24 & 378, was adopted in 1933 to bar commercial banks from the investment banking business and securities firms from the commercial banking business. From 1970 through 2000, 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 continue to regulate insurance-related activities. Gramm-Leach-Bliley allows bank holding companies to engage in more securities and insurance activities. It also created a category known as a financial holding company, which can engage in a wide variety of financial activities, including investment banking, commercial banking, and insurance.

97. Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, H.R. 4173, 111th Cong. (2d Sess. 2010).

98. The Volcker Rule is named after former Federal Reserve Board Chairman Paul Volcker, who urged that beneficiaries of the federal financial safety net—deposit insurance guarantees and discount window borrowing—be prohibited from engaging in high-risk activities. See S. Rep. No. 111-176, at 91, 111th Cong. (2d Sess. 2010).

99. S. Rep. No. 111-176, at 8, 111th Cong. (2d Sess. 2010). These limitations were designed to “reduce potential taxpayer losses at institutions protected by the federal safety net, and reduce threats to financial stability, by lowering their exposure to risk.” *Id.* They are also meant to “reduce the scale, complexity, and interconnectedness of those banking entities and nonbank financial companies that are now actively engaged in proprietary trading, or have hedge fund or private equity exposure” and to “reduce the possibility that banking entities and nonbank financial companies will be too big or too complex to resolve in an orderly manner should they fail.” *Id.* at 9.

100. Bank Holding Co. Act § 13(h)(4), 12 U.S.C. § 1851(h)(4), as added by Dodd-Frank Act § 619.

sponsoring, acquiring, or retaining any equity, partnership, or other ownership interest in a private equity or hedge fund.¹⁰¹

Because securities are included in the definition of *commodity* in the Commodity Exchange Act, “futures contracts” on individual securities and stock market and other financial indexes are regulated by the Commodity Futures Trading Commission (CFTC) as well as by the SEC.¹⁰² In 2000, the Commodity Exchange Act (CEA) was amended to permit, for the first time, futures on individual equity securities.¹⁰³ 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. Options trading on outstanding securities, which has mushroomed since 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. The Commodity Futures Modernization Act of 2000¹⁰⁴ codified the existence of unregulated OTC derivatives markets for eligible sophisticated participants. Hundreds of billions of dollars in credit default swaps were among the contracts traded in the unregulated OTC derivatives markets. In the wake of the 2008 credit crisis and financial meltdown, numerous proposals emerged to regulate these markets. As a result of the Dodd-Frank Act, most swap transactions are subject to CFTC or SEC regulation and central clearing requirements.¹⁰⁵ Security-based swap transactions are subject to SEC jurisdiction, while other swaps are regulated by the CFTC. The Dodd-Frank Act sets forth a broad definition of *swap transaction*.¹⁰⁶ There are several exclusions from the definition of *swap*, including futures contracts, options on futures contracts,

101. *Id.* § 13(h)(5), 12 U.S.C. § 1851(h)(5). A “hedge fund” or “private equity fund” is (1) any fund that would be an investment but for the exemptions provided by § 3(c)(1) or § 3(c)(7) of the Investment Company Act of 1940, and (2) any similar fund as the applicable regulators may determine.

102. For an opinion analyzing the challenging question of whether a novel financial instrument should be considered a futures contract or a security, see *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537 (7th Cir. 1989). See also *Board of Trade v. SEC*, 187 F.3d 713 (7th Cir. 1999).

103. See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

104. Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000), codified in various sections of the Commodity Exchange Act (7 U.S.C. §§ 1–27f) and the securities laws (15 U.S.C. §§ 77a–77z-3).

105. Pub. L. No. 111-203, H.R. 4173, 111th Cong. (2d Sess. 2010).

106. CEA § 1a(47), 7 U.S.C. § 1a(47). This broad definition of *swap* includes: (1) any form of option for the transfer of a thing of value or that tracks the value of that thing; (2) any agreement where performance depends on a contingency associated with a potential financial, economic, or commercial consequence; (3) any agreement calling for payment based on the value or level of a referenced thing but without entitling either party to ownership of the thing; or (4) any other instrument “commonly known to the trade” as a swap.

and “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.”¹⁰⁷

II.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,¹⁰⁸ 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. The Uniform Securities Act (USA), designed to bring uniformity to state regulation of securities, imposes registration requirements for broker-dealers and their agents, investment advisers, as well as securities offerings.¹⁰⁹ The USA has been substantially or partially adopted in more than thirty states.

Prior to 1996, 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. With the enactment of the National Securities Markets Improvement Act (NSMIA) in 1996,¹¹⁰ Congress preempted a significant portion of state regulation of securities offerings. The NSMIA bars states from regulating offerings of securities 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, §§ 3 and 4. States remain free to bring antifraud proceedings, require filing of notices, and collect transaction fees.

107. *Id.* § 1a(47)(B), 7 U.S.C. § 1a(47).

108. The term “blue sky” has many possible origins. For example, the Kansas legislature was said to have been spurred by the fear of fast-talking, eastern industrialists selling everything including the blue sky. And as stated in an early Supreme Court opinion, the state securities laws were designed to prevent “speculative schemes which have no more basis than so many feet of ‘blue sky.’” *Hall v. Geiger-Jones*, 242 U.S. 539, 550 (1917). Another suggested meaning came from one of the drafters of the Kansas securities law harkening back to rain makers when referring to the securities statute as a “blue sky” law. See Rick A. Fleming, *100 Years of Securities Law: Examining a Foundation Laid in the Kansas Blue Sky*, 50 Washburn L.J. 583, 584–86 (2011).

109. For the most recent version of the Uniform Securities Act, as recommended by the National Conference of Commissioners on Uniform State Laws, see <https://www.uniformlaws.org/committees/community-home?CommunityKey=8c3c2581-0fea-4e91-8a50-27eee58da1cf>.

110. Pub. L. No. 104-290, 110 Stat. 3416, 104th Cong. (1996).

Section 15(h) of the Securities Exchange Act of 1934¹¹¹ 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 exempt from state regulation.¹¹² Investment advisers with less than \$25 million under management and regulated by their home states are 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 § 14,¹¹³ which regulates the solicitation of proxies in connection with shareholder meetings; § 16,¹¹⁴ which imposes liability on officers, directors, and large shareholders for their profits on short-swing trading in the corporation's shares; and § 10(b), which imposes liability for a variety of fraudulent or deceptive acts.¹¹⁵ Another example is SEC Rule 10b-5,¹¹⁶ which also imposes liability for fraudulent or deceptive acts.

Many state laws regulate corporate takeovers, generally imposing greater obstacles to such takeovers than are found in the federal Williams Act.¹¹⁷ The validity of such laws under the Supremacy Clause and the Commerce Clause has been considered in a number of cases.¹¹⁸ The state takeover laws that have passed constitutional scrutiny 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.¹¹⁹ Even without an exemption, traditional insurance policies and annuities would not likely be deemed securities. However, the Supreme Court held that when insurance companies issue "variable" annuities or insurance policies in which the rate of return varies

111. 15 U.S.C. § 78o.

112. See Investment Advisers Act § 203A, 15 U.S.C. § 80b-3a.

113. 15 U.S.C. § 78n.

114. *Id.* § 78p.

115. *Id.* § 78j(b).

116. 17 C.F.R. § 240.10b-5.

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

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

119. 1933 Act § 3(a)(8), 1934 Act § 3(a)(10), 15 U.S.C. §§ 77c(a)(8) & 78c(a)(10).

with the profitability of an investment portfolio, such instruments are securities subject to the provisions of the federal securities laws.¹²⁰

The financial crisis that emerged in 2008 triggered many proposals for increased regulation of financial institutions. As noted earlier, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 introduced heightened regulation of financial institutions. As a result, new landscape for the regulation of banking institutions has emerged.

120. See *SEC v. Variable Annuity Life Ins. Co.*, 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 § 3(a)(8) of the 1933 Act.



Regulating Distribution of Securities: Securities Act of 1933

III.A

Structure of 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. Here is the basic “road map” for determining whether a transaction falls under the statute. 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 § 3. Section 4 lists certain transactions that are exempt, even if the security itself does not qualify for a § 3 exemption. In addition, pursuant to § 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 § 5, which also establishes limitations on offers and sales. Sections 6 and 8 set forth the procedure for registration; §§ 7 and 10 list the disclosure requirements. If any of these sections are violated, there are civil liabilities under §§ 11 and 12. Additionally, there is a general antifraud provision regulating these transactions in § 17, violation of which may result in SEC or criminal prosecution.

III.B

Registration Process Under 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 “pre-filing” 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.¹²¹ The “post-effective” period starts at the effective date of the registration statement. 1933 Act § 8 provides that the registration statement becomes effective twenty days from the date of the original filing or of the filing of the most recent amendment, whichever is last.

Section 5 limits the type of selling efforts that may be used and puts various restrictions on the dissemination of information throughout the registration process.¹²² 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.

In 2005 the SEC introduced several reforms to its public offering rules.¹²³ The reforms were an attempt to bring the rules in line with current practices and with technological developments. Among other things, these offering reform rules relaxed the restrictions on offers for larger public companies known as Well-Known

121. 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 § 8, the effective date of deficient registration statements can be delayed by a stop order or refusal order. Formal § 8 orders are the exception, since the SEC generally responds to deficient registration statements with a letter of comment suggesting changes. The prospective issuer often files a delaying amendment, putting off the effective date until the deficiencies are corrected. When appropriate, the effective date can be accelerated (*see* SEC Rule 461).

122. By virtue of §§ 4(a)(1) and 4(a)(4) of the 1933 Act, § 5 does not apply to transactions not involving issuers, underwriters, and dealers; nor does § 5 apply to unsolicited brokers' transactions.

123. *See* Securities Offering Reform, Securities Act Release No. 33-8591; Exchange Act Release No. 34-52056; Inv. Co. Act Release No. IC-26993, 70 Fed. Reg. 44722-01, 2005 WL 1811282 (SEC Aug. 3, 2005).

Seasoned Issuers (“WKSIs”).¹²⁴ Another important innovation was the SEC’s “access equals delivery” rule under which providing investors with a link to a website where the prospectus can be found will satisfy the 1933 Act’s prospectus delivery requirements.¹²⁵

The Jumpstart Our Business Startups Act (JOBS Act)¹²⁶ introduced provisions to decrease some of the disclosure obligations of emerging growth companies. An emerging growth company is an issuer with less than \$1 billion in annual gross revenue during its most recent fiscal year.¹²⁷ The JOBS Act added a provision permitting pre-filing research reports for emerging growth companies.¹²⁸ Emerging growth companies may submit a draft registration to the SEC on a confidential basis. Fifteen days after the public filing of the registration statement, emerging growth companies may conduct road shows.¹²⁹ Emerging growth companies can take advantage of what is referred to as an on-ramp for initial public offerings (IPOs) that eases or eliminates some of the more burdensome disclosure and reporting requirements for up to five years after the company’s IPO. The on-ramp for emerging growth companies provides significant relief from 1934 Act obligations that otherwise would apply.¹³⁰

124. As defined in SEC Rule 405 (17 C.F.R. § 230.405), a WSKI is a company that qualifies for registration on 1933 Act Form S-3 or F-3 and either (1) as of a date within 60 days of the determination date, has a worldwide market value of its outstanding voting and nonvoting common equity held by nonaffiliates of \$700 million or more; or (2a) as of a date within 60 days of the determination date, has issued in the last three years at least \$1 billion aggregate principal amount of nonconvertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Act; and (2b) will register only nonconvertible securities, other than common equity, and full and unconditional guarantees permitted under paragraph (1)(ii) of the WSKI definition unless, at the determination date, the issuer also is eligible to register a primary offering of its securities relying on General Instruction I.B.1 of Form S-3 or Form F-3.

125. See, e.g., Rule 173, 17 C.F.R. § 230.173, which provides that notice of the availability of a statutory prospectus will satisfy § 5(b)’s prospectus delivery requirement. See also Rule 172(b), 17 C.F.R. § 230.172(b).

126. Jumpstart Our Business Startups Act § 106(a), H.R. 3606, 112 Cong. 2d Sess. (2012).

127. 1933 Act § 2(a)(19), 15 U.S.C. § 77b(a)(19); 1934 Act § 3(a)(80), 15 U.S.C. § 78c(a)(80).

128. 1933 Act § 2(a)(3), 15 U.S.C. § 77b(a)(3).

129. *Id.* § 6(e)(1), 15 U.S.C. § 77f(e)(1). In 2016 Congress shortened the period when the emerging growth company may conduct road shows after public filing of a registration statement that had been filed confidentially from 21 to 15 days after having filed the registration statement publicly. 15 U.S.C. § 6(e) as amended by the Fixing America’s Surface Transportation Act (the “FAST Act”), 325; Pub. L. No. 114-94, Div. G, Title LXXVI, § 76001(a), 129 Stat. 1787 (Dec. 4, 2015).

130. For example, during the years following the IPO, emerging growth companies are excused from detailed, executive pay disclosures and the non-binding, “say on pay” votes that are required for larger companies; compliance with new accounting standards; and future mandates that firms rotate auditors.

III.B.1

Going Public

The 1933 Act's public offering provisions are based on a paradigmatic offering process. The typical sequence of the movement of the securities being offered from the issuer to the public looks like this:

ISSUER → UNDERWRITERS → DEALERS → PUBLIC

Of course, not every securities distribution follows this pattern, but it is the one on which the definitions and restrictions of the 1933 Act are based. The basic public offering provisions of the 1933 Act are discussed directly below, starting with the heart of the Act, § 5's provisions.

Traditionally, there have been three basic varieties of negotiated underwriting arrangements in the securities industry: strict underwriting, firm-commitment underwriting, and "best efforts" underwriting. Other underwriting arrangements have developed, but these three are still among the most common. In recent years, direct listings have become more popular. A direct listing does not use an underwriter; instead, the company's shares are listed on an exchange, where they begin trading. Underwritten offerings remain the most common in the U.S. markets.

Strict Underwriting. Also known as "old-fashioned" or "stand by" underwriting, strict underwriting is insurance in its strictest sense. Instead of using an investment banker as an agent to resell the securities to the public, the issuer turns to an "insuring house" for the securities being offered. The strict underwriting method is relatively rare in the United States.

Firm-Commitment Underwriting. The second type and most common arrangement in the United States is firm-commitment underwriting. Under a typical firm commitment agreement, the issuer sells the entire allotment outright to a group of securities firms represented by one or more managers, managing underwriters, or principal underwriters. The underwriting group, headed by the managing or principal underwriters, agrees to purchase the securities from the issuer. Typically, the principal underwriters will sign the firm-commitment underwriting agreement. These managers or principal underwriters, in turn, contact other broker-dealers to become members of the underwriting group; these broker-dealers will act as wholesalers of the securities to be offered. In many instances, the securities distribution network will include the use of a selling group of other investment bankers or brokerage houses. Members of the selling group generally do not share the underwriters' risk and are thus retailers who are compensated with agents' or brokers' commissions rather than by sharing in the underwriting fee.

Best Efforts Underwriting. The third basic type of underwriting arrangement used in the United States is known as “best efforts” underwriting. Its defining feature is that the underwriter is not at risk if investors do not purchase the entire allotment being offered to the public. Rather than buying the securities from the issuer for resale to the public, the investment banker or brokerage firm sells them for the issuer merely as an agent.

SPAC Offerings. Over the past decade there has been a dramatic increase in public offerings for blank check companies known as SPACs (special purpose acquisition companies). A blank check company is one where investors commit their funds to a company and give the managers a blank check to decide how to invest those funds. A SPAC is a blank check company that will be used to acquire a yet-to-be-determined privately held company in order to make the privately held company publicly held. A SPAC public offering will have minimum disclosures unless the company plans to target particular industries. When a privately-held target company has agreed to a merger with a publicly held SPAC, the SPAC shareholders will ordinarily get to vote on the acquisition. A SPAC allows a privately held company to go public with much less advance disclosure than would exist in a traditional initial public offering. SPACs have led to some lawsuit filings. As the number of SPAC offerings increases, so will the number of lawsuits.

III.B.2

Operation of Section 5

How does § 5 work? As noted above, § 5 divides the registration process into three parts: the pre-filing period, the waiting period, and the post-effective period. Section 5(a)(1) prohibits the use of the mails or other facilities of interstate commerce to sell a security prior to the effective date of the 1933 Act registration statement.¹³¹ Taken literally, § 5(a)(1)’s language could be read to include merely making offers to sell. But when § 5(a)(1) is read in conjunction with §§ 5(b) and 5(c), it is clear that § 5(a)(1) was designed to prevent the use of the mails or other instrumentalities to make a binding contract (as opposed to something less binding or formal, including a simple offer to sell). Section 5(a)(1)’s prohibitions cover the use of the mails, “through the use or medium of any prospectus or otherwise.”¹³² The Act defines prospectus to include a written offer to sell,¹³³ and § 5(b)(1)¹³⁴ expressly allows the use of certain forms of prospectuses during the waiting period.

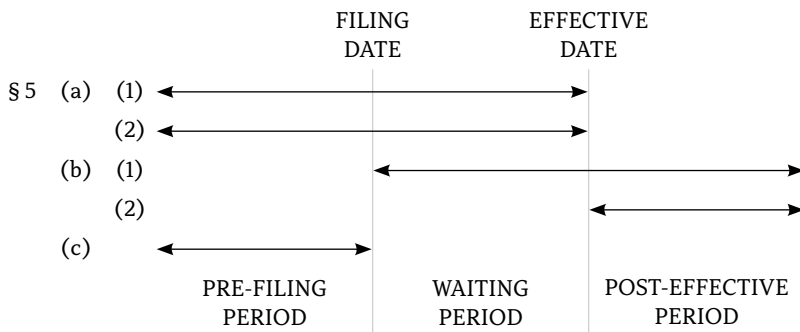
131. 15 U.S.C. § 77e(a)(1).

132. *Id.*

133. *Id.* § 2(a)(10).

134. *Id.* § 77e(b)(1).

Section 5(a)(2)¹³⁵ prohibits the delivery of any security for sale unless a registration statement is in effect, extending its prohibitions into the waiting period. Section 5(b)¹³⁶ imposes prospectus requirements and thereby prescribes the types of prospectuses that may be used for offers during the waiting period and for offers and sales during the post-effective period. Section 5(c),¹³⁷ which is the broadest in prohibitions, applies only to the pre-filing period. The following diagram shows how § 5 works:



Section 5(c) prohibits all offers to sell and all offers to buy prior to the filing of a registration statement. This necessarily includes oral as well as written offers. Section 5(c) contains the only prohibition on oral offers and is also the only restriction on offers to buy. Since it covers both offers to sell and offers to buy securities, § 5(c) would seem applicable to negotiations between issuers and underwriters. However, as discussed later, 1933 Act § 2(a)(3)¹³⁸ expressly provides an exclusion from the definition of offer to sell for preliminary negotiations between an issuer and an underwriter or among underwriters in privity with the issuer. Without such an exclusion, it would be impossible to negotiate a public offering, as the issuer would have to file the registration statement before even establishing either the terms of the offering or the underwriting agreement. The exclusion of preliminary underwriter negotiations and agreements is a major exception to the pre-filing prohibitions. (But as will be seen later, even beyond this exclusion for preliminary underwriting negotiations and agreements, limited, pre-filing publicity is permissible.¹³⁹) Section 5(c)'s prohibition¹⁴⁰ on offers

135. *Id.* § 77e(a)(2).

136. *Id.* § 77e(b).

137. *Id.* § 77e(c).

138. *Id.* § 77b(a)(2).

139. *See, e.g.*, 17 C.F.R. § 230.135.

140. 15 U.S.C. § 77e(c).

operates during the pre-filing period, and violations of these “quiet period” limitations have come to be known as illegal “gun jumping.”

By virtue of § 5(b),¹⁴¹ all written offers or prospectuses must conform with the statutory prospectus requirements. Section 2(a)(10) of the 1933 Act¹⁴² defines prospectus to include any written offer to sell¹⁴³ in addition to offers made over radio or television.¹⁴⁴ Accordingly, oral offers to sell are not covered by § 5(b) nor are offers to buy, whether oral or in writing. Oral offers to sell and all offers to buy are thus unregulated during the waiting period; they are also unregulated during the post-effective period. Sections 10(a) and 10(b) of the 1933 Act¹⁴⁵ set out the requirements for permissible written offers during both the waiting and post-effective periods.

III.B.3

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.¹⁴⁶ An offer to sell is any communication reasonably calculated to generate a buying interest.¹⁴⁷ 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. Communications by issuers more than 30 days

141. *Id.* § 77e(b).

142. *Id.* § 77b(a)(10).

143. Although not expressly covered by the statute, computer email, computer disks, and other digitally encoded communications would appear to and certainly should fall within the definition of prospectus.

144. The definition as adopted in 1933 was patterned on the British Companies Act of 1929. See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 599–600 (1995) (Ginsburg, J., dissenting).

145. 15 U.S.C. § 77j(a), (b).

146. *Id.* § 77e(c).

147. *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 prefiling 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 § 5(c). Subsequently, the SEC, recognizing the informational tensions at issue, amended one of its rules to address prefiling 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.

before filing a registration statement would not be considered prohibited offers so long as they did not reference a securities offering.¹⁴⁸

As noted above, the JOBS Act introduced a “testing the waters” process for emerging growth companies. Section 5(d) of the 1933 Act allows the issuer and underwriters to test the waters by contacting qualified institutional buyers (“QIBs”) and accredited institutional investors to determine if there is sufficient investor interest before filing a registration statement for an emerging growth company.¹⁴⁹ In 2019 the SEC expanded the testing the waters procedure to all 1933 Act registrations so long as the investors solicited are reasonably believed to be QIBs or accredited institutional investors.¹⁵⁰

Balanced against the desire to prevent “gun jumping” as expressed by the prohibitions of § 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.¹⁵¹ Therefore, there are various exemptions from § 5(c)’s prohibitions in the prefiling period. For example, SEC Rule 163¹⁵² exempts prefiling communications by large public companies from § 5(c)’s gun-jumping prohibitions. SEC Rules 137, 138, and 139¹⁵³ (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.¹⁵⁴ 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 § 5 of the 1933 Act. These exemptions are conditioned on certain protective requirements, including that the issuer of the recommended securities be sufficiently large and

148. See Rule 163A, 17 C.F.R. § 230.163A.

149. 15 U.S.C. § 77e(d).

150. 17 C.F.R. § 230.163B. See *Solicitations of Interest Prior to a Registered Public Offering*, Securities Act Release No. 33-10699, 2019 WL 4693560 (SEC Sept. 25, 2019).

151. 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).

152. 17 C.F.R. § 230.163 (exemption from § 5(c) for communications on behalf of well-known seasoned issuers).

153. *Id.* §§ 230.137, 230.138, 230.139.

154. 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. 15 U.S.C. §§ 78m, 78o.

subject to reporting requirements (which ensure that there is adequate 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 § 5 (unless, of course, some other exemption could be found).

The definition of *offer to sell* under 1933 Act § 2(a)(3)¹⁵⁵ 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.¹⁵⁶ Thus press releases and other announcements about a company or its securities can violate § 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.¹⁵⁷

To permit the formation of the underwriting agreement, § 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. The final underwriting agreement usually is not executed until the eve of the offering, and generally only a letter of intent is signed at the prefiling stage.

Section 5(a)¹⁵⁸ of the 1933 Act prohibits sales before 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.

155. *Id.* § 77b(a)(3).

156. *In re Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. 843 (1959) (discussed *supra* note 147). 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).

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

158. 15 U.S.C. § 77e(a).

Rule 169 provides a safe harbor for “factual business information” that is not directed to investors but is issued as part of the company’s ordinary business. So for example, product advertisements are protected by the safe harbor. Rule 169’s safe harbor applies to non-reporting companies as well as to reporting companies. 1934 Act reporting companies are given a broader safe harbor in Rule 168,¹⁵⁹ which permits the dissemination of not only factual information but also forward-looking information. Rule 168’s safe harbor for reporting companies applies only if “the timing, manner, and form in which the information is released or disseminated is consistent in material respects with similar past releases or disseminations” and also excludes from the safe harbor communications “containing information about the registered offering or released or disseminated as part of the offering activities in the registered offering.”¹⁶⁰ As is the case with Rule 169, Rule 168’s safe harbor does not apply to communications made as part of the offering and is limited to the types of information the company had made in the past. The safe harbors in Rules 168 and 169 apply both to § 5(c) gun jumping and to § 5(b) information during the waiting and post-effective periods because the rules refer to § 2(a)(10)’s definition of prospectus as well.

III.B.4

Waiting Period

The waiting period begins once the registration statement has been filed and ends when the registration statement becomes effective. While § 5(c)’s prohibitions on offers to sell and buy no longer apply after the prefiling period, § 5(a)’s prohibitions on sales of securities continue through the waiting period. In addition, § 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 § 2(a)(10),¹⁶¹ 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 online

159. *Id.* § 230.168.

160. 17 C.F.R. § 230.169.

161. 15 U.S.C. § 77b(a)(10).

communications qualify as prospectuses.¹⁶² A written confirmation of a sale is expressly included in the statutory definition of a prospectus.¹⁶³

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 § 5 permits offers during the waiting period, written offers must meet certain requirements. Thus § 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 § 10.¹⁶⁴ The information called for by § 10, however, may not be available until the underwriting agreements have been signed and the offering price set. The 1933 Act solves this problem by exempting from this path two types of written offering material: a type of identifying statement often referred to as a “tombstone ad”¹⁶⁵ and the preliminary prospectus (discussed below).

Although offers to buy are permissible (since § 5(c) does not apply during the waiting period), an offer to buy that leads to a premature or otherwise illegal sale violates § 5(a). By virtue of § 10(b), which permits certain prospectuses during the waiting period, and § 2(a)(10), which excludes certain communications from the definition of *prospectus*, there are five 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 § 5(a)).¹⁶⁶ Since an oral communication is not “permanent,” it is excluded from the § 2(a)(10) definition of *prospectus*.

Second, an identifying statement, as defined in § 2(a)(10)(b) and Rule 134,¹⁶⁷ 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* if the requirements of Rule 134 are met. Inclusion of any infor-

162. Information in emails and on websites 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.*

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

164. 15 U.S.C. § 77e(b)(1). See 15 U.S.C. § 77j.

165. A tombstone ad is the industry term for an identifying statement that simply announces the offering and lists the underwriter. 17 C.F.R. § 240.10b-5.

166. 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 § 5 implications, oral offers to sell are, of course, subject to the securities acts' general antifraud provisions.

167. 15 U.S.C. § 77b(a)(10)(b); 17 C.F.R. § 230.134.

mation not specifically permitted by Rule 134 renders the rule unavailable and thus may result in a prospectus that fails to comply with § 10's requirements. This, in turn, can result in a violation of § 5.

Third, a preliminary (or red herring) prospectus, as defined in Rule 430,¹⁶⁸ 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 preliminary prospectus may be used only during the waiting period; it may not be used after the effective date.

Fourth, a preliminary summary prospectus, as defined in Rule 431,¹⁶⁹ 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 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 § 5(b)(1);¹⁷⁰ it does not satisfy § 5(b)(2).¹⁷¹ Thus, when a Rule 431 prospectus is used, a “full-blown” (or “statutory”) § 10(a) prospectus must still be delivered to all purchasers. This necessarily increases the record-keeping and monitoring activities of the underwriters.

Fifth and finally, the “free writing prospectus” is a document that may be used during the waiting period,¹⁷² and it allows companies to supplement the information in the prospectus with additional information.¹⁷³ Except for larger public companies, the free writing prospectus must be filed with the SEC.

168. 17 C.F.R. § 230.430.

169. *Id.* § 230.431.

170. Section 5(b)(1) requires any written offer or confirmation to comply with § 10; a summary prospectus is valid for this purpose under § 10(b). 15 U.S.C. § 77e(b)(1).

171. 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 § 10(a) “full-blown” prospectus prior to delivery of that security. 15 U.S.C. § 77e(b)(2).

172. WKSIs may use the free writing prospectus during the prefilings period. *See* Rule 163, 17 C.F.R. § 230.163.

173. Rule 164, 17 C.F.R. § 230.164.

III.B.5

Post-Effective Period

Once the registration statement becomes effective, § 5(a)'s prohibitions cease to apply and sales are permitted. Both of § 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 § 10(a) full-blown statutory prospectus or a qualifying § 10(b) prospectus). Section 5(b)(2) provides that no security may be delivered for sale unless accompanied or preceded by a statutory § 10(a) prospectus. In the case of securities held for a customer's account by a broker or other custodian, the customer must still receive the prospectus before delivery.¹⁷⁴

Under § 2(a)(10), "free writing" is permitted in the post-effective period.¹⁷⁵ Thus, supplemental sales information may be sent to prospective purchasers provided that the information is preceded or accompanied by a prospectus that meets the requirements of § 10(a). In such a case, free writing is limited only by the antifraud provisions of the securities laws.¹⁷⁶

III.B.6

Shelf Registration (Rule 415)

SEC Rule 415¹⁷⁷ permits "shelf registration," which allows a corporation to register securities before they are issued. Using Form S-3, a firm can register securities for sale periodically for up to two years. The company has a duty to regularly update the information in Form S-3. Prior to Rule 415, registration of securities was considered effective when the shares were on sale. In fact, holding the shares off the market could be deemed a manipulative practice. With the increasing sophistication of public offerings, delayed or intermittent offerings needed to be accommodated.

174. The SEC has implemented an "access equals delivery" approach to satisfy the prospectus delivery requirement. See *supra* note [125](#) and accompanying text.

175. 15 U.S.C. § 77b(a)(10). This statutory free writing during the post-effective period predates and supplements the free-writing prospectus that is now permitted under Rule 164 during both the waiting and post-effective periods. 17 C.F.R. § 230.164.

176. See also Rules 137, 138, and 139, which deal with broker-dealer recommendations of securities during the registration process. 17 C.F.R. §§ 230.137, 230.138, 230.139.

177. 17 C.F.R. § 230.415.

III.B.7

Allocating Shares in an IPO

Especially when an underwriter expects a large investor demand for an IPO, allocating the shares for distribution can be problematic. Both FINRA and the SEC have guidelines to avoid potential abuses. For example, in addition to applicable FINRA rules,¹⁷⁸ the SEC suggests that underwriters avoid the following during an IPO:

- Inducements to purchase, in the form of tie-in agreements or other solicitations of aftermarket bids or purchases, before distribution is completed.
- Communicating to customers that expressing an interest in buying shares in the immediate aftermarket (“aftermarket interest”) or immediate aftermarket buying would help them obtain allocations of hot IPOs.
- Soliciting customers prior to the completion of the distribution regarding whether and at what price and in what quantity they intend to place immediate aftermarket orders for IPO stock.
- Proposing aftermarket prices to customers or encouraging customers who provide aftermarket interest to increase the prices that they are willing to place orders in the immediate aftermarket.
- Accepting or seeking expressions of interest from customers that they intend to purchase an amount of shares in the aftermarket equal to the size of their IPO allocation (“1 for 1”) or intend to bid for or purchase specific amounts of shares in the aftermarket that are pegged to the allocation amount without any reference to a fixed total position size.
- Soliciting aftermarket orders from customers before all IPO shares are distributed or rewarding customers for aftermarket orders by allocating additional IPO shares to such customers.
- Communicating to customers, in connection with one offering, that expressing an interest in the aftermarket or buying in the aftermarket would help them obtain IPO allocations of other hot IPOs.¹⁷⁹

178. FINRA Rules 5130 and 5131, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5130>, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5131>.

179. Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations, Sec. Act Release No. 33B8565, Sec. Exchange Act Release No. 34-51500, Inv. Co. Act Release No. IC-26828, 70 Fed. Reg. 19672-01, 2005 WL 836562 (SEC Apr. 13, 2005).

III.B.8

Market Transactions After an IPO

Once the registration statement is effective, the shares covered by the registration statement will start trading in what is known as the aftermarket. Especially in the case of IPOs, there is potential for manipulation and other prohibited practices. The desire to raise the capital targeted by an initial public offering creates an incentive to not overprice the securities being offered lest there be a soft reception in the market. One possible response to the fear of not raising sufficient funds is to condition the offering on a certain number of shares being sold. In these part-or-none or all-or-none offerings, the offering will be cancelled unless the issuer and underwriters are able to sell the minimum number of shares specified. These conditional offerings present their own disclosure problems as well as the increased temptation for manipulation in order to try to assure that the conditions will be triggered so the offering can proceed. SEC Regulation M permits price stabilization under very limited circumstances.¹⁸⁰

The incentive not to overprice the securities covered by the registration statement often results in the initial demand exceeding the supply of shares covered by the initial offering. In such a case, the trading in the aftermarket will be at a price that exceeds the initial offering price. The benefit of the increased aftermarket price does not inure to the issuer, but rather results in profits for investors who purchased at the initial offering price.

Impermissible price stabilization can become a problem in securities offerings that appear in a soft market. And the potential for manipulation arises in a bull market for the securities in distribution, also known as a “hot issue.” When the offering is oversubscribed, there is usually little doubt that once the stock begins to trade publicly in the aftermarket it will exceed the original offering price. In the case of such a hot issue there is great potential for abuse. For example, there may be the temptation to create the false appearance of a hot issue in order to create additional buying demand and upward price pressure.

The SEC has pointed out a number of legal consequences of questionable, IPO-related activities. Any arrangements regarding “workouts” (i.e., “dribbling” or allowing securities, over a slow period of time, into the market by withholding them from the market), special allotments of securities or the creation of trading firms to be used as “market-makers” must be disclosed in detail on the registration statement. It is common for underwriters in IPOs to act as market-makers in the aftermarket. Any trading firms would clearly fall within the category of

180. Regulation M, 17 C.F.R. §§ 242.100–105.

“underwriter” under 1933 Act § 2(a)(11). Another problem associated with hot issues is the practice of “free riding,” whereby a subscriber to the offering hopes to resell at a premium but plans to withdraw the order if the “temperature” seems to go down before allotment. Free riding clearly falls within the purview of manipulative conduct. Broker–dealer complicity in a free riding scheme violates the securities laws.

Two other prohibited manipulative practices can occur in connection with hot issues. A brokerage firm might unduly encourage its registered representatives to generate customer purchases by giving salespersons a higher commission for transactions in which the customer purchases, rather than sells, the securities in question. Especially if undisclosed to the customer, this type of compensation for trades encourages the creation of more purchases than sales. Another practice, known as “laddering,” is to pre-sell the offering in the aftermarket. Laddering generates additional aftermarket buying activity that is manipulative, in that it is designed to push the price higher once the security comes to market. FINRA’s IPO practices rules outlaw specified conduct in connection with a public offering.¹⁸¹ For example, the prohibited conduct includes allocating IPO shares to persons related to the issuer or underwriter, participating in flipping and spinning (allocating shares to customers who plan to quickly resell their shares).

III.C

Disclosure Requirements in Securities Offerings

III.C.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. Alternative disclosure forms may be available to issuers for registration, depending on the nature of the issuer, the circumstances surrounding the offering, and the type or types of securities offered. All registration forms are divided into two principal parts. The information contained in the first portion of the registration statement is the same information in the prospectus as required by § 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

181. FINRA Rule 5130, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5130>, and Rule 5131, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5131>.

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 and S-X. Regulation S-K describes in detail the ways in which the relevant information should be set forth. Companies with less than \$75 million in public equity float¹⁸² now qualify for scaled disclosure requirements under Regulation S-K, as amended—and under the applicable 1933 and 1934 Act forms, as amended. Companies that do not have a calculable public equity float qualify for scaled disclosure if their revenues were below \$50 million in the previous year. Regulation S-B formerly provided simplified disclosures for use, in certain instances, by small business issuers. In 2007 the SEC eliminated Regulation S-B and the specialized forms.¹⁸³ The SEC also redefined the concept of small business issuers so that more companies could qualify for the new “scaled disclosure requirements” available under both the 1933 and 1934 Acts for smaller reporting companies. 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 system for registration of securities under the 1933 Act. The three-tiered system of registration and prospectus disclosure of registrant-oriented information¹⁸⁴ is based on the registrant's reporting history and market following. Two registration forms—S-1¹⁸⁵ and S-3¹⁸⁶—provide the basic framework for this system.

182. Public float refers to the number of shares held by public shareholders that may be traded publicly (as contrasted with privately held shares that are not freely resalable in the public markets).

183. See Smaller Reporting Company Regulatory Relief and Simplification, Securities Act Release No. 33-8876, Exchange Act Release No. 34-56994, Trust Indenture Act Release No. 39-2451, 2007 WL 4440393 (SEC Dec. 19, 2007). The SEC issued a guide for small business issuers to help them through the revised Regulation S-K and applicable forms. See *Changeover to the SEC's New Smaller Reporting Company System by Small Business Issuers and Non-Accelerated Filer Companies: A Small Entity Compliance Guide*, available at <http://www.sec.gov/info/smallbus/secg/smrepcosysguid.pdf> (SEC Jan. 25, 2008).

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

185. 17 C.F.R. § 239.11.

186. *Id.* § 239.13.

Form S-1 is the basic long-form registration generally available to issuers that do not qualify for one of the other forms.¹⁸⁷ Form S-1 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.¹⁸⁸

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. It may only be used for certain kinds of offerings—secondary offerings—where the registrant passes the “market following” test. 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.

In examining completed registration statements, the SEC has pinpointed a number of areas particularly susceptible to inadequate or misleading disclosures.¹⁸⁹ For example, shortcomings in management’s statements have led to requirements¹⁹⁰ 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

187. Specialized registration forms geared toward more specific situations include Form S-4 for certain mergers and other business combinations involving public companies (17 C.F.R. § 239.25); Form S-6 for registration of securities or units in certain investment trusts (17 C.F.R. § 239.16); Form S-8 for employee stock purchase plans (17 C.F.R. § 239.16b); and Form S-11 for securities issued by certain real estate investment companies (17 C.F.R. § 239.18).

188. The SEC rescinded Form S-2 (formerly available for smaller public companies). Public companies not qualifying for Form S-3 can use Form S-1 to take advantage of integrated disclosure with 1934 Act requirements.

189. See, e.g., *In re Universal Camera Corp.*, 19 S.E.C. 648 (1945). 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).

190. See Items 101(a)(2), 101(c)(x), and 506 of Regulation S-K, 17 C.F.R. §§ 229.101(a)(2), 229.101(c)(x), and 229.506.

resulting from the disparity between the prices paid for the company's securities by public investors and those paid by "insiders."

III.C.2

Adequacy of Registration Statement Disclosures

The registration statement must include all material facts. For the purposes of a 1933 Act registration statement, Rule 405¹⁹¹ defines *material* as "matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered." This definition encompasses, but is not limited to, financial information.¹⁹² Under § 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.

SEC policy encourages disclosure beyond its mandatory disclosure requirements,¹⁹³ 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 the issuer 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.¹⁹⁴

191. 17 C.F.R. § 230.405.

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

193. In its early years, however, 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).

194. *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).

Section 27A of the 1933 Act¹⁹⁵ and § 21E of the 1934 Act¹⁹⁶ codify the earlier case law and provide a safe harbor for forward-looking statements and the “bespeaks caution” doctrine created by the 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 basis¹⁹⁷ for the projections.¹⁹⁸ The “bespeaks caution” doctrine provides that specific cautionary language can render inaccurate projections not actionable.¹⁹⁹ 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.²⁰⁰

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

195. 15 U.S.C. § 77z-2.

196. *Id.* § 78u-5(c).

197. See, e.g., *In re 2TheMart.com, Inc. Sec. Litig.*, 114 F. Supp. 2d 955 (C.D. Cal. 2000) (projections that online auction site would soon be operational lacked reasonable basis where there were no agreements to design or construct site).

198. See SEC Rules 175 and 3b-6, 17 C.F.R. §§ 230.175, 240.3b-6. The Private Securities Litigation Reform Act of 1995 (Pub. L. No. 104-67, 109 Stat. 737, H.R. 1058, 104th Cong. (1995)) 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), *aff’d* 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.*, No. CV97-4320-GHK(CWX), 1997 WL 809750 (C.D. Cal. Nov. 26, 1997) (plaintiffs adequately alleged existence of facts contradicting optimistic projections).

199. 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 & Assocs. 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. *N2K*, 202 F.3d 81 (sufficient cautionary language that financial performance might fall below analysts’ expectations).

200. Item 303 of Regulation S-K, 17 C.F.R. § 229.303 (management discussion and analysis). See also *Iowa Pub. Emps.’ Ret. Sys. v. MF Global, Ltd.*, 620 F.3d 137 (2d Cir. 2010) (rejecting application of “bespeaks caution” doctrine to statement containing both historical and forward-looking elements).

III.D

Exemptions from Registration Under 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 § 3,²⁰¹ while “transaction” exemptions are generally covered by § 4²⁰² and various SEC rules promulgated under §§ 3, 4, or 28.²⁰³ 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 during a planned exempt transaction can destroy the entire exemption.²⁰⁴ The consequences of losing an exemption are dire, ranging from § 12(a)(1)²⁰⁵ liability for rescission of any sale to possible criminal liability.

Many of the exemptions from registration are extremely detailed. The discussion that follows is a summary of the most common exemptions.²⁰⁶

III.D.1

Exempt Securities

Section 3 of the 1933 Act authorizes exemptions from § 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.²⁰⁷

201. 15 U.S.C. § 77c.

202. *Id.* § 77d.

203. Section 28 of the 1933 Act gives the SEC broader exemptive power than is found in § 3 or § 4 of the Act. 15 U.S.C. § 77z-3. 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. The SEC had relied on this broad exemptive power, which was used sparingly until it relied on § 28 to expand the Regulation A, Rule 504, and crowdfunding exemptions from registration.

204. *But see* SEC Rule 508, 17 C.F.R. § 230.508, 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.

205. 15 U.S.C. § 77l.

206. For details, *see* 1-2 Hazen, *supra* note [11](#), Chapter 4.

207. 15 U.S.C. § 77c(a)(2).

Section 3(a)(3) exempts short-term commercial paper from registration.²⁰⁸ 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.”²⁰⁹ 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 § 3(a)(4).²¹⁰ Generally, availability of this exemption depends on the ruling of the IRS regarding whether a contribution to the issuing institution is a proper charitable deduction. These *securities* 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.²¹¹

A rather narrow category—interests in railroad equipment trusts—is also exempt from 1933 Act registration by virtue of § 3(a)(6).²¹² Another exemption of relatively narrow applicability is found in § 3(a)(7),²¹³ 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.²¹⁴ 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*.²¹⁵

Although the following five § 3 exemptions—§§ 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

208. *Id.* § 77c(a)(3).

209. H.R. Rep. No. 73-85, at 15 (1933), *supra* note 1.

210. 15 U.S.C. § 77c(a)(4).

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

212. 15 U.S.C. § 77c(a)(6).

213. *Id.* § 77c(a)(7).

214. *Id.* § 77c(a)(8).

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

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.

III.D.1.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 § 3(a)(9),²¹⁶ 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 § 3(a)(10),²¹⁷ again because the transaction is already supervised in a proceeding where the fairness of the exchange is considered.

III.D.1.b

Intrastate Exemption: Section 3(a)(11); Rules 147, 147A

Section 3(a)(11) of the 1933 Act, 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 § 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

216. 15 U.S.C. § 77c(a)(9).

217. *Id.* § 77c(a)(10).

offering,²¹⁸ or (4) resale, so long as the securities have “come to rest” within the state – in other words, provided there have been no out-of-state “downstream” resales.²¹⁹ 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. Prior to the promulgation of Rule 147 in 1974, relatively little judicial precedent and few SEC interpretive releases and rules were available relating to the intrastate exemption. 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 § 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 its income from operations within the state and use substantially all the proceeds of the offering within the state.²²⁰ Furthermore, to retain the exemption, case law requires that the issue come to rest in the hands of state residents.²²¹

Rule 147 provides a “safe harbor” for those hoping to use 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 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.

Rule 147 follows the statute and is limited to issuers “doing business” within the state of the offering. There are four alternative tests to satisfy this requirement of doing business. An issuer is considered to be doing business in the state

218. A general solicitation is likely, however, to trigger state securities law registration requirements.

219. Certain out-of-state downstream resales (i.e., before the securities have “come to rest”) may destroy the intrastate exemption. See 1 Hazen, *supra* note 11, § 4:25.

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

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

if (i) the issuer derives at least 80% of its consolidated gross revenues from operating a business or of real property within such state; (ii) at the end of its most recent semi-annual fiscal period prior to the Rule 147 offering, the issuer has at least 80% of its assets and those of its subsidiaries on a consolidated basis located within the state; (iii) the issuer intends to use and uses at least 80% of the offering's net proceeds from the Rule 147 offering for the operation of a business or of real property, the purchase of real property located in, or the rendering of services within the state; or (iv) a majority of the issuer's employees are based in such state or territory.

Rule 147A is a stand-alone exemption, not subject to the statutory limitations of § 3(a)(11), except to the extent that they are incorporated in the rule.²²² Rule 147A parallels Rule 147 but allows the issuer to be incorporated outside the state of its principal place of business. In addition, Rule 147A permits out-of-state offerees so long as actual purchasers are limited to residents of the state in which the offering is made. Rule 147A's "nature of the purchaser" requirements do not state that all offerees must be residents of the state. In contrast, Rule 147, following § 3(a)(11)'s statutory mandate, requires that the company have a reasonable basis for believing that all offerees are residents of the state. The other requirements for a Rule 147A intrastate offering parallel those in the § 3(a)(11) safe harbor in Rule 147.

Rule 147A was adopted to facilitate intrastate crowdfunding offerings but is not limited to those offerings. It parallels the requirements for § 3(a)(11)'s Rule 147 safe harbor. Unlike Rule 147, Rule 147A is not a safe harbor for § 3(a)(11); it is its own, self-contained exemption. Thus, reliance on Rule 147A's broader provisions (such as incorporation in a state other than the state of the offering or having offers to persons outside of the state) will not allow the company to fall back on the statutory exemption unless all of Rule 147A's provisions are satisfied.

Even a limited number of resales to nonresidents before the issue has come to rest will render the intrastate exemption inapplicable to the entire offering.²²³ In such a case, the resident purchasers can claim that the securities they purchased were sold in violation of § 5, thus giving them a right of rescission under § 12(a)(1) of the Act.²²⁴ 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

222. 17 C.F.R. § 230.147A. Rule 147A is authorized by 1933 Act § 28.

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

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

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.²²⁵ 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 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.

III.D.1.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.²²⁶ Section 3(b) is not self-executing: It requires “enabling rules” developed and promulgated by the SEC. Thus the SEC has the freedom to create the exemptions it believes necessary or appropriate in light of policy considerations. Section 3(b) exemptions are limited to offerings of \$5 million or less except for the Regulation A ceiling that was raised by § 3(b)(2). The exemptions authorized by the § 3(b) include those found in Regulation A, as well as Rule 504 of Regulation D.²²⁷ The SEC had proposed legislation to raise § 3(b)’s ceiling to \$10 million, but the proposal became moot when Congress enacted § 28’s general exemptive authority, which does not place a dollar limit on exemptions. Section 3(b)(1)’s \$5 million ceiling is now supplemented by § 3(b)(2) which enables Regulation A offerings up to \$50 million during any twelve-month period. As discussed below, the SEC used § 28’s general exemptive authority to raise the Regulation A exemption to \$75 million. It also raised the Rule 504 exemption to \$10 million, and § 4(a)(6)’s crowdfunding exemption from \$1 to \$5 million.

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.”²²⁸ The SEC has exercised this power by promulgating Regulation E, which provides an exemption for small business investment companies. By definition, the § 3(c) exemption is not available to the vast majority of public issuers of securities.

Table 1 summarizes the key exemptions for raising capital that are discussed below.

225. *Busch*, 827 F.2d at 657.

226. 15 U.S.C. § 77c(b).

227. 17 C.F.R. §§ 230.501–230.508.

228. 15 U.S.C. § 77c(c).

Table 1: Key Exemptions for Raising Capital

Type of Offering	Offering Limit within 12-month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Section 4(a)(2)	None	No	None	Transactions by an issuer not involving any public offering. See <i>SEC v. Ralston Purina Co.</i>	None	Yes, Restricted securities	No
17 CFR 230.506(b) ("Rule 506(b)" of Regulation D)	None	No	"Bad actor" disqualifications apply	Unlimited accredited investors Up to 35 sophisticated but non-accredited investors in a 90-day period	17 CFR 239.500 ("Form D")	Yes, Restricted securities	Yes
17 CFR 230.506(c) ("Rule 506(c)" of Regulation D)	None	Yes	"Bad actor" disqualifications apply	Unlimited accredited investors Issuer must take reasonable steps to verify that all purchasers are accredited investors	Form D	Yes, Restricted securities	Yes

Type of Offering	Offering Limit within 12-month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Regulation A: Tier 1	\$20 million	Permitted; before qualification, testing the waters permitted before and after the offering statement is filed	U.S. or Canadian issuers Excludes blank check companies, registered investment companies, business development companies, issuers of certain securities, certain issuers subject to a Section 12(i) order, and Regulation A and Exchange Act reporting companies that have not filed certain required reports. “Bad actor” disqualifications apply No asset-backed securities.	None	Form 1-A, including two years of financial statements Exit report	No	No
Regulation A: Tier 2	\$75 million			Non-accredited investors are subject to investment limits based on the greater of annual income and net worth, unless securities will be listed on a national securities exchange	Form 1-A, including two years of audited financial statements Annual, semi-annual, current, and exit reports	No	Yes

Type of Offering	Offering Limit within 12- month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Rule 504 of Regulation D	\$10 million	Permitted in limited circumstances	Excludes blank check companies, Exchange Act reporting companies, and investment companies “Bad actor” dis-qualifications apply	None	Form D	Yes. Restricted securities except in limited circumstances	No
Regulation Crowdfunding: Section 4(a)(6)	\$5 million	Testing the waters permitted before Form C is filed Permitted with limits on advertising after Form C is filed Offering must be conducted on an internet platform through a registered intermediary	Excludes non-U.S. issuers, blank check companies, Exchange Act reporting companies, and investment companies “Bad actor” dis-qualifications apply	No investment limits for accredited investors Non-accredited investors are subject to investment limits based on the greater of annual income and net worth	Form C, including two years of financial statements that are certified, reviewed or audited, as required Progress and annual reports	12-month resale limitations	Yes
Intrastate: Section 3(a)(11)	No federal limit	Offerees must be in-state residents.	In-state residents “doing business” and incorporated in-state; excludes registered investment companies	Offerees and purchasers must be in-state residents	None	Securities must come to rest with in-state residents	No

III.D.2

Exempt Transactions

III.D.2.a

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

Section 4 of the 1933 Act describes the types of transactions that are exempt from the registration requirements of § 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(a)(1) provides a transaction exemption for persons other than an issuer, underwriter, or dealer. *Issuer* and *dealer* are defined in the 1933 Act²²⁹ 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.²³⁰

Determining who is included in this definition requires substantial interpretation. Underwriter status does not depend 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

229. *Id.* § 77d(1). *Issuer* is defined in § 2(a)(4) as “every person who issues or proposes to issue any security.” *Id.* § 77b(a)(4). *Dealer* is defined in § 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.” *Id.* § 77b(a)(12).

230. *Id.* § 77b(a)(11).

be a statutory underwriter.²³¹ By definition, underwriters include participants in relatively large transactions who may unwittingly become “underwriters” and thus subject to the proscriptions of § 5.²³² The Act’s definition encompasses persons who purchase or otherwise obtain a large amount of securities directly from the issuer (or a control person) and then resell the securities.²³³

It is not enough that the putative underwriter was a significant factor in the transaction. As the Second Circuit explained,

the text, case law, legislative history, and purpose of the statute demonstrate that Congress intended the participation clause of the underwriter definition to reach those who *participate* in purchasing securities with a view towards distribution, or in offering or selling securities for an issuer in connection with a distribution, but not further.²³⁴

Underwriter status attaches when an individual or an entity plays an *essential* role in the distribution of securities.²³⁵

Case law and applicable SEC rules tend to determine investment intent as mostly an objective question of how long the securities are held before resale. Early 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. To try to avoid underwriter status, purchasers often drafted letters of “investment intent” at the time of their purchase. But these letters were deemed mere evidence of intent and not determinative, especially when the stock was held for a

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

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

233. See, e.g., *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969) (defendant purchased securities from issuer); *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960) (defendant-bank accepted stock as collateral, knowing substantial likelihood that loan recipient would default and bank would foreclose and sell stock). Broker-dealers effecting transactions are under a reasonable duty of inquiry to determine if the transaction is by a “control person” or whether it qualifies for the § 4(a)(4) exemption. *World Trade Fin. Corp. v. SEC*, 739 F.3d 1243 (9th Cir. 2014).

234. *In re Lehman Bros. Mortgage-Backed Sec. Litig.*, 650 F.3d 167, 182 (2d Cir. 2011).

235. See *id.* at 177 (emphasis added) (relying on *SEC v. Kern*, 425 F.3d 143, 152 (2d Cir. 2005) and *United States v. Abrams*, 357 F.2d 539, 547 (2d Cir. 1966)). See also *SEC v. Platforms Wireless Int’l Corp.*, 617 F.3d 1072, 1086 (9th Cir. 2010); *In re Refco, Inc. Sec. Litig.*, No. 05 Civ. 8626 (GEL), 2008 WL 3843343, at *4 (S.D.N.Y. Aug. 14, 2008).

short period of time.²³⁶ Older cases indicated that holding securities for two years or more before reselling them is ordinarily sufficient to show that an underwriter had investment intent.²³⁷ Now there is likely to be a shorter holding period. SEC Rule 144 includes a safe-harbor period of one year which is reduced to six months for publicly held companies. It is likely that the courts might be receptive to the one year holding period even outside of Rule 144's safe harbor provisions.

Over time, determining investment intent became, in large part, an objective question of how long the securities are held before resale. The consensus now is that holding the securities for a year or two is ordinarily sufficient to show investment intent.²³⁸ The SEC shortened the safe harbor period in its Rule 144 to one year and six months in the case of a publicly held company.²³⁹

However, passage of time alone will not always 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. This is the appropriate approach because the statute is written in terms of the seller's intent.²⁴⁰

Rule 144 is a commonly used exemption for resale of unregistered securities that otherwise might constitute an illegal unregistered offering. Rule 144 is a safe harbor rule that can be applied to sales by control persons, sales by affiliates²⁴¹ of the issuer, and resales of restricted securities (generally restricted to preserve the original exemption) by nonaffiliates. A control person includes anyone who can directly or indirectly influence management decisions whether through the ownership of voting securities or otherwise.²⁴² As explained below, in many re-

236. *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 insufficient to show investment intent).

237. *See, e.g., United States v. Sherwood*, 175 F. Supp. 480 (S.D.N.Y. 1959).

238. *Id.* at 483 (investment intent shown where defendant held stock for two years).

239. 17 C.F.R. § 230.144.

240. Many corporate and securities lawyers believed the seller's intent 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 the defense in permitting transactions without registration. The availability of the "change of circumstances" defense remains uncertain even in the face of Rule 144's safe harbor.

241. 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." 17 C.F.R. § 230.144(a)(1).

242. "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." Rule 405, 17 C.F.R. § 230.405.

spects Rule 144 applies differently to affiliates as compared to nonaffiliates of the company.²⁴³

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 1934.²⁴⁴
- Second, the seller of the “restricted securities” must have beneficially owned them for at least one year, or six months in the case of a publicly held company.²⁴⁵

As a result of amendments in 2008, the one-year holding period was shortened to six months for securities of a public company filing periodic reports under the 1934 Act.²⁴⁶ 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.²⁴⁷ The full purchase price must be paid for at least one year prior to the sale. The “change in circumstances” defense²⁴⁸ 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.²⁴⁹

- Third, all sales of the issuer’s securities by a Rule 144 seller who is an affiliate of the company and other specified related individuals must comply with prescribed volume limitations.²⁵⁰

243. Affiliates include control persons, officers, and directors of the company. *See* Rule 144, 17 C.F.R. § 230.144. *See also, e.g.*, SEC v. M & A West, Inc., 538 F.3d 1043, 1053 (9th Cir. 2008) (“Where a single transaction accomplishes both a change in status from an affiliate to a non-affiliate and a transfer of stock from that person or entity, the transfer must be viewed as a transfer from an affiliate for the purposes of determining Rule 144(k) eligibility.”).

244. Rule 144(c), 17 C.F.R. § 230.144(c).

245. Rule 144(d), 17 C.F.R. § 230.144(d). When Rule 144 was adopted, the holding period was two years.

246. *See* Revisions to Rules 144 and 145, Securities Act Release No. 33-8869 (SEC Dec. 6, 2007).

247. 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.

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

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

250. Rule 144(e), 17 C.F.R. § 230.144(e).

Specifically, sales by these persons 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 no longer have to comply with this volume limitation. 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.

- Fourth, the sales must be § 4(a)(4) unsolicited brokers' transactions, executed in the usual and customary manner, without special commissions or solicitations.²⁵¹
- Fifth, notice of the Rule 144 sales must be transmitted to the SEC on Form 144²⁵² unless the number of shares to be sold is less than 500 *and* their market value is less than \$50,000.

The SEC summarized the application of Rule 144 to both affiliates and non-affiliates as follows:²⁵³

251. Rule 144(g), 17 C.F.R. § 230.144(g). See 15 U.S.C. § 77d(4).

252. 17 C.F.R. § 230.144.

253. Revisions to Rules 144 and 145, Securities Act Release No. 33-8869, 2007 WL 4270700 (Dec. 6, 2007).

Summary of Rule 144

	Affiliate or Person Selling on Behalf of an Affiliate	Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)
Restricted Securities of Reporting Issuers	<u>During six-month holding period</u> - no resales under Rule 144 permitted. <u>After six-month holding period</u> - may resell in accordance with all Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	<u>During six-month holding period</u> - no resales under Rule 144 permitted. <u>After six-month holding period but before one year</u> - unlimited public resales under Rule 144 except that the current public information requirement still applies. <u>After one-year holding period</u> - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.
Restricted Securities of Non-Reporting Issuers	<u>During one-year holding period</u> - no resales under Rule 144 permitted. <u>After one-year holding period</u> - may resell in accordance with all Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	<u>During one-year holding period</u> - no resales under Rule 144 permitted. <u>After one-year holding period</u> - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.

III.D.2.b

Transactions by Issuer Not Involving Public Offering: Section 4(a)(2)

Section 4(a)(2) of the 1933 Act exempts private placements and other “transactions by an issuer not involving any public offering.”²⁵⁴ 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,²⁵⁵ and judicial scrutiny, the Supreme Court identified four key factors in distinguishing a private offering from a public offering.

First, the number of offerees is an important factor: the fewer the offerees, the greater likelihood that a § 4(a)(2) exemption applies.²⁵⁶ 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 and financial matters, as well as with respect to the particular investment being offered.²⁵⁷ Fourth, the manner of the offering should be limited to offerees who have a privately expressed interest rather than 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.²⁵⁸

III.D.2.c

“Section 4(1½)” Exemption

Section 4(a)(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 otherwise meets the requirements of § 4(a)(2) should be similarly exempt. However, sometimes it is difficult to point to the statutory provision that would provide the

254. 15 U.S.C. § 77d(2).

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

256. See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). The Court expressly refused to adopt a “numbers test” as determinative, however.

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

258. *Hill York Corp. v. American Int’l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971). Although not explicitly required by the cases, as a precaution, each offeree should receive an offering circular containing full disclosure.

equivalent exemption. For example, when the security has not been held for one year (six months in the case of a publicly held company), the Rule 144 exemption is not available. Furthermore, if the sale involves a large block of stock, the § 4(a)(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-action letters,²⁵⁹ interpretive releases,²⁶⁰ judicial decisions,²⁶¹ and commentators’ writings.²⁶² Unfortunately, the SEC no-action letters do not provide a bright-line statement of what is necessary to satisfy the exemption.²⁶³ A reading of the applicable no-action letters reveals five main considerations in the creation of a § 4(1½) exemption. First, each purchaser must have access to information similar to what would be made available through a registration statement. Second, each purchaser must meet the § 4(a)(2) qualifications, such as sophistication of the investor or the investor’s representative. Third, any general solicitation of purchasers destroys the exemption. Fourth, too many § 4(1½) sales within a given time frame could be found to be a distribution, which would destroy the exemption. And fifth, the seller must make clear that the proceeds are going to the selling shareholder, not the issuer. The § 4(1½) exemption is supplemented by § 4(a)(7) which sets forth a non-exclusive safe harbor for resales to accredited investors. Even after the enactment of § 4(a)(7), the § 4(1½) exemption remains significant for resales to unaccredited investors that would not be for them.

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.”²⁶⁴ The SEC promulgated Rule 144A in 1992 to help create a secondary market for institutional investors to trade privately placed securities.

259. See, e.g., Sidney Stahl, SEC No-Action Letter, 1981 WL 24892 (Apr. 23, 1981); Illinois Cap. 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).

260. See, e.g., Securities Act Release No. 33-6188 n.178, 19 SEC Docket 465 (Feb. 1, 1980); Securities Act Release No. 33-5452, SEC Docket 449 (Feb. 1, 1974).

261. See, e.g., *Ackerberg v. Johnson*, 892 F.2d 132 (8th Cir. 1989); *Stoppelman v. Owens*, No. 81-2637, 1984 U.S. Dist. LEXIS 16064 (D.D.C. June 7, 1984); *Neuwirth Inv. Fund, Ltd. v. Swanton*, 422 F. Supp. 1187 (S.D.N.Y. 1975); *Value Line Income Fund, Inc. v. Marcus*, 161 F. Supp. 533 (S.D.N.Y. 1965).

262. 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) [hereinafter *Olander & Jacks*]; Carl Schneider, *Section 4(1½)—Private Resales of Restricted or Control Securities*, 49 Ohio St. L.J. 501 (1988).

263. *Olander & Jacks*, *supra* note 262, at 353.

264. There are also informational requirements unless the issuer is either a reporting company or a foreign issuer. Rule 144A(d)(4)(i), 17 C.F.R. § 230.144A(d)(4)(i).

Rule 144A—a relatively narrow exemption—operates more as an experimental adoption of the concept behind the § 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 States.²⁶⁵ Simultaneously with its adoption of Rule 144A, the SEC approved the establishment of the computerized PORTAL (Private Offerings, Resales, and Trading through Automated Linkages) system to facilitate trading and provide a more liquid market for Rule 144A securities.

III.D.2.d

Exemption for Certain Dealer Transactions: Section 4(a)(3)

Section 4(a)(3) provides an exemption from the prospectus delivery requirements for certain transactions by dealers.²⁶⁶ This exemption is directed generally to the aftermarket, after primary distribution has occurred. Section 4(a)(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. Section 4(a)(3)(A) was intended to cover unregistered offerings and to protect nonparticipating dealers in subsequent transactions. 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.²⁶⁷ If a registration statement has been filed, § 4(a)(3)(B) provides that the exemption applies during the first forty days²⁶⁸ after (1) the securities were offered to the public or (2) the effective date, whichever is later.²⁶⁹ 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, § 4(a)(3) covers most transactions. While § 4(a)(3) is available to underwriters no longer acting as such, § 4(a)(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.

265. 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.

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

267. *Kubik v. Goldfield*, 479 F.2d 472 (3d Cir. 1973).

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

269. Since § 4(a)(3)'s exemption is limited to the prospectus delivery requirements and applies at some point after the effective date (or bona fide offering date), it has no bearing on the following: pre-filing gun-jumping violations of § 5(c); § 5(a)'s prohibitions against sales prior to the effective date; or § 5(b)(1)'s prospectus delivery requirements during the waiting period.

SEC Rule 174 provides further exemptions under § 4(a)(3) for nonparticipating dealers under certain circumstances by shortening or eliminating the period during which a prospectus need be delivered.²⁷⁰ Additionally, Rule 174(d) shortens to twenty-five days the “quiet period,” in which stock is listed on a national securities exchange or qualifies for inclusion on the National Association of Securities Dealers Automated Quotation system (Nasdaq).

III.D.2.e

Exemption for Unsolicited Brokers’ Transactions: Section 4(a)(4)

Section 4(a)(4) of the 1933 Act exempts unsolicited brokers’ transactions. Neither the 1933 Act nor the rules promulgated thereunder explicitly define *broker*. But the Act’s definition of *dealer* clearly includes brokers. Thus unless exempted under § 4(a)(3), and in the absence of § 4(a)(4), brokers’ transactions would come within § 5’s purview because of § 4(a)(1). The § 4(a)(4) exemption is limited to unsolicited customer orders and is designed to apply to day-to-day transactions where there is no potential for § 5 abuse. The exemption does not apply, however, to transactions so large that they are susceptible to characterization as a distribution,²⁷¹ in which case a registration statement would be required unless another exemption is available.

III.D.2.f

Exemption for Certain Small and Limited Offerings: Regulation D

Regulation D consists of two²⁷² separate small-offering and private-offering exemptions: Rule 504, an exclusive harbor, and Rule 506, a safe harbor.²⁷³ Rule 504 used to be a § 3(b) exemption but was expanded above § 3(b)’s \$5 million ceiling

270. 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) or 2) if the company was a public reporting company before the registration statement was filed and is current in its 1934 Act reporting. 17 C.F.R. § 230.174(d).

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

272. Regulation D used to have a third exemption in former Rule 505. But Rule 505 was rescinded when Rule 504 was increased from \$1 million to \$5 million, which had been the ceiling under former Rule 505. As noted earlier, the \$5 million ceiling has since been raised to \$10 million.

273. Because Rule 506 is a safe harbor, a transaction that does not meet Rule 506’s requirements may nevertheless be exempt under the statutory § 4(a)(2) exemption. In contrast, Rule 504 is dependent on strict compliance with its terms, as there is no statutory exemption to fall back on.

when the SEC raised the ceiling to \$10 million, relying on § 28's general exemptive authority. Rule 506 was promulgated under § 4(a)(2)'s nonpublic offering exemption. These two exemptions are governed by Rules 501, 502, 503, 507, and 508. The exemptions, of course, are only from registration—not from the antifraud or civil liability sections of the federal securities laws—and do not relieve the issuer of the obligation 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* in Rule 501(a).²⁷⁴ There are thirteen categories of accredited investors that 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; directors, executive officers, and general partners of the issuer; knowledgeable employees; family offices; and family clients.²⁷⁵

Rule 501(e) provides rules for computing the number of purchasers²⁷⁶ with respect to the 35-purchaser limit in Rule 506. Among other things, the 35-purchaser limit does not include accredited investors.

Rule 502 provides general conditions that must be met in order to qualify for the exemptions provided by Rules 504 and 506. Rule 502(a) provides an integration safe harbor (incorporating by reference Rule 152) to prevent other offerings from being integrated into the initial offering and thereby destroying the

274. 17 C.F.R. § 230.501(a). See also 1933 Act § 2(a)(15), Rule 215; 15 U.S.C. § 77b(a)(15); 17 C.F.R. § 230.215. As part of the Dodd-Frank Act, Congress mandated that the SEC periodically reexamine the \$1 million net worth threshold. But so far, no changes have been made.

275. (1) banks, brokerage firms, insurance companies, investment companies, and specified employee benefit plans, (2) private business development companies, (3) charitable or educational institutions with assets of more than \$5 million, (4) any of the issuer's directors, executive officers, or general partners, (5) any natural person with a net worth of more than \$1 million, (6) natural persons with an annual income of more than \$200,000 (or, together with his or her spouse or spousal equivalent, more than \$300,000), (7) trusts with more than \$5 million in assets which is managed by a "sophisticated person," (8) any entity in which all of the owners are accredited investors, (9) an entity not formed for the purpose of the securities offered owning more than \$5 million in investments, (10) anyone in good standing with professional certifications approved by the SEC, (11) knowledgeable employees of the issuer as defined in Investment Company Act of 1940 (ICA) Rule 3c-5(a)(4), (12) family offices with more than \$5 million under management, and (13) any "family client," as defined in Investment Advisers Act of 1940 (IAA) Rule 202(a)(11)(G)-1. 1933 Act Rules 215, 501(a), 17 C.F.R. §§ 230.215, 230.501(a).

276. This provision is only relevant to Rule 506 (which is 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.

exemption (e.g., by exceeding the offering price ceiling in a Rule 504 transaction or by including unqualified purchasers in the case of a Rule 506 transaction).²⁷⁷ Rule 502(b) sets forth informational requirements that must be met for exemptions relying on Rule 506.²⁷⁸ In general, the larger the 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, unless the general solicitation involves only accredited investors.²⁷⁹ Finally, Rule 502(d) sets forth limitations on the resale of securities acquired in a Regulation D transaction.²⁸⁰ 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 § 2(a)(11).²⁸¹

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 that (1) the failure to comply did not affect the complainant; (2) the violation was insignificant with respect to the offering as a whole; and (3) 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 provides that Regulation D is not available to persons who have been enjoined from violating Rule 503's notice-of-sales requirement.

277. Under Rule 152, offers made more than thirty calendar days before or after the offering at issue may be excluded from integration with Regulation D transactions.

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

279. General solicitation includes, but is not limited to, advertising, general meetings, general letters, and circulars. See *infra* text accompanying note 435 for the categories of accredited investors. In the limited situation in which 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.

280. Again, in the limited situation in which 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.

281. Rule 502(d) contains examples of the requisite reasonable care, such as placing an appropriate legend on the stock certificate. 17 C.F.R. § 230.502(d).

The SEC may, however, waive this provision in an individual case upon a showing of good cause.

Offerings up to \$10 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 \$10 million do not qualify for this exemption. All securities offered in violation of § 5 within the past twelve months are included in calculating the aggregate offering price.²⁸² General solicitations of purchasers are permitted and there are no resale restrictions, but only if the offering is registered under applicable state securities (or blue sky) law provisions.

Safe harbor for nonpublic offerings by issuers—Rule 506. Rule 506, is a safe harbor for a § 4(a)(2) 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.²⁸³ Moreover, all of the unaccredited purchasers must be knowledgeable, sophisticated, and able to evaluate and bear the risks of the prospective investment.²⁸⁴ 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 is subject to the limitations on resale imposed by Rule 502(d), and downstream sales are similarly governed by Rule 144.

III.D.2.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

282. The planning and timing of offerings is very important.

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

284. Rule 506. Rule 146, the former safe-harbor rule for § 4(a)(2) that was replaced by Rule 506, 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).

and the stock outstanding.²⁸⁵ There are restrictions on resale; thus, any downstream sales must be in accordance with Rule 144. Notice of sales relying on this exemption must 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.²⁸⁶

Section 4(a)(5) (formerly § 4(6))²⁸⁷ exempts offerings made solely to accredited investors where the aggregate amount of securities sold does not exceed the dollar limit of § 3(b)(1) (currently \$5 million). Accredited investors, as defined in § 2(a)(15) of the 1933 Act, include institutional investors and individuals with a large net worth. Rule 215 incorporates by reference the expanded definition of accredited investor in Rule 501(a) that, as pointed out above, includes 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; directors, executive officers, and general partners of the issuer; knowledgeable employees; family offices; and family clients.²⁸⁸ The JOBS Act added § 4(a)(6) to provide a limited exemption from registration for certain crowdfunding offerings of up to \$1 million per year, which has been increased by SEC rule to \$5 million.²⁸⁹

Under the authority of § 3(b) of the 1933 Act, the SEC promulgated Regulation A²⁹⁰ to exempt certain small issues. Regulation A is limited to issuers in the United States or Canada that are not investment companies. The SEC amended Regulation A to exceed § 3(b)(2)'s \$50 million ceiling by using the general exemptive authority of § 28 to increase the maximum dollar amount to \$75 million²⁹¹ within a one-year period for issuer transactions and up to \$15 million for sales

285. 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.

286. Rules 901–904, 17 C.F.R. §§ 230.901–230.904. See 6 Hazen, *supra* note 11, §§ 17:15–17:16.

287. Former § 4(5), repealed as part of the Dodd-Frank Act of 2010, was 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.

288. 17 C.F.R. § 230.215.

289. 15 U.S.C. § 77d(a)(6); 17 C.F.R. § 227.100.

290. Rules 251–264, 17 C.F.R. §§ 230.251–230.264.

291. Section 3(b)(2) authorizes Regulation A offerings up to \$50 million while § 3(b)(1) retains the former \$5 million ceiling for other § 3(b) transactions.

by existing shareholders.²⁹² Regulation A contains “bad actor” disqualification provisions that render the exemption unavailable in most cases if a participant in the offering has been subject to SEC disciplinary proceedings or convicted of a violation of relevant laws in the last five years.²⁹³

Regulation A is not an unconditional exemption, but rather is conditioned on what is comparable to a “mini” registration. The issuer must file an offering circular 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. The alternative disclosure requirements for a Regulation A offering are found in Form 1-A.²⁹⁴ Finally, the issuer must file reports of all sales with the SEC (Form 2-A).²⁹⁵ In general, the advantages of a Regulation A filing are that the information disclosed may be less detailed, the filing does not require audited financial statements, and the filing does not subject the issuer to periodic reporting requirements.

III.D.3

General Exemptive Authority

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.²⁹⁶ This virtually unlimited exemptive power frees the SEC from the more rigid parameters of the specific exemptions set forth in §§ 3 and 4 of the Act. For example, § 28 has been used to raise the dollar ceilings that would formerly have applied to Regulation A, Rule 504, crowdfunding, and Rule 701 offerings. Section 28 was also used when the SEC adopted Rule 147A to relax some of the intrastate transaction restrictions.

292. Rule 251(a) permits secondary sales of up to \$6 million in a tier 1 offering (up to \$20 million) while the \$15 million ceiling for secondary sale applies to tier 2 offerings up to \$75 million.

293. Rule 262, 17 C.F.R. § 230.262.

294. 17 C.F.R. § 239.90.

295. *Id.* § 239.91.

296. 15 U.S.C. § 77z-3 (adopted in 1996). 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, is in the public interest, and is consistent with the protection of investors. *Id.* In contrast to its general exemptive authority under the 1933 Act, the parallel provision of the 1934 Act gave the SEC authority to provide an exemption by administrative order in addition to providing for an exemption in its rules and regulations. See 1934 Act § 36, 15 U.S.C. § 78mm(a).

III.D.4

Integration of Transactions

The integration doctrine²⁹⁷ permits the telescoping of two or more purportedly separate transactions into one transaction. Under the integration doctrine, the SEC and the courts examine multiple offerings to determine whether the offerings 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. 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 § 4 and, in particular, the § 4(a)(2) exemption for transactions not involving a public offering. Rule 152 sets forth a safe harbor from integration. Outside of the safe harbor, integration is to be determined according to the particular facts and circumstances. The SEC developed a five-factor test²⁹⁸ 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 about how these factors should be weighted. Accordingly, any one or more of the five factors could be determinative in a particular case. Thus, for example, the absence of a prearranged, single plan of financing is likely to preclude integration. In 2020 the SEC expanded the safe harbors from integration, thereby providing that integration in transactions not covered by the safe harbor be considered in light of the particular facts and circumstances. Presumably, the five-factor test will still be useful in analyzing the particular facts and circumstances.

297. 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 § 3(b) exemptions, such as Regulation A. Similarly, the “issue” concept has been carried over to the § 3(a)(9) exemption for exchanges of securities exclusively with existing securities holders. The integration doctrine has also been applied to the § 3(a)(10) exemption for administratively approved reorganizations.

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

The integration doctrine essentially depends on the facts and nuances of each situation. Gleaning knowledge from the sparse precedent can be difficult. Much of the relevant precedent is based on no-action letters, which, by their nature, are persuasive but not binding.²⁹⁹

III.E

Liabilities Under 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.

III.E.1

SEC Administrative Remedies

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 initiate formal stop-order proceedings at any time.³⁰⁰ Again, the order can be issued only after formal notice and an opportunity for a hearing. However, both of these formal proceedings are drastic measures that are not part of the normal process for dealing with deficient registration materials. Instead, the normal process generally involves the use of deficiency letters³⁰¹ 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 § 8 proceedings, § 8A gives the SEC the authority to issue cease and desist orders.

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

300. See 1 Hazen, *supra* note 11, § 3:40; William McLucas, *Stop Order Proceedings Under the Securities Act of 1933: A Current Assessment*, 40 Bus. L. 515 (1985).

301. Deficiency letters are letters 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 11, § 3:40.

III.E.2

Private Rights of Action

Three sections of the 1933 Act prohibit fraud and misstatements: §§ 11, 12, and 17. Sections 11 and 12 create private rights of action, while § 17(a) is a more generalized antifraud provision used primarily by the SEC and by the Department of Justice in criminal actions. The current consensus in the courts is that § 17(a) does not support an implied private remedy.³⁰² 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.³⁰³ Most state securities class actions are federally preempted by the Private Securities Litigation Reform Act (PSLRA).³⁰⁴

Any material deficiencies in the registration statement that carry over to the prospectus will result in violations of the § 5(b) prospectus delivery requirements, which call for an accurate and up-to-date prospectus.³⁰⁵ Any violation of § 5 gives rise to possible criminal sanctions as well as judicially secured SEC equitable sanctions. Furthermore, private remedies may exist for aggrieved persons under §§ 11 and 12 of the 1933 Act. Purported waivers of 1933 Act claims are invalid, except in connection with settlement of threatened or pending litigation.³⁰⁶

302. See, e.g., *Crookham v. Crookham*, 914 F.2d 1027 (8th Cir. 1990) (\$10,000 sanction for bringing suit under § 17(a) of the 1933 Act).

303. 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. For a more detailed discussion of Rule 10b-5, see *infra* §§ [IVE.2.b](#) and [IV.F.1](#).

304. Pub. L. No. 104-67, 109 Stat. 737 (H.R. 1058, 104th Cong. (1995)). The PSLRA is discussed more fully *infra* § [III.F.1](#). 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); 1934 Act § 28(f)(1), 15 U.S.C. § 78bb(f)(1). The 1934 Act includes enhanced pleading requirements applicable to fraud actions. 1934 Act § 21D(b), 15 U.S.C. § 78u-4(b). The litigation reform legislation also included substantive amendments that addressed 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.

305. 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 date of delivery, was a violation of § 5(b)(2), subjecting the dealer who delivered the prospectus to liability under § 12(a)(1)).

306. 1933 Act § 14. See *Meyers v. C & M Petrol. Producers, Inc.*, 476 F.2d 427 (5th Cir.), *cert. denied*, 414 U.S. 829 (1973).

The applicable statutes of limitations for private remedies under the 1933 Act are set forth in § 13.³⁰⁷

III.E.2.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.³⁰⁸ It imposes broader liability than other antifraud provisions because the aggrieved purchaser need only show that she bought the security and there was a material misrepresentation in the registration statement. There is no requirement under § 11 that purchasers show that they *relied* on the misstatement. 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.³⁰⁹ However, § 11 imposes two standards of liability. The first is on the issuer, who generally is strictly liable once the plaintiff has proved that 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 purchase, 2) lack of materiality, or 3) expiration of the statute of limitations.

307. Actions under §§ 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 § 12(a)(1) must be brought within one year of discovery of the registration violation and within three years of the sale. 15 U.S.C. § 1658 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 §§ 11 and 12 do not speak in terms of fraud, it is doubtful that these three-year/five-year limitations prevail over the one-year/three-year periods mentioned in § 13 of the 1933 Act.

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

309. See, e.g., *Lone Star Ladies Inv. Club v. Schlotsky's Inc.*, 238 F.3d 363 (5th Cir. 2001) (Rule 9(b)'s particularity requirements do not apply in actions under either § 11 or § 12 of the 1933 Act); *In re Ultrafem, Inc. Sec. Litig.*, 91 F. Supp. 2d 678 (S.D.N.Y. 2000) (particularity requirements did not apply to either § 11 or § 12(a) claims). *But see*, e.g., *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 288 (3d Cir.), *cert. denied*, 506 U.S. 934 (1992) (when § 11 and § 12 claims are grounded in fraud rather than negligence, particularity requirements apply).

The second standard of liability applies to non-issuers who may raise defenses not available to issuers. For all persons other than the issuer,³¹⁰ § 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 § 11 defendant may be relieved of liability by resigning or taking steps toward resignation, and by informing the SEC and the issuer in writing that he 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 § 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 § 11(b)(3), is the most frequently used. It absolves defendants from liability if, after reasonable investigation, 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. Alternatively, these defendants may rely on experts whose statements are included in the registration statement. 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." This is often referred to as the "due diligence" defense, although that phrase does not appear in the statute.

The courts have not articulated a bright-line test as to what satisfies the due diligence and reasonable investigation standard of care.³¹¹ 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

310. Persons liable include all signers of the registration statement (which must include principal executive and financial officers, issuer, and majority of directors), all directors (including people not yet directors but agreeing to be named as about to become directors), experts (e.g., certifying accountant), and underwriters. See §§ 11(a)(1)–11(a)(5) for a list of these persons. 15 U.S.C. §§ 77k(a)(1)–77k(a)(5).

311. See, e.g., *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2005 WL 638268 (S.D.N.Y. Mar. 21, 2005); *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.*, 680 F. Supp. 1360 (N.D. Cal. 1987).

process and in preparing registration materials.³¹² 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.³¹³

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

Damages under § 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

312. For more detail, see 2 Hazen, *supra* note 11, §§ 7:30–7:38.

313. 17 C.F.R. § 230.176.

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 trying to prove that the decrease in value is the result of something other than their misleading statement. However, § 11 gives the court discretion to award the plaintiff costs and attorneys' fees as part of the damage award. Liability under § 11 is joint and several³¹⁴ subject to two exceptions. First, underwriters of the public offering are not liable under § 11 beyond their proportionate participation in the offering.³¹⁵ Second, outside directors may seek contribution from more culpable § 11 defendants.³¹⁶

III.E.2.b

Securities Sold in Violation of Section 5, and 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 § 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 or omission. Unlike § 11, § 12 by its terms applies to any transaction, whether or not it is subject to the registration provisions of the 1933 Act.³¹⁷ However, the Supreme Court has limited the offerings subject to § 12(a)(2)'s antifraud provisions.³¹⁸ A major issue in many § 12 cases is whether the defendant is a permissible one—that is, whether the defendant is a “seller” for purposes of § 12. Issuers and underwriters generally are not sellers within the meaning of § 12 unless they actively participate in the negotiations with the plaintiff/purchaser.³¹⁹ Similarly, an attorney's having worked on the offering cir-

314. 1933 Act § 11(e), 15 U.S.C. § 77k(e).

315. *Id.*

316. 1933 Act § 11(f), 15 U.S.C. § 77k(f). 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).

317. For a violation of the federal securities law to occur, some means of or instrument of interstate commerce must be used.

318. The Supreme Court held that a § 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 2 *Hazen*, *supra* note 11, §§ 7:46–7:47.

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

cular will not make him or her a seller.³²⁰ On the other hand, a broker who deals directly with the plaintiff is a § 12 seller.³²¹

Section 12 appears to require privity between the plaintiff and the defendant.³²² 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.³²³ The Supreme Court delineated two factors for consideration in identifying a seller under § 12: 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.³²⁴

Civil liability under § 12(a)(1) for sales in violation of § 5. Anyone who offers or sells a security in violation of § 5 is liable in a civil action under § 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* (equal fault) defense. While the *in pari delicto* defense was initially thought to be unavailable in an action under § 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.³²⁵ Relying on an earlier Court decision,³²⁶ 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.”³²⁷ Applying the test to § 12(a)(1) violations (i.e., securities sold in violation of § 5), the Court held that “the *in pari delicto* defense may defeat

320. See, 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).

321. See, e.g., *Quincy Co-Operative Bank v. A.G. Edwards & Sons, Inc.*, 655 F. Supp. 78 (D. Mass. 1986).

322. 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. See, 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, Estabrook & Weeden, Inc.*, 709 F. Supp. 95 (M.D. Pa. 1988) (privity not required under § 12(a)(2) for open-market transaction).

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

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

325. *Id.*

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

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

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."³²⁸

Under § 12(a)(1), the successful plaintiff is entitled to rescission and return of the purchase price. If the security has already been sold, damages under § 12(a)(1) are based on the loss comprising the difference between the plaintiff's purchase price and sale price. Since § 12(a)(1) does not require a causal connection between 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 § 5 violation.³²⁹ Also, at least one court has held that even where a violation of the § 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 § 12(a)(1).³³⁰

Liability of sellers under § 12(a)(2) for material misstatements or omissions. 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 omissions³³¹ in connection with the offer and sale. Section 12(a)(2) does not require scienter, and thus most courts have held that § 12 does not implicate the enhanced pleading requirements that apply to fraud actions.³³² The statutorily mandated enhanced pleading requirements appear in the 1934 Act, but not in the 1933 Act.³³³ Several courts have applied the enhanced pleading standards to § 12(a)(2) claims, at least when the claims sound in fraud.³³⁴

As with § 12(a)(1), § 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

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

329. This is in contrast to §§ 11 and 12(a)(2), which require a causal connection between the misstatement and the plaintiff's loss. 1933 Act §§ 11(e), 12(b), 15 U.S.C. §§ 77k(e), 78l(b). Similarly, 1934 Act Rule 10b-5 imposes a causation requirement. 17 C.F.R. § 240.10b-5.

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

331. 15 U.S.C. § 77l(a)(2).

332. See, e.g., *Lone Star Ladies Inv. Club v. Schlotsky'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).

333. See 1934 Act § 21D(b), 15 U.S.C. § 78u-4(b).

334. *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, 892-93 (7th Cir. 1990).

the prospectus or oral communication. There is no requirement that the plaintiff prove reliance; it will be presumed.³³⁵ The plaintiff also need not have read the misstatement in question.³³⁶ However, if the plaintiff *knew* of the untruth or omission prior to purchase, the § 12(a)(2) claim should be dismissed.³³⁷

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.”³³⁸ Section 12(a)(2)’s “reasonable care” requirement imparts some sort of negligence standard, and the purchaser need not show any type of scienter on the seller’s part.³³⁹ Indeed, the § 12(a)(2) standard of reasonable care may impose a duty to investigate in some circumstances.³⁴⁰ 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.³⁴¹

Unlike § 11 or Rule 10b-5, damages under § 12(a)(2), like those under § 12(a)(1), 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 with § 11 damages, damages under § 12(a)(2) will not include any decline in the value of the security that can be attributed to factors other than the material misrepresentation or omission in question.³⁴²

335. *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.*, No. 88-33-CIV-5, 1988 WL 110054 (E.D.N.C. July 21, 1988).

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

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

338. *Id.* at 755 (quoting 15 U.S.C. § 77l(2)).

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

340. *Sanders*, 619 F.2d at 1228.

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

342. 1933 Act § 12(b), 15 U.S.C. § 77l(b).

III.E.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.³⁴³ Section 17(a) applies regardless of whether the securities are registered or exempt from registration under § 3. However, unlike its 1934 Act counterpart (Rule 10b-5), § 17(a) applies only to sales of and offers to sell securities. It covers activities of the offeror or seller, but not fraud by the purchaser. The Supreme Court has held that scienter must be shown in order to establish a violation of § 17(a)(1), but not for either § 17(a)(2) (the language of which was found “devoid of any suggestion whatsoever of a scienter requirement”) or § 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”).³⁴⁴ The vast majority of decisions hold that private plaintiffs do not have an implied remedy under § 17(a) of the 1933 Act.³⁴⁵

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 § 17(a), § 17(b) applies to securities whether registered or exempt under § 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.³⁴⁶ It has also been held that § 17(b) is not limited to securities distributions but applies both to new and outstanding securities.³⁴⁷

343. Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) 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.

15 U.S.C. § 77q(a).

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

345. *See* 2 *Hazen*, *supra* note 11, § 7:64, 12:197.

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

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

Violations of § 17 may result in both criminal sanctions and an SEC civil suit. Although a few cases recognize an implied private right of action under § 17(a), the overwhelming majority of decisions do not.³⁴⁸ In fact, the nonexistence of an implied right under § 17(a) is so clear that at least one court imposed sanctions under Federal Rule of Civil Procedure 11 for claims brought under such a theory.³⁴⁹

III.E.4

Secondary Liability Under 1933 and 1934 Acts

III.E.4.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.”³⁵⁰ A controlling person is sometimes referred to as an affiliate.³⁵¹ Section 15 also provides that 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.”³⁵² But 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

348. 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 4 Hazen, *supra* note 11, § 12:197.

349. *Crookham v. Crookham*, 914 F.2d 1027 (8th Cir. 1990) (\$10,000 sanction for bringing suit under § 17(a) of the 1933 Act).

350. 17 C.F.R. § 230.405. See, e.g., *United States v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969).

351. “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.

352. 15 U.S.C. § 77o.

controlling-person liability.³⁵³ The majority of the federal courts of appeals hold that statutorily imposed controlling-person liability does not preclude application of either the common-law principle of *respondeat superior* or the agency concepts of actual or apparent authority.³⁵⁴

III.E.4.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 majority of cases have held that aiding and abetting principles do not apply to broaden the range of defendants in private actions under §§ 11 and 12 of the 1933 Act. The Supreme Court has made it clear that there is no private remedy against aiders and abettors;³⁵⁵ 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

353. *San Francisco-Oklahoma Petrol. Expl. 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. Illinois 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 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).

354. *See, e.g., Hollinger v. Titan Cap. 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. Texas Com. 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 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). *But see, e.g., Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975); *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981). A different rule applies, however, to actions complaining of insider trading. *See* 1934 Act § 21A(b)(1).

355. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959 (1993) (rejecting aiding and abetting liability in private suit). *See also, e.g., SEC v. Tambone*, 597 F.3d 436 (1st Cir. 2010) (underwriter not primary violator); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (refusing to apply expansive definition of primary liability). Liability is unavailable in a private suit unless the statements can be attributed to the defendant, and thus the plaintiff had some basis for reliance on the defendant's participation. *See, e.g., Stoneridge*, 552 U.S. 148; *Affco Invs. 2001 LLC v. Proskauer Rose LLP*, 625 F.3d 185 (5th Cir. 2010); *Pacific Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010).

§ 17(a).³⁵⁶ Congress reaffirmed the government's ability to recognize aiding and abetting claims as part of the Dodd-Frank Act.³⁵⁷ Dodd-Frank also contained a mandate to study the question of whether to allow private claims against aiders and abettors.

There is broad agreement among the circuits on the elements necessary to establish aider and abettor liability. First, the court must find a primary violation of the securities laws.³⁵⁸ Second, the aider and abettor must be found to have a "general awareness" that his role was part of an overall plan of wrongdoing.³⁵⁹ Finally, the aider and abettor must have given knowing and substantial assistance to the person perpetrating the primary violation.³⁶⁰

The courts are split on whether a person can be held liable as an aider and abettor when 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.³⁶¹ 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.³⁶² 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.³⁶³ With the passing of the

356. See, e.g., *Cleary v. Perfecttune*, 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).

357. 15 U.S.C. § 77o(b), as added by the Dodd-Frank Wall Street Reform & Consumer Protection Act § 929M, Pub. L. No. 111-203, H.R. 4173, 111th Cong. (2d Sess. 2010).

358. See, e.g., *Coffey*, 493 F.2d at 1314. But see *Kaliski v. Hunt Int'l Res. Corp.*, 609 F. Supp. 649, 653-54 (N.D. Ill. 1985) (although "lulling" activities can constitute primary violation of securities laws, they are not sufficient to establish aiding and abetting liability).

359. 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).

360. 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).

361. See, e.g., *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975); *Coffey*, 493 F.2d 1304; *Martin v. Pepsi-Cola Bottling Co.*, 639 F. Supp. 931 (D. Md. 1986).

362. 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. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978).

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

Dodd-Frank Act, Congress clarified that reckless conduct is sufficient to sustain aiding and abetting liability.³⁶⁴

III.E.4.c

Secondary Liability and Primary Liability Compared

The demise of “aiding and abetting” liability in private actions puts a premium on being able to characterize the defendant as a primary violator. In 2008, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,³⁶⁵ the Supreme Court rejected a requirement that the defendant must have uttered or authored the misstatement in order to be held accountable as a primary violator. However, the Supreme Court subsequently ruled that a primary violator must have actually made the statement to have violated Rule 10b-5(b).³⁶⁶ A person or entity can be viewed as the maker of a statement if he or she had control over the statement’s contents.³⁶⁷

Some courts hold that when someone’s active participation in a *scheme* to defraud creates the necessary deception, primary liability could be found. This has been referred to as “scheme liability” to distinguish those cases in which the defendant actively participated in the misstatement. In a five-to-three decision, the Supreme Court in *Stoneridge* rejected scheme liability as a way to extend the scope of primary liability under Rule 10b-5(b).³⁶⁸ The Court ruled that the defendant’s connection to the statement was not strong enough to support a claim of reliance by the plaintiff. Investors must thus have some basis for relying on the defendant’s participation in the alleged scheme.³⁶⁹ The *Stoneridge* decision does not impose a *per se* requirement that the defendant have actually signed or drafted the disclosure in question. Establishing a basis for the plaintiff’s reliance on the defendant’s participation is sufficient.³⁷⁰

364. 15 U.S.C. § 77o.

365. 552 U.S. 148 (2008).

366. *Janus Cap. Group, Inc. v. First Derivative Traders, Inc.*, 564 U.S. 135 (2011).

367. “The question . . . is whether a reasonable jury could find that it also had authority over the content of the Registration Statements.” *City of Roseville Emps’ Ret. Sys. v. EnergySolutions, Inc.*, 814 F. Supp. 2d 395, 417 n.9 (S.D.N.Y. 2011) (holding that key and controlling shareholder could be found to be maker of statement that was signed by others).

368. *Stoneridge*, 552 U.S. 148.

369. A Rule 10b-5 claim can be stated when the public has a basis for relying on the defendant’s participation.

370. See, e.g., *In re Bristol Myers Squibb Co. Sec. Litig.*, 586 F. Supp. 2d 148 (S.D.N.Y. 2008) (upholding allegations against an officer who negotiated settlement that was misrepresented in public statements).

In *Janus Capital Group, Inc. v. First Derivative Traders, Inc.*,³⁷¹ relying on the express language of Rule 10b-5(b), the Supreme Court—in a sharply divided, five-to-four decision—ruled that primary liability exists and thus a private right of action may only be brought against someone who *makes* the materially misleading statement in question. In so ruling, the Court rejected the contention that “make” should be defined as including “create,” which would have allowed private plaintiffs to sue a person who provides the false or misleading information that another person puts into a statement.³⁷²

The Court in *Janus* focused on subsection (b) of Rule 10b-5 that expressly refers to someone who *makes* a statement.³⁷³ Rule 10b-5 can be violated under either subsection (a), which prohibits fraud, or subsection (c), which prohibits “any device, scheme, or artifice to defraud” or anyone who engages “in any act or practice, or course of business which operates or would operate as a fraud or deceit. In *Lorenzo v. SEC*,³⁷⁴ the Supreme Court held that the *Janus* “maker” requirement is limited to 10b-5(b) and thus conduct other than actually making the statement in question can form the basis for 10b-5(a) and 10b-5(c) violations. Since the same language is found in § 17(a)(1) and (3) of the 1933 Act, the *Lorenzo* standard should apply there as well.³⁷⁵

III.F

Securities Class Actions

Congress amended the Securities Act of 1933 and the Securities Exchange Act of 1934 in 1995 and again in 1998. The Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998—enacted in

371. 564 U.S. 135 (2011). *See also, e.g., In re Puda Coal Sec. Inc., Litig.*, 30 F. Supp. 3d 261 (S.D.N.Y. 2014) (underwriter to public offering was a maker of statements contained in the prospectus so as to be subject to Rule 10b-5); *In re Coinstar Inc. Sec. Litig.*, No. C11-133MJP, 2011 WL 4712206 (W.D. Wash. Oct. 6, 2011) (dismissing claims against defendants who did not *make* the statements in question).

372. *Janus*, 564 U.S. at 144–46.

373. Rule 10b-5(b) specifies that it is unlawful “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.” 17 C.F.R. § 240.10b-5(b).

374. 139 S. Ct. 1094, 1101 (2019) (“we conclude that (assuming other here-irrelevant legal requirements are met) dissemination of false or misleading statements with intent to defraud can fall within the scope of subsections (a) and (c) of Rule 10b-5, as well as the relevant statutory provisions. In our view, that is so even if the disseminator did not ‘make’ the statements and consequently falls outside subsection (b) of the Rule”).

375. *See, e.g., Malouf v. SEC*, 933 F.3d 1248 (10th Cir. 2019) (conduct can violate 1933 Act § 17(a)(1) as well as Rule 10b-5(a) and (c)).

part to curb abusive securities litigation—introduced requirements and procedures relating to the conduct of securities class-action litigation.

III.F.1

Private Securities Litigation Reform Act

The Private Securities Litigation Reform Act of 1995 (PSLRA)³⁷⁶ 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 were an attempt to decrease frivolous securities class action lawsuits in federal courts by making it more difficult for shareholders to bring class actions 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 § 21D of the 1934 Act³⁷⁷ require that a “lead plaintiff” be appointed as the representative party in most class-action suits, presumably to encourage substantial investors (and institutional investors, in particular³⁷⁸) to gain control of suits and discourage lawyer-driven suits.³⁷⁹ The lead plaintiff must file a sworn certification with the complaint stating that 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 she has served as representative party; and (6) will not

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

377. 15 U.S.C. § 78u-4; 15 U.S.C. § 77z-1.

378. 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 Mortg. Corp.*, No. 3:98-CV-1716-L (consolidated action), 2000 U.S. Dist. LEXIS 9941 (N.D. Tex. July 12, 2000) (memorandum opinion & order) (appointing group of investors rather than one of two institutional investors as lead plaintiff).

379. S. Rep. No. 104-98, at 11 (1995) (stating “[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) (stating 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)).

accept any payment beyond her pro rata share in the suit. The lead plaintiff's share of any recovery is to be determined on a pro rata basis of the final judgment or settlement. The lead plaintiff is prohibited from serving in a lead plaintiff capacity more than five times in three years.³⁸⁰ The trial court's order appointing a lead plaintiff cannot be appealed on an interlocutory basis by disappointed, would-be lead plaintiffs.³⁸¹

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.³⁸² 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 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.³⁸³

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.³⁸⁴ Although the appointment of a group may not be com-

380. However, it has been held that the five-case limit 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).

381. *Z-Seven Fund, Inc. v. Motocar Parts & Accessories*, 231 F.3d 1215 (9th Cir. 2000); *Florida State Bd. of Admin. v. Brick*, Nos. 99-4173 & 99-4174, 2000 WL 178416 (6th Cir. Feb. 8, 2000) (unpublished).

382. *See Burke v. Ruttenberg*, 102 F. Supp. 2d 1280 (N.D. Ala. 2000) (notice 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).

383. *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 In re Conesco, Inc. Sec. Litig.*, 120 F. Supp. 2d 729 (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 not representative of class); *Saddle Rock Partners, Ltd. v. Hiatt*, No. 96-CIV-9474(SHS), 2000 U.S. Dist. LEXIS 11931 (S.D.N.Y. Aug. 21, 2000) (plaintiff's sophistication did not render him atypical class representative; fact that plaintiff gave conflicting testimony in two depositions did not render him inadequate class representative).

384. *See, e.g., In re Tyco Int'l Ltd. Sec. Litig.*, MDL No. 00-MD-1335-B, 2000 WL 1513772 (D.N.H. Aug. 17, 2000). *See also Local 144 Nursing Home Pension Fund v. Honeywell Int'l, Inc.*, No. 00-3605(DRD), 2000 WL 33173017 (D.N.J. Nov. 16, 2000) (appointing group of five largest institutional investors as lead plaintiff).

monplace, it is appropriate when the identity of interests required by the statute exists.³⁸⁵ When there are multiple plaintiffs but different groups allege different securities law claims, the appointment of separate groups is appropriate.³⁸⁶ Alternatively, the court may decide to accept the group that represents the largest aggregate losses from the alleged violations in question.³⁸⁷ Courts have held that an overly liberal interpretation of the group concept is contrary to the intent of the PSLRA in limiting lead plaintiffs.³⁸⁸ 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.³⁸⁹ Where a member of a group is atypical of most class members, the entire group may be disqualified for certification as lead plaintiff.³⁹⁰

Issues also arise as to how to select the most appropriate lead counsel. 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.³⁹¹ Also, misconduct by lead counsel

385. *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).

386. *In re Nanophase Techs. Corp. Sec. Litig.*, Nos. 98C3450 & 98C7447, 1999 WL 965468 (N.D. Ill. Sept. 30, 1999).

387. *In re Ribozyme Pharms., Inc. Sec. Litig.*, 192 F.R.D. 656 (D. Colo. 2000) (of two competing groups qualified to serve as lead plaintiff, court selected group with larger aggregate loss).

388. *Telxon*, 67 F. Supp. 2d 803. See also *Bowman v. Legato Sys., Inc.*, 195 F.R.D. 655 (N.D. Cal. 2000) (subset of plaintiffs selected by lawyer did not qualify as 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 group); *In re Nice Sys., Ltd. Sec. Litig.*, 188 F.R.D. 206 (D.N.J. 1999) (rejecting appointment of nine lead plaintiffs but certifying five lead plaintiffs as group); *Switzenbaum v. Orbital Scis. Corp.*, 187 F.R.D. 246 (E.D. Va. 1999) (group of investors did not satisfy requirements for appointment as 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 triumvirate of lead plaintiffs is good way to deal with unrelated investors, but refusing to appoint 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).

389. *Sakhrani v. Brightpoint, Inc.*, 78 F. Supp. 2d 845 (S.D. Ind. 1999). See also *Tyco*, 2000 WL 1513772 (appointing group of three substantial shareholders as lead plaintiffs); *Burke v. Ruttenberg*, 102 F. Supp. 2d 1280 (N.D. Ala. 2000) (group of 300 unrelated investors could not serve as lead plaintiff under PSLRA, but court appointed 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 not appropriate group; instead court appointed bona fide investor group as lead plaintiffs).

390. *Seamans v. Aid Auto Stores, Inc.*, Nos. 98-CV-7395(DRH), 99-CV-852(DRH), 99-CV-1696 (DRH), 2000 WL 33769023 (E.D.N.Y. Feb. 15, 2000) (one of three members of group was market-maker, and not typical class representative).

391. See *Dietrich v. Bauer*, 192 F.R.D. 119 (S.D.N.Y. 2000).

can result in disqualification.³⁹² The PSLRA provides that “[t]he most adequate lead plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class.”³⁹³ The court is thus given considerable discretion in determining whether the lead plaintiff’s choice of representative best suits the needs of the class.³⁹⁴ In exercising this discretion, courts should consider both the quality and the cost³⁹⁵ 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.”³⁹⁶ Courts may also take into account a firm’s experience, size, and financial resources.³⁹⁷

PSLRA³⁹⁸ 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.³⁹⁹ Attorneys’ fees may be

392. See *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).

393. 15 U.S.C. § 78u-4(a)(2)(A)(v). See also *id.* § 77z-1(a)(3)(B)(v).

394. 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 class); *In re Cendant Corp. Litig.*, 182 F.R.D. 144, 149 (D.N.J. 1998) (“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 *Koppel v. 4987 Corp.*, 191 F.R.D. 360 (S.D.N.Y. 2000) (lead plaintiff’s partial recall not sufficient to render him inadequate; his alleged animosity with one of defendants did not disqualify him); *Miller v. Material Scis. Corp.*, 31 Sec. Reg. & L. Rep. (BNA) 1007 (N.D. Ill. 1999) (fact that plaintiff purchased shares from husband did not make her atypical so as to disqualify her as class-action plaintiff).

395. See, e.g., *Tarica v. McDermott Int’l, Inc.*, No. CIV-99-3831, 2000 WL 377817 (E.D. La. Apr. 13, 2000) (appointing co-lead counsel plus third firm as liaison counsel, provided this arrangement did not result in higher legal fees).

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

397. See, e.g., *Wenderhold v. Cylink Corp.*, 191 F.R.D. 600 (N.D. Cal. 2000). A few 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. 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 Corp.*, 182 F.R.D. 144; *In re Wells Fargo Sec. Litig.*, 156 F.R.D. 223 (N.D. Cal. 1994). See also *In re Amino Acid Lysine Antitrust Litig.*, 918 F. Supp. 1190 (N.D. Ill. 1996).

398. 15 U.S.C. § 78u-4(a)(6). See also 15 U.S.C. § 77z-1(a)(6).

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

calculated according to the lodestar approach—multiplying an attorney’s hours by a reasonable hourly fee and increasing the amount for any risk or other relevant factors.⁴⁰⁰

PSLRA⁴⁰¹ 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 defendants.⁴⁰² The stay is mandatory.⁴⁰³ However, the mandatory discovery stay does not apply to certification of the class.⁴⁰⁴ The certification may be decided before resolving a motion to dismiss. During a stay of discovery, the court may impose sanctions on defendants who willfully destroy evidence. Additionally, 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.⁴⁰⁵

Notice of final or proposed settlement agreements in class actions must be provided to class members.⁴⁰⁶ 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

400. See, e.g., *Williams v. MGM-Pathe Commc’ns Co.*, 129 F.3d 1026 (9th Cir. 1997) (attorneys’ fees out of settlement fund should be based on entire settlement fund or on lodestar rather than class members’ claims against fund); *In re F & M Distribs., Inc. Sec. Litig.*, No. 95-CV-71778-DT, 1999 U.S. Dist. LEXIS 11090, at *10 (E.D. Mich. June 29, 1999) (approving fee award of \$6,075,000 as 30% of settlement fund in light of “excellent performance” of attorneys). See also *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 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 not part of attorneys’ fees within meaning of PSLRA).

401. 15 U.S.C. § 78u-4(b)(3).

402. 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).

403. *SG Cowen Sec. Corp. v. United States Dist. Ct.*, 189 F.3d 909 (9th Cir. 1999) (limited discovery order improper given mandatory stay of all discovery).

404. *In re Diamond Multimedia Sys., Inc. Sec. Litig.*, No. C96-2644SBA, 1997 WL 773733 (N.D. Cal. Jan. 13, 1997).

405. 15 U.S.C. § 78u-4(d).

406. See, e.g., *Krangel v. Golden Rule Res., Inc.*, 194 F.R.D. 501 (E.D. Pa. 2000) (notice adequate). For examples of forms for class-action notices in securities cases (PDFs of the Full Notice, Publication Notice (English & Spanish), Language for Envelope, and PSLRA Cover Letter), visit <https://www.fjc.gov/content/securities-notices>.

a statement outlining the reasons for settlement. As with class actions generally, courts will review settlements to determine fairness to class members.⁴⁰⁷

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, PSLRA⁴⁰⁸ 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 the sanctions not being imposed. The court must give the attorney or party notice and an opportunity to respond.

If the court finds that 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. To warrant the imposition of sanctions, the complaint must have been frivolous.⁴⁰⁹ Once a party moves for the imposition of Rule 11 sanctions, by virtue of the PSLRA a court

407. See, e.g., *In re Mego Fin. Corp. Sec. Litig.*, 213 F.3d 454 (9th Cir. 2000) (approving class-action settlement); *Neuberger v. Shapiro*, 110 F. Supp. 2d 373 (E.D. Pa. 2000) (approving settlement as reasonable); *Krangel*, 194 F.R.D. 501 (approving settlement); *In re Blech Sec. Litig.*, Nos. 94 Civ. 7696 (RWS) & 95 Civ. 6422 (RWS), 2000 WL 661680 (S.D.N.Y. May 22, 2000) (same); *In re Ikon Office Solutions, Inc. Sec. Litig.*, 194 F.R.D. 166 (E.D. Pa. 2000) (same).

408. 15 U.S.C. § 78u-4(b)(1).

409. See, e.g., *Richter v. Achs*, 174 F.R.D. 316 (S.D.N.Y. 1997) (denying sanctions under PSLRA even though plaintiff failed to identify any alleged violation of securities laws by defendant; claims were unconvincing but 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 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 for injunctive relief by plaintiff who was neither purchaser nor seller was not frivolous, but Rule 10b-13 claim was frivolous).

cannot deny the motion without making explicit findings regarding compliance with Rule 11(b).

III.F.2

Securities Litigation Uniform Standards Act

The Securities Litigation Uniform Standards Act of 1998 (SLUSA)⁴¹⁰ mandates that most class actions involving publicly traded securities be brought in federal court.⁴¹¹ The preemptive provisions of SLUSA apply only to class actions with 50 or more class members involving “covered” securities under the 1934 Act.⁴¹² Covered securities under the Act are securities registered with the SEC and traded on the New York Stock Exchange, American Stock Exchange, the Nasdaq National Stock Market, or other national markets designated by the SEC, as well as securities issued by investment companies registered under the Investment Company Act of 1940.⁴¹³ The preemption applies to any class action involving misrepresentations, omissions, deception, or manipulation in connection with the purchase or sale of a covered security.⁴¹⁴

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.⁴¹⁵ SLUSA thus does not preclude individual actions, derivative suits,⁴¹⁶ 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.⁴¹⁷ This exclusion requires that all class members fit within one of these categories so as

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

411. 15 U.S.C. § 78bb(f); 1933 Act § 16(f), 15 U.S.C. § 77p(f).

412. 1934 Act § 27, 15 U.S.C. § 77aa. While jurisdiction over 1934 Act claims is exclusively federal, private actions under §§ 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).

413. 1933 Act § 16(f)(3), 15 U.S.C. § 77p(f)(3); 1934 Act § 28(f)(5)(E), 15 U.S.C. § 78bb(f)(5)(E). This definition in turn refers to § 18 of the 1933 Act, 15 U.S.C. § 77r, which preempts those securities from state registration requirements.

414. 1934 Act § 28(f)(1), 15 U.S.C. § 78bb(f)(1) (defining 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).

415. 1934 Act § 28(f)(5)(B), 15 U.S.C. § 78bb(f)(5)(B); 1933 Act § 16(f)(2), 15 U.S.C. § 77p(f)(2).

416. 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); 1933 Act § 16(f)(3), 15 U.S.C. § 77p(f)(3).

417. 1934 Act § 28(f)(3)(B), 15 U.S.C. § 78pp(f)(3)(B); 1933 Act § 16(d)(2), 15 U.S.C. § 77p(d)(2).

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.⁴¹⁸

SLUSA preempts class actions based on state law causes of action for misrepresentation or fraud.⁴¹⁹ The preemption also applies to covered class actions involving liabilities under the 1933 Act⁴²⁰ (provided the class action involves fifty or more plaintiffs). As noted earlier, the Supreme Court held that the state courts' concurrent jurisdiction under the 1933 Act is not nullified by SLUSA.⁴²¹ The Court also made it clear that SLUSA did not impact the rule that class actions alleging solely 1933 Act claims in state court are not subject to removal to federal court.⁴²²

Presumably simple breach of contract,⁴²³ breach of fiduciary duty,⁴²⁴ or conversion⁴²⁵ actions can be brought in state court. Courts should be mindful that state-law claims do not represent an attempt to disguise a securities claim as something else in order to avoid SLUSA's preemption.⁴²⁶ Class actions involving securities that are not publicly traded may remain in state court.

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

418. 1934 Act §§ 28(f)(3)(B), (C), 15 U.S.C. §§ 78pp(f)(3)(B), (C); 1933 Act §§ 16(d)(2), (3), 15 U.S.C. §§ 77p(d)(2), (3).

419. 1933 Act § 27(b)(4), 15 U.S.C. § 77z-1(b)(4); 1934 Act § 21D(b)(3), 15 U.S.C. § 78u-4(b)(3).

420. 1933 Act § 22(a), 15 U.S.C. § 77v(a).

421. *Cyan, Inc. v. Beaver Cnty. Emps.' Ret. Fund*, 138 S. Ct. 1061 (2018).

422. *Id.* at 1069–70.

423. See, e.g., *Green v. Ameritrade, Inc.*, 120 F. Supp. 795 (D. Neb. 2000) (breach of contract claim not preempted). In fact, SLUSA 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. § 77p(d)(3); 1934 Act § 28(f)(3)(C), 15 U.S.C. § 78u-4(f)(3)(C).

424. See, e.g., *Banks v. Northern Trust Corp.*, 929 F.3d 1046 (9th Cir. 2019), *cert. denied*, 140 S. Ct. 1243 (2020) (SLUSA did not preempt trust beneficiary's state-law mismanagement suit).

425. See, e.g., *Gray v. Seaboard Sec., Inc.*, 126 F. App'x 14 (2d Cir. 2005) (although complaint was framed in terms of action for breach of contract, the underlying alleged wrong was fraud in connection with securities transactions and thus SLUSA preemption applied); *Burns v. Prudential Sec.*, 116 F. Supp. 2d 917 (N.D. Ohio 2000) (SLUSA did not preempt state jurisdiction over plaintiffs' state law claims of conversion, breach of contract, breach of fiduciary duty, and negligent supervision).

426. See, e.g., *Holtz v. JPMorgan Chase Bank, N.A.*, 846 F.3d 928 (7th Cir. 2017) (SLUSA preempted claims regarding covered securities where nondisclosure was lynchpin of claim); *Goldberg v. Bank of Am., N.A.*, 846 F.3d 913 (7th Cir. 2017) (SLUSA preempted claim that bank breached duties by not disclosing that it retained a fee for mutual fund sweep accounts).

duty; or asserting statutory appraisal rights.⁴²⁷ Often referred to as the “Delaware carve out”—although not expressly limited to Delaware—the preservation of these state-law claims 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.⁴²⁸ The action will be remanded to state court only if it is determined that SLUSA’s preemptive provisions do not apply.⁴²⁹ Since a federal court’s decision to remand is jurisdictional, there is no right of appeal to a federal court of appeals.⁴³⁰ In addition, SLUSA empowers a federal court to stay discovery in any state court action if deemed to aid in the federal court’s jurisdiction.⁴³¹

427. 1934 Act § 28(f)(3)(A), 15 U.S.C. § 78pp(f)(3)(A); 1933 Act § 16(d)(1), 15 U.S.C. § 77p(d)(1).

428. 1934 Act § 28(f)(2), 15 U.S.C. § 78pp(f)(2); 1933 Act § 16(c), 15 U.S.C. § 77p(c).

429. 1934 Act § 28(f)(4)(D), 15 U.S.C. § 78pp(f)(4)(D); 1933 Act § 16(d)(4), 15 U.S.C. § 77p(d)(4). *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).

430. *Kircher v. Putnam Funds*, 547 U.S. 633, 643 (2006). The Court also held that the state court, on remand, is then free to make its own decision about SLUSA preemption. The state court’s ruling would then be reviewable by the Supreme Court.

431. 1934 Act § 21D(b)(3), 15 U.S.C. § 78u-4(b)(3); 1933 Act § 27(b)(4), 15 U.S.C. § 77z-1(b)(4). *See, e.g., In re Bankamerica Corp. Sec. Litig.*, 95 F. Supp. 2d 1044, 1049 (D. Mo. 2000) (staying state court class action that “threaten[ed] the orderly conduct of the federal case,” which represented more than twenty-six times the dollar amount in claims than state court proceeding that was stayed).

IV

Regulating Issuers, Securities Professionals, and Securities Markets: Securities Exchange Act of 1934

IV.A

Scope of 1934 Act

The Securities Exchange Act of 1934 presents a broad umbrella of regulation including securities transactions in the secondary market. For example, there are periodic disclosure requirements for publicly traded companies. 1934 Act regulation also includes market regulation to create transparency in the markets and to prevent fraud and manipulation. The three principal targets of the 1934 Act are issuers, securities markets, and market professionals. Securities markets and market professionals are overseen directly by the SEC and by a system of self-regulation, which also is overseen by the SEC.

The 1934 Act has a much broader scope than the 1933 Act in its regulation of securities distributions—the 1934 Act’s scope includes 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 almost 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 § 10(b) and, in particular, SEC Rule 10b-5; and (2) the tender offer antifraud provision in § 14(e).

There are two jurisdictional bases for regulation of securities and the companies issuing the securities 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 § 14(e) of the 1934 Act. The second basis for jurisdiction is found in the registration provisions of § 12 and the periodic reporting provisions of §§ 13 and 15(d). There are two triggers for 1934 Act periodic reporting requirements. First, as discussed below, §§ 12(a) and 12(g) require registration of most publicly traded securities and those registration requirements in turn trigger the periodic reporting requirements. Second, companies that have gone public through a 1933 Act registration are subject to periodic reporting even if not registered under 1934 Act § 12.

Section 12 of the 1934 Act requires registration of most publicly traded securities. Under § 12(a), any security that is traded on a national exchange must be registered under the 1934 Act.⁴³² The New York and American stock exchanges (and the various regional exchanges) are the oldest national exchanges. Nasdaq's national stock market was registered with the SEC as a national securities exchange in 2007. Section 12(a) covers exchange-traded equity securities (stock and securities convertible into stock), exchange-traded options (puts and calls),⁴³³ and exchange-traded debt securities (bonds). In subsection (g), § 12's registration provisions further apply to equity securities that are publicly traded through Nasdaq or other quotations systems,⁴³⁴ rather than on a more traditional stock exchange.

Section 12(g) requires registration of companies with at least \$10 million in assets and a specified number of shareholders of record. The JOBS Act amended § 12(g) to increase the registration threshold from 500 to 2,000 shareholders of record. But it kept the former 500 "shareholder of record" threshold with respect

432. The 1934 Act's registration requirement is set forth in § 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 offering of that class of securities under the 1933 Act.

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

434. For more background, *see supra* § [1.D](#), Self-Regulation.

to unaccredited investors.⁴³⁵ Shareholders who receive shares as part of an employee compensation plan that is exempt from 1933 Act registration are excluded from the shareholder of record calculation.

Section 12(g) was also amended to exclude from the shareholder calculation any holders of shares issued pursuant to an exempt crowdfunding offering. As noted earlier, § 12 registration subjects companies to the 1934 Act's periodic reporting requirements and other requirements, including proxy regulation, tender offer and other takeover regulation, and reporting of insider transactions in the company shares.

It is curious that § 12(g)(1) focuses on shareholders of record instead of beneficial owners. With many shares held by brokerage houses in street name (or held in depositories like Cede Corporation and the Depository Trust Corporation), the number of beneficial owners—each of whom makes *their* own investment decisions—far exceeds the number of shareholders of record.

The registration and consequent periodic reporting obligations cease if, on the last day of each of the issuer's last three fiscal years, the issuer has had fewer than 300 shareholders of record of that class of securities; or has had assets not exceeding \$10 million.⁴³⁶ Under these circumstances, the issuer may withdraw its registration.

Registration under the 1934 Act brings with it periodic disclosure obligations. Section 13 sets forth the periodic reporting requirements. The Act mandates quarterly public filings supplemented by interim filings based on certain triggering events or developments. The basic reports that must be filed with the SEC are Form 10-K, an annual report;⁴³⁷ Form 10-Q, a quarterly report;⁴³⁸ and Form 8-K,

435. The term accredited investor is defined with respect to the 1933 Act exemptions. As noted earlier, there are 13 categories of accredited investors: (1) banks, brokerage firms, insurance companies, investment companies, and specified employee benefit plans, (2) private business development companies, (3) charitable or educational institutions with assets of more than \$5 million, (4) any of the issuer's directors, executive officers, or general partners, (5) any natural person with a net worth of more than \$1 million, (6) natural persons with an annual income of more than \$200,000 (or, together with his or her spouse or spousal equivalent, more than \$300,000), (7) trusts with more than \$5 million in assets managed by a "sophisticated person," (8) any entity in which all of the owners are accredited investors, (9) an entity not formed for the purpose of the securities offered owning more than \$5 million in investments, (10) anyone in good standing with professional certifications approved by the SEC, (11) knowledgeable employees of the issuer as defined in ICA Rule 3c-5(a)(4), (12) family offices with more than \$5 million under management, and (13) any "family client," as defined in IAA Rule 202(a)(11)(G)-1. 1933 Act Rules 215, 501(a), 17 C.F.R. §§ 230.215, 230.501(a).

436. SEC Rule 12h-3, 17 C.F.R. § 240.12h-3.

437. 17 C.F.R. § 249.310.

438. *Id.* § 249.308a.

an interim “current report.”⁴³⁹ Form 8-K’s mandated, interim reporting requirements formerly were quite limited⁴⁴⁰ but were significantly expanded by SEC rule making in the wake of a mandate contained in the Sarbanes-Oxley Act of 2002.⁴⁴¹ Even with the expanded reporting requirements, mandatory Form 8-K interim disclosures are limited to a discrete set of events and circumstances. Absent a “line item” disclosure mandate in an SEC form, publicly traded companies are not under an affirmative duty to disclose information until the next quarterly report. Nevertheless, companies still use Form 8-K for voluntary interim filings.

Some publicly held companies not required to register under § 12 of the 1934 Act are nevertheless subject to the periodic reporting requirements mentioned above. Section 15(d) of the 1934 Act provides that issuers having issued securities under a 1933 Act registration statement with more than 300 record holders are subject to 1934 Act requirements. Section 15(d) reporting companies are subject to a lower level of regulation than companies registered under the 1934 Act. They are not subject to the proxy regulations under § 14, the takeover and tender offer provisions of the Williams Act, or the insider trading and reporting provisions in § 16.

IV.B

Prohibition of Manipulative Activities

Three provisions of the 1934 Act expressly address manipulative practices. Section 9 applies to all securities transactions in interstate commerce.⁴⁴² Sec-

439. *Id.* § 249.308.

440. Prior to expansion in 2004, only the following items had to 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 that 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).

441. Public Company Accounting Reform & Investor Protection Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, as codified in 18 U.S.C. §§ 1341, 1343, 1512, 1513, 3553, and 994. Those additional disclosure items include: entry into a material, non-ordinary course agreement; termination of a material, non-ordinary course agreement; creation of a material, direct financial obligation or a material obligation under an off-balance sheet arrangement; triggering events that accelerate or increase a material, direct financial obligation or a material obligation under an off-balance sheet arrangement; material costs associated with exit or disposal activities; material impairments; notice of delisting or failure to satisfy a continued listing rule or standard; transfer of listing; and nonreliance on previously issued financial statements or a related audit report or completed interim review (restatements).

442. 15 U.S.C. § 78i. Section 9 was formerly limited to exchange-traded securities.

tions 10(b) and 15(c) give the SEC rule-making authority to define and thereby prohibit manipulative practices.⁴⁴³

Section 9(a) prohibits transactions entered into simultaneously where the purpose is to create a misleading appearance of active trading. It also prohibits any transactions that give the artificial impression of active trading, as well as transactions entered into for the purpose of depressing or raising the price of the securities.

Manipulative practices include wash sales. A wash sale is a fictitious sale that does not result in a change of 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. Wash sales and other manipulative acts create the appearance of liquidity that makes a stock more attractive. A “matched” order, which is not necessarily manipulative, 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 benefit the firm’s customers if the savings on commissions are passed on to the customers. Cross-trades become problematic when the cost savings are not passed on to the customer.

Prearranged trades as a manipulation can be used to set an artificially high price. Section 9 applies not only to securities transactions, but also to transactions involving security-based swap agreements. In addition, § 9(a)(6) empowers the SEC to promulgate rules prohibiting “pegging, fixing, or stabilizing” securities prices.⁴⁴⁴

Manipulation does not include all transactions that result in a security’s price movement. Manipulation is limited to transactions designed and intended to impact the price artificially. Manipulative intent, which is often difficult to prove, is a necessary element of any manipulation claim.⁴⁴⁵

443. *Id.* §§ 78j(b), 78o(c).

444. The SEC addressed the problem of stabilization 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).

445. See, e.g., *United States v. Mulheren*, 938 F.2d 364 (9th Cir. 1991) (failure to establish manipulative intent).

Another type of manipulation covered by § 9 involves options (puts and calls).⁴⁴⁶ 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 and call options for securities by requiring an adequate disclosure document for purchasers and sellers.

IV.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 § 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 § 14(a), there must be full and fair disclosure of all material facts about 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.⁴⁴⁷ 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

446. The anti-manipulation provisions relating to options do not apply to warrants (options issued by the issuer). Furthermore, the provisions are limited to options for securities, not to be confused with futures contracts or options relating to commodities, which are regulated by the Commodities Futures Trading Commission.

As explained in the [Glossary](#) *infra*, 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 11, §§ 1:72-1:79; 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).

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

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 § 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 § 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, § 14(c) nevertheless requires management to mail a statement containing information similar to that required for a proxy solicitation to the shareholders in advance of any shareholders' meeting.⁴⁴⁸

The proxy rules govern disclosure but not voting mechanics or substantive voting rights.⁴⁴⁹ 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 proxy⁴⁵⁰ and solicitation⁴⁵¹ materials. All solicitations must be accompanied by or preceded by a written proxy statement containing the information required by Schedule 14A⁴⁵² (described below). If shareholder action is to be taken without a proxy solicitation, Schedule 14C⁴⁵³ requires similar disclosures in an information statement. 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

448. 15 U.S.C. § 78n(c). These informational requirements are set out in Regulation 14C, 17 C.F.R. §§ 240.14c-1 to 240.14c-7, and Schedule 14C, 17 C.F.R. § 240.14c-101.

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

450. *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 are in Rule 14a-4.

451. *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. 17 C.F.R. § 240.14a-1(l). Rule 14a-2 lists the types of solicitations exempt from the proxy rules. 17 C.F.R. § 240.14a-2. Rule 14a-3 sets forth the types of information that must be included in proxy solicitations. 17 C.F.R. § 240.14a-3.

452. 17 C.F.R. § 240.14a-101

453. *Id.* § 240.14c-101.

security holders.⁴⁵⁴ The annual report must contain financial information as well as management's analysis of operations.

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 contains one of the more significant director election disclosure requirements—disclosure of the nominee's experience in office. Nondisclosure of a director's conduct in office may be a material omission with respect to a shareholder's decision on how to cast her vote.⁴⁵⁵ As is the case with disclosures generally, the pertinent information relating to the composition of the board of directors⁴⁵⁶ and the directors' conduct must be disclosed clearly and conspicuously.

The federal proxy rules also provide for shareholder access to information.⁴⁵⁷ Rule 14a-8, the shareholder proposal rule, tells management 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 a shareholder proposal to be included, the proponent must have owned, for one year, at least \$25,000 worth of the market value of the securities; and must continue to be a security holder through the date on which the shareholder meeting is held. The dollar amount decreases if the proponent held the securities for more than a year. If the proponent owned the securities for at least two years, the minimum dollar value drops to \$15,000; if the proponent owned the securities for at least two years, the minimum dollar value drops to \$2,000. Separate shareholders may not aggregate their shares to meet these thresholds.

The proposal submission must be timely under the requirements of Rule 14a-8(a)(3). A shareholder may submit only one proposal per year that qualifies for mandatory inclusion in management's proxy statement. In addition to the proposal

454. Rule 14a-3(b), 17 C.F.R. § 240.14a-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.

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

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

457. *See* Rule 14a-7, designed for nonmanagement persons intending to make a solicitation. 17 C.F.R. § 240.14a-7. 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. In *Haas v. Wieboldt Stores, Inc.*, 725 F.2d 71 (7th Cir. 1984), the Seventh Circuit held that violations of Rule 14a-7's mailing requirements can give rise to private rights of action.

itself, the proponent may provide a supporting statement, subject to length limitations. The issuer may exclude certain proposals, even those filed properly and timely. For example, the issuer may exclude a proposal on the grounds that it is inconsistent with state law, that it relates to a personal grievance, or that it is beyond the company's power to accomplish.⁴⁵⁸ Management may exclude a shareholder proposal from its proxy statement on the basis of relevance or if it relates to the company's ordinary business.⁴⁵⁹ However, if a proposal is valid under state law and is properly excludable under the SEC's shareholder proposal rule, it must nevertheless be described in the issuer's proxy statement.⁴⁶⁰ The essence of Rule 14a-8(i)(7), as it relates to ordinary business operations, is that shareholder proposals concerning the day-to-day managerial decisions about how the nuts and bolts of the business are carried out may be excluded from management's proxy statement even though extraordinary matters may not be excluded.

A shareholder proposal may be excluded if it relates to election to a corporate office. Under Rule 14a-8(i)(8), a proposal may be excluded if it "relates to an election for membership on the company's board of directors or analogous governing body."⁴⁶¹ The proxy rules generally provide the ground rules for disclosures relating to contested elections, but contrary to the views of many critics, the rules do not guarantee non-management's nominations to be listed in management's proxy statement. A shareholder proposal is not excludable simply because it relates to the election process but only if it relates to the election or removal of a person from office. After many years of debates within and outside of the SEC, and after several false starts, the SEC in August 2010 adopted proxy access for shareholder nominations, provided that certain conditions are met and the shareholder is not seeking control of the board.⁴⁶² Shortly after the SEC adopted the proxy access rules, the U.S. Chamber of Commerce and the Business Roundtable filed suit claiming that the rule violates the First Amendment,

458. 17 C.F.R. §§ 240.14a-8(i)(1), (2), (4), (6). Proposals that contradict a proposal put forward by management may be omitted, as may duplicative proposals. *Id.* §§ 240.14a-8(i)(9), (11). If the proposal has been rendered moot, it may be excluded as well. *Id.* § 240.14a-8(i)(10).

459. 17 C.F.R. §§ 240.14a-8(i)(5), (7). Other grounds for exclusion include proposals that violate the proxy rules and that relate to dividends. *Id.* §§ 240.14a-8(i)(3), (13). Proposals may also be excluded if they are resubmissions and did not garner sufficient votes in previous years. *Id.* § 240.14a-8(i)(12). For discussion of all the grounds for exclusion, see 3 Hazen *supra* note 11.

460. Schedule 14A, item 21, 17 C.F.R. § 240.14a-101.

461. 17 C.F.R. § 230.14a-8(i)(8).

462. See Facilitating Shareholder Director Nominations, Securities Act Release No. 33-9136, Exchange Act Release No. 34-62764, Inv. Co. Act Release No. IC-29384, 2010 WL 3343532 (SEC Aug. 25, 2010).

and also that the rule is invalid because it is arbitrary and capricious.⁴⁶³ The SEC then granted the plaintiffs' request for an administrative stay of the new rules pending resolution of the challenge to SEC rule making.⁴⁶⁴ The D.C. Circuit Court of Appeals invalidated the proxy access rule because of the SEC's failure to give a sufficient analysis of the rule's economic impact.⁴⁶⁵ Despite the previous unsuccessful attempts to grant shareholder access to management's proxy statement regarding director elections, it finally became a reality. In 2021, the SEC adopted a universal proxy for contested elections whereby management-solicited proxies must include the slate of opposition candidates in addition to the slate of management-supported candidates.⁴⁶⁶

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.⁴⁶⁷ 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 on the clear implication of the language of Rule 14a-9,⁴⁶⁸ in order to establish standing to sue, all a private plaintiff needs to show in a Rule 14a-9 action is that it was injured in connection with a proxy solicitation covered by the 1934 Act's regulation.⁴⁶⁹ Courts have held that a shareholder has standing to challenge a misleading proxy statement by alleging direct injury notwithstanding

463. *Business Roundtable v. SEC*, No. 10-1305 (D.C. Cir. filed Sept. 29, 2010). See *Chamber, Roundtable Files Suit Challenging Proxy Access Rulemaking; Asks SEC for Stay*, *Sec. Law Daily* (BNA) (Sept. 30, 2010).

464. *In re Business Roundtable*, Securities Act Release No. 33-9149, Exchange Act Release No. 34-63031, Inv. Co. Act Release No. IC-29456, 2010 WL 3862548 (SEC Oct. 4, 2010) (order granting stay).

465. *Business Roundtable v. SEC*, 674 F.3d 1144, 1148-49 (D.C. Cir. 2011) ("Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.").

466. Rule 14a-19, 17 C.F.R. § 240.14a-19, adopted in *Universal Proxy*, Sec. Exch. Act Release No. 34-93596, Inv. Co. Act Release No. IC-34419, 2021 WL 5545055 (SEC Nov. 17, 2021).

467. 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).

468. 17 C.F.R. § 240.14a-9.

469. See, e.g., *Palumbo v. Deposit Bank*, 758 F.2d 113 (3d Cir. 1985) (director has standing to bring suit under proxy rules); *Ameribanc Invs. Group v. Zwart*, 706 F. Supp. 1248 (E.D. Va. 1989) (even issuer or target corporation has standing to sue under proxy rules); *District 65, UAW v. Harper & Row Publishers*, 576 F. Supp. 1468 (S.D.N.Y. 1983) (plaintiff must be a shareholder at time of proxy solicitation).

the absence of the shareholder's alleging actual reliance.⁴⁷⁰ All that is necessary is that the reliance of some shareholders on the misleading statement was likely to have affected how they voted.

IV.C.1

Materiality

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 described the determination of "materiality" as a mixed question of law and fact.

[a]n 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.⁴⁷¹

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,⁴⁷² and it was echoed in an SEC rule pertaining to materiality in the context of 1934 Act registration and reporting.⁴⁷³ 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 in this monograph).

It is difficult to generalize about issues of materiality, since the decisions are highly fact-specific. But the cases reflect, in large part, the common law of misrepresentation, which states that opinions, predictions, intentions, and mere statements of value are generally not actionable.⁴⁷⁴ Opinions, predictions, and projections will not be actionable unless they constitute a misrepresentation of

470. See, e.g., *Bradshaw v. Jenkins*, No. C83-771R, 1984 U.S. Dist. LEXIS 24101 (W.D. Wash. Aug. 27, 1984). 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 fraud claim).

471. *TSC Indus.*, 426 U.S. at 449.

472. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). The definition of *materiality* does not vary between proxy-related statements subject to § 14(a) and statements generally that would be subject to § 10(b) and Rule 10b-5.

473. Rule 12b-2, 17 C.F.R. § 240.12b-2.

474. 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).

fact.⁴⁷⁵ The Supreme Court has pointed out, however, that opinions of management can be material facts in and of themselves.⁴⁷⁶ Even aside from a materially misleading statement of opinion, an opinion may be actionable if there is a material omission of fact from the statement containing the opinion because a reasonable investor “expects not just that the issuer believes the opinion (however irrationally), but that it fairly aligns with the information in the issuer’s possession at the time.”⁴⁷⁷ Complicating matters are the disclosures required in Management Discussion and Analysis (MD&A) concerning the significant trends and uncertainties that could have a material impact on the company’s operations.⁴⁷⁸ In addition to MD&A disclosures, companies are required to discuss risk factors in terms of industry risks, company risks, and investment risks.⁴⁷⁹

Nondisclosure or inadequate disclosure of conflicts of interest frequently constitute material misrepresentations.⁴⁸⁰ In some contexts, however, 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.⁴⁸¹

IV.C.2

Causation

In addition to materiality, establishing an actionable violation of the proxy rules requires the private plaintiff to establish causation. Causation under the proxy

475. See, e.g., *Krauth v. Executive Telecard, Ltd.*, 890 F. Supp. 269 (S.D.N.Y. 1995). The “bespeaks caution” doctrine, discussed *supra* text and accompanying notes 197–200, precludes liability for forward-looking statements made in good faith. 15 U.S.C. § 77z-2. See, e.g., *Wielgos v. Commonwealth Edison*, 892 F.2d 509 (7th Cir. 1989). See also *Roots P’ship v. Land’s End, Inc.*, 965 F.2d 1411 (7th Cir. 1992).

476. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) (management’s statement regarding fairness of transaction could be material fact and thus basis of proxy rule claim).

477. *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 575 U.S. 175, 188–89 (2015).

478. Reg. S-K, Item 303, 17 C.F.R. § 229.303. Item 303’s disclosure mandate is significantly broader than the disclosure mandate imposed by Rule 10b–5. See *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046 (9th Cir. 2014).

479. Regulation S-K item 105, 17 C.F.R. § 229.105. See *Jaroslavicz v. M&T Bank Corp.*, 962 F.3d 701, 711 (3d Cir. 2020) (quoting SEC Division of Corporation Finance: Updated Staff Legal Bulletin No. 7, “Plain English Disclosure,” Release No. SLB-7, 1999 WL 34984247, at **5, 6 (SEC June 7, 1999)).

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

481. 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 Commc’ns v. Murdoch*, 581 F. Supp. 1482 (D. Del. 1984).

rules' private right of action is 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.⁴⁸² Once cause in fact has been established, it must be shown that the causal connection is sufficiently proximate in 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 are not sufficient to state a claim.⁴⁸³ 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.⁴⁸⁴ 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.⁴⁸⁵

IV.C.3

Culpability Required

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.⁴⁸⁶ Although a few courts have indicated that scienter is required in actions under Rule 14a-9,⁴⁸⁷ the Supreme Court's ruling in *Aaron v. SEC*,⁴⁸⁸ though decided under § 17(a) of the 1933 Act, seems to mandate that a showing of negligent conduct would suffice.

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

483. 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).

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

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

486. *Herskowitz v. Nutri/Sys., 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).

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

488. 446 U.S. 680 (1980).

IV.C.4

Remedies

Material misstatements and omissions in connection with a proxy solicitation can result in civil liability to shareholders who can show injury. 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 requirements.⁴⁸⁹ Injunctive relief may also be secured in an SEC enforcement action,⁴⁹⁰ and in an appropriate case the SEC can refer the matter for criminal prosecution.⁴⁹¹ But it is impossible 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,⁴⁹² 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, 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). 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.

IV.D

Tender Offers and Takeover Bids: 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 rise 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

489. 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 claim, preliminary injunction denied because of plaintiff's failure to show that otherwise there would be irreparable injury).

490. 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 action against shareholders waging proxy battle).

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

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

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, comprising amendments to the 1934 Act that were enacted to regulate these tender offers and takeover bids. The Williams Act is codified in 1934 Act §§ 13(d) and (e), and 14(d), (e), and (f).

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 13D⁴⁹³ 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 under § 12.⁴⁹⁴ Once this 5% threshold is reached, the person has ten days to file the Schedule 13D,⁴⁹⁵ unless a shorter filing window is provided by SEC rule making. After the Schedule 13D filing, there is a ten-day moratorium on additional purchases. In 2022, the SEC proposed reducing the ten-day window to five days and also requiring next-day filing of amendments to Schedules 13D and 13G.⁴⁹⁶

As defined by § 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. According to the Second Circuit, 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

493. 17 C.F.R. § 240.13d-101.

494. The Schedule 13D 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 of its own shares, directly or through an affiliate, are subject to similar disclosure requirements under § 13(e).

495. 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. Attempts have been made 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). *See also D'Amato Introduces Comprehensive Proposal for Tender Offer Reform*, 19 Sec. Reg. & L. Rep. (BNA) 84 (Jan. 24, 1987).

496. Modernization of Beneficial Ownership Reporting, Sec. Act Release No. 33-11030, Sec. Exch. Act Release No. 34-94211 (SEC Feb. 10, 2022).

shift in control; no agreement to purchase further securities is necessary.⁴⁹⁷ In contrast, the Seventh Circuit requires more explicit 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.⁴⁹⁸

A group may be deemed to exist when individual parties agree to act in concert to buy additional shares, regardless of the absence of a common plan with respect to the target corporation beyond the additional share acquisitions.⁴⁹⁹ 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 § 13(d) filing requirement even though no additional shares are to be purchased. Whether a failure in the Schedule 13D⁵⁰⁰ to disclose the existence of a group constitutes a material misstatement or omission depends on the facts of the case.⁵⁰¹

Rule 13d-3 sets forth the SEC's standards for determining who is a beneficial owner for purposes of § 13(d) and § 13(g)⁵⁰² filing requirements. Section 13(d)(4) addresses the computation of the 5% threshold.⁵⁰³

497. *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972) (finding that four shareholders constituted group). *Accord* *Global Intellicom, Inc. v. Thomson Kernaghan & Co.*, No. 99 CIV. 342(DLC), 1999 U.S. Dist. LEXIS 11378 (S.D.N.Y. July 27, 1999) (sufficient allegations that a number of investors constituted group); *Strauss v. American Holdings, Inc.*, 902 F. Supp. 475 (S.D.N.Y. 1995) (allegation that one person was president and CEO of one firm that was a shareholder and sole general partner of another was sufficient to allege group).

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

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

499. *Mid-Continent Bancshares, Inc. v. O'Brien*, No. 81-1395-C(C), 1981 WL 1404 (E.D. Mo. Dec. 11, 1981).

500. 17 C.F.R. § 240.13d-101.

501. *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).

502. 15 U.S.C. §§ 78m(d), 78m(g). *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).

503. 15 U.S.C. § 78m(d)(4).

Section 13(d)(6) exempts certain acquisitions from the filing requirements of §§ 13(d) and 13(g). Section 13(d)(6) gives the SEC the power to provide additional exemptions through rule making.⁵⁰⁴

Section 13(d)'s filing requirements are aimed at creeping acquisitions and open-market or privately negotiated large-block purchases. In contrast, § 14(d)'s filing requirements⁵⁰⁵ and § 14(e)'s general antifraud proscriptions⁵⁰⁶ are triggered by a tender offer.⁵⁰⁷ 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 the following 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 the 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.⁵⁰⁸

504. 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 other than through the pro rata share offering of preemptive rights; and 3) the acquisition is duly reported, if required, pursuant to § 16(a). 17 C.F.R. § 240.13d-6.

505. 15 U.S.C. § 78n(d).

506. *Id.* § 78n(e). Unlike the other provisions of the Williams Act, § 14(e) is not limited to securities subject to the 1934 Act registration requirements. Thus, as is the case with SEC Rule 10b-5, § 14(e) and the SEC rules thereunder apply to transactions utilizing an instrumentality of interstate commerce. See 17 C.F.R. §§ 14e-1 through 14e-5.

507. Section 14(f) relating to disclosures about management turnover is not limited to tender offers. 15 U.S.C. § 78n(f).

508. 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), and *Hoover Co. v. Fuqua Indus., Inc.*, No. C79-1062A, 1979 U.S. Dist. LEXIS 11809 (N.D. Ohio June 11, 1979).

These are only broad guidelines. Any predictability must be gleaned from the cases and SEC rulings.⁵⁰⁹ Cases involving both open-market and privately negotiated stock purchases seem to turn on whether or not the “pressure-creating characteristics of a tender offer”⁵¹⁰ accompany the transactions.⁵¹¹ 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.⁵¹² 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; but the cases show that this will rarely be the case.

Once an offer is deemed a tender offer, the offer is governed by various procedural provisions of the Williams Act. In general, § 13(e) and the rules promulgated under § 13(e) regulate issuer tender offers, or “self tender offers,” and §§ 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

509. See, e.g., *Holstein v. UAL Corp.*, 662 F. Supp. 153 (N.D. Ill. 1987) (holding poison-pill plan involving distribution of rights not tender offer); *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985) (five privately negotiated purchases and one open-market purchase not tender offer; transactions in question referred to as “end run” because they were preceded by tender offer that was withdrawn and then followed by 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 third-party tender offer not tender offer subject to § 13(e)); *Beaumont v. American Can Co.*, 621 F. Supp. 484 (S.D.N.Y. 1984), *aff’d*, 797 F.2d 79 (2d Cir. 1986) (cash-option portion of merger with cash-election feature not tender offer); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890 (N.D. Me. 1971) (large block-purchase of shares made without intent to obtain control not tender offer).

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

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

512. See, e.g., *Cattlemen’s Inv. Co. v. Fears*, 343 F. Supp. 1248, 1251 (W.D. Okla. 1972) (any privately negotiated purchase that interferes with shareholder’s “unhurried investment decision” and “fair treatment” of investors defeats protections of Williams Act and is probably tender offer); *Wellman*, 475 F. Supp. 783 (secret offers to twenty-eight of target company’s largest shareholders, giving each only from half-hour to overnight to decide, constituted 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 tender offer where tender offeror and solicited shareholder agree on secrecy and private nature of transaction, and no high-pressure tactics 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 tender offer).

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 (§§ 13(e) and 14(d) and applicable rules), but some of the federal tender offer regulations apply regardless of 1934 Act registration (§ 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 § 12 must be filed with the SEC⁵¹³ 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 § 14(d) filings must be updated to reflect material changes and developments.⁵¹⁴ Section 14(d) does not apply to an issuer’s acquisition of its own shares—those transactions are covered by § 13(e), which, by virtue of SEC rule making, imposes regulations for issuer tender offers that are comparable⁵¹⁵ 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 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.⁵¹⁶ 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.

513. Schedule TO (formerly Schedule 14D-1) is the appropriate form for filing tender offers under § 14(d). 17 C.F.R. § 240.14d-100.

514. See, e.g., *In re Revlon, Inc.*, Sec. Exchange Act Release No. 34-23320, 1986 WL 626158 (June 16, 1986) (finding violations of Rule 14d-4 for failure to amend Schedule 14D-9 to reflect defensive merger negotiations).

515. See, e.g., Rule 13e-1, 17 C.F.R. § 240.13e-1.

516. 1934 Act § 14(d)(6), 15 U.S.C. § 78n(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. 17 C.F.R. §§ 240.14d-8, 240.13e-4(f)(3).

The “all holders” rule prohibits discriminatory tender offers that exclude one or more shareholders from participating.⁵¹⁷ There is an exception to the all holders requirement when the tender offer is in compliance with a constitutionally valid state statute.⁵¹⁸ In addition to reserving general exemptive power under the all holders rule,⁵¹⁹ the SEC promulgated a specific but limited exemption for “odd-lot tender offers” by issuers.⁵²⁰ An odd-lot offer is one limited to security holders owning less than a specified number of shares under one hundred. Within that group, however, both the “all holders” and “best price” requirements will apply to the terms of the odd-lot offer.

The “best price” rule states that the highest price paid to any tendering security holder must be paid to all tendering security holders.⁵²¹ This requirement applies only to shares purchased during a single tender offer. Unlike state “fair price” statutes,⁵²² it does 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.⁵²³ 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.⁵²⁴ As is the case with the all holders rule, the SEC can grant exemptions from the best price requirement.⁵²⁵

517. Rule 14d-10(a)(1), 17 C.F.R. § 240.14d-10(a)(1) (third-party tender offers); Rule 13e-4(f)(8)(i), 17 C.F.R. § 240.13e-4(f)(8)(i) (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 Petrol. Co.*, 493 A.2d 946 (D. Del. 1985).

518. Rule 14d-10(b)(2), 17 C.F.R. § 240.14d-10(b)(2) (third-party tender offers); Rule 13e-4(f)(9)(ii), 17 C.F.R. § 240.13e-4(f)(9)(ii) (issuer tender offers).

519. Rule 14d-10(e), 17 C.F.R. § 240.14d-10(e); Rule 13e-4(g)(7), 17 C.F.R. § 240.13e-4(g)(7).

520. Rule 13e-4(g)(5), 17 C.F.R. § 240.13e-4(g)(5).

521. Rule 14d-10(a)(2), 17 C.F.R. § 240.14d-10(a)(2) (third-party tender offers); Rule 13e-4(f)(8)(ii), 17 C.F.R. § 240.13e-4(f)(8)(ii) (issuer tender offers).

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

523. 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 sham). *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 § 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. 15 U.S.C. § 78n(d)(7).

524. Rule 14d-10(c), 17 C.F.R. § 240.14d-10(c) (third-party tender offers); Rule 13e-4(f)(10), 17 C.F.R. § 240.13e-4(f)(10) (issuer tender offers).

525. Rule 14d-10(e), 17 C.F.R. § 240.14d-10(e); Rule 13e-4(g)(7), 17 C.F.R. § 240.13e-4(g)(7).

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.⁵²⁶ 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.⁵²⁷ 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.⁵²⁸

Table 2 summarizes some of the more important Williams Act requirements as implemented by SEC rules:

Table 2: Williams Act Requirements

	Third-Party Tender Offer	Issuer Tender Offer
Best Price Rule	§ 14(d)(7), Rule 14d-10(a)(2)—the highest price paid to any tendering security holder must be paid to all tendering security holders. Rule 14d-10(c) allows different types of consideration to be offered which need not be substantially equivalent in value as long as: 1) security holders are free to elect among the types of consideration offered; and 2) the highest consideration of each type paid to any security holder is paid to any security holder electing that type.	Rule 13e-4(f)(8)(ii)—the highest price paid to any tendering security holder must be paid to all security holders. Rule 13e-4(f)(10) (same as third-party offer)

526. Rule 14e-1(a), 17 C.F.R. § 240.14e-1(a) (third-party tender offers); Rule 13e-4(f)(1)(i), 17 C.F.R. § 240.13e-4(f)(1)(i) (issuer tender offers).

527. Rule 14e-1(b), 17 C.F.R. § 240.14e-1(b) (third-party tender offers); Rule 13e-4(f)(1)(ii), 17 C.F.R. § 240.13e-4(f)(1)(ii) (issuer tender offers).

528. Rule 14d-4(c), 17 C.F.R. § 240.14d-4(c) (third-party tender offers); Rule 13e-4(e)(2), 17 C.F.R. § 240.13e-4(e)(2) (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 where the change is as significant as a change in consideration of the percentage of securities sought.

	Third-Party Tender Offer	Issuer Tender Offer
All Holders Rule	Rule 14d-10(a)(1) requires that the tender offer be open to all holders of the class of securities sought. Rule 14d-10(b)(2) permits a bidder to exclude holders in a state where the bidder is prohibited by statute from making the offer after a good faith effort to comply with the statute.	Rule 13e-4(f)(8)(i) (same as third-party offer) Rule 13e-4(f)(9)(ii) (same as third-party offer)
Pro Rata Rule	§ 14(d)(6)—where the offer is for less than all outstanding securities of a class and the offer is oversubscribed, the bidder must take up the tendered securities on a pro rata basis. • The statute only applies to securities tendered w/in 10 days from the original publication of the offer or notice of an increase in consideration—Rule 14d-8 extends the proration requirement to the entire duration of the offer. • The rule does not apply if the bidder's acquisitions of that class of securities during the past 12 months does not exceed 2% of that class.	Rule 13e-4(f)(3)—where the offer is for less than all outstanding securities of a class and the offer is oversubscribed, the bidder must take up the tendered securities on a pro rata basis. • The rule provides exceptions for odd-lot tender offers and for shares tendered on an all or none basis.

	Third-Party Tender Offer	Issuer Tender Offer
Duration of the Tender Offer	Rule 14e-1(a)—the tender offer must remain open for at least 20 business days. Rule 14e-1(b)—a change in the consideration to be paid, the percentage of securities sought, or the dealer’s solicitation fee will require that the offer be held open at least 10 business days from the date of notice of such change. - Exception—acceptance of additional securities not exceeding 2% of the class sought Rule 14d-4(c)—notice of “material” changes in the terms of the offer must be made in a manner reasonably designed to inform security holders of such change. - The SEC interprets this rule to mean that a material change would require holding the offer open for at least 5 business days from the date of notice and 10 business days when the change approaches the level of a change in consideration or the % of securities sought.	Rule 13e-4(f)(1)(i) (same as third-party offer) Rule 13e-4(f)(1)(ii) (same as third-party offer) (same as third-party offer) Rule 13e-4(e)(2)—notice of a “material” change in the information sent to security holders must be made in a manner reasonably calculated to inform security holders of such change.
Withdrawal Rights	§ 14(d)(5) tendered securities may be withdrawn at any time during the first 7 days of the tender offer and at any time after 60 days from the date of the original tender offer. Rule 14d-7—tendered securities may be withdrawn while the tender offer remains open.	Rule 13e-4(f)(2) tendered securities may be withdrawn: (i) at any time while the tender remains open; and (ii) after 40 days from commencement of the offer if the securities have not been accepted.

Whether or not a tender offer is made for equity securities subject to the 1934 Act's reporting requirements, § 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.⁵²⁹ Contemplated management turnover, including any arrangement regarding the makeup of the majority of directors, also must be disclosed.⁵³⁰ The purpose of § 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 their relationships with the issuer, both in terms of employment contracts and stock holdings.

In *Schreiber v. Burlington Northern, Inc.*,⁵³¹ the Supreme Court limited the thrust of § 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 § 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."⁵³² In a rather unusual review of the section's legislative history, the Court concluded that disclosure was the sole thrust of the section,⁵³³ 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 § 10(b), on which § 14(e) is based. This could lead to the invalidation of some of the § 10(b) rules dealing with manipulative conduct. The Third Circuit, however, was reluctant to give *Schreiber* such an unwarranted broad reading.⁵³⁴

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)

529. 15 U.S.C. § 78n(f).

530. Rule 14d-4(c), 17 C.F.R. § 240.14d-4(c) (third-party tender offers); Rule 13e-4(e)(2), 17 C.F.R. § 240.13e-4(e)(2) (issuer tender offers). *See also* Rule 14f-1, 17 C.F.R. § 240.14f-1 (requiring disclosure of change in majority of directors).

531. 472 U.S. 1 (1985).

532. *Id.* at 12.

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

534. *See, e.g.,* *Polaroid v. Disney*, 862 F.2d 987 (3d Cir. 1988) (upholding validity of "all holders" rule, which prohibits excluding shareholders from tender offer).

under § 14(e)'s antifraud provision.⁵³⁵ The availability of an implied remedy under the Williams Act's filing requirements (§§ 13(d), 13(e), and 14(d)) is also significant. The cases are in conflict, but a number of decisions have held that the relevant provisions of §§ 13 and 14 themselves provide a basis for at least limited private relief.⁵³⁶ Courts seem more likely to grant injunctive relief⁵³⁷ than damages.⁵³⁸ The Supreme Court indicated *in dicta* that a target company may have standing to complain of delays by a purchaser in filing a Schedule 13D when the target company can show a resultant injury.⁵³⁹

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 § 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.

535. Whether a violation of § 14(e) requires a showing that the defendant acted with scienter remains an open question. The Supreme Court originally granted certiorari in a case raising the question of whether negligence would support a private remedy under § 14(e), but never reached the issue. *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018), *cert. dismissed as improvidently granted*, 139 S. Ct. 1407 (2019). See *infra* § IV.E.3.

536. See, e.g., *Motient Corp. v. Dondero*, 529 F.3d 532, 536 (5th Cir. 2008) (denying the existence of a § 13(d) remedy for damages and noting that "[n]o other Circuit has found a private right of action for money damages under Section 13(d)"); *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, 286 F.3d 613, 620 (2d Cir. 2002), *aff'g* *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, No. 00 Civ. 1115 (LAK), 2001 WL 46978 (S.D.N.Y. Jan. 22, 2001) (dismissing § 13(d) claim for money damages). Cf. *Morrison v. Berry*, 191 A.3d 268 (Del. 2018) (as revised July 27, 2018) (a company's materially misleading Schedule 14d-9 filing may form the basis of a state-law claim that an ensuing shareholder vote was not made upon full disclosure and is therefore invalid).

537. See, e.g., *Conagra, Inc. v. Tyson Foods, Inc.*, 708 F. Supp. 257 (D. Neb. 1989); *Morrison Knudsen Corp. v. Heil*, 705 F. Supp. 497 (D. Idaho 1988); *Schnell v. Schnell*, 550 F. Supp. 650 (S.D.N.Y. 1982); *Berman v. Metzger*, No. 80-0394, 1981 WL 1596 (D.D.C. Feb. 9, 1981).

538. For a case holding that § 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 *Sanders v. Thrall Car Mfg. Co.*, 730 F.2d 910 (2d Cir. 1984), *aff'g* 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 *American Bakeries Co. v. Pro-Met Trading Co.*, No. 80 C 2088, 1981 WL 1616 (N.D. Ill. March 27, 1981); *Gateway Indus., Inc. v. Agency Rent A Car, Inc.*, 495 F. Supp. 92 (N.D. Ill. 1980).

539. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 60 (1975).

IV.E

Liabilities Under 1934 Act

The 1934 Act contains a number of sections creating private rights of action. Most federal securities litigation arises out of a few remedies that have been implied from criminal provisions of the Act. The discussion that follows examines the express and implied liability provisions according to their coverage.

IV.E.1

Manipulation: Section 9(f)

As noted earlier, 1934 Act § 9 outlaws manipulative practices in connection with the trading securities through any means of interstate commerce.⁵⁴⁰ It also provides a private remedy for investors injured by such prohibited manipulative conduct. Manipulation also is prohibited by §§ 10(b) and 15(c), which do not contain an express private right of action.⁵⁴¹ *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.⁵⁴²

Section 9(f)⁵⁴³ provides a private remedy in damages to any investor injured by conduct that violates § 9. 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 manipulative conduct. Liability under § 9(f) is expressly limited to persons “willfully” participating in the manipulative conduct. As noted earlier, the plaintiff must also prove manipulative intent.⁵⁴⁴

Courts have described the § 9(f) remedy as follows:

To show a violation of section 9(a)(2) in a private suit under section 9(e) [now 9(f)], a plaintiff must plead and prove that (1) a series of transactions

540. 15 U.S.C. § 78i. Section 9 also applies to transactions in security-based swap agreements even if not traded on an exchange. 1934 Act § 9 formerly was limited to exchange-traded securities.

541. 15 U.S.C. §§ 78j(b), 78o(c).

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

543. 15 U.S.C. § 78(i)(f) (formerly § 9(e)).

544. *See, e.g., United States v. Mulheren*, 938 F.2d 364 (9th Cir. 1991) (failure to establish manipulative intent).

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.⁵⁴⁵

Although the above-quoted test indicates that plaintiffs must prove actual reliance, and that 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.⁵⁴⁶ 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 § 9(f) remedy is a rather limited one. Market manipulation and deceptive practices are also regulated by §§ 10, 14(e), and 15(c).

IV.E.2

False Filings and Other Misstatements

IV.E.2.a

Section 18

Section 18 of the 1934 Act provides an express right of action for any investor injured by purchasing or selling securities while relying on a materially misleading statement or omission in a document required to be filed⁵⁴⁷ with the SEC. However, § 18's usefulness 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).⁵⁴⁸ That the plaintiff saw similar information in other documents prepared by the issuer is not sufficient. 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.

545. *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)).

546. *See, e.g., Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014) (reaffirming fraud-on-the-market presumption); *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (recognizing fraud-on-the-market presumption of reliance in Rule 10b-5 actions).

547. The concept of a filed document is narrow. 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 it 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), 17 C.F.R. § 240.14a-3(b).

548. *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).

IV.E.2.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 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.⁵⁴⁹

Rule 10b-5 was promulgated under § 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”⁵⁵⁰ 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.⁵⁵¹

The power to adopt Rule 10b-5 is delegated from 1934 Act § 10(b), which gives the SEC rulemaking authority with respect to manipulative and deceptive practices

549. *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 § 17(a) of the 1933 Act was *Osborne v. Mallory*, 86 F. Supp. 869 (S.D.N.Y. 1949). *Cf.* *Crookham v. Crookham*, 914 F.2d 1027 (8th Cir. 1990) (no § 17(a) remedy).

550. 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-16, 240.10b-17, & 240.10b-18.

551. 17 C.F.R. § 240.10b-5.

in connection with purchases or sales of securities.⁵⁵² As a result of the statutory language, Rule 10b-5 can be no broader than the terms of the authorizing statute.⁵⁵³ Thus, for example, although not explicitly referenced in the text of Rule 10b-5, deception is a necessary element of any 10b-5 violation.⁵⁵⁴

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-5'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 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. Transactions in foreign or domestic securities will only give rise to a private remedy if the transactions take place in the United States.⁵⁵⁵ The Dodd-Frank Act attempts to preserve the SEC's jurisdiction over foreign transactions in which there is substantial conduct or impact in the United States.⁵⁵⁶ This was the rule for private suits as well before being cut back by the Supreme Court.⁵⁵⁷

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.⁵⁵⁸ The scienter standard applies under Rule 10b-5 regardless of whether the action is a

552. 15 U.S.C. § 78j(b) (making it unlawful “[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”)

553. “The scope of Rule 10b-5 is coextensive with the coverage of § 10(b).” SEC v. Pirate Inv. LLC, 580 F.3d 233, 237 n.1 (4th Cir. 2009) (quoting SEC v. Zandford, 535 U.S. 813, 816 n.1 (2002)).

554. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

555. See *Morrison v. National Australia Bank Ltd.*, 516 U.S. 247 (2010).

556. As amended, the jurisdictional provisions of the securities laws provide that the SEC can pursue securities fraud for “conduct within the United States that constitute[s] significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors” as well as “conduct occurring outside the United States that has a foreseeable substantial effect within the U.S.” Dodd-Frank Wall Street Reform & Consumer Protection Act § 929P(b), Pub. L. No. 111-203, H.R. 4173, 111th Cong. (2d Sess. 2010), adding 15 U.S.C.A. §§ 77v(c), 78aa(b), 80b-14(b).

557. See *Morrison*, 516 U.S. 247.

558. *Hochfelder*, 425 U.S. 185.

private damage action or an enforcement action brought by the SEC.⁵⁵⁹ Reckless conduct is sufficient to satisfy the scienter requirement so long as there is a strong inference of recklessness.⁵⁶⁰

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.⁵⁶¹ Plaintiffs also must provide facts that indicate a “strong inference” that a defendant acted with a particular state of mind.⁵⁶² A reasonable inference of scienter is not sufficient.⁵⁶³ Although the inference must be strong and not merely a reasonable one, scienter may be inferred from circumstantial evidence.⁵⁶⁴

To withstand the scrutiny imposed by the Private Securities Litigation Reform Act of 1995 (PSLRA), the inference of scienter must be both reasonable and strong.⁵⁶⁵ The circuits are divided 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

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

560. *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 323 (2007) (“in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences”). *See, e.g.*, *Glazer Cap. Mgmt. LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008). *See also, e.g.*, *South Ferry LP, No. 2 v. Killinger*, 542 F.3d 776 (9th Cir. 2008); *Metzler Inv. GMBH v. Corinthian Colls., Inc.*, 540 F.3d 1049 (9th Cir. 2008).

561. 1934 Act § 21D(b), 15 U.S.C. § 78u-4(b). *See, e.g.*, *Griffin v. GK Intelligent Sys., Inc.*, 87 F. Supp. 2d 684 (S.D. Tex. 1999). *See also* 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.

562. *See, e.g.*, *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000) (PSLRA did not heighten Second Circuit requirement; it merely added particularity requirement).

563. *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 188 (1st Cir. 1999). *See also, e.g.*, *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410 (3d Cir. 1997).

564. *Tellabs*, 551 U.S. at 323.

565. *See, e.g.*, *Novak*, 216 F.3d at 316; *Coates v. Heartland Wireless Commc’ns, Inc.*, 100 F. Supp. 2d 417, 523-27 (N.D. Tex. 2000). For full discussion of the PSLRA, see *supra* § [III.F.1](#).

scienter.⁵⁶⁶ Other courts have held that motive and opportunity alone are not sufficient to establish scienter.⁵⁶⁷

Any statement reasonably calculated to affect the investment decision of a reasonable investor will satisfy the rule's "in connection with" requirement.⁵⁶⁸ 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. In *SEC v. Zandford*,⁵⁶⁹ a stockbroker embezzled the proceeds of a securities transaction. The Fourth Circuit had 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.⁵⁷⁰

566. See, e.g., *EP Medsystems, Inc. v. EchoCath, Inc.*, 255 F.3d 865 (3d Cir. 2000); *Novak*, 216 F.3d 300. See also *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999) (upholding complaint alleging motive and opportunity); *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999) (same).

567. *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), *aff'd* 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, not sufficient). See also *In re Omega Healthcare Invs., Inc. Sec. Litig.*, 375 F. Supp. 3d 496 (S.D.N.Y. 2019) (insufficient allegations based on motive and opportunity; other allegations of scienter were also insufficient); *Wilbush v. Ambac Fin. Group, Inc.*, 271 F. Supp. 3d 473 (S.D.N.Y. 2017) (failure to adequately allege motive); *Varjabedian v. Emulex Corp.*, 152 F. Supp. 3d 1226 (C.D. Cal. 2016); *Weber v. Contempo Colours, Inc.*, 105 F. Supp. 2d 769 (W.D. Mich. 2000) (scienter not established by allegations of motive and opportunity); *Dalarne Partners, Ltd. v. Sync Res., Inc.*, 103 F. Supp. 2d 1209 (C.D. Cal. 2000) (scienter 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 not sufficient).

568. See, e.g., *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000) ("in connection with" requirement could be satisfied by proving materiality and dissemination to public in manner upon which reasonable investor would rely); *In re Carter-Wallace, Inc. Sec. Litig.*, 150 F.3d 153 (2d Cir. 1998) (technical detailed advertisements in sophisticated medical journals could be found to be made "in connection with" securities transaction); *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 sale of stock under stock bonus plan); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (misstatements in corporate press release were made "in connection with" purchases and sales made by shareholders in open market, and violated Rule 10b-5, even though corporation itself was not buying or selling shares).

569. 535 U.S. 813 (2002).

570. See also *United States v. O'Hagan*, 521 U.S. 642 (1997) (finding lawyer guilty of insider trading); *Carpenter v. United States*, 484 U.S. 19 (1987) (taking broad view of Mail Fraud Act).

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.⁵⁷¹ In *Blue Chip Stamps v. Manor Drug Stores*,⁵⁷² 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 seems apparent that, likewise, mere “would-be” sellers cannot raise Rule 10b-5 claims.⁵⁷³ The courts have generally assumed that the defendant need not have been a purchaser or seller of securities in order to have violated Rule 10b-5.⁵⁷⁴

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-5.⁵⁷⁵ 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 basis⁵⁷⁶ (although a share exchange or merger with a shell company undertaken merely for corporate restructuring

571. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). *See also* *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).

Although the law of some states may allow someone who refrained from selling a security to make a fraud claim (*see, e.g., Small v. Fritz Cos.*, 65 P.3d 1255 (Cal. 2003)), if brought as a class action with more than fifty class members, the claim will be preempted by federal law, which does not allow such a suit. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 547 U.S. 71 (2006).

572. 421 U.S. 723 (1975).

573. 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).

574. *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 purchaser or seller precluded liability); *Blue Chip Stamps*, 421 U.S. 723 (imposing purchaser/seller standing requirement on plaintiff but not mentioning defendants).

575. *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).

576. *See, e.g., Alabama Farm Bureau Mut. Cas. Co. v. American 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) (same); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961) (same). *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).

has been held not to constitute a purchase or sale under Rule 10b-5⁵⁷⁷). A corporation's repurchase of its own shares or an additional issuance of its shares may also give rise to a shareholder derivative claim.⁵⁷⁸

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,⁵⁷⁹ although there is some disagreement on this point.⁵⁸⁰ A secured creditor who is injured because of a foreclosure sale of securities has been held to have standing to sue under Rule 10b-5.⁵⁸¹

Notwithstanding the requirement that, in a private right of action, the plaintiff has been a purchaser or seller, there is no comparable requirement for the defendant. Accordingly, a defendant who disseminates a materially misleading statement can be held liable even though the defendant did not purchase or sell securities.⁵⁸² In a sharply divided five-to-four decision, the Supreme Court held that primary liability under Rule 10b-5 requires that the defendant *made* the statement in question, and it is not sufficient that the defendant played a role in creating the misstatement.⁵⁸³ As discussed more fully below, aiders and abettors can be held accountable in government actions but not in private damage actions.⁵⁸⁴

As noted earlier, for a misstatement or omission to be actionable under Rule 10b-5, it must be material.⁵⁸⁵ 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.⁵⁸⁶ The materiality of a particular item is

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

578. *See Basic*, 485 U.S. 224; *Blue Chip Stamps*, 421 U.S. 723.

579. *See, 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 § 17(a) of 1933 Act).

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

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

582. *See Basic*, 485 U.S. 224 (upholding claim against corporation for materially misleading statement).

583. *Janus Cap. Group, Inc. v. First Derivative Traders, Inc.*, 564 U.S. 135 (2011). *See supra* § III.E.4.c.

584. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959 (1993). *Accord Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

585. If sufficiently alleged, materiality need not be determined at the time of class certification but should await summary judgment or trial on the merits. *See Amgen Inc. v. Connecticut Ret. Plans & Trust Funds*, 133 S. Ct. 1184 (2013).

586. *See, e.g., Basic*, 485 U.S. 224 (decided under Rule 10b-5); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (decided under proxy rules).

determined within the total mix of information that is publicly available. Because materiality questions are highly fact-specific, judgment on the pleadings or summary judgment will rarely be appropriate.⁵⁸⁷ The Supreme Court has reaffirmed its long-held view that materiality determinations are not subject to formulas or bright-line tests.⁵⁸⁸ Instead, whether a fact is material depends on the totality of surrounding circumstances and publicly available information. In other words, a fact is material if there is “‘a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.’”⁵⁸⁹ Overly generalized and vague statements are unlikely to be material. Similarly, statements that are aspirational rather than factual assertions are not likely to be material. For example, statements about a corporation’s code of ethics or code of conduct are likely to be treated as aspirational rather than representations of compliance with those codes and thus are likely to be held not material.⁵⁹⁰ Reading the relevant securities cases yields the following general rule: while a good faith opinion (or even “puffing”) is not material, a statement of opinion made with no belief in its truth is actionable. This is consistent with the general rule that merely because statements are couched as opinion does not preclude a finding that there is an express or implied misrepresentation of fact.⁵⁹¹

587. For examples of materiality in various contexts, see 3 Hazen, *supra* note 11, § 12:60-12:7.

588. *Matrixx Initiatives, Inc. v. Siracusana*, 563 U.S. 27 (2011).

589. *Id.* at 38 (quoting *Basic*, 485 U.S. at 231–32 and *TSC Indus.*, 426 U.S. at 449).

590. See, e.g., *Retail Wholesale & Dep’t Store Union Local 338 Ret. Fund v. Hewlett-Packard Co.*, 845 F.3d 1268, 1278 (9th Cir. 2017) (alleged sexual misconduct of officer and alleged violation of ethics code were not material; the court noted that the company’s statements promoting its code of ethics “were transparently aspirational” and “did not reasonably suggest that there would be no violations of the [code] by the CEO or anyone else”). See also, e.g., *Retail Wholesale & Singh v. Cigna Corp.*, 918 F.3d 57 (2d Cir. 2019) (statements in corporation’s code of ethics expressing its commitment to regulatory compliance were puffery and could not support securities fraud claims).

591. See, e.g., *Searls v. Glasser*, 64 F.3d 1061 (7th Cir. 1995) (statement that company was recession-proof too vague to be actionable).

Facts can be material even if quantitatively they seem relatively insignificant.⁵⁹² The SEC and the courts have embraced qualitative materiality for many years.⁵⁹³ Concerns about qualitative materiality can be especially prominent when dealing with financial disclosures. In its Staff Accounting Bulletin (SAB) 99, the SEC takes the position that even relatively small accounting discrepancies can be material.⁵⁹⁴ The SEC additionally requires both qualitative and quantitative disclosures relating to market risk.⁵⁹⁵

Following the common law of fraud, reliance is an element of any private Rule 10b-5 claim.⁵⁹⁶ In a divided decision with only five justices in agreement, the

592. See, e.g., *SEC v. Joseph Schlitz Brewing Co.*, 452 F. Supp. 824, 829-31 (E.D. Wis. 1978) (nondisclosure of kickback scheme was material regardless of de minimis quantitative significance because inter alia, it reflected on the lack of management integrity); *In re Petrobras Sec. Litig.*, 116 F. Supp. 3d 368, 380 (S.D.N.Y. 2015) (“The errors in Petrobras’ financial statements were directly related to its concealment of the unlawful bribery scheme, revelation of which would ‘call into question the integrity of the company as a whole.’”) (quoting *Strougo v. Barclays PLC*, 105 F. Supp. 3d 330, 349 (S.D.N.Y. Apr. 24, 2015)); *In re Franchard Corp.*, 42 S.E.C. 163 (1964) (CEO’s cash withdrawals should be judged not by the quantitative amount but rather the extent to which they reflect negatively on management integrity which rendered the disclosures materially misleading). See also, e.g., *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650, 655 (2d Cir. 1979) (“factual information concerning the honesty of directors in their dealings with the corporation . . . would be material to shareholders”).

593. See, e.g., *Schlitz Brewing Co.*, 452 F. Supp. at 829-31; *Petrobras*, 116 F. Supp. 3d at 380; *Franchard*, 42 S.E.C. 163. See also, e.g., *Weisberg*, 609 F.2d at 655.

594. See Staff Accounting Bulletin No. 99—Materiality, Release No. SAB 99, 64 Fed. Reg. 451250-01 (Aug. 12, 1999), which, among other things, sets forth non-exclusive examples of qualitative factors that might cause a small quantitative misstatement to be considered material. Those factors include whether the misstatement masks a change in earnings or other corporate trends; hides a failure to meet analysts’ consensus expectations for the business; and changes a loss into income or changes income into a loss.

595. Regulation S-K item 305, 17 C.F.R. § 229.305 (qualitative and quantitative disclosures about market risk are required to the extent they are material).

596. See, e.g., *Stoneridge*, 552 U.S. 148 (plaintiff must establish basis for reliance on defendant’s participation in allegedly misleading statement); *Basic*, 485 U.S. 224 (reliance is an element of Rule 10b-5 claim for damages).

Supreme Court in *Basic, Inc. v. Levinson*,⁵⁹⁷ recognized the fraud-on-the-market presumption of reliance under which a showing that a material misstatement or omission that adversely affects the market price creates a presumption of reliance. Subsequently, the Supreme Court refused to overrule *Basic* and reiterated the validity of the fraud-on-the-market presumption.⁵⁹⁸ The defendant may rebut the fraud-on-the-market presumption of reliance with evidence of other factors that may have affected the market price or by using expert testimony.

The availability of the fraud-on-the-market presumption is premised on the existence of a relatively liquid and, hence, efficient market for the securities in question.⁵⁹⁹ The absence of an efficient market will therefore preclude the fraud-on-the-market presumption of reliance.⁶⁰⁰ Additionally, failure to allege a price impact resulting from the misstatement will preclude the fraud-on-the-market presumption.⁶⁰¹ The Supreme Court explained that the burden of establishing the absence of a price impact is on the defendant but “the allocation of the burden is unlikely to make much difference on the ground. In most securities-fraud class actions, ... the plaintiffs and defendants submit competing expert evidence on price impact.”⁶⁰² The Court also noted that in the case of a

597. 485 U.S. 224 (1988). The fraud-on-the-market doctrine was reaffirmed in *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014). See also *Malack v. BDO Seidman LLP*, 617 F.3d 743 (3d Cir. 2010) (rejecting “fraud-created-the-market” theory recognized by some courts to allow presumption of reliance in connection with first-time offering); *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987), cert. denied, 485 U.S. 959 (1988) (discussing necessity of efficient market at time of disclosure). And see *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972) (applying presumption of reliance in face-to-face transaction). Distinct from the fraud-on-the-market presumption, *Affiliated Ute* presumed reliance from a finding of materiality in a case based on material omissions. The circuits are divided as to whether *Affiliated Ute*’s presumption is limited to pure omissions (Fourth, Fifth, Ninth, Eleventh), or also applies to half-truths (D.C., Second, Third, Tenth). See, e.g., *In re InterBank Funding Corp. Sec. Litig.*, 629 F.3d 213 (D.C. Cir. 2010).

598. *Halliburton*, 573 U.S. 258 (reaffirming fraud-on-the-market presumption).

599. See, e.g., *Waggoner v. Barclays PLC*, 875 F.3d 79 (2d Cir. 2017); *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).

600. See, e.g., *Detroit Partners, Inc. v. Lustig*, 403 F. Supp. 3d 934 (D. Colo. 2019) (absence of efficient market prevented any presumption of reliance).

601. See, e.g., *Halliburton*, 573 U.S. 258 (defendant entitled to establish no price impact and therefore defeat class certification); *In re Allstate Corp. Sec. Litig.*, 966 F.3d 595 (7th Cir. 2020) (price impact must be shown at class certification stage); *Grae v. Corrections Corp. of Am.*, No. 3:16-cv-2267, 2019 WL 1746492 (M.D. Tenn. Apr. 18, 2019) (class certification denied since fraud on the market did not apply because of convincing evidence of lack of price impact).

602. *Goldman Sachs Group, Inc. v. Arkansas Tchr. Ret. Sys.*, 141 S. Ct. 1951, 1963 (2021).

generic rather than specific misstatement, the generic nature of the statement may negate evidence of a price impact.⁶⁰³

Causation is a key element of a private 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.⁶⁰⁴ This means that there must be a price movement in the shares that corresponds to the timing of the misstatement.⁶⁰⁵ But that is far from inevitable. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect—not the earlier misrepresentation—but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which—taken separately or together—account for some or all of that lower price. (The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been—a claim we do not consider here.) Other things being equal, the longer the time between purchase and sale, the more likely that this is so, *i.e.*, the more likely that other factors caused the loss.

Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will *sometimes* play a role in bringing about a future loss. It may prove to be a necessary condition of any such loss, and in that sense, the inflated purchase price suggests that the misrepresentation (using language the Ninth Circuit used) “touches upon” a later economic loss. But even if that is so, it is insufficient. To “touch upon” a loss is not to *cause* a loss, and it is the latter that the law requires.⁶⁰⁶

Resolving a circuit split as to at what point in the law suit loss causation should be considered, the Supreme Court unanimously held that loss causation need not

603. *Id.* at 1961 (“[t]he generic nature of a misrepresentation often will be important evidence of a lack of price impact”).

604. See 4 Hazen, *supra* note 11, § 12:93.

605. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005). As the Supreme Court explained: the logical link between the inflated share purchase price and any later economic loss is not invariably strong. Shares are normally purchased with an eye toward a later sale. But if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the marketplace, an initially inflated purchase price *might* mean a later loss.

606. *Id.* at 342–43 (internal citations omitted). Three circuits apply *Dura*’s “loss causation” analysis. See, e.g., *United States v. Rutkoske*, 506 F.3d 170 (2d Cir. 2007); *United States v. Olis*, 429 F.3d 540 (5th Cir. 2005); *United States v. Nacchio*, 573 F.3d 1062 (10th Cir. 2009). But the Ninth Circuit uses a “modified market” capitalization theory. *United States v. Berger*, 587 F.3d 1038 (9th Cir. 2009).

be shown at the time of class certification but that it will be resolved later in the litigation.⁶⁰⁷

Also, as with any fraud claim, the plaintiff must be able to establish damages. For most Rule 10b-5 litigation, the appropriate measure of damages is the out-of-pocket loss caused by the material misstatement or omission.⁶⁰⁸ On occasion, disgorgement of ill-gotten profits or the benefits of the bargain might be a more appropriate measure of damages.⁶⁰⁹

Section 10(b) and Rule 10b-5 do not contain a statute of limitations for the implied remedy. In the decisions prior to 1991, the applicable statute of limitations for antifraud claims was generally the most analogous state statute of limitations.⁶¹⁰ Many courts held this to be the blue sky limitations period.⁶¹¹ 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, § 13 of the 1933 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.⁶¹² A similar one-year/three-year limitations period applies to express remedies under §§ 9(f) and 18(a) of the 1934 Act.⁶¹³ In 1991 the Supreme Court, in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,⁶¹⁴ held that the applicable limitations period was to be

607. See *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804 (2011).

608. *E.g.*, *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1436–37 (9th Cir. 1987); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986).

609. See *Green v. Occidental Petrol. Corp.*, 541 F.2d 1335 (9th Cir. 1976). See also 4 *Hazen*, *supra* note 11, § 12:94-12:100.

610. See 4 *Hazen*, *supra* note 11, §§ 12:150-12:154.

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

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

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

614. 501 U.S. 350 (1991).

found in the most analogous federal (rather than state) statute.⁶¹⁵ Accordingly, the Court applied the one-year-from-discovery/three-year repose period. In 2002 Congress added a new statute of limitations for actions based on fraud and deceptive conduct.⁶¹⁶ The limitations period for private fraud actions is two years from discovery of the facts constituting the violation, but in no event more than five years after the violation. The two-year limitations period begins to run once the plaintiff's reasonable diligence would have put him on inquiry notice of the violation.⁶¹⁷ The 2002 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 unless there is a statutory limitations period.⁶¹⁸

Whether the three-year repose period starts with the sale or the violation differs depending on whether the 1933 Act or 1934 Act applies⁶¹⁹—this in turn would determine whether a continuing fraud could toll the statute beyond the three-year repose period.

In *Herman & MacLean v. Huddleston*,⁶²⁰ the Supreme Court held that the remedies under § 11 of the 1933 Act for misstatements in registration materials and Rule 10b-5 are cumulative. Presumably, Rule 10b-5 remedies are cumulative

615. In so ruling, the Supreme Court followed its earlier decision in *Agency Holding Corp. v. Malley-Duff & Assocs., 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 *Lampf*. 1934 Act § 27A. 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 § 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).

616. 28 U.S.C. § 1658.

617. *Merck & Co. v. Reynolds*, 599 U.S. 633 (2010) (also holding scienter is “fact constituting the violation” for purposes of statute of limitations). See also, e.g., *City of Pontiac Gen. Emps.' Ret. Sys. v. MBIA, Inc.*, 637 F.3d 169 (2d Cir. 2011) (discussing knowledge required to start statute of limitations running).

618. For example, 1933 Act § 13 and 1934 Act §§ 9, 16, and 18 contain their own statutes of limitations. 15 U.S.C. §§ 77m, 78k, 78p, 78r.

619. The three-year period in a § 9(f) action begins to run from the date of the violation; in an action under § 18(a), the three-year repose period runs from the time the cause of action “accrues.”

620. 459 U.S. 375 (1983).

with other express remedies, such as those under § 12 of the 1933 Act (e.g., those under §§ 12(a)(1) and 12(a)(2)).⁶²¹

IV.E.2.c

Additional Implied Rights of Action

With the exception of Rules 10b-5 and 14a-9 and §§ 14(e) and 29(b),⁶²² 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-5,⁶²³ starting in the mid-1970s the Court showed less willingness to recognize implied rights of action. In 1975, it set forth a restrictive test for determining when implied remedies should be recognized.⁶²⁴ Subsequent decisions have made it clear that additional implied remedies are at best doubtful.⁶²⁵ Moreover, at least one court has awarded Rule 11

621. The measure of damages under § 12 of the 1933 Act is based on rescission. *See also* the remedy under § 18(a) of the 1934 Act (misstatements in false filings). The remedies under the Insider Trading and Securities Fraud Enforcement Act of 1988, codified in § 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.

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

623. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971) (first Supreme Court case recognizing Rule 10b-5 private remedy). *See also, e.g.*, *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286 (1993) (implied right of contribution for liability in Rule 10b-5 action); *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) (discussing implied remedy under proxy rules); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (discussing standing in private action under Rule 10b-5); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (recognizing private right of action under proxy rules using tort theory of liability).

624. 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 most heavily on the second factor, 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.

625. *See Northstar Fin. Advisors Inc. v. Schwab Invs.*, 615 F.3d 1106 (9th Cir. 2010) (investors have no implied private right of action under § 13(a) of 1940 Investment Company Act governing charges to mutual funds' stated investment policies); *Crookham v. Crookham*, 914 F.2d 1027 (8th Cir. 1990) (no remedy under 1933 Act § 17(a)); *Landry v. All Am. Assurance Co.*, 688 F.2d 381 (5th Cir. 1982) (same). *See also* 3 Hazen, *supra* note 11, § 12:14.

sanctions against claims based on other provisions where the implied remedy has been denied.⁶²⁶

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: controlling-person liability; vicarious liability based on *respondeat superior*; and 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 set forth both in the 1934 Act (§ 20(a)) and the 1933 Act (§ 15). Although worded differently, the provisions are interpreted as similar.⁶²⁷ The SEC has defined control as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”⁶²⁸ 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. It holds a controlling person liable only if that person did not act in good faith or induced or knowingly participated in the violation. Controlling-person liability is broader than *respondeat superior*. It is not limited to employers. Is controlling-person liability exclusive? Most courts of appeals have held that § 20(a) of the 1934 Act is not an exclusive remedy and thus can be supplemented by common-law principles of *respondeat superior*.⁶²⁹ In contrast to the prevailing

626. *Crookham*, 914 F.2d 1027 (\$10,000 sanction for bringing suit under § 17(a) of 1933 Act). Other provisions that are unlikely to support an implied remedy include § 7 of the 1934 Act (margin violations), as well as violation of rules of self-regulatory organizations. See 5 Hazen, *supra* note 11, § 14:175.

627. *Maher v. Durango Metals*, 144 F.3d 1302 (10th Cir. 1998).

628. Rule 405, 17 C.F.R. § 230.405. Courts have defined *control* as influence short of actual direction. *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761 (3d Cir. 1976).

629. *Hollinger v. Titan Cap. 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 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981); *Paul F. Newton & Co. v. Texas Com. 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).

rule as to controlling-person liability generally, § 21A(b)(2) denies *respondeat superior* liability in actions dealing with insider trading.⁶³⁰

Aiding and abetting liability⁶³¹ for violations of the antifraud provisions of the 1934 Act is available in SEC enforcement actions⁶³² and in criminal prosecutions but not in private actions.⁶³³ 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.⁶³⁴ The Supreme Court has recognized an implied right of contribution for damages based on 1934 Act Rule 10b-5.⁶³⁵

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.⁶³⁶ However, when the aider and abettor has a fiduciary relationship with the plaintiff, recklessness will satisfy the scienter requirement for imposing liability on

630. 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).

631. See discussions *supra* § III.E.4 and 4 Hazen, *supra* note 11, §§ 12:206-12:217.

632. 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.

633. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959 (1993). *Accord* *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (knowing participation in fraudulent scheme not sufficient to make defendant primary violator so as to expose him to liability in private suit). See also, e.g., *Affco Invs. 2001 LLC v. Proskauer Rose LLP*, 625 F.3d 185 (5th Cir. 2010) (law firm not liable since false statements not attributable to firm).

634. See, e.g., *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

635. *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286 (1993).

636. See, e.g., *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.”).

the defendant for aiding and abetting.⁶³⁷ In 2010 Congress clarified that reckless conduct is sufficient for aider and abettor liability.⁶³⁸

RICO in securities cases. The Racketeer Influenced and Corrupt Organizations Act (RICO), enacted in 1973,⁶³⁹ 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.⁶⁴⁰

An “enterprise” consists of any association, formal or informal⁶⁴¹—it need not be a permanent association.⁶⁴² The concept of enterprise connotes a group

637. See *Frank v. Dana Corp.*, No. 09-4233, 2011 U.S. App. LEXIS 10437, at *14 (6th Cir. May 25, 2011) (adopting “holistic” approach to scienter; declining to follow previous method of scienter review based on each allegation by itself, rather, courts should “review scienter pleadings based on the collective view of the facts, not the facts individually”). See also *Herm v. Stafford*, 663 F.2d 669, 684 (6th Cir. 1981) (holding recklessness will satisfy scienter requirement even absent 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 required where alleged aider and abettor does not stand in fiduciary or confidential relationship to 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).

638. 15 U.S.C. § 77o(b), as added by Dodd-Frank Wall Street Reform & Consumer Protection Act § 929M, Pub. L. No. 111-203, H.R. 4173, 111th Cong. (2d Sess. 2010).

639. 18 U.S.C. §§ 1961–1968. Many states have enacted “little RICO” statutes.

640. *Id.* § 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*, No. 98-4108, 1999 U.S. App. LEXIS 24827 (6th Cir. Sept. 30, 1999) (unpublished op.) (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). Cf. *Mezzonen, S.A. v. Wright*, No. 97 CIV.9380 LMM, 1999 WL 1037866 (S.D.N.Y. Nov. 16, 1999) (unpublished op.) (alleged misappropriation of assets occurred after securities transaction; thus, misappropriation not in connection with purchase or sale of security; RICO claim could proceed despite PSLRA).

641. 18 U.S.C. § 1961(4).

642. See, e.g., *United States v. Turkette*, 452 U.S. 576 (1981) (applying term to band of hooligans who had one-night rampage of murder and other acts covered by RICO).

with a common purpose, a continuity of personnel, and an ongoing formal or informal organization.⁶⁴³ The Supreme Court 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.⁶⁴⁴

In addition to the enterprise requirement, a violation of RICO § 1962 requires a “pattern of racketeering activity.”⁶⁴⁵ A pattern of racketeering requires two or more underlying predicate acts, as defined by § 1961(1), occurring within ten years of each other.⁶⁴⁶ 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 requires the defendant to have been convicted of the underlying securities law violation. Fraud and mail fraud are also included as predicate acts.⁶⁴⁷ 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 in *H.J., Inc. v. Northwestern Bell Telephone Co.*⁶⁴⁸ 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.⁶⁴⁹

The treble damage provision and availability of attorneys’ fees make RICO counts attractive in appropriate securities cases.⁶⁵⁰ A RICO action can be brought in either federal or state court.⁶⁵¹ RICO has been applied in securities cases, for example, where a broker-dealer (i.e., enterprise) engages in more than one fraudulent act.

643. *Id.*

644. *Id.* See also *Police Ret. Sys. v. Midwest Inv. Advisory Servs., Inc.*, 706 F. Supp. 708 (E.D. Mo. 1989) (enterprise requirement was satisfied but no pattern of racketeering activity shown).

645. 18 U.S.C. § 1962.

646. See *id.* § 1961(5).

647. Congress did not explicitly extend the criminal conviction requirement to mail and wire fraud (or to fraud generally). However, if that conduct involves securities, the criminal conviction requirement should apply. See *Cyber Media Group v. Island Mortg. Network*, 183 F. Supp. 2d 559, 578–80 (E.D.N.Y. 2002); *Mezzonen, S.A. v. Wright*, No. 97 CIV.9380 LMM, 1999 WL 1037866, at *3 (S.D.N.Y. Nov. 16, 1999) (unpublished op.). The SEC has used the Wire Fraud Act to combat securities fraud. See, e.g., *SEC v. Holmes*, No. 5:18-CV-01602, Litig. Release No. 24069 (SEC March 19, 2018) (settlement involving fraud-on-investors in raising funds for Therasys, Inc.).

648. 492 U.S. 229 (1989).

649. *Id.*

650. 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 in appropriate cases.

651. *Yellow Freight Sys., Inc. v. Donnelly*, 494 U.S. 820 (1990).

Mail and wire fraud. Two federal acts—the Mail Fraud Act⁶⁵² and the Wire Fraud Act⁶⁵³—can be potent weapons in the enforcement of securities law. The Supreme Court in *Carpenter v. United States*,⁶⁵⁴ a unanimous opinion, held that trading securities on nonpublic information could support a mail fraud conviction. 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 their property rights, tangible or intangible.⁶⁵⁵ 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.”⁶⁵⁶ 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.

The Second Circuit, in *United States v. Blaszcak*,⁶⁵⁷ recently used the mail and wire fraud statutes to capture insider trading that would not fall within Rule 10b-5 because of its deception requirement. However, the Supreme Court, in *Kelly v. United States*,⁶⁵⁸ held that the federal Wire Fraud Act does not apply to all fraud and deception by government officials. This could have an impact on the *Blaszcak* ruling.⁶⁵⁹ It is quite possible that the *Kelly* decision will be limited to public corruption not satisfying the requirement that there be an injury to property rather than foreshadowing a general scaling back of expansive wire fraud decisions. In January 2021, the Court granted certiorari in *Blaszcak*⁶⁶⁰ and remanded for further consideration in light of *Kelly*.

652. 18 U.S.C. § 1341.

653. *Id.* § 1343.

654. 484 U.S. 19 (1987).

655. *Id.* at 25–28. The Court specifically declared that “[c]onfidential business information has long been recognized as property.” *Id.* at 26.

656. *Id.* at 27.

657. 947 F.3d 19 (2d Cir. 2019), *vacated and remanded for further consideration*, 141 S. Ct. 1040 (mem.) (2021) (mail and wire fraud can be used by the government to bypass the personal-benefit requirement for liability based on tipping material inside information.)

658. 140 S. Ct. 1565 (2020) (realignment of bridge access lanes did not involve taking property and thus did not constitute fraud nor did time and labor employees spent in connection with the scheme).

659. See, e.g., Davis Polk Client Memorandum, Supreme Court Reverses “Bridgegate Convictions, Clarifies Meaning of “Property” Under Federal Fraud Statutes,” <https://www.davispolk.com/files/supreme-court-reverses-bridgegate-convictions-clarifies-meaning-of-property-under-federal-fraud-statutes.pdf> (May 11, 2020).

660. *Blaszcak v. United States*, 141 S. Ct. 1040 (mem.) (2021).

IV.E.3

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.⁶⁶¹ Disclosure of preliminary merger negotiations is not always necessary. But the Supreme Court has held that whether preliminary merger negotiations have crossed the materiality threshold is a question of fact⁶⁶² depending on whether a reasonable investor would consider negotiations significant in making an investment decision.⁶⁶³

In *Piper v. Chris-Craft Industries, Inc.*,⁶⁶⁴ the Supreme Court determined that there is no private remedy for a competing tender offeror. The Court did not rule out any private remedy; in fact, the opinion held out much hope for the recognition of a § 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 by serving the 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,⁶⁶⁵ as well as the right of a competing tender offeror to seek injunctive relief.⁶⁶⁶ Shareholders—but not management—of the target company, may be able to assert claims under Regulation 14D.⁶⁶⁷ The cases are divided as to whether scienter is an element of a § 14(e) violation. The apparent majority of decisions favor the imposition of a scienter requirement.⁶⁶⁸ More recently, the Ninth Circuit held that

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

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

663. *Id.* See also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

664. 430 U.S. 1 (1977).

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

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

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

668. See *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*, 565 F.3d 200, 207 (5th Cir. 2009); *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *SEC v. Ginsburg*, 362 F.3d 1292, 1297-98 (11th Cir. 2004); *Connecticut Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 961 (2d Cir. 1987); *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 431 (6th Cir. 1980).

scienter is not an element of a § 14(e) violation.⁶⁶⁹ The rationale for not imposing a scienter requirement is that unlike 1934 Act § 10(b), § 14(e) includes deceptive conduct but is not expressly so limited, which opens the door to follow Supreme Court precedent in *Aaron v. SEC*,⁶⁷⁰ which held that scienter is not required to establish a violation of 1933 Act 17(a)(2) or 17(a)(3).

IV.E.4

Insider Reporting and Short-Swing Profits: Section 16 Overview

Section 16 of the 1934 Act is intended to prevent corporate insiders from using access to nonpublic information about important, impending corporate actions to trade short-term in the securities of a company for profit—a practice known as “short-swing” trading. Short-swing trading is short-term trading in the corporation’s stock. As defined in the statute, it is 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 § 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 on the second business day following any transaction resulting in a change in that person’s holdings. These reports are then made available on the SEC website. The SEC also publishes monthly summaries of the reports.

IV.F

Insider Trading

IV.F.1

Insider Trading and Rule 10b-5

Perhaps the most 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

669. *Varjabedian v. Emulex Corp.*, 888 F.3d 399 (9th Cir. 2018), *cert. dismissed as improvidently granted*, 139 S. Ct. 1407 (2019).

670. 446 U.S. 680 (1980).

on inside information.⁶⁷¹ 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-5⁶⁷² but also violates principles of common-law fraud.⁶⁷³ 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, the premise of insider trading liability under Rule 10b-5 has changed from one of unfairness to investors⁶⁷⁴ to one of fiduciary duty and misappropriation.⁶⁷⁵ Rule 10b-5(c) makes it unlawful for "any 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-5.⁶⁷⁶ 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."

671. Promulgated by the SEC in 1942, Rule 10b-5 is patterned directly on § 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 § 17(a) is limited to fraudulent sales. The former assistant solicitor of the SEC, Milton Freeman, formulated Rule 10b-5 in response to a fraudulent purchase of corporate securities by a company's president. He describes the drafting and adoption of the rule in *Conference on Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 922 (1967).

672. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

673. *See, e.g., Strong v. Repide*, 213 U.S. 419 (1909).

674. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). *See* 4 Hazen, *supra* note 11, § 12:161.

675. *See, e.g., United States v. O'Hagan*, 521 U.S. 642 (1997); *Chiarella v. United States*, 445 U.S. 222 (1980). For an explanation of the development of Rule 10b-5, *see Chiarella*, 445 U.S. at 226–29 (Powell, J.). *See also* 4 Hazen, *supra* note 11, §§ 12:161–12:167.

676. *Chiarella*, 445 U.S. 222.

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.⁶⁷⁷ This 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.⁶⁷⁸ 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.⁶⁷⁹ The Court has since held, however, that 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.⁶⁸⁰

Rule 10b-5's "disclose or abstain" obligation applies only if the information is both material and nonpublic. As discussed above, materiality depends on whether there is a substantial likelihood that a reasonable investor would find the information significant in making an investment decision. Information is public when it is available to the public generally whether in SEC filings, the media, or other publicly available sources.⁶⁸¹ For insider trading purposes, "publicly available information" may be considered public even if known by only a few people.⁶⁸²

In *Chiarella v. United States*,⁶⁸³ the Supreme Court held that a Rule 10b-5 claim cannot be based solely on the defendant's knowingly trading to his advantage while in possession of material nonpublic information. 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

677. *Cady*, 40 S.E.C. 907. See also, e.g., *In re Smith Barney, Harris, Upham & Co.*, Sec. Exchange Act Release No. 34-21242, 1984 WL 472584 (Aug. 15, 1984) (brokerage firm should give its customers time to digest research recommendations reflecting material change in firm's position before 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.

678. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

679. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

680. *O'Hagan*, 521 U.S. 642; *Chiarella*, 445 U.S. 222.

681. See *United States v. Contorinis*, 692 F.3d 136, 143 (2d Cir. 2012).

682. *Id.* ("As the district court instructed the jury, information is also deemed public if it is known only by a few securities analysts or professional investors. This is so because their trading will set a share price incorporating such information.")

683. 445 U.S. 222 (1980).

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. 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 advantage.⁶⁸⁴

The Supreme Court had an opportunity to address the misappropriation theory in *Carpenter v. United States*.⁶⁸⁵ There 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 about the contents of upcoming columns that would affect the price of certain stocks. The Second Circuit had ruled 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-5.⁶⁸⁶ An equally divided Supreme Court affirmed the Second Circuit's decision without opinion. Whether the Court was divided over the validity of the misappropriation theory in general or on some other issues raised by the case was not clear.⁶⁸⁷

The Court subsequently adopted the misappropriation theory of liability in *United States v. O'Hagan*.⁶⁸⁸ In *O'Hagan*, a partner in a law firm knew that a client was about to launch a takeover of another company and purchased stock in the target company. It is hard to define situations in which there is a sufficient duty that gives rise to Rule 10b-5's "disclose or abstain from trading" obligation as to

684. *Id.* at 237-39 (Stevens, J., concurring; Brennan, J., concurring in judgment); *Id.* at 239-45 (Burger, C.J., dissenting); *Id.* at 245-52 (Blackmun, J., joined by Marshall, J., dissenting).

685. 484 U.S. 19 (1987).

686. *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986). 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, 100th Cong. (Oct. 2, 1988).

687. For example, the Supreme Court may 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.

688. 521 U.S. 642 (1997).

material nonpublic information. The SEC has given some helpful interpretive guidance in Rule 10b5-2.⁶⁸⁹

A Second Circuit decision is illustrative of the problem of defining insider trading. In *United States v. Chestman*,⁶⁹⁰ a stockbroker's customer relayed to the broker information about an impending takeover.⁶⁹¹ Armed with that knowledge, the broker bought shares in the target company and subsequently was indicted for violating Rules 14e-3⁶⁹² 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 counts.⁶⁹³ The Second Circuit then agreed to rehear the case *en banc*.⁶⁹⁴ The court affirmed the Rule 14e-3 convictions but reversed the Rule 10b-5 and mail fraud convictions.

689. The SEC adopted Rule 10b5-2 in 2000 to provide a degree of certainty in identifying the types of relationships in which the duty to "disclose or abstain from trading" arises. 17 C.F.R. § 240.10b5-2. Under Rule 10b5-2 there are three nonexclusive 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. 3442259 (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 tip of information between husband and wife). The breadth of Rule 10b5-2 has been brought into question by a few decisions. See, e.g., *United States v. Kim*, 173 F. Supp. 2d 1035 (N.D. Cal. 2001), *amended by*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002) (expectation or understanding of confidentiality not sufficient). Until definitively decided to the contrary, Rule 10b5-2 should be considered a valid exercise of the SEC's rulemaking authority.

690. 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).

691. The facts of *Chestman* were as follows. 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. 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 about the impending sale of Waldbaum, Inc., to the Great Atlantic & Pacific Tea Company, and relayed it to a broker.

692. Adopted by the SEC immediately after *Chiarella*, Rule 14e-3 prohibits trading in advance of tender offers. 17 C.F.R. § 240.14e-3. It was promulgated under § 14(e), which arguably, unlike Rule 10b-5, is not subject to a duty requirement.

693. *United States v. Chestman*, 903 F.2d 75 (2d Cir. 1990).

694. *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991).

However, these decisions were reached as a result of many separate opinions.⁶⁹⁵ In affirming the broker's Rule 14e-3 convictions, ten of the eleven judges rejected the broker's arguments (1) that Rule 14e-3 was invalid, or that, if not, there was insufficient evidence to sustain the convictions; and (2) that 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.⁶⁹⁶ 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-3.⁶⁹⁷ Although there is sparse authority on point, a fiduciary duty is not necessary under Rule 10b-5 if the defendant has agreed to keep the information confidential and not trade on it.⁶⁹⁸ If someone has obtained the information by trickery and deception, the "disclose or abstain" obligation will apply even in the absence of a fiduciary relationship.⁶⁹⁹

In *Dirks v. SEC*,⁷⁰⁰ 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. 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 expose the company's fraud.

695. 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. *Id.*

696. 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 Bank America. 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. The court held that the psychiatrist had violated Rule 10b-5 because of the breach of the fiduciary relationship between the psychiatrist and his patient.

697. Rule 14e-3 was upheld by the Supreme Court in *United States v. O'Hagan*, 521 U.S. 642 (1997).

698. See *SEC v. Cuban*, 620 F.3d 551, 558 (5th Cir. 2010):

Given the paucity of jurisprudence on the question of what constitutes a relationship of "trust and confidence" and the inherently fact-bound nature of determining whether such a duty exists, we decline to first determine or place our thumb on the scale in the district court's determination of its presence or to now draw the contours of any liability that it might bring, including the force of Rule 10b5-2(b)(1).

For further discussion, see Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Non-Public Information*, 61 *Hastings L.J.* 881 (2010).

699. *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009) (computer hacker would be subject to "disclose or abstain" rule if the hacker obtained information through deceit).

700. 463 U.S. 646 (1983).

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.

The Supreme Court held that in the absence of some breach of fiduciary duty, or “misappropriation,” there is no violation of Rule 10b-5. The Court in *Dirks* also suggested that for liability to attach, there must be “*personal gain*” by the wrongdoer.⁷⁰¹ Subsequent case law suggests that this is not limited to pecuniary gain.⁷⁰² In the wake of the Supreme Court’s unanimous ruling in *Salman v. United States*,⁷⁰³ tipper-tippee liability can be summarized as follows: Tipping without a personal benefit is not sufficient to hold the tippee liable.⁷⁰⁴ A personal benefit does not have to be pecuniary in nature; and passing the information to a friend or relative as a gift clearly is sufficient.⁷⁰⁵ When the personal benefit is the result of a gift to a friend, it is not necessary to weigh the closeness of the friendship.⁷⁰⁶ Rather, the personal benefit is found in providing the tip, knowing he or she will trade on it, in lieu of a cash gift to the tippee.⁷⁰⁷ Although the Court in *Salman* did not address the issue,⁷⁰⁸ there is authority to the effect that in order to hold the tippee liable, the tippee must have known of the personal benefit to

701. *Id.* at 659, 662.

702. In addition, the personal benefit requirement can be bypassed if suit is brought under the mail and wire fraud statutes. See *United States v. Blaszczyk*, 947 F.3d 19 (2d Cir. 2019), *vacated and remanded for further consideration*, 141 S. Ct. 1040 (mem.) (2021). *Blaszczyk* was remanded for further consideration in light of *Kelly v. United States*, 140 S. Ct. 1565 (2020), discussed *supra* text accompanying notes 658–61.

703. 137 S. Ct. 420 (2016).

704. *Id.* at 427–28.

705. *Id.*

706. *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017), *opinion amended and superseded*, 894 F.3d 64 (2d Cir. 2017), *cert. denied*, 139 S. Ct. 2665 (2019).

707. *Id.*

708. See *Salman*, 137 S. Ct. at 425 n.1 (“The Second Circuit also reversed the *Newman* defendants’ convictions because the Government introduced no evidence that the defendants knew the information they traded on came from insiders or that the insiders received a personal benefit in exchange for the tips. 773 F.3d, at 453–454. This case does not implicate those issues.”).

the tipper.⁷⁰⁹ In addition, the tipper must have intended that the tippee trade on the information.⁷¹⁰

Another issue in insider trading is whether it must be shown that the trader in fact used the information in question; namely, that the trader would not have traded but for the confidential information. Courts have favored this view, although use could be inferred from trades made while in possession of the information.⁷¹¹ The SEC adopted a rule requiring the defendant to have used the information in making the challenged securities transactions.⁷¹² Rule 10b5-1 also contains a presumption that someone who trades while in possession of information has used that information in making the trade.⁷¹³ 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.⁷¹⁴

IV.F.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. Violations may also result in sanctions from the SEC. The SEC may impose administrative sanctions. For example, a violator who is a broker-dealer or other market professional may have her license suspended or revoked. By virtue of § 21(d)(1) of the 1934 Act, the SEC is authorized to seek either temporary or permanent injunctive relief in the courts

709. See *id.* at 427 (“The Government also notes that, to establish a defendant’s criminal liability as a tippee, it must prove that the tippee knew that the tipper breached a duty—in other words, that the tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue.”).

710. See, e.g., *United States v. Klein*, 913 F.3d 73 (2d Cir. 2019) (upholding conviction notwithstanding defendant’s claim that he was bragging and/or joking rather than intending that anyone trade on the information).

711. See, e.g., *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998); *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998). Cf. *United States v. Teicher*, 987 F.2d 112 (2d Cir.), *cert. denied*, *Teicher v. United States*, 510 U.S. 976 (1993).

712. 17 C.F.R. § 240.10b5-1. The SEC originally adopted the possession test, but after reviewing the public comments, it re-proposed the rule to adopt the use requirement plus a presumption of use. See Exchange Act Release No. 34-24259 (Dec. 20, 1999).

713. 17 C.F.R. § 240.10b5-1.

714. *Id.*

“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.”⁷¹⁵

Although the statutory enabling provisions are written solely in terms of the power to enjoin, the courts and the SEC have recognized remedies ancillary to the traditional injunctive decree relying on “the general equitable powers of the federal courts.”⁷¹⁶ Ancillary relief has taken many forms, ranging from disgorgement of ill-gotten profits to more imaginative corrective action. Among the latter remedies are the appointment of an independent majority on the board of directors,⁷¹⁷ the appointment of a receiver,⁷¹⁸ prohibitions against exercising voting control in a proxy battle,⁷¹⁹ the appointment of “special professionals” to ensure compliance with securities laws,⁷²⁰ orders designed to protect remaining assets,⁷²¹ and prohibitions on continued participation as an officer or director of any public company.⁷²²

In the wake of the Supreme Court’s decisions in *Chiarella v. United States*⁷²³ and *Dirks v. SEC*,⁷²⁴ Congress enacted even stronger insider trading penalties available for use by the SEC. The Insider Trading Sanctions Act of 1984 (ITSA)

715. 15 U.S.C. § 78u(d)(1).

716. See, e.g., James Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 Harv. L. Rev. 1779, 1781 (1976).

717. See, e.g., SEC v. Vesco, 571 F.2d 129 (2d Cir. 1978); SEC v. Mattel, Inc., No. 74 Civ. 1185, 1974 WL 449 (D.D.C. Oct. 1, 1974) (litigation release) (consent to sanctions).

718. See, e.g., SEC v. United States Fin. Group, Inc., 474 F.2d 354 (9th Cir. 1973); SEC v. Florida Bank Fund, No. 78-759-CIV-TH, 1978 U.S. Dist. LEXIS 15237 (M.D. Fla. Sept. 28, 1978). This power is expressly given to the SEC by § 42(e) of the Investment Company Act for violators of the Act’s registration requirements. 15 U.S.C. § 80a-42(e).

719. 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).

720. See, e.g., SEC v. Beisinger Indus. Corp., 552 F.2d 15 (1st Cir. 1977) (appointment of receiver); SEC v. First Jersey Sec., Inc., No. 8585, 1985 WL 5819 (S.D.N.Y. Oct. 31, 1985) (unpublished) (appointment of consultant to review broker-dealer’s practices, pursuant to permanent injunction entered by parties’ consent).

721. See, e.g., SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1105–06 (2d Cir. 1972) (appointment of trustees to protect assets); SEC v. R.J. Allen & Assocs., Inc., 386 F. Supp. 866, 881 (S.D. Fla. 1974) (creation of temporary trust and ordering an accounting). See also SEC v. Vaskevitch, 657 F. Supp. 312 (S.D.N.Y. 1987) (freeze order in insider trading case); SEC v. American 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).

722. See, e.g., SEC v. Cosmopolitan Invs. Funding Co., Litig. Release No. 7366 (SEC Apr. 23, 1976); 42 SEC Ann. Rep. 119 (1976).

723. 445 U.S. 222 (1980).

724. 463 U.S. 646 (1983).

increased civil and criminal penalties for trading while in possession of material nonpublic information. The SEC is authorized to seek disgorgement of profits and a civil penalty of up to three times the profits made or the 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 did 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 used by the SEC to vigorously enforce insider-trading prohibitions and reach some lucrative settlements.⁷²⁵

However, the SEC's general enforcement authority under § 21(d) is displaced by the § 21A remedy. The Second Circuit held that a civil penalty in an SEC action under 1934 Act § 21(d)(3) cannot be imposed for insider trading where the violations are subject to specific penalty provisions of 1934 Act § 21A.⁷²⁶ The court noted, "history suggests that Congress, cognizant of the reach of section 21A, intended the amendment that became section 21(d)(3) to fill a gap in the SEC's enforcement powers by addressing violations other than those 'described in' section 21A."⁷²⁷

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*,⁷²⁸ 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. The Court eased double jeopardy concerns with its decision in *Hudson v. United States*.⁷²⁹ 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 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*

725. See, e.g., SEC v. Galleon Mgmt. LP, SEC Litig. Release No. 21732, 2010 WL 4467012 (SEC Nov. 8, 2010) (settlement by multiple defendants in massive insider trading case); SEC v. Certain Unknown Purchasers of Common Stock & Call Options of Santa Fe Int'l Corp., 1986 WL 2686 (S.D.N.Y. Feb. 26, 1986) (litigation release), *aff'd* 817 F.2d 1018 (2d Cir. 1987) (consent order to disgorge \$7.8 million in alleged insider trading profits); SEC v. Boesky, No. 86 Civ. 8767, 1986 WL 15283 (S.D.N.Y. Nov. 14, 1986) (litigation release) (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).

726. SEC v. Rosenthal, 650 F.3d 156 (2d Cir. 2011).

727. *Id.* at 161.

728. 490 U.S. 435 (1989).

729. 522 U.S. 93 (1997).

test of whether a civil sanction is punitive proved “unworkable.” Instead, the Court referred to the test it had enunciated previously in *United States v. Ward*,⁷³⁰ 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 label of a civil sanction is disregarded. It thus became increasingly unlikely that a civil penalty, such as the one imposed by the ITSA, will be viewed as criminal in nature. Accordingly, double jeopardy should not be an issue for successive SEC and criminal actions against insider trading.⁷³¹

IV.F.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.⁷³² In an open-market context, however, standing to sue can be more problematic. In a Ninth Circuit case,⁷³³ 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 an application of 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.⁷³⁴ Similarly, the Second Circuit held that a tippee of inside information who was convicted of having violated Rule 10b-5 was not liable in damages to people who were selling their stock at the same time that

730. 448 U.S. 242 (1980).

731. *But see* *United States v. Andrews*, 146 F.3d 933 (D.C. Cir. 1998). The D.C. Circuit indicated that a 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. *Id.* at 941–42.

732. *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.

733. *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979).

734. *Friedrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

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.⁷³⁵

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. ITSFEA provides an express private right of action for contemporaneous traders against persons making improper use of material nonpublic information.⁷³⁶ 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 a penalty) under the 1984 Insider Trading Sanctions Act (ITSA).

ITSFEA also specifically addresses controlling-person liability.⁷³⁷ Such liability in a private suit is still governed by § 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.

In a further attempt to provide incentive for private persons to expose illegal insider trading, ITSFEA added a “bounty” provision. Under § 21A(e), 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.⁷³⁸

735. *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

736. 1934 Act § 20A.

737. 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).

738. These amendments also require additional disclosures about penny stocks. See *supra* § [II.C](#).

IV.F.4

Insider Transactions and Section 16

Section 16 of the Exchange Act regulates directors, officers, and 10% (or greater) beneficial owners⁷³⁹ of any class of equity securities⁷⁴⁰ subject to § 12 registration requirements. Section 16(a) contains reporting requirements; § 16(b) imposes liability for short-swing profits; and § 16(c) prohibits insider short sales.

Persons falling within the scope of § 16 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, or such shorter period as the SEC may prescribe.⁷⁴¹ Thereafter, whenever they acquire or dispose of any equity securities of the company, they must file notice thereof with the SEC by the second business day following the acquisition or disposition of shares.⁷⁴²

In addition to its reporting requirements, § 16(a) determines who is subject to § 16(b)'s provisions for disgorgement of insider short-swing profits. However, the 1934 Act does not precisely define *officer*, *director*, or *10% beneficial owner*. As a result, many questions have been raised as to the scope of § 16's coverage.

739. 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). *See also Rosenberg v. XM Ventures*, 129 F. Supp. 2d 681 (D. Del. 2001).

740. The owner of convertible securities becomes a 10% beneficial owner of the underlying securities once his conversion rights would permit 10% ownership of the underlying securities. *Medtox Scientific, Inc. v. Morgan Cap. 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).

741. 1934 Act § 16(a).

742. *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). The filing obligation belongs to the officer, director, or 10% beneficial owner. While the company does not have a filing obligation under § 16(a), item 405 of Regulation S-K requires the company to periodically report on its insiders' § 16(a) compliance. Many companies follow the best practice of requiring its officers, directors, and 10% beneficial owners to preclear trades with the company, and then the company will file the § 16(a) reports on the insiders' behalf.

IV.F.4.a

Officer

The courts and the SEC have both considered the scope of *officer*. SEC Rule 3b-2 provides that under the 1934 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.⁷⁴³ In 1991 the SEC completely revamped its interpretive rules under § 16. As part of this reform, for the purposes of § 16, *officer* is limited to high-ranking company officials in policy-making positions.⁷⁴⁴ Since Rule 16a-1 specifically addresses § 16 of the Act, its definition prevails over the more general definition in Rule 3b-2.

IV.F.4.b

Director

Another problem in determining who is subject to § 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.⁷⁴⁵ The Court appeared to require the plaintiff to prove an actual deputizing or agency relationship,⁷⁴⁶ but subsequent case law suggest that it may be enough to show that the potential for abuse was more than a mere possibility.⁷⁴⁷

743. *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.

744. Rule 16a-1(f), 17 C.F.R. § 240.16a-1(f).

745. *Blau v. Lehman*, 368 U.S. 403 (1962).

746. *Id.* at 411.

747. See, e.g., *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

The mere presence of an interlocking directorate will not be sufficient to create a § 16 deputization⁷⁴⁸—each situation must be examined on its own facts.

Section 16 also warrants consideration of the effect of timing of the transactions on an officer's or director's assumption of office or resignation. In general, courts tend to find liability if either the purchase or sale occurred while the defendant was an officer or director.⁷⁴⁹ If both the purchase and sale were before or after the defendant held the position, courts tend not to find liability.⁷⁵⁰

IV.F.4.c

10% Beneficial Owner

In contrast to cases dealing with officers and directors, § 16 provides that where insider status attaches by virtue of 10% beneficial equity ownership, the section applies only where beneficial ownership existed “both at the time of purchase and sale, or the sale and purchase.” The Supreme Court has held that the purchase that pushes the defendant over the 10% threshold does not qualify as a purchase subject to § 16, and that only purchases made after the threshold purchase will give rise to liability.⁷⁵¹ Similarly, when a holder of more than 10% first sells enough to bring her holdings down to 9.9%, and on the next day liquidates the remaining holdings, the second sale cannot be subject to § 16, even if the two sales were parts of a single, prearranged scheme.⁷⁵²

Section 16(b) requires statutory insiders under § 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 § 16(b) as a “crude rule of thumb” or objective method of preventing “the unscrupulous employment of (corporate) inside information.”⁷⁵³ Accord-

748. See, e.g., *Popkin v. Dingman*, 366 F. Supp. 534 (S.D.N.Y. 1973).

749. See, e.g., *Feder*, 406 F.2d 260 (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).

750. See *Lewis v. Mellon Bank*, 513 F.2d 921 (3d Cir. 1975) (officer who exercised stock option immediately after resigning, then sold at profit, not liable under § 16, since he was not insider at time of purchase or sale); *Lewis v. Varnes*, 505 F.2d 785 (2d Cir. 1974) (defendant not officer or director at time of short-swing transaction and thus not liable under § 16(b)). Since this result appears justified by the language of § 16, such conduct could be used to raise a presumption of reliance on inside information to find a possible violation of Rule 10b-5. See 4 Hazen, *supra* note 11, § 12:162.

751. *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976).

752. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972).

753. Hearings on S. Res. 84, S. Res. 97 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. pt. 15 at 6,557 (1934) [hereinafter *Hearings on S. Res. 84*].

ingly, in light of its broad remedial purpose, § 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 § 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” § 16(b).⁷⁵⁴

A § 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 § 16(b) is not dependent on the possession or use of inside information.⁷⁵⁵

A shareholder may bring an action under § 16(b) after a demand has been made to and refused by the directors.⁷⁵⁶ Section 16(b) actions arise even though the SEC has no enforcement powers under § 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 § 16(b) action is that attorneys’ fees will be awarded to the successful plaintiff’s attorneys out of the fund created by the recovery.⁷⁵⁷ 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 § 16(b).⁷⁵⁸ Thus people who purchase their shares after the transactions in question may

754. 1934 Act § 16(b). The SEC has adopted rules exempting transactions. For example, it has exempted certain transactions by registered investment 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.

755. *Hearings on S. Res. 84*, *supra* note [753](#).

756. *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).

757. *See, e.g., Super Stores, Inc. v. Reiner*, 737 F.2d 962 (11th Cir. 1984).

758. *Portnoy v. Kawecky Berylco Indus., Inc.*, 607 F.2d 765 (7th Cir. 1979); *Dottenheim*, 227 F.2d 737; *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954).

bring suit. Notwithstanding the possible champerty implications,⁷⁵⁹ the courts have held that it is no defense to an action under § 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.⁷⁶⁰ An action under § 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 § 16, the next question is whether there has been a "purchase" and "sale." Where there is a "garden variety" cash-for-stock transaction, § 16(b)'s application will be determined by an objective test.⁷⁶¹ However, the courts have also had to decide whether other transactions—so-called "unorthodox" transactions—fall within § 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.*,⁷⁶² the Supreme Court addressed the applicability of § 16(b) to sales of the target company's shares by a defeated tender offeror. In finding that a § 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 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.⁷⁶³

759. *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 § 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.

760. *Magida v. Continental Can Co.*, 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956).

761. 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 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); *Oloff 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 repurchase under compulsion of paying 205% penalty to IRS for self-dealing in prior sale, and IRS called repurchase a "rescission" of prior sale).

762. 411 U.S. 582 (1973).

763. *Id.* at 594–95 (footnotes omitted). See also, e.g., *Gwozdzinsky v. Zell/Chil-mark Fund, L.P.*, 156 F.3d 396 (2d Cir. 1998), *aff'g* 979 F. Supp. 263 (S.D.N.Y. 1997).

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.”⁷⁶⁴ If there is no fear of or potential for § 16(b) abuse in the unorthodox transaction at issue, the pragmatic analysis should find no purchase or sale.⁷⁶⁵

There has also been significant debate over the method of computing a profit within the meaning of § 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.⁷⁶⁶ 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.⁷⁶⁷ Furthermore, there is authority to the effect that dividends declared on shares sold at a profit will be considered part of the § 16(b) profit, provided that insider status applied at the time of declaration of the dividend.⁷⁶⁸

Section 16(c) prohibits certain speculative activities by insiders (10% beneficial owners, officers, and directors) who must file reports under § 16(a). Section 16(c) is aimed at two types of speculative transactions: (1) short sales,⁷⁶⁹ which involves selling the security of the issuer without owning the underlying security; and (2) sales “against the box,”⁷⁷⁰ which occurs when the seller owns the securities but 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

764. *Kern County*, 411 U.S. at 594 n.24.

765. See 4 Hazen, *supra* note 11, § 13:33.

766. *Arrow Distrib. Corp. v. Baumgartner*, 783 F.2d 1274, 1278–82 (6th Cir. 1986); *Whittaker v. Whitaker Corp.*, 639 F.2d 516, 530–32 (9th Cir.), *cert. denied*, 454 U.S. 1031 (1981); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

767. See *Smolowe*, 136 F.2d at 239.

768. *Western 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 excluded from § 16(b) computation absent evidence defendant manipulated dividend)).

769. 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 received on the sale to the buyer.

770. A “sale against the box” takes place when the seller, anticipating a decline in the price of stock she owns, sells it to a buyer at the present market price, but delivers it later, when (the seller hopes) the market price will have fallen below the sales price, thus creating a paper profit for the seller.

are high-risk transactions subject to speculative abuse, particularly by insiders. Section 16(c) 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.

IV.G

Regulation of the Marketplace and Securities Professionals

IV.G.1

Overview

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.⁷⁷¹ 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 market regulation is to ensure orderly markets. There are also prohibitions against fraudulent and manipulative broker-dealer conduct. 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-dealers⁷⁷² engaged in interstate business involving securities transactions.⁷⁷³ 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

771. SEC and self-regulatory organization rules can operate as a preemption or implied repeal of the antitrust laws. For example, the SEC regulation of IPO practices serves as an implied repeal of the antitrust laws, leading the Second Circuit to hold that purchasers in public offerings lacked antitrust standing to challenge price fixing by the underwriters. *Friedman v. Salomon/Smith Barney, Inc.*, 313 F.3d 796 (2d Cir. 2002). The Supreme Court, in another case, subsequently held that IPO practices, including “laddering,” were immune from antitrust attack because of their regulation under the securities laws. *Credit Suisse Sec. (USA) LLC v. Billing*, 551 U.S. 264 (2007).

772. See generally Jerry W. Markham & Thomas L. Hazen, *Broker-Dealer Operations Under Securities and Commodities Law: Financial Responsibilities, Credit Regulation, and Customer Protection* (2002).

773. 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.” 1934 Act § 15(a)(1), 15 U.S.C. § 78o(a)(1).

engaging in certain types of proscribed conduct.⁷⁷⁴ 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. Pursuant to § 15(b)(7), broker-dealers must meet the operational and financial competence standards established by the SEC. 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 (1934 Act Rule 15c3-1), which sets out the minimum standards of broker-dealer solvency based on the balance sheet.⁷⁷⁵ The net capital rule imposes extremely complicated accounting and solvency requirements for a brokerage firm's assets and liabilities. The SEC also requires disclosure when brokers do not segregate either customer funds or securities.⁷⁷⁶ In addition, in order to maintain minimum liquidity, the SEC imposes a reserve requirement that cash be held in a reserve account.⁷⁷⁷

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).⁷⁷⁸

774. 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; or 4) when the broker-dealer has been barred by the SEC or enjoined from being a broker-dealer. 1934 Act § 15(b)(4).

775. 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).

776. Rule 15c3-2, 17 C.F.R. § 240.15c3-2.

777. Rule 15c3-3, 17 C.F.R. § 240.15c3-3, requires a bank account in which the brokerage firm holds cash or U.S. government securities in an amount equal to (a) free credit balances in customers' accounts (plus other amounts owing to customers) less (b) debit balances in customers' cash and margin accounts.

778. There are nine national exchanges registered under § 6 of the Act and one securities association registered under § 15A (the National Association of Securities Dealers).

IV.G.2

Self-Regulation

Section 19 of the Exchange Act, as originally enacted, gave the SEC power to suspend or withdraw the registration of an exchange, to suspend or expel any member of an exchange, to suspend trading in listed securities, and to require changes in exchange rules with respect to a wide range of matters. However, it did not require SEC approval for changes in stock exchange rules, nor did it provide for SEC review of disciplinary actions by exchanges against their members. Section 19, as amended in 1975, expanded and consolidated the SEC's authority over *all* self-regulatory organizations. The SEC's increased authority over exchanges and FINRA for the over-the-counter (OTC) markets is roughly comparable to, but even broader than, its previous authority over the NASD.⁷⁷⁹ In particular, since 1975, the SEC must give advance approval for any exchange rule changes, and it has review power over exchange disciplinary actions.⁷⁸⁰

When Congress decided to extend federal regulation over the nonexchange (or OTC) market, it followed the pattern already established with respect to exchanges. Section 15A⁷⁸¹ authorized the establishment of “national securities associations” to be registered with the SEC. Like an exchange, any such association must have rules designed “to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade” in transactions in the OTC market.⁷⁸² Only one such association has been established – the NASD, which has since become a part of FINRA. The NASD adopted a substantial body of “Rules of Fair Practice” (now embodied in FINRA's Code of Conduct), which deal with various problems in the OTC markets. Among the most important FINRA rules in this area are: the rule that a dealer may not recommend a secu-

779. See Marianne K. Smythe, *Self-Regulation and the Antitrust Laws: Suggestions for An Accommodation*, 62 N.C. L. Rev. 475, 505–06 (1984).

780. See, e.g., *Ho v. SEC*, No. 06-3788, 2007 WL 1224027 (7th Cir. Apr. 25, 2007) (affirming SEC's affirmation of Chicago Board Option Exchange's three-year suspension of already suspended exchange member and market-maker who continued to trade on exchange in violation of his earlier suspension). Cf. *PAZ Sec., Inc. v. SEC*, 494 F.3d 1059 (D.C. Cir. 2007) (SEC can review de novo disciplinary decisions of self-regulatory organizations; finding SEC abused its discretion in failing to consider mitigating factors in imposing sanctions) (applying 15 U.S.C. § 78s(e) and relying on *Otto v. SEC*, 253 F.3d 960, 964, 966–67 (7th Cir. 2001) (“the SEC conducts de novo review of the NASD's sanctions”)); *McCarthy v. SEC*, 406 F.3d 179, 189–90 (2d Cir. 2005) (holding SEC's affirmation of sanction deficient because it failed to provide reasoned basis to show it was not arbitrary).

781. 15 U.S.C. § 78o, added by the “Maloney Act” of 1938, Pub. L. No. 75–719, 52 Stat. 1070 (1938).

782. FINRA Conduct Rule 2010, available at <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2010> (“[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade”).

urity unless the dealer has reason to believe the security is “suitable” to the customer’s financial situation and needs; the interpretation of its mark-up rule that presumptively prohibits markups in excess of 5% on principal transactions; the procedures for reviewing underwriting compensation and provisions to ensure that members make a bona fide public offering of underwritten securities; and its rules about execution of orders in the OTC market and disclosure in confirmations to customers.

From time to time, FINRA (and formerly the NASD) promulgates rules and issues interpretations directed to specially enumerated prohibited practices.⁷⁸³ Although FINRA and former NASD rules and interpretations identify impermissible practices, their list of prohibited practices is not exclusive.⁷⁸⁴ In other words, FINRA can invoke general antifraud principles as well as the general concept of just and equitable principles of trade to invalidate improper conduct that is not specifically defined in FINRA or SEC rule making.⁷⁸⁵

That an industry practice has been followed for a long time does not mean it is compliant with FINRA and SEC standards of fair and equitable conduct.⁷⁸⁶ Similarly, the fact that a certain type of conduct has been long-standing industry practice does not prevent it from being fraudulent.⁷⁸⁷ As noted above, FINRA has cease and desist powers with respect to certain securities law violations.⁷⁸⁸

783. In 2002, for example, the NASD issued a notice to members pointing out the impropriety of interfering with a customer’s attempt to transfer to another broker-dealer. Rule Change by the National Association of Securities Dealers, Inc. Relating to the Adoption of Interpretive Material Regarding Interfering With the Transfer of Customer Accounts, 67 FR 1790–01, 2002 WL 29460 (SEC Jan. 14, 2002); NASD Notice to Members 02-07 (Jan. 2002).

784. Initial public offering (IPO) abuses implicate numerous anti-manipulation rules. For example, the SEC has imposed severe penalties against firms charged with improper IPO practices. *See, e.g.*, SEC v. Morgan Stanley & Co. Inc., No. 1:05CV00166(HHK) (D.D.C. 2005), Litigation Release No. 19050, 2005 WL 156766 (SEC Jan. 25, 2005); SEC v. Goldman Sachs & Co., No. 05 CV 853 (SAS) (S.D.N.Y. 2005), Litigation Release No. 19051, 2005 WL 156767 (SEC Jan. 25, 2005).

785. *See In re Kunz*, Admin. Proc. File No. 3-9960, Exchange Act Release No. 34-45290 n.2, 2002 WL 54819, at *9 n.2 (SEC Jan. 16, 2002) (paying compensation to unregistered representative violated NASD (now FINRA) Conduct Rule 2110).

786. *Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 274 (3d Cir. 1998).

787. SEC v. Johnson, No. 03 Civ. 177 (JFK), 2005 WL 696891, at *5 (S.D.N.Y. Mar. 24, 2005) (“even where a defendant is successful in showing that it has followed a customary course in the industry, the first litigation of such a practice is a proper occasion for its outlawry if it is in fact in violation”) (quoting *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171 (2d Cir. 1970)); SEC v. Dain Rauscher, Inc., 254 F.3d 852, 857 (9th Cir. 2001) (“the standard of care by which [defendant’s] conduct must be measured is not defined solely by industry practice, but must be judged by a more expansive standard of reasonable prudence, for which the industry standard is but one factor to consider”).

788. This increased enforcement authority was given in 2003. *See* NASD Special Notice to Members 03-35, available at <https://www.finra.org/rules-guidance/notices/03-35> (NASDR June 23, 2003).

IV.G.3

Broker–Dealer Sales Practices

Section 15(c) 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 others⁷⁸⁹ are used most often by the SEC and courts to regulate (1) excessive prices for over-the-counter securities;⁷⁹⁰ (2) activities of market-makers who deal directly with individual customers;⁷⁹¹ (3) generation of commissions by excessive trading in customers’ accounts (“churning”) and other fraudulent trading practices;⁷⁹² and (4) undisclosed interests of investment advisers⁷⁹³ in the stocks they recommend.⁷⁹⁴ This series of SEC rules is supplemented by Regulation Best Interest (BI)⁷⁹⁵ which, effective June 2020, governs the broker–dealer duty of

789. Most notably, other provisions include § 17(a) of the 1933 Act and § 10(b) of the 1934 Act and rules promulgated under both Acts.

790. See, e.g., *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943) (holding violation of securities laws where broker–dealer made high-pressure “cold calls,” convincing purchasers to pay an undisclosed 16%–40% markup over market value of securities).

791. See, e.g., *In re Alstead, Dempsey & Co.*, Exchange Act Release No. 34-20,825, 30 SEC Docket 211 (Apr. 5, 1984) (in OTC market, where market maker’s customers hold 95.7% of stock of company at issue, and market maker controls market, markups of 11%–20% over transactions in independent interdealer market are excessive); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970) (failure to disclose market-maker status is nondisclosure of material fact in violation of securities laws). See also SEC Rule 10b-10.

792. 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, high turnover rate—particularly of securities unsuitable to complaining investors—generates excessive commissions in violation of securities laws); *Nesbit v. McNeil*, 896 F.2d 380 (9th Cir. 1990) (in churning case, successful plaintiff entitled to receive as damages—at her option—decline in value of her portfolio, amount of excess commissions generated by churning in account, or both).

793. Investment advisers are fiduciaries. See *SEC v. Capital Gains Res. Bureau, Inc.*, 375 U.S. 180 (1963). See also Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Inv. Adv. Act Release No. IA-5248, 2019 WL 3779889, at *2 (SEC June 5, 2019) (“Under federal law, an investment adviser is a fiduciary. The fiduciary duty an investment adviser owes to its client under the Advisers Act, which comprises a duty of care and a duty of loyalty, is important to the Commission’s investor protection efforts.” (footnote omitted)).

794. See, e.g., *Capital Gains Res. Bureau*, 375 U.S. 180 (failure to disclose purchases of securities before making recommendation constituted violation of Investment Advisers Act § 206).

795. 17 C.F.R. § 240.15l-1; Regulation Best Interest: The Broker–Dealer Standard of Conduct, Sec. Exchange Act Release No. 34-86031, 2019 WL 2420297 (SEC June 5, 2019) [hereinafter *Regulation Best Interest*]. See 5 Hazen, *supra* note 11, §§ 14:133, 14:139.50. A challenge to Regulation Best Interest was dismissed in *XY Planning Network, L.L.C. v. SEC*, 963 F.3d 244 (2d Cir. 2020) (Regulation Best Interest is not invalid as arbitrary and capricious; also holding plaintiff lacked standing).

loyalty and suitability obligations.⁷⁹⁶ First, Regulation Best Interest imposes a duty of care on broker-dealers when making recommendations. In particular, broker-dealers must understand not only the risks and potential rewards of a recommendation but also the costs.⁷⁹⁷ Other factors in assessing the duty associated with making recommendations include the characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, and likely performance of market and economic conditions; the expected return of the security or investment strategy; and any financial incentives to recommend the security or investment strategy.⁷⁹⁸ Second, the Regulation Best Interest imposes a know-your-customer requirement—to the extent that the broker-dealer must have sufficient information about the customer to make a proper evaluation along with a duty to ascertain such information and keep it current.⁷⁹⁹ Third, a broker-dealer must have a reasonable basis to believe that a recommendation of a series of transactions will be in the customer's best interest and also will not unduly increase the broker's overall fees.⁸⁰⁰ And fourth, there are explicit conflict-of-interest obligations. Some brokerage firms have been established to focus on high-pressure sales practices, although not a separate category of violations. These firms are colloquially known as boiler rooms.⁸⁰¹ These high-pressure sales tactics will violate many of the prohibitions discussed herein.⁸⁰²

Traditionally, with retail stock brokerage accounts, the customer is charged a sales commission in the form of a mark-up or mark-down. When a customer buys securities, the customer will be charged a commission over the market execution

796. The suitability doctrine requires that when making recommendations, the broker have a reasonable basis for the recommendation (in terms of knowing the security), and that the recommendation be suitable for the investor's particular investment objectives, risk tolerance, and sophistication. The elements are summarized in FINRA Rule 2111.

797. See *Regulation Best Interest*, Securities Exchange Act Release No. 34-86031, *supra* text accompanying notes 795–800.

798. *Id.*

799. *Id.*

800. *Id.*

801. Typical boiler rooms were accurately depicted in the movies, *Boiler Room* (2000) and *The Wolf of Wall Street* (2013). In a typical boiler room operation, callers recommend purchases of large blocks of speculative securities in new companies, predicting dramatic earnings and rapid increases in the market prices of the securities. Technology has expanded boiler rooms beyond telecommunications as the Internet has become a fertile medium for securities fraud. It has been observed that “[i]n the old days, you had the boiler rooms where you had to hire 20 people to make thousands of phone calls to sell fraudulent securities. Now one person can do this by the push of a button.” Debate in Senate on H.R. 1058 Reported by Conference Committee (2000) (James B. Adelman, former head of enforcement of the SEC's Boston office).

802. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1466 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997).

price. This is known as a mark-up. Conversely, when a customer sells securities, the commission will be deducted from the proceeds from the sale. This is known as a mark-down. FINRA has a policy that a mark-up above five percent is presumptively excessive.⁸⁰³

In recent years, commission-free brokers like Schwab, TD Ameritrade, and Robinhood, have become available for retail investors. How do these commission-free retail brokerage firms get compensated? “Payment for order” flow is a controversial, but currently permissible practice whereby a market maker pays a fee to a retail brokerage firm in exchange for the brokerage firm receiving a payment. Although not directly related to “payment for order” flow, the erratic trading in 2021 involving GameStop stock and the online broker Robinhood⁸⁰⁴ resulted in increased regulatory scrutiny and possible regulatory changes. These events may also lead to litigation charging securities fraud and/or claims of manipulation.

Broker-dealers can loan funds to their customers to enable leveraged investments. Under 1934 Act § 7, the Federal Reserve Board is empowered to establish permissible leverage limits. For most securities, the maximum credit that can be extended is fifty percent of the total value of the securities held as collateral.⁸⁰⁵ In addition to the Federal Reserve rule that governs the extension of credit, FINRA sets limits for margin maintenance.⁸⁰⁶ When an account is over-margined, the broker will require additional capital contribution from the customer or will liquidate part or all of the securities held in the over-leveraged account.

803. FINRA Rule 2121, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2121>.

804. Some major hedge funds had large, short positions in GameStop. Retail investors talked up the possibility, on Reddit's social media platform, of creating a short squeeze by paying the stock and options. Primarily using Robinhood as their online broker, frenetic purchasers, plus the short sellers needing to purchase the stock to cover their short positions, drove the price of GameStop from \$18.84 on December 31, 2020, to a high of \$347.51 on January 27, 2021. While the stock was soaring, Robinhood stopped taking orders on the stock. Suddenly, its investors were unable to trade. Robinhood explained that was necessary due to a capital call from Citadel, to whom the GameStop orders were directed. Several class actions have been filed claiming, among other things, that Robinhood's trading halt violated the securities laws. Other possible violations include manipulation and fraud by the retail investors talking up the stock on Reddit. Whether any of these claims have merit remains to be seen. Congressional hearings have been held, and the SEC has launched an investigation. See Dave Michaels, *GameStop Mania Is Focus of Federal Probes Into Possible Manipulation*, Wall. St. J., Feb. 11, 2021, available at <https://www.wsj.com/articles/gamestop-mania-is-focus-of-federal-probes-into-possible-manipulation-11613066950>. It likely will take many years to determine exactly what caused this and whether the securities laws were in fact violated.

805. Federal Reserve Regulation T, 17 C.F.R. Part 220.

806. FINRA Rules 4210–4230. FINRA sets a minimum 25% margin maintenance. *Id.* But most brokerage firms impose a higher minimum of 30% to 40% to help assure that accounts do not fall below the FINRA 25% minimum.

Margin regulations also govern short sales, whereby an investor borrows shares to sell stock the customer does not own in order to profit from the stock declining in value. If a shorted stock rises in price, the short seller's margin balance will be affected and at some point, the seller may have to either liquidate the short position by acquiring the stock or put additional collateral into the account. When other investors engage in active buying of a shorted stock, this can result in a short squeeze requiring the short seller to purchase the stock to cover the short position at a substantial loss.⁸⁰⁷

Margin-rule violations by themselves are not a basis for a private right of action.⁸⁰⁸ However, if a customer is injured as a result of margin-related fraud, then an action would lie under SEC Rule 10b-5.⁸⁰⁹ In addition, a broker's decision to allow a customer to open a margin account can raise suitability issues depending on the customer's background and risk tolerance.

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 the broker-dealer 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.⁸¹⁰ 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.⁸¹¹

807. For example, concerted retail investor purchases of GameStop stock in 2021 caused hedge funds with large short positions to incur substantial losses as a result of this short squeeze. Also in 2021, a substantial short-options position by a hedge fund resulted in major losses. See Sofia Horta e Costa, Tracy Alloway & Bei Hu, *Billions in Secret Derivatives at Center of Archegos Blowup*, Bloomberg Law, https://www.bloomberglaw.com/bloomberglawnews/securities-aw/X54T1D9C000000?bna_news_filter=securities-law#jcite (March 29, 2021).

808. *Useden v. Acker*, 947 F.2d 1563 (11th Cir. 1991); *Bennett v. United States Trust Co. of New York*, 770 F.2d 308 (2d Cir. 1985); *Bassler v. Central Nat'l Bank in Chicago*, 715 F.2d 308 (7th Cir. 1983); *Gilman v. FDIC*, 660 F.2d 688 (6th Cir. 1981).

809. Rule 10b-16 requires disclosures particularly tailored to margin accounts. 17 C.F.R. § 240.10b-16.

810. *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969).

811. *Id.*

Furthermore, FINRA and the case law require broker-dealers to “know the customer.” Imposed by rules of self-regulatory organizations, the duty to know your customer 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 customer’s investment objectives, e.g., financial security as opposed to speculation; income as opposed to growth). The “know your security” and “know your customer” obligations are codified in FINRA’s suitability rule.⁸¹² FINRA’s suitability rule also includes “quantitative suitability” which measures whether the frequency of recommended trades is suitable given the customer’s investment objectives.

Although the broker-dealer obligations are high, 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.⁸¹³ On the other hand, if an injured customer can state the equivalent of a Rule 10b-5 violation—including showing the requisite scienter, materiality, reliance, causation, damages, and deception—a violation of the “know the customer” rule will be actionable.⁸¹⁴

Relatively few broker-customer disputes end up in the courts, especially because of the 1987 Supreme Court decision holding that pre-dispute arbitration agreements are enforceable.⁸¹⁵ Since that decision, pre-dispute 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.”⁸¹⁶

812. FINRA Rule 2111, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111>.

813. 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).

814. 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).

815. *Shearson Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

816. E.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*, 808 F.2d 930, 933 (2d Cir. 1986).

IV.H

Regulation of Exchanges and Securities Markets⁸¹⁷

IV.H.1

Background and History

Market regulation extends beyond the broker–dealer industry. For example, the SEC and the self-regulatory organizations oversee the markets themselves. At one time the exchanges and the over-the-counter markets were self-regulatory organizations. However, the largest markets—the New York Stock Exchange (NYSE) and the Nasdaq market—demutualized and became for-profit enterprises. Eventually both the Nasdaq markets and the NYSE became publicly held companies and it became necessary to spin off the regulatory function into a separate independent entity.⁸¹⁸ Thus, two new independent organizations—NASD Regulation (NASDR) and New York Stock Exchange Regulation (NYSER)—took over the regulatory functions. The SEC approved the merger of the NASDR and NYSER in 2007, creating a more efficient, single self-regulator and avoiding duplication.⁸¹⁹ As a consequence, the Financial Industry Regulatory Authority (FINRA) carries out the self-regulatory functions previously handled by the NYSE and the National Association of Securities Dealers (NASD).

When Congress created the SEC in 1934, stock exchanges, as private associations, had been regulating their members for almost 140 years. Rather than displace this system of “self regulation,” Congress superimposed the SEC as an additional level of regulation. The effect of § 5⁸²⁰ of the 1934 Act is to require every “national securities exchange” to register with the SEC. Under § 6(b) of the Act,⁸²¹ an exchange cannot be registered unless the SEC determines that its rules are designed, among other things, to “prevent fraudulent and manipulative acts

817. This discussion was adapted from 4 Hazen, *supra* note [11](#), §§ 14:5–14:9.

818. The Nasdaq national market became a registered national securities exchange in 2006. See In the Matter of the Application of the NASDAQ Stock Market LLC for Registration as a National Securities Exchange Findings, Opinion, and Order of the Commission, Exchange Act Release No. 34-53128, 2006 WL 92913 (SEC Jan. 13, 2006); *SEC Approves NASDAQ Stock Market Bid To Become Registered National Exchange*, 38 Sec. Reg. & L. Rep. (BNA) 117 (Jan. 17, 2006).

819. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., Exchange Act Release No. 34-56145 (File No. SR-NASD-2007-023) (SEC July 26, 2007).

820. 15 U.S.C. § 78e.

821. *Id.* § 78f(b).

and practices, to promote just and equitable principles of trade,”⁸²² and to provide for appropriate discipline of its members for any violations of its own rules or the securities laws.

Under the authority of § 6 of the Act, the various exchanges—of which the NYSE is by far the largest and most important—and now FINRA, maintained and enforced a large body of rules for the conduct of their members. These rules fall into two categories: rules relating to transactions on the particular exchange, and rules relating to the internal operations of the member firms and their dealings with their customers.

In the first group are rules governing the following: criteria for listing securities on the exchange and provisions for delisting or suspension of trading in particular securities; obligations of issuers of listed securities; bids and offers on the exchange floor; activities of “specialists” (now referred to as designated market-makers in listed securities); transactions by members in listed securities for their own account; rules for when transactions in listed securities may take place off the exchange; clearing and settlement of exchange transactions; and rules for the governance and operation of the exchange itself.

IV.H.2

Market-Makers

Market-makers are broker-dealers that qualify under FINRA rules to publish “bid” (the price at which the market-maker is willing to purchase the security) and “asked” (the price at which the market-maker is willing to sell the security). The difference between the bid and the asked price is the “spread” which is the market-maker’s compensation. More actively traded securities have multiple market-makers. The market-maker’s obligation is to maintain an orderly market while at the same time providing the best execution for customer offers. Market-makers are typically retail brokers, as well. If there is a conflict between the duty to maintain an orderly market and the best execution obligation to retail customers, the obligation to the customer is paramount.⁸²³ With less frequently

822. For examples of cases in which exchanges received censure and bar for violating “just and equitable principles of trade,” see, e.g., *In re Hazelgrove-Mulkerrins*, Exchange Hearing Panel Decision 00-211, 2000 WL 33158159 (N.Y.S.E. Nov. 28, 2000); *In re Hudson*, Exchange Hearing Panel Decision 00-76, 2000 WL 897699 (N.Y.S.E. May 11, 2000); *In re Falbo*, Exchange Hearing Panel Decision 93-189, 1993 WL 594332 (N.Y.S.E. Dec. 21, 1993).

823. See, e.g., *Eichler v. SEC*, 757 F.2d 1066 (9th Cir. 1985).

traded stocks, there may be only one active market maker. This type of dominated market presents opportunities for manipulation.⁸²⁴

In addition to regulating broker-dealers and exchanges, the SEC regulates firms that are engaged in the clearing of securities transactions. Congress decided to implement a more unified national market to replace the fragmented set of markets that existed previously. This included use of a national system for clearing and settlement of securities transactions established pursuant to § 17A of the 1934 Act.⁸²⁵ The Act regulates clearing agencies and the activities of securities brokers engaging in clearing activities. The pervasive federal regulation of clearing of securities transactions results in federal preemption of state law that would provide contrary rules.⁸²⁶

IV.I

Regulation of Credit Rating Agencies

Credit ratings help monitor the risk of debt securities and, in turn, the risks related to investment banking, commercial banking, insurance companies, and other regulated entities—not to mention the risks of unregulated entities like hedge funds. The markets, as well as many regulators—including the SEC—have relied on credit ratings since the early 1990s. Many companies that failed during the turn of the twenty-first century, however, had good credit ratings, so the market was surprised when these highly rated companies experienced severe problems.

To address concerns about the efficacy of credit-rating agencies, the SEC appointed many of them as nationally recognized, statistical-rating organizations (NRSROs) by issuing no-action letters, for regulatory and legislative purposes. The Credit Rating Agency Reform Act, enacted in 2006 as an amendment to the Securities Exchange Act of 1934, granted the SEC the regulatory authority to

824. See, e.g., *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1466 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997).

825. 15 U.S.C. § 78q-1. As part of the national market system implementation, the SEC requires registration of securities information processors that are used to facilitate quotations for securities. 17 C.F.R. § 240.11Aa3-2. Section 17A does not support an implied private right of action. *Baltia Air Lines, Inc. v. CIBC Oppenheimer Corp.*, 6 F. App'x 106 (2d Cir. 2001) (unpublished).

826. See *Whistler Invs., Inc. v. Depository Trust & Clearing Corp.*, 539 F.3d 1159 (9th Cir. 2008) (challenge to naked short-selling precluded by conflict-preemption regulation under § 17A; court found filed preemption not applicable); *Pet Quarters, Inc. v. Depository Trust & Clearing Corp.*, 545 F. Supp. 2d 845 (E.D. Ark. 2008) (since federal and state law conflicted, conflict-preemption preempted state law); *Nanopierce Techs., Inc. v. Depository Trust & Clearing Corp.*, 168 P.3d 73 (Nev. 2007) (compliance with 1934 Act § 17A and state law not possible; conflict-preemption preempted state law).

register and oversee NRSROs.⁸²⁷ The SEC also implemented regulation of rating agencies⁸²⁸ and introduced proposals to refine and expand regulation. In the aftermath of the 2008–09 credit crisis and market collapse, calls have continued for increased regulation of credit-rating agencies.

827. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006). *See* 1934 Act § 15E, 15 U.S.C. § 78o-7 (Registration of Nationally Recognized Statistical Rating Organizations).

828. *See* 1934 Act Rules 17g-1 through 17g-6; 17 C.F.R. §§ 240.17g-1–240.17g-6.

Appendix A

Statutory Conversion

Securities Act of 1933 (key provisions)

<u>Act §</u>	<u>15 U.S.C. §</u>	
1	77a	Short Title
2	77b	Definitions
2A	77b-1	Swap Agreements
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

<u>Act §</u>	<u>15 U.S.C. §</u>	
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
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 (key provisions)

<u>Act §</u>	<u>15 U.S.C. §</u>	
1	78a	Short Title
2	78b	Necessity for Regulation
3	78c	Definitions and Applications
3A	78c-1	Swap Agreements
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
4C	78d-3	Appearance and Practice Before the Commission
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

<u>Act §</u>	<u>15 U.S.C. §</u>	
15C	78o-5	Government Securities Brokers and Dealers
15D	78o-6	Securities Analysts and Research Reports
15E	78o-7	Registration of Nationally Recognized Statistical Rating Organizations
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
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

<u>Act §</u>	<u>15 U.S.C. §</u>	
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
30B	78dd-2	Prohibited Foreign Trade Practices by Domestic Concerns
30C	78dd-3	Prohibited Foreign Trade Practices by Persons Other than Issuers or Domestic Concerns
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
37	78nn	Tennessee Valley Authority
38	78oo	Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Federal Home Loan Banks

Appendix B

For Further Reference

Securities Regulation

Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* (Thomson Reuters 7th ed. 2016)

Louis Loss, Joel Seligman & Troy Paredes *Securities Regulation* (Wolters Kluwer Law & Business 4th ed. 2016)

Jerry W. Markham & Thomas Lee Hazen, *Broker Dealer Operations Under Securities and Commodities Law* (Westgroup, now Thomson Reuters 1995; 2d ed. 2003)

Commodities Regulation

Phillip McBride Johnson & Thomas Lee Hazen, *Derivatives Regulation* (Aspen Law & Business, now Wolters Kluwer Law & Business 2004)

Jerry W. Markham, *Commodities Regulation: Fraud, Manipulation, and Other Claims* (Westgroup, now Thomson Reuters 2001)

Glossary

blank check company – A blank check company is usually a development stage company not having a specific business plan.

blue sky law – Blue sky law is a term used to refer to state securities laws.

boiler room – Boiler room refers to a brokerage firm that focuses on high-pressure sales practices and various fraudulent activities.

bucket shop – A variety of boiler room where the customer orders are not actually placed. The orders are bucketed rather than entered in the markets.

call option – 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. See also *put option*.

churning – Churning is an illegal practice when brokers with discretionary authority or control over an account enter into trades to generate commissions.

cross trade – See *matched order*.

flipping – Flipping occurs when someone purchases securities as part of a public offering with an intent to sell immediately into a rising aftermarket.

free writing – Free writing refers to information not contained in a prospectus relating to a company that may be disseminated by that company while engaged in a public offering.

gun-jumping – Gun-jumping results from premature publicity about an upcoming public offering. Gun-jumping is prohibited by 1933 Act § 5(c).

haircut – A haircut is a discount deducted from the value of securities when computing value for purposes of the net capital requirements for securities broker-dealers (SEC Rule 15c3-1).

issuer – A company or other entity that issues its own securities.

margin – A margin transaction involves buying securities with funds borrowed from the broker. The Federal Reserve Board and the exchanges set the minimum margin requirements.

Market-maker – A market-maker is a securities dealer that provides firm bid and asked (ask) prices for securities. Market-makers are regulated by FINRA and originally functioned primarily in the over-the-counter markets, but now they also make a market for exchange-traded securities.

marking the close – Marking the close is a manipulative practice whereby a portfolio manager artificially inflates the price of stocks held in the portfolio just before the close of trading for the purpose of increasing the portfolio's value.

mark-up (and **mark-down**) – A mark-up or mark-down refers to the commission received by a broker-dealer for a retail transaction in the Nasdaq market. A mark-up represents the amount that the customer is charged above the actual purchase price. A mark-down is the amount deducted from the proceeds of the sales price.

matched order – 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. Cross-trades can actually benefit the firm's customers if the savings on commissions are passed on to the customers. Cross-trades become problematic when the cost savings are not passed on to the customer.

no-action letter – A no-action letter is an advisory opinion issued by the SEC staff. No-action letters are publicly available.

odd-lot – An odd-lot refers to a block of shares containing fewer than 100 shares. Traditionally shares in publicly held companies have been traded in 100-share lots. Transactions in 100-share lots are referred to as round lots.

over-the-counter – An over-the-counter transaction is one that takes place through something other than the facilities of an organized securities exchange.

painting the tape – Painting the tape is a manipulative practice of reporting fictitious orders to make it appear that real transactions are taking place.

parking – Parking is a fraudulent practice of placing shares in someone else's name in order to hide the identity of the true owner.

post-effective period – The post-effective period is the time after a 1933 Act registration has become effective. Sales of the securities covered by the registration statement are not permitted until the beginning of the post-effective period. During the post-effective period, the prospectus delivery requirements of 1933 Act §§ 5(b) and 10 continue to apply.

prefiling period – The prefiling period is that time shortly before the filing of a registration when all offers to buy and all offers to sell are prohibited by the terms of 1933 Act § 5(a).

prospectus – As defined in 1933 Act § 2(a)(10), a prospectus is an offer to sell in writing or through other permanent means such as online. During a public offering, a prospectus is subject to the disclosure requirements spelled out in § 10. Also § 5(b) sets forth the circumstances under which a prospectus must be provided to investors.

proxy – Proxy is a power of attorney, granted by a shareholder, authorizing the proxy holder to vote the shares owned by the shareholder. *Proxy* is defined in SEC 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 are found in Rule 14a-4.

proxy solicitation – Solicitation, as defined in SEC 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.

public float – Public float refers to the number of shares held by public shareholders that may be traded publicly (as contrasted with privately held shares that are not freely resalable in public markets).

pump and dump – A pump-and-dump scheme is the fraudulent and manipulative practice of hyping particular stocks to bring them to artificially high levels and then dumping the stock into the market.

put option – A put option 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 (the strike 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. See also *call option*.

quiet period – The quiet period is the time shortly before a 1933 Act registration statement is filed in connection with a public offering (also known as the pre-filing period). During the quiet period, participants in the offering must be careful not to disseminate information that could be construed as an illegal offer to sell the securities to be covered by the registration statement.

red herring prospectus – A red herring prospectus is a preliminary prospectus that may be used after the filing of a 1933 Act registration during the waiting period (see SEC Rule 430).

reporting company – A reporting company is a publicly held company that is subject to the 1934 Act's periodic (annual, quarterly, and interim) reporting requirements. Reporting companies include those having to register under 1934 Act § 12 because their shares are listed on a national exchange (including the NYSE, AMEX, and Nasdaq stock market), as well as over-the-counter companies having more than \$10 million in assets and 500 shareholders of record.

restricted securities – A restricted security is one that is subject to transfer restrictions. Restricted securities often result from securities that are sold in a private placement as opposed to a public offering.

safe harbor rule – A safe harbor rule is a rule under which the SEC provides guidance as to how to comply with specific provisions of the securities laws. It is a safe harbor, but it is not the exclusive way of complying with the applicable law.

sale against the box – A sale against the box takes place when the seller, anticipating a decline in the price of stock they own, sells it to a buyer at the present market price, but delivers it later, when (they hope) the market price will have fallen below the sales price, thus creating a paper profit for the seller.

scalping – Scalping is the illegal practice that occurs when someone touts securities that they own with the goal of raising the price to increase the value of his holdings.

secondary offering – A secondary offering occurs when securities are offered as part of a distribution by existing securities holders. In a secondary offering, the proceeds of the sale go to the selling shareholders. In contrast, with a primary offering the shares are sold by the issuer and the proceeds go to the company.

shelf registration – A shelf registration is a 1933 Act registration statement for securities that are going to be offered on a delayed or continuous basis (see SEC Rule 415).

short sale – 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 seller received on the sale to the buyer.

solicitation – See *proxy solicitation*.

SPAC (special purpose acquisition company) – A SPAC is a company set up, usually through a public offering, with no specific business plan other than to acquire a privately held company.

specialist – For most of its existence, New York Stock Exchange trading took place through specialist firms who had no retail securities business. Over time, the specialist system has given way to a system based on designated market-makers who function much like market-makers in the over-the-counter markets.

spread – The spread is the difference between the bid and the asked price of a security. A market maker earns its commission through the spread—by buying at the bid price and then selling the securities at the asked price. *See also* mark-up and mark-down.

street name – Securities are held in street name when the brokerage firm holds the securities in their own name for the benefit of the customer as beneficial owner.

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

underwriter – An underwriter is a broker-dealer or investment banking firm that acts as a wholesaler for a securities distribution. Underwriter status can also result from substantial participation in a securities distribution (see 1933 Act § 2(a)(11)).

waiting period – The waiting period is the time between the filing of a 1933 Act registration statement and the time that it becomes effective. Sales of the securities covered by the registration statement are not permitted during the waiting period (1933 Act § 5(a)). During the waiting period, written, online, radio, and television communications must satisfy or be exempt from the prospectus requirements of 1933 Act §§ 5(b) and 10.

warrant – A warrant is a stock option issued by the company itself, often as compensation to promoters or as a separate security to be publicly traded. Stock options may also be issued by the company to employees or consultants; generally these are simply referred to as stock options and not as warrants.

wash sale – A wash sale is a fictitious sale in which 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.

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