# TOPIC 14: SECURITIES LAW

## Overview

Securities is a broad term that basically refers to any form of ownership or beneficial interest in a business entity. Securities law concerns the sale or transfer of these business interests. This chapter introduces the security and the catch-all provision for "investment contracts" as securities. It explains the primary statutory and regulatory framework making up the securities law. It introduces the Securities Exchange Commission and its objectives and functions in enforcing the securities laws. It explains the process of selling or transferring securities to the public, known as issuing securities, before moving on to the subsequent sale or exchange of securities in the public market, such as trading securities on public exchanges. Lastly, it reviews the the major laws and forms of civil and criminal liability associated with violation of the securities laws.

## VIDEO LESSON - INTRODUCTION

## VOCABULARY & CONCEPTS

## TOPIC 14: SECURITIES LAW - QUESTIONS & ANSWERS

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### 1. What are "securities laws"?

Securities laws are the federal and state statutes and regulations that control the sale or transfer of rights or ownership interests in a business entity (securities). Specifically, securities laws purport to protect the general public from deceptive practices in the sale or trade of securities. The major securities laws include the Securities Act of 1933 and the Securities Exchange Act of 1934. The primary method of protecting investors prescribed under these acts is thorough disclosure of relevant or material information. As we discuss in this chapter, the requirements for the disclosure of information vary based upon the nature of the sale or transfer of securities.

- ***Discussion***: Why do you think the Federal Government seeks to protect the rights of private owners of a business entity? Do you believe that the disclosure of relevant or material information is the best way of achieving this goal? Why or why not?
- ***Practice Question***: What are the laws applicable to the sale or trade of securities?
- ***Resource Video***: http://thebusinessprofessor.com/what-are-securities-laws/

### 2. What is a "security"?

Most people think of a security as simply stock or other ownership units of a business entity; however, the statutory definition of a security is far more extensive. The term "security" means any,

> "note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral trust certificate, pre-organizational certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate or deposit, or group or index 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 commonly known as a security."

The definition of a security is broad, but it leaves open the inclusion of any interest not identified within the definition, but that the court deems to constitute a security. There is a great deal of common law surrounding the judicial interpretation of what constitutes a security. Most notably, the term "investment contract" from the definition of a security is construed very broadly and is somewhat of catch-all for business interests that may constitute a security.

- ***Discussion***: Why do you think Congress applied such a broad definition of what constitutes a security? Does the fact that common law goes much further to define a security affect your opinion about the suitability of the statutory definition?
- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-security/

**3. What qualifies as an "investment contract"?**

The broadest category of a business interest constituting a security is an "investment contract". Courts have developed a number of tests to determine what constitutes an investment contract. The most influential is the "*Howey* test". The elements for determining whether a business interest constitutes an investment contract (and thereby a security) are as follows:

- an investment of money,
  - *Note*: To invest money means to provide any sort of value to the company in exchange for a beneficial interest in or ownership of the company. The investment does not have to be cash or currency.
  - *Example*: I receive an ownership interest (10% ownership) in your business activity in exchange for my contribution of a pickup truck for use in the business.
- in a common enterprise,
  - *Note*: A common enterprise is any form of concerted business activity. The enterprise does not have to be a registered business entity.
  - *Example*: A common enterprise may include a default entity form, such as a general partnership.
- with the expectation of profits, and
  - *Note*: The expectation of profits is a very broad notion. An individual can invest in the enterprise with the purpose of directly or indirectly deriving profits. This may include the objective of taking advantage of any tax benefits associated with the investment.
  - *Example*: I invest in ABC, LLC. The LLC will have losses this year and for the next couple of years. I am not actively involved in the business. As such, I will be able to offset the passive losses against the active profits I have in a separate investment. This will reduce my tax liability. Eventually, I expect ABC, LLC to produce a profit.
- derived solely from the efforts of others.
  - *Note*: Derived solely from the efforts of others means that the investor does not actively take part in the business activity. She may be able to offer limited guidance to the business managers, but she does not take part in the active affairs of the business. This provision seems to eliminate investments in games of chance that do not involve a business activity or a concerted activity with someone else.
  - *Example*: I am interested in providing money to Alice's design services business. I may offer some guidance to Alice in how to run the business, but I do not take part in any of Alice's business operations. It is Alice's efforts and not my personal activity that constitute the business (such as in a sole proprietorship or general partnership).

Each element of this test requires considerable analysis. Courts have interpreted each element to add a great deal of specificity and complexity to the individual factors.

- ***Discussion***: Why do you think the definition of an investment contract has been interpreted so broadly? What would be the potential effect of a narrow interpretation?

- ***Practice Question***: Ralph is an avid gambler. He loves to wager money on any type of sporting event or game of chance. He puts his money in a pool to purchase lottery tickets under the understanding that everyone will split any winnings. Is this an investment contract? Why or why not? Does it change your analysis if Ralph and the other investors depend upon Carter to manage the funds, purchase and hold the tickets, collect any winnings, and distribute those funds to any investors? Why?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-an-investment-contract-under-securities-law/

**4. What are the primary security laws?**

Securities are subject to federal and state regulation. State securities laws are known as "Blue Sky laws" and are discussed at the end of this chapter. The two primary federal laws governing the trade or sale of securities are the Securities Act of 1933 ('33 Act) and the Securities Exchange Act of 1934 ('34 Act).

- *'33 Act* - The '33 Act provides the rules for the initial sale of securities to the public. This includes detailed rules for the personal disclosure to prospective purchasers and disclosure of information to the general public through registration with the Federal Government.

- *'34 Act* - The 34' Act concerns the on-going disclosure requirements once company securities are traded publicly, such as on national exchanges. These laws provide for the substantive content of the disclosure, the procedural disclosure requirements, and the repercussions (such as civil and criminal penalties) for failing to adhere to these laws.

Both the '33 and '34 Acts are administered by the Securities Exchange Commission. Along with the regulations promulgated by the SEC, they govern the sale or exchange of securities in any context.

- ***Discussion***: Why do you think the securities laws treats the initial sale of securities to the public separately from the subsequent sale of issued securities on public markets? How are these types of securities different?

- ***Practice Question***: What type of activity is regulated by the Securities Act of 1933? The Securities Exchange Act of 1934?

- ***Resource Video***: http://thebusinessprofessor.com/major-federal-securities-laws/

**5. What are the regulatory goals of security laws?**

The regulatory goals or purpose of the securities laws include:

- preventing manipulation of the securities market;
- full disclosure of “material information” to stakeholders;
- preventing fraud; and
- leveling the playing field between insiders of a company and investors.

Each of these regulatory goals are not independent. Fairness and the prevention of deceit underline each objective.

- ***Discussion***: How do you feel about these securities law objectives? Are there any additional objectives that should be achieved under the securities laws?
- ***Resource Video***: http://thebusinessprofessor.com/regulatory-goals-of-the-security-laws/

**6. What is the “Securities and Exchange Commission” (SEC)?**

The Securities and Exchange Commission (SEC) is a semi-independent, administrative agency created in 1934 (as part of the ’34 Act) to regulate the sale or exchange of securities. The commissioners are appointed by the President under the advisement of Congress. The SEC is divided into five main divisions regulating: Corporation Finance, Trading and Markets, Investment Management, Enforcement, and Economic and Risk Analysis. The SEC has quasi-legislative and quasi-executive powers. The SEC develops the regulations to carry out the statutory laws passed by Congress. It has the ability to issue cease and desist orders, issue fines, and bring civil actions against issuers of securities who violate the law.

- *Note*: Criminal actions for violation of securities laws are referred to the US Attorney’s Office for prosecution.

- ***Discussion***: Why do you think securities law requires a dedicated administrative agency? How do you feel about an independent agency making securities regulations with the force and effect of law?
- ***Practice Question***: What is the role of the Securities and Exchange Commission in the regulation of securities?
- ***Resource Video***: http://thebusinessprofessor.com/what-is-the-securities-and-exchange-commission/

**BUSINESS FINANCING AND PUBLIC OFFERINGS**

**7. What is an “initial public offering”?**

An initial public offering is the process by which a company first sells an equity interest in the company to the public at large. The primary purpose of the IPO is to generate operating capital for the company. Equity shares in a company constitute securities, so the IPO process is subject to securities law and is closely scrutinized by the SEC. The IPO process is complicated and generally involves a number of professional service providers. The process for an IPO is substantially as follows:

- *Underwriting* - "Underwriting" involves hiring an investment bank (or group of investment banks) to market and sell company securities. In some instances, smaller companies will make an offering directly to individual customers through a licensed broker. This process is known as a "direct public offering" and is often associated with low-value securities, commonly referred to as "penny stocks". For larger companies, investment banks stand in a unique position to be able to create awareness of the issuance and sell the securities to large, institutional investors. This process is commonly known as a "road show". In some instances the bank will purchase shares from the company and then resell them to investors in pre-arranged transactions on the open market. In this situation the bank is making a "firm commitment" as underwriter. The bank will often keep a percentage of the shares for itself as compensation for the underwriting process. In other arrangements, an underwriter may simply act as a sales agent for the issuer. The bank may guarantee a limited number of sales, but generally it does not guarantee any specific number. This is known as a "best efforts commitment". The bank earns a commission on the number of shares sold. The underwriter assists the issuer in determining the price and number of shares to issue.

    - *Note*: The underwriter has the ability to garner interest in the securities, but no sale of securities can take place at this point. The issuer can only sell to the underwriter or to prospective purchasers identified by the underwriter once the registration process is complete.

    - *Example*: ABC Corp intends to undergo an IPO and needs assistance with arranging for the sale of its shares to the public. JP Morgan Bank contracts with ABC Corp to handle the IPO. JP Morgan will advise ABC Corp on the number and value of shares to issue. It will then seek to sell (seek commitments for the purchase of) these shares to institutional investors. JP Morgan makes a firm commitment, so it is obligated to purchase a predetermined number of shares, which it will sell to the institutional investors for a price above what it pays ABC Corp.

- *Registration* - Registration is the process of filing extensive disclosures with the SEC about the companies finances and operations and characteristics of the issuance of securities. The filings with the SEC are made public and provide information to potential investors in the market. The SEC will review the disclosures for completeness, but it does not evaluate the quality of the securities being issued. The approval of the SEC is based upon whether sufficient information is disclosed to allow a potential investor to make an informed decision. Often this is a back-and-forth process until the SEC is satisfied that all necessary information has been disclosed.

    - *Note*: Disclosure to the SEC is a very complicated process. Though expensive, businesses generally hire experienced legal firms to help with the disclosure process. Private sale of securities (discussed below) may be exempt from the registration process.

- *Solicitation of Purchasers* - After the registration process is complete, the issuer will solicit prospective purchasers and consummate the sale of securities. At this point, the investment bank will proceed with the road show and begin contacting potential purchasers. As part of this process, the issuer or underwriter must provide all offerees or prospective purchasers with a disclosure document, known as a "prospectus". The prospectus contains much of the same information contained in the registration statement but provides a more concise presentation of material information.

The extensive registration requirements associated with an IPO can be very burdensome and expensive to the company. As such, many companies seeking to raise capital avoid the IPO process and seek equity financing from private investors. This process is known as a "private offering" and is discussed further below.

- ***Discussion***: How do you feel about the extensive registration requirements and sale restrictions on securities? Are these regulations a benefit or detriment to businesses? Society? Why or why not?
- ***Practice Question***: Ernest is interested in offering shares of his company, ABC Corp, for sale to the public. He believes that this will bring in the capital necessary to continue growth. Outline the securities law process that ABC Corp will need to undergo prior to selling to the public.
- ***Resource Video***: http://thebusinessprofessor.com/what-is-an-initial-public-offering/

**8. What is a "direct public offering"?**

A direct public offering is the process by which a company offers its shares for sale directly to the public without employing the services of an underwriter. The underwriter has the ability to reach out to large institutional investors and guarantee the sale of a certain quantity of securities. In a direct public offering, the company will generally enlist the services of a broker to make certain the offering is carried out in accordance with the securities laws. The requirement to register securities still applies; however, the company may be able to employ an exemption from registration (discussed below). Once registration (or an exemption therefrom) is complete, the company will advertise the offering and begin selling to individuals, investment firms, etc. The direct public offering has become popular for companies seeking to crowdfund its growth. Numerous websites and services now exist to meet this demand.

- *Note*: The direct public offering is generally employed by smaller firms who cannot attract an investment bank to underwrite the public offering. It is far cheaper than an IPO, particularly if the company is able to employ an exemption from the securities registration process.

- ***Discussion***: Why do you think larger companies generally go through the IPO process, rather than undertaking a direct public offering? Can you see any advantages to the IPO over the DPO or vice versa?
- ***Practice Question***: How does the process of a direct public offering differ from that of an initial public offering? What are the advantages of the DPO process?
- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-direct-public-offering/

**THE SECURITIES ACT OF 1933**

The '33 Act is a federal disclosure law covering the initial sale of securities to the public. Specifically, the '33 Act makes it illegal to use the mail or any other means of interstate communication or transportation to sell securities without disclosing certain financial information to potential investors. Most notably, the issuer must register the issuance of securities with the SEC, unless the issuer is able to conduct the issuance pursuant to a registration exemption. Regardless, the '33 Act covers all initial offers to sell securities and places detailed disclosure requirements on those issuing securities (issuees). These disclosures allow potential investors to make informed decisions about purchasing the issued securities.

- *Note*: Failure to comply with the '33 Act may lead to civil and criminal penalties. Often, however, violations of the '33 Act may lead to court ordered relief such as injunctions against the violator or equitable remedies for those negatively affected by the issuance.

- ***Resource Video***: http://thebusinessprofessor.com/securities-act-of-1933/

**9. What is an "offer" to sell securities?**

The '33 Act specifically regulates any offer to sell securities. The term "offer" is defined very broadly under the '33 Act as any attempt to solicit interest in buying shares. The definition of an offer to sell securities goes far beyond actually attempting to sell securities. As such, securities law regulates a much wider range of conduct than many people anticipate.

- *Note*: Even if the communicator includes disclaimers or provisions stating that the information is not an offer and that the recipient cannot purchase securities at this time, the communication may still be considered an offer.

- *Example*: Under this definition, direct mail or advertisement of any sort would constitute an offer. Posting information about a securities offering on a website would be considered a solicitation of offers. Further, any communication that discloses information about the decision to sell securities, depending upon the context, may be considered an offer.

- ***Discussion***: Why do you think an offer to sell securities is defined so broadly? Do you think it is appropriate or overly broad? Why?

- ***Practice Question***: ABC Corp is considering raising money for operations by selling bonds to the public. ABC Corp wants to gauge public interest, and posts an announcement on a popular investment website stating the ABC Corp will be selling bonds at the end of the year. Does this activity implicate the securities laws?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-an-offer-to-sell-securities/

**10. Who are the parties regulated in an offer to sell securities?**

The '33 Act regulates offers to sell securities by a number of individuals, including the issuer, underwriter, controlling party, or sales representative. The "issuer" is the individual or business organization offering a security for sale to the public. "Underwriters" are individuals participating in the original distribution of securities by selling such securities for the issue or by guaranteeing their sale. A "controlling party" is one who controls or is controlled by the issuer, such as a major stockholder of a corporation. A "sales representative" is anyone who contracts with a purchaser or who is a motivating influence that causes the purchase transaction to occur.

- ***Discussion***: Why do you think that the securities laws regulate the conduct of such a wide variety of sellers or securities? How does regulating the conduct of these individuals align with the objectives of the securities laws?

- ***Resource Video***: http://thebusinessprofessor.com/who-is-regulated-in-a-securities-issuance/

**11. What are the primary disclosure documents required in a offer to sell securities?**

The '33 Act requires that an issuer of securities register with the SEC by filing a registration statement prior to any offer or sale of securities. Further, the issuer (or individual offering to sell securities) must provide a detailed disclosure document, known as a "prospectus", to any potential investor prior to consummating a sale.

- *Registration Statement* **-** Generally, it is illegal to sell securities to the public unless those securities are registered or there is an exemption from registration. The registration statement is the primary document that the entrepreneur must file with the SEC before undertaking a securities offering. The registration statement provides extremely detailed information about the business and the intended equity offering. The SEC reviews this information and makes it available to the public. Potential investors considering investing in the venture will use this information to make an informed decision. The investor can feel confident in the veracity of the information.

    - *Note*: There are several versions of the registration statement – the applicability of each depends upon the character and status of the business. The most common and recognized registration statement is the S-1, which applies to larger corporate entity forms that intend to offer securities to the public at large. The form S-1 contains instructions and references to dozens, if not hundreds, of applicable regulations that provide detailed information that must be included in the statement. While the actual requirements for registration are sufficient to fill a textbook, we simply make reference to them in order to illustrate the extensive requirements associated with registering the sale of a covered security.

- *Prospectus* **-** Due to the volume of the disclosure included in the statement, it is somewhat difficult for a perspective investor to use the registration statement effectively to glean information about a particular investment opportunity. As such, the SEC requires that an issuer also prepare a "prospectus", which is summary document containing fundamental information about the issuer, the security issuance, and the terms that apply. It provides the investor with sufficient facts (including financial information) to allow her to make an informed investment decision. At a bare minimum, it includes balance sheets and statements of operation by the investor. The issuer must provide this document to prospective investors prior to selling a security or accepting any investor funds. Like the registration statement, the information contained in the prospectus is subject to review and approval by the SEC.

    - *Note*: The prospectus delivery requirements generally do not apply to persons other than issuers (and their affiliates), underwriters or dealers. An individual purchaser of a security is generally exempt from providing this document in sales to a subsequent purchaser.

- ***Discussion***: Why do you think the SEC requires both an issuer to file a registration statement and prospectus prior to offering securities for sale? Why do you think the SEC requires the issuer to provide the prospectus to perspective purchasers of securities? Do you think this method of disclosure is effective? Why or why not?

- ***Practice Question***: What are the disclosure documents required under the Securities Act of 1933 and how are they used?

- ***Resource Video***: http://thebusinessprofessor.com/disclosure-documents-in-a-securities-issuance/

**12. What is an issuer allowed to do during each stage of the registration process?**

A company offering its shares for sales to public for the first time (an initial public offerings) must register with the SEC or perfect an exemption from registration. If the company must register, the ability to advertise or offer to sell securities to the public follows a process that is linked to the filing of the registration statement. Generally, companies must follow the following framework and timeline:

- *Pre-filing Period* - This refers to the period leading up to making the regulatory filings required by the SEC. During this period, the issuer cannot make offers to sell or take offers to buy securities. The issuer may, however, engage underwriters about the planned issuance. The underwriters may make commitments regarding the underwriting process for the securities, but no securities are actually sold during this period.

- *Waiting Period* - This period refers to the post-SEC filing period during which an issuer can undertake limited efforts to market or sell the securities. The waiting period generally lasts for 20 days following the filing, if not extended. During this period, the SEC is charged with evaluating the registration statement and investigating the information contained therein. The SEC is looking for disclosures that may be incomplete or confusing to investors. The issuer may use this period to solicit offers to purchase securities, but no sales can take place until the registration is complete. The issuer will generally put out advertisements, known as “tombstone ads”, to garner interest in the offering. The ads generally identify the securities being offered, the broker, provide access to prospectus information, and state an offer price.

    - *Note*: Nearly all registrations filings extend beyond the standard 20-day period. This gives the SEC more time to evaluate the issuance. Companies are rightfully woeful to proceed with the sale of securities if the SEC has not properly evaluated the offering disclosures. Issuing securities with noncompliant disclosures can subject the company to civil and criminal liability.

- *Post-Effective Period* - This is the period following registration. At this point, the registration and plan for issuing securities is officially approved. Unless the SEC gives notice that the registration and plan is defective, the approval is automatic. The issuer is now free to sell securities.

As stated above, the ability of an issuer to undertake activity in promoting, offering, or selling securities varies somewhat based upon the status of the issuer.

- ***Discussion***: Why do you think the securities laws prohibit the offer to sell securities to varying degrees based upon the stage of filing of the registration statement? Should there be any restrictions that remain in place following the post-effective date?

- ***Practice Question***: ABC Corp is in the process of registering with the SEC to sell company shares to the public. Rachel, a large investor, approaches ABC Corp immediately following the filing of the registration statement. Rachel wants to get ahead of other investors and purchase a large quantity of shares. What are ABC Corp’s options and limitations in this situation?

- ***Resource Video***: http://thebusinessprofessor.com/limitations-during-securities-issuance-process/

**13. How are issuers of securities classified for purposes of the registration and offering process?**

The rules applicable to an issuing company during the above time periods depend upon the issuer's classification. The classifications are as follows:

- *Non-reporting Issuer* - This refers to a company that is not subject to any SEC reporting requirements at the time of the issuance. This includes non-public companies below a certain capitalization ($75 million).
    - *Note*: Most companies seek to maintain a non-reporting status as long as possible. Many companies will maintain their private status until they reach this reporting threshold. Once the threshold is reached, the company is required to undertake the extensive reporting similar to that of a public company. At this point, the companies often decide to become public companies to open this funding channel.
- *Unseasoned Issuer* - This is a company subject to SEC public reporting requirements, but it has either not been subject to the reporting requirements for 12 consecutive months or does not meet the $75 million public float requirement.
- *Seasoned Issuer* - A seasoned issuer is a reporting company that has greater than $75 million in public float, but less than $700 million and at least one year of timely reporting.
- *Well-Known Seasoned Issuer* (WKSI) – This is an issuer with worldwide stock float of $700M or outstanding debt of $1billion that has been issued within the past 3 years.

Each classification relates to the capitalization of the company or status as a company compelled to report to the SEC. The purpose behind classifying companies in this manner regards the ability of the company to offer for sale or solicit offers to purchase securities during the pre-filing and waiting periods.

- ***Discussion***: How do you feel about classifying companies and providing different rights to offer for sale or solicit purchasers of securities based upon the capitalization and reporting history of the company? Should there be other considerations that affect the extent of regulation? Why or why not?
- ***Practice Question***: What are the different classifications of issuers of securities?
- ***Resource Video***: http://thebusinessprofessor.com/classification-of-issuance-of-securities/

**14. What is an issuer allowed to do during the "Pre-Filing Period" (and the exceptions)?**

During the pre-filing period, no offers to sell or offers to buy securities are permitted. There is a limited exception to this rule under SEC Rule 135, which allows for the announcement of an upcoming offer. The issuer can have discussions with underwriters or with an underwriting syndicate. This allows the company to undertake the procedural arrangements and financing of the offering. In any event, the communications or announcement of the upcoming offer cannot have the purpose or effect of "conditioning of the market". That is, it cannot cause a market reaction for the pending IPO that is commensurate with the effect of an actual offering. This is a poorly defined standard, which does not provide a great deal of guidance to issuers. There are some other notable exceptions to the general prohibition against offers to sell during the pre-filing period that are worthy of note.

- *Emerging Market Company Exception* - The JOBS act makes an exception and eliminates the "conditioning the market" restriction for "emerging market companies". So, if a company meets the criteria to be an emerging market company, the announcement of the upcoming issuance faces few limitations aside from waiting to consummate the sale until the post-effective period.

- *Section 5(b) Exception* - This provision allows oral or written communication with qualified institutional buyers (QIBs) and accredited investors that are institutions, prior to filing of the registration statement. This is a limited exception that allows issuers with connections with potential purchasers who have the knowledge and sophistication that warrants a lower level of protection under the securities laws.

- *Public Company Exception* - Public filers can (must) continue their periodic disclosure (quarterly and annual reports) and Rule 168 permits forward-looking information. This means that a public company that is planning to issue more securities on the market must disclose this intended action to the market and existing shareholders. The prohibition against conditioning the market is trumped by the need for full disclosure.

- *Free-Writing Prospectus Exception* - Under Rule 163, WKSIs can use a "free-writing prospectus" during the pre-filing period, so long as it is filed with SEC prior to distribution. Per Rule 405, a free-writing prospectus is a written communication (including electronic/graphic) that constitutes an "offer to sell" that does not fall under a statutorily defined format (such as preliminary prospectus defined in section 10(b) or Rule 430 "red herring" prospectus).

There are other limited exceptions to the ability to make offers of securities at the pre-filing stage; however, these are the most commonly recognized.

- ***Discussion***: What do you think is the reason for restricting the sale of securities prior to filing a registration statement? Do you think that requiring the filing of a registration statement achieves the underlying objectives? Why or why not? Why do you think the securities law allows for these exceptions?

- ***Practice Question***: What are the limitations on an issuer of securities prior to filing a registration statement? What are the primary exemptions from these limitations?

- ***Resource Video***: [http://thebusinessprofessor.com/securities-issuance-prefiling-period/](http://thebusinessprofessor.com/securities-issuance-prefiling-period/)

**15. What are the limitations on an issuer during the "Post-Filing Waiting Period"?**

During the post-registration, waiting period, special rules apply to the general dissemination of information about the issuance. Generally, oral discussions or offers to buy the securities are unregulated. This allows investment banks to carry on a "road show", which is a concerted effort by the bank to build a book of subscribers for the security issuance. Written offers to sell (or other solicitations) must be accompanied by a prospectus that meets statutory standards for disclosure. Anyone submitting a written request to purchase must receive a prospectus that has been reviewed and approved by the SEC. No actual sales can occur until the registration statement "goes effective" for any issuer.

- *Note*: One notable exception under Rules 164 and 433, seasoned issuers and WKSI can use a free-writing prospectus, so long as it contains information on where to get the statutory prospectus. Unseasoned issuers and non-reporting issuers (IPO filers) can use free writing so long as accompanied by statutorily approved prospectus.

- ***Discussion***: Why do you think the securities laws closely regulate written disseminations of information during the post-filing period? Why do you think these are treated differently than oral communications? Should there be a free-writing prospectus exception for certain issuers? Why or why not?
- ***Practice Question***: ABC Corp is a well-known, seasoned issuer. It has made the registration statement with the SEC and is awaiting approval. Jamie is an investor and approaches ABC Corp (through its representative) with a written request to purchase a large block of shares. If ABC Corp chooses to respond to Jamie's inquiry with any information about the issuance, what are its obligations and limitations?
- ***Resource Video***: http://thebusinessprofessor.com/securities-issuance-post-filing-waiting-period/

**16. What is an issuer allowed to do during the "Post-Effective Period"?**

During the Post-Effective Period, the issuer can begin selling securities. The issuer must still deliver a statutorily prescribed prospectus to offerees. Additional rules benefiting WKSIs exist during this stage that allow for an automatic "shelf registration". Shelf registration is the pre-registration of securities that will not be issued until a later date. This can be useful when the business plans for multiple stages of funding over a period of time.

- ***Discussion***: Why do you think the securities laws are less restrictive on communications by issuers following the post-effective period? Should there be any continued regulation (beyond the requirement to provide purchasers with a prospectus) following the post-effective date?

**17. What is an "Emerging Growth Company" and why is it important?**

An emerging growth company (EGC) is any company that meets the following requirements:

- the company has less that $1billion or more of total gross revenue in a consecutive 12-month period;
- is within 5 years of its original IPO;
- the company cannot have issued more than $1 billion in non-convertible bonds within the last 3 years, and
- the company does not qualify as a "large accelerated filer", meaning a public float of over $700 million.

Status as an emerging growth company provides a number of benefits to the company with regard to security laws and regulation.

- *Confidentiality* - An EGC may make confidential submission to SEC of a preliminary prospectus prior to the public filing with SEC. This gives the SEC an opportunity to review the prospectus and maintains confidentiality about the securities issuance.

- *Note*: Eventually this draft and all amendments must be filed public with the SEC at least 21 days prior to underwriters commencing a road show.

- *Unregulated Communications* - An EGC may have unregulated oral or written communications with qualified institutional buyers and accredited investors. This effectively allows the EGC to “test the waters” before the preliminary prospectus is filed with SEC.

  - *Note*: This is a big difference from non-EGC companies that must file the preliminary prospectus with the SEC before discussions/selling efforts could begin.

- *Audited Financial Statements* - The EGC must produce 2 years of audited financial statements with the registration statement.

  - *Note*: Non-EGC companies are required to submit 3 years of audited statements.

- *Security Analyst Reports* - Securities analysts will be permitted to freely publish research reports about companies about to issue securities.

  - *Note*: Securities analysts generally do not have access to information from non-public company. Disclosing this information to the public could be seen as conditioning the market for the issuance, which is prohibited for non-EGC companies. This benefit is so broad as to allows companies participating in underwriting process to publish an analyst report.

- *Accounting Standards* - Exemption from new or revised accounting standards.

  - *Note*: This can reduce the cost of updating disclosures of financial documents based upon new or revised accounting procedures.

- *Auditor Exemptions* - The EGC is exempt from compliance with PCAOB rules requiring mandatory rotation of external firms auditing the company. Further, the company executives are not required to produce an auditor attestation of internal controls under section 404(b) of SOX of 2002.

  - *Note*: Smaller companies generally do not have the funds or resources to rotate auditing firms or verify compliance with SOX.

- *Executive Compensation Rights* - EGC companies are exempt from many requirements to disclose executive compensation. Also, EGC companies are exempt from “say-on-pay” vote requirements placed on non-EGC companies by securities laws. Say-on-pay rights allow shareholders to vote to approve the compensation of executives of the business.

Given the benefits associated with EGC status, companies are apt to monitor their growth and plan for the effects of losing EGC status.

- ***Discussion***: Why do you think Congress established the category of Emerging Growth Company and provided the above-referenced benefits? Can you think of any other factors that should be considered in categorizing a company as an EGC? Which of the state exemptions do you see as the greatest benefit to EGCs?

- ***Practice Question:*** What are the requirements to qualify as an emerging growth company? What advantages does this designation provide to the company?

- ***Resource Video***: http://thebusinessprofessor.com/what-is-an-emerging-growth-company/

**18. What type of information must an issuer disclose?**

Securities laws intend to protect individuals from financial loss due to a lack of understanding of the risk associated with an investment or intentional fraudulent activity by an issuer. As such, the SEC requires that anyone offering to sell securities disclose certain "material" information about the venture to prospective purchasers. The disclosure requirements vary with the type of investor and the amount and context of the security offering. Courts have held that "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."

- *Note*: The "total mix" is inherently fact specific. It also raises questions about who is the reasonable investor.

- ***Discussion***: Why do you think the law focuses on the disclosure of only material information? How do you feel about the subjective determination of what information is material?

- ***Practice Question***: What standard will a court apply in determining whether an issuer of securities has complied with its duty of disclosure?

- ***Resource Video***: http://thebusinessprofessor.com/types-of-information-disclosed-in-securities-issuance/

**19. What laws govern the mechanics of disclosure of information in a securities offering?**

Regulation S-K is an SEC promulgated regulation that applies to new issuances under the '33 Act and subsequent sale or transfer of securities under the '34 Act. This regulates the specific types of information that an issuer must disclose to the public. The primary disclosure statement in an IPO is the registration statement (Forms S-1 and S-3 for Securities Act (33 Act)). Publicly-traded companies are subject to Schedule 14A (requiring disclosure of proxy statements). Public companies are also subject to continued reporting by filing form 10-K, 10-Q, 8-K for '34 Act.

- *Note*: The disclosure requirements are often extensive and difficult for companies to manage.

- ***Discussion***: Do you think that the extensive disclosure measures have the intended effect of protecting investors? How do you think these disclosures should be balanced against the possibility of deterring companies from going public?

- ***Resource Video***: http://thebusinessprofessor.com/rules-governing-disclosure-during-registration-process/

**EXEMPTIONS FROM '33 ACT REGISTRATION REQUIREMENT**

The registration and public offering process is extremely burdensome for startup companies. Numerous statutory and rule-based exemptions to the securities registration process exist. The statutory exemptions fall under Sections 3 and 4 of the '33 Act. The rule-based exemptions are based upon statutory exemptions and are found primarily in "Regulation A" and "Regulation D" of the '33 Act. These statutory and rule-based exemptions either exempt this type of security from registration or exempt a particular type of transaction from registration.

**20. What are "exempt securities" and "exempt transactions"?**

Certain types of securities and certain transactions are deemed by the SEC to be exempt from registration requirements.

- *Exempt Security* - Common types of exempt securities are government securities, bank securities, high-quality debt instruments, non-profit securities, and insurance contracts. Most important for private, for-profit companies is the broad exemption under Section 4 of the '33 Act of "transactions by an issuer not involving any public offering." This is known as a "private offering". A private offering is generally for a lesser amount of money that is invested by a small number or closely-related investors.
    - *Note*: The exempt type of security never has to be registered, even if it is resold following the issuance.
- *Exempt Transaction* - An exempt transaction is a transaction that does not warrant full-blown registration. Exempt transactions generally involve either a limited amount of capital or sophisticated or accredited investors.
    - *Note*: A security sold in an exempt transaction may have to be registered to avoid violating the '33 Act if resold within a short period of time.

- ***Discussion***: Why do you think the securities laws exempt certain securities from regulations and certain types of transactions for regulation? How is your reasoning influenced by the underlying goals of the securities regulations?
- ***Practice Question***: What is an exempt transaction and an exempt security and why does this designation matter?
- ***Resource Video***: http://thebusinessprofessor.com/exempt-securities-and-exempt-transactions/

**21. What are "restricted securities"?**

Restricted securities, as the name implies, are subject to restrictions on when they can be sold or transferred following their issuance. Rule 144 of the '33 Act lays out the rules for restricted securities.

- *Holder Restrictions* - Restricted securities in public companies are those held by officers, directors, or major shareholders (10% of total shares). These individuals cannot sell a number of shares greater than 1) the average weekly trading volume for the shares during the prior 4 weeks of trading, or 2) a quantity equal to 1% of total shares outstanding.

- *Transactional Restrictions* - Securities issued pursuant to a transactional exemption are also restricted from immediate resale. Regulation D exemptions prohibit resale for 12 months following the date of the issuance. This is to make certain that an exemption is not used as a straw transaction to transfer shares to individuals who could not otherwise be investors under the applicable exemption.

- ***Discussion***: Why do you think the securities laws restrict the ability of certain insiders from selling a specific quantity of their shares? Is this fair to those shareholders? Why or why not? Why do you think the securities laws limit the transfer of shares issued in an exempted transaction?

- ***Practice Question***: Robert is a large shareholder and COO of ABC Corp, a publicly traded corporation. He acquired many of his shares when he joined ABC Corp, immediately prior to the company going public. He received the shares in an exempted transaction that did not require registration of the securities. He now believes that ABC Corp has plateaued in its share price and he wants to sell a large quantity of his shares on the open market. What limitations might Robert face in selling the shares?

- ***Resource Video***: [http://thebusinessprofessor.com/what-are-restricted-securities/](http://thebusinessprofessor.com/what-are-restricted-securities/)

**22. What is a "Section 3 exemption" from registration under the '33 Act?**

*Section 3(a) Exemption* - Section 3(a)(11) is an "intrastate offering exemption" designed to allow businesses to seek local funding. The issuer may offer securities for sale to residents of the state in which the business primarily does business without registering the issuance or securities with the SEC.

  - *Note*: Issuers of securities pursuant to the section 3(a)(11) statutory exemption must be careful that no offer is made to prospective out-of-state purchasers. Even one offer to a non-resident will destroy the exemption. Issuers can use the legal fiction of publishing information likely to go only to intrastate residents with a legend, "this is an offer only to in-state residents" to try to protect themselves.

- *Exempt Security* - Section 3(a)(11) offers an exemption for a class of securities, rather than an exemption for the particular issuance or transaction. The securities can be freely resold without worrying about registration.

- *Benefits of Section 3 Exemptions* - The exemption is attractive to issuers because it allows for:
  - an unlimited number of investors,
  - an unlimited amount of raised capital, and
  - general solicitation of investors may be allowed under the applicable state law.

- *Coming to Rest* - Purchasers cannot immediately resell the security, as that resale may involve out-of-state purchasers. If the securities have not "come to rest" then resale out of state destroys the exemption for the entire offering.

    - *Note*: The issuer must encourage purchasers to avoid immediate resale in order to avoid the appearance of a sham attempt to achieve a non-intrastate offering.

- *Integration Doctrine* - The "integration doctrine" applies to Section 3 issuances. This doctrine states that any offering of securities by the issuer within the last 12 months may be integrated into the current offering. Even if the other offerings were under another exemption, they may be "integrated" into a single transaction. If the issuances are integrated, it is possible that the prior offering will cause the loss of the registration exemption for the present and former transactions.

    - *Note*: The result of a failed exemption is that any purchasers in either offering may seek to rescind the transaction.

- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-section-3a-securities-registration-exemption/

*Section 3(b) Exemption*

- *Section 3(b)(1) Exemption* - Section 3(b)(1) of the '33 Act is an exemption from registration of securities. It gives the SEC authority to define the types of exempt transactions where the value of securities issued does not exceed $5 million ("small issues" exemption).

    - *Note*: This statutory authority is the basis for an exemption under Rule 504 of Regulation D (discussed below).

- *Section 3(b)(2) Exemption* - Section 3(b)(2) allows the SEC to define a new "small issuance" class with a limit on the amount of funds raised of $50 million. These are unrestricted securities, which can be traded freely.

    - *Note*: This statutory authority is the basis for an exemption under Regulation A+ (discussed below).

- ***Discussion***: Why do you think the securities laws allow an exemption from registration of securities sold strictly to residents of the state in which the issuer primarily does business? Why do you think the law exempted the security, rather than the transaction? Do the benefits of an intrastate offering make it compelling for issuers despite the geographical limitations?

- ***Practice Question***: ABC Corp decides to sell shares to instate investors to raise $2.5 million in operating capital. ABC works diligently to make certain to offer the securities to only instate residents. What are the benefits of an intrastate offering? What is the risk to ABC Corp of purchasers immediately reselling the issued securities? This is ABC Corp's third issuance of securities pursuant to an exemption? What information do you need to know to determine if the current issuance will cause a problem for ABC Corp?

- ***Resource Video***: http://thebusinessprofessor.com/securities-registration-exemption-section-3b/

**23. What is "Rule 147" and how does it relate to a Section 3 exemption?**

Rule 147 of the '33 Act is a safe harbor for section 3(a)(11). It lays out the strict requirements that the issuer must meet to remain within the confines of the statutory exemption. To qualify for the intrastate offering exemption under SEC Rule 147:

- the issuer (company) must be incorporated in the state where the offering is made;
- at least 80% of the issuer's revenues must come from business within that state;
- at least 80% of the issuer's assets must be located in that state; and
- at least 80% of the proceeds of the offering must be used in that state.

As the name of the exemption implies, the issuer and all purchasers of the security must be primary residents of the state in which the securities are sold. As previously stated, a single offer or sale to an out-of-state individual destroys the exemption. Under the broad definition of an offer under the '33 Act, any inadvertent contact with an out-of-state investor regarding the intended offering could be considered an offer to sell the securities. Lastly, a purchaser cannot resell the security to an out-of-state purchaser within 9 months of the issuance.

- *Note*: Ultimately, the issuer bears the burden of verifying the residency of each offeree or potential investor.

- ***Discussion***: Why do you think the securities regulations allow for a rule-based exemption (regulation) that is a safeguard against violating the section 3(a)(11) statutory exemption? Do you agree that a purchase who meets the above-referenced characteristics should be considered an in-state purchaser? Why or why not?
- ***Practice Question***: ABC Corp plans on an instate issuance of securities. They are worried about violating the section 3(a)(11) statutory exemption and losing the exemption. What options are available to ABC Corps to make certain they do not violate the statutory exemption?
- ***Resource Video***: http://thebusinessprofessor.com/rule-147-and-section-3-exemption/

**24. What is a "Section 4" exemption from registration under the '33 Act?**

Section 4 provides for two statutory exemptions from registration of securities by an issuer. The exemptions available under Section 4 of the '33 Act provide for transactional exemptions for the securities, rather than a blanket exemption for the security itself.

*Private Offering Exemption - Section 4(a)(2)* - Section 4(a)(2) provides that, "the provisions of section 5 shall not apply to transactions by an issuer not involving any public offering." The SEC has deemed certain transactions to constitute "private offerings" and fall outside of the scope of a public offering. That is, the securities are not being sold in a public offering and, therefore, are exempt from the registration and reporting requirements of Section 5.

- *Note*: Rule 506, discussed in a separate lesson, is a "safe harbor" for the Section 4(a)(2) exemption. That is, if you follow the requirements of Rule 506, but fail to perfect the exemption, you may still qualify for an exemption under Section 4(a)(2). The requirements for exemption under Rule 506 are less stringent than those under Section

4(a)(2). For example, Rule 506 allows for purchase by non-sophisticated investors through an agent (purchaser representative). The main advantage of having this safe harbor provision is that, in the event the issuer fails to meet the requirements, it may still attempt to claim the exemption under Section 4(a)(2) or another exemption.

The characteristics of a section 4(a)(2) offering are as follows:

- *Exempt Transactions* - Section 4 provides for a long list of exempt transactions that include:
    - transactions falling under Section 4(2) and Reg. D and Rule 144A;
    - securities issued as compensation – Rule 701;
    - cross-border rights and exchanges for business combinations: Rule 800-802; and
    - foreign issuances: Reg. S (Rules 901-905).
- *Benefits of Section 4(a)(2)* - Section 4(a)(2) allows for the following benefits:
    - there is no geographical limitations on the issuance within the United States,
    - an unlimited number of offerees and investors, and
    - there is no limit upon the amount of money raised in the issuance.
- *Limitations of Section 4(a)(2)* - The following limitations apply to a section 4(a)(2) exemption:
    - *Disclosure* - Prospective purchasers must receive the pre-sale, statutory disclosures in the form of a private placement memorandum.
    - *Sophistication Requirement* - The issuer may offer or sell securities only to investors who are sophisticated and are not in need of the public protections afforded under the SEC's regulations. Courts have interpreted this standard to mean that an investor must have the financial ability to bear the risk of loss in the investment or extensive business experience and open access to necessary information.
        - *Note*: There is no bright-line test for sophistication and financial ability to bear risk under the statute. If the potential investor does not meet the standard of "sophistication", the exemption could be lost. If so, any investor who purchased securities within twelve months of the unauthorized offer will have an action to rescind the purchase of the security.
    - *Integration* - This offering may be integrated with prior offerings within the past 12 months.
    - *General Solicitation* - The offering cannot involve the general solicitation of purchasers. This concept is discussed further below.
    - *Restricted Securities* - These are "restricted securities". They cannot be resold unless:

- they are held for 6 months (reporting company) or 12 months (not a reporting company), or
- they are registered prior to resale, or
- the seller perfects another transactional exemption.

- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-section-4-securities-exemption/

*Statutory Exemption for Accredited Investors - Section 4(a)(5)* -Section 4(a)(5) of the ’33 Act provides a statutory exemption for securities sold in accordance with its provisions.

- *Note*: The notable difference between Section 4(a)(5) and Regulation D exemptions is that Regulation D also allows for sales to non-accredited investors. Section 4(a)(5) is rarely used as a stand-alone exemption. The reason is because this statutory exemption generally fits within the rule-based exemptions of regulation D (Rules 505 and 506, for example), but does not contain many of the benefits.

The following limitations apply to a Section 4(a)(5) issuance:

- *Disclosure* - The issuer must provide a prospectus to purchases that complies with ’33 Act disclosure provisions;
- *Accredited Investors* - The issuer can only offer and sell securities to accredited investors;
- *General Solicitation* - The issuer cannot undertake any advertising or other forms of general solicitation of purchasers;
- *Dollar Value* - The maximum offering amount cannot exceed $5,000,000;
- *Notice* - The issuer must provide notice of sale to the SEC;
- *Restricted Securities* - Securities sold under section 4(a)(5) constitute "restricted securities" under Rule 144(a)(3) and cannot be resold in the future without registration or perfection of a separate exemption; and
- *State Registration* - Securities exempted under section 4(a)(5), like some other statutory exemptions, do not fall within the meaning of a federally covered security. The result is that federal law does not preempt state laws regulating the securities.

- ***Resource Video***: http://thebusinessprofessor.com/what-is-a-section-4a5-securities-registration-exemption/

- ***Discussion***: Why do you think the securities laws allow for a statutory exemption from registration of private offerings that meet the requirements of section 4(a)(2)? What about 4(a)(5)? Can you see how the restrictions on section 4(a)(5) make it a rarely-used exemption?

- ***Practice Question***: ABC Corp is your employer and is considering a private issuance of securities. As a consultant for ABC Corp, you want to make certain that they understand the limitations and restrictions that apply to an issuance under Section 4. If asked, can you explain the limitations that apply to section 4(a)(2) and 4(a)(5)?

**25. What is a "Regulation A" exemption?**

Regulation A is a "conditional small issues" exemption from registration available for issuances that meet certain characteristics. Like Section 3(11), Regulation A provides for an exemption of the actual securities issued under the exemption. As such, the securities are not restricted from later sale.

- *Note*: The exemption is available for the issuer but is not available for broker-dealers offering the security for sale.

*General Limitations* - The following general limitations apply to all Regulation A exemptions:

- *Private, Non-Reporting Company* - The issuer cannot have stock registered with the SEC under Section 12 (i.e., cannot have stock that is traded on a public exchange) or be a reporting company under Section 15(d) of Securities Exchange Act of 1934 ('34 Act).

- *US Company* - The company must be a US or Canadian-based company.

- *Operating Company* - It cannot be an investment company, shell company, or involve fractional interests in oil or gas rights.

*Types of Regulation A Exemption* - Regulation A is actually divided into two classes of issuances, as follows:

- *Tier 1 Issuance*: The maximum amount of the issuance is $5 million in a 12-month period. There is no limit on the number of amount of securities purchased by any investors.

- *Tier 2 Issuance*: The maximum amount of the issuance is $50 million in a 12-month period. An investor may only purchase a number of securities valued at 10% of her annual income or 10% of her net worth, whichever is less.

*Regulation A Disclosures*

Regulation A is a middle ground between complying with the full registration and disclosure requirements of Section 5. The issuance requires review by the SEC prior to sale of the securities. The issuer must file an offering statement containing both non-financial and financial disclosures about the company and the issuance. This document has several components, including offering circular and financial statements. The issuer's CEO, CFO, and majority board members, and any selling shareholder must sign the offering statement certifying the information contained therein. This certification subjects these individuals to liability for any material omissions or misstatements. While this exemption does entail a filing requirement, the filing is far less demanding than those completing the entire registration process.

- *Note*: The issuer cannot solicit investors, make any binding commitments for sale, or sell any securities before the request for issuance and exemption is reviewed and approved by the SEC. There is, however, an exception that allows the issuer to "test the waters".

*Regulation A and General Solicitation*

Regulation A allows the issuer of securities to “test the waters” for interested investors. That is, the issuer can use a written document or a radio or television broadcast to seek feedback from interested investors. The purpose of this provision is to allow the issuer to determine, prior to preparing the detailed offering disclosure documents, whether or not there is sufficient interest from investors to proceed with the issuance. The key limitations are that the test-the-waters communication must be filed with the SEC on the date of use.

- *Note*: Failing to file the “test-the waters” communication does not automatically forfeit the exemption, but it can prejudice future issuances under this provision.

*Regulation A and State Regulations*

Regulation A securities are not exempt from state regulation. This means that, even though the federal exemption applies, states may require that the issued securities be registered in the state and, in some states, undergo a merit review. Perhaps most importantly, many states do not allow general solicitation of investors unless the securities being sold are registered. This would strictly limit the open solicitation of purchasers in person or through television, radio, or Internet. So, even though Regulation A allows for testing the waters, the state may require state registration prior to doing so.

- *Note*: A prohibition against general solicitation requires that an issuer approach regular business contacts or professional brokers to generate interest in the issuance.

- ***Discussion***: Why do you think Regulation A offers an exemption that accompanies a registration requirement? Given the extent of the disclosure requirements, do you think Regulation A is more or less attractive to issuers than full registration? Why?

- ***Practice Question***: ABC Corp decides to issue securities in an effort to raise $45 million in financing. What are some of the restrictions that ABC Corp must understand when considering Regulation A?

- ***Resource Video***: [http://thebusinessprofessor.com/regulation-a-exemption/](http://thebusinessprofessor.com/regulation-a-exemption/)

**26. What are “Regulation D exemptions”?**

Regulation D is the most commonly used set of exemptions for private placement. It consists of Rules 501-508 of the ’33 Act. In addition to several statutory exemptions from registration, the SEC adopted Regulation D to provide "safe harbors" for issuers of securities. These exemptions are referred to as safe harbors because compliance with these rules will provide for an exemption from the standard disclosure requirements. Unlike the statutory exemptions, such as Section 4(a)(2) or Section 4(a)(5), failure to achieve or perfect an exemption is not completely detrimental to the validity of the securities offering. Rather, if the validity of the issuance under a Regulation D rule is challenged, the issuer can then attempt to assert a statutory exemption for the issuance. As such, Regulation D provides a safe harbor for pursing an exemption and leaves open other possibilities for seeking exemption if somehow the offering runs afoul of the Regulation D exemptions.

- *Note*: The statutory authority for exemptions under Regulation D are found in Sections 3 and 4. Pursuant to this authority, the SEC used its quasi-legislative authority as an administrative agency to pass these exemption rules.

*Regulation D, Rule-Based Exemptions*

Regulation D, rules 501, 502 and 503 provide definitions and conditions for the applicable exemptions. Rules 504, 505 and 506, are the substantive exemptions. Rules 507 and 508 lay out the consequences for failing to comply with the requirements of an individual exemption. Taken together, these rules provide for the most commonly employed exemptions to securities registration requirements.

- *Note*: Each of the rule-based exemptions are discussed in detail below. It is important, however, to remember that the general provisions of Rules 501- 503 apply to each exemption.

*Limitations of Regulation D*

- *Issuer Protections* - A notable limitation of Regulation D safe harbor provisions is that they only provide exemptions for the issuers of the securities during the original issuance of the security. The rules do not exempt individuals who later sell those same securities to third parties.
  - *Note*: This restriction is quite important, as some securities sold to equity investors are “restricted” and limit the investor’s ability to resell. The importance of this limitation will be become apparent as we review the available exemptions.
- *General Solicitation* - Another important limitation is the restriction on the ability to make offers to sell securities to individuals. Many Regulation D exemptions prohibit issuers from soliciting investors to purchase the securities.
  - *Note*: The ability to solicit investors by making offers to sell securities is dependent upon the assumed knowledge and personal wealth of the investor.
- *Accredited & Sophisticated Investors* - Some exemptions limit the ability to sell securities to a certain number of “accredited investors” or “sophisticated investors”. Accredited investors are individuals with a net worth (not counting their primary residence) of more than $1 million or an annual income of more than $200,000 or institutions (such as banks and insurance companies). A sophisticated investor is an individual who has sufficient knowledge or experience to assess the risks of an offering themselves.
  - *Note*: A sophisticated investor may also be an accredited investor and *vice versa*. However, it is possible that one may not qualify as the other.

- ***Discussion***: Why do you think the SEC decided to offer rule-based exemptions as safe harbors for the statutory exemptions? Do you think that offering additional protections to issuers against challenges by purchasers is a good thing? Why or why not?
- ***Practice Questions***: What are the primary rules under regulation D? What are the rule-based exemptions from registration of securities and how do these rules relate to the statutory authorizations?
- ***Resource Video***: http://thebusinessprofessor.com/regulation-d-securities-exemption/

**27. What is a Rule 504 "small offerings exemption"?**

Rule 504 is a transactional exemption from registration under Regulation D for small securities offerings. The statutory authority for the rule is pursuant to Section 3(b) of the '33 Act. The general requirements and limitations on the exemption are as follows:

- *Issuer Protections* - The exemption is available to the original issuer. The exemption is available to any company that is not a "reporting company", "investment company", or a "blank check company" under the Securities Exchange Act.

- *Dollar Limits* - Rule 504 allows an issuer an exemption for small offerings of shares with an aggregate annual value of up to $1 million. The issuer may not split a single offering between Rule 504 and some other exemption. Any other offerings during the previous twelve-month period, even if under another exemption, will be integrated into the Rule 504 offering.

- *Number of Purchasers* - The issuer can make sales to an unlimited number of persons. It does not matter whether the purchasers are sophisticated or accredited investors.

- *Restricted Securities* - Securities are restricted. Affiliates and non-affiliates of an issuer who wish to resell securities must look elsewhere for a transactional exemption.

- *General Solicitation* - Rule 504 prohibits the issuer or anyone on the issuer's behalf to "offer or sell the securities by any form of general solicitation or general advertising". Rule 504 does allow for general solicitation in the following circumstances:

    - the offering is registered in the state where securities are sold, or

    - the state permits general solicitation and sales are only made to accredited investors in that state, or

        - *Note*: In these situations, the securities issued pursuant to either of these provisions are not restricted.

    - the state of issuance does not require registration, but the securities are registered in another state.

        - *Note*: This is a situation where the state allows the issuer to piggyback on the registration of securities in another state. The issuer must generally file an informational notice to the issuing state regarding the registration in another state.

- *Private Placement Memorandum* - To qualify for this exception, the state law must require "the public filing and delivery to investors of a substantive disclosure document before sale." The disclosure document must disclose all material information to investors.

- *State Regulation* - A Rule 504 exemption does not preempt state regulations of securities under such an issuance. States may still regulate the issuance.

- ***Discussion***: What do you think is the SEC's purpose in allowing for the Rule 504 exemption? Who do you think this exemption best serves? What do you think is the greatest limitation on this exemption? Why do you think the SEC allows for exceptions to the rule against general solicitation?

- ***Practice Question***: ABC Corp is a relatively new company that is growing quickly. ABC needs about $1 million in investment capital reach its growth goals for the next 18 months. In a brief letter, can you summarize the benefits and drawbacks of seeking an exemption from securities registration under Rule 504?

- ***Resource Video***: http://thebusinessprofessor.com/rule-504-securities-exemption/

**28. What is a Rule 505 "small offerings" exemption?**

Rule 505 of Regulation D provides a transactional exemption from registration of a securities issuance.

- *Issuer Protections* - The exemption is generally available to all types of issuers (individuals, non-corporate businesses, corporations, as well as those reporting under the '34 Act) but it is not available for investment companies or for issuers that are subject to any statutory disqualification provisions, such as companies formally sanctioned by the SEC for untrue statements or omissions in securities offerings.

- *Dollar Limits* - This exemption allows an issuer to raise up to $5 million within a 12-month period.

- *Purchaser Requirements* - The exemption allows for sale to an unlimited number of accredited investors and up to 35 non-accredited investors.

    - *Note*: Exceeding the number of non-accredited investors can forfeit the exemption.

- *Restricted Securities* - The securities exempted in the issuance are restricted from resale.

- *General Solicitation* - General solicitation of purchasers is prohibited in the same manner as under a Rule 504 exemption.

- *Private Placement Memorandum* - The issuer does not have to make specified disclosures to accredited investors, but it must make extensive disclosures to non-accredited investors. This is normally done through the private placement memorandum, a disclosure document similar in nature to the prospectus. Notably, the disclosures must include certified financial statements.

- *State Regulation* - Rule 505 does not provide an exemption from registration of securities under state law. This is similar to a Rule 504 offering.

- ***Discussion***: The primary differences between a Rule 504 and 505 exemption is the dollar value of the issuance and classification of purchasers of securities. Why do you think Rule 505 separates classes of purchasers of securities into accredited and unaccredited investors?

- ***Practice Question***: ABC Corp is an established company that is steadily growing. ABC needs about $5 million in investment capital reach its growth goals for the next 18 months. In a brief letter, can you summarize the benefits and drawbacks of seeking an exemption from securities registration under Rule 505?

- ***Resource Video***: http://thebusinessprofessor.com/rule-505-securities-exemption/

**29. What is a "Rule 506" exemption?**

Rule 506 of Regulation D allows for two exemptions of securities issuances. The statutory authority for a Rule 506 is pursuant to Section 4(a)(2) of the '33 Act. Rule 506 exemptions are the most commonly employed exemptions to securities registration.

*Rule 506(b) Safe Harbor Exemption*

- *Issuer Protection* - Rule 506 protections available for issuers are similar those of Rule 505. The notable exception is that the limitations for reporting companies under the '34 Act, or the so-called "bad boy" disqualifications do not apply to this exemption.

- *Dollar Limits* - This exemption allows for an unlimited dollar value for issuances.

- *Purchaser Requirements* - An issuer may sell its securities to an unlimited number of accredited investors and up to 35 non-accredited investors.

- *Restricted Securities* - This is a transactional exemption. As such, this exemption applies only to issuers and does not cover later sales by investors.

- *General Solicitation* - Rule 506(b) does not allow for general solicitation, which means that the issuer cannot use general advertising methods to reach potential customers. Of note, this general rule applies only to actual sales of securities, rather than to both offers and actual sales.

    - *Note*: The issuer must also use reasonable care to assure that the purchasers of the securities are not statutorily considered to be underwriters of the securities, as this can cause general solicitation issuers.

- *Private Placement Memorandum* - Rule 506(b) information disclosures are divided between accredited and non-accredited investors. There is no information disclosure requirement for the accredited investors, but the non-accredited investors must receive extensive disclosures. These disclosures are similar to those required under other Regulation D exemptions. The issuer must provide a private placement memorandum containing the necessary disclosures. Also, all non-accredited investors must meet a sophistication requirement. More specifically, they must have the knowledge or resources necessary to evaluate the merits of the investment.

    - *Note*: As with a Section 4(a)(2) exemption, the issuer must ascertain that offers only happen to individuals who meet qualification requirements to be purchasers. These non-accredited investors must either have sufficient sophistication to evaluate the merits and risk of the prospective investment or be represented by a sophisticated agent.

- *State Regulation* - Section 18 of the '33 Act exempts Rule 506 securities from registration requirements or a merits review under state law. As such, states cannot place additional registration requirements on the security issuance.

- ***Resource Video***: http://thebusinessprofessor.com/rule-506b-securities-exemption/

*Rule 506(c) - Exemption Pursuant to JOBs Act of 2013*

The JumpStart our Businesses Act of 2013 (JOBs Act) made extensive changes to the securities registration exemption regime. As a result, it allowed the SEC to develop Rule 506(c) exemption with the following characteristics:

- *Issuer Protections* - Rule 506(c) applies to issuers to the same extent as Rule 506(b).

- *Dollar Limits* - The exemption allows an issuer to raise an unlimited amount of funds.

- *Purchaser Requirements* - The most daunting requirement of Rule 506(c) offerings is the requirement that the issuer verify that each purchaser of securities is accredited. An issuer who fails to exercise reasonable care in making this determination risks losing the exemption. The standard for judging an issuer's reasonable efforts to make this determination is uncertain. The SEC identified four primary methods of verifying that an individual is an accredited investor, including:

    - *Annual Income* - The issuer may examine proof of the purchaser's income, such as IRS filings from the last two tax years.

        - *Note*: This may require a certification by the issuer that they expect to sustain the previous years' earnings.

    - *Net Worth* - The issuer may examine bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessment, or appraisal reports, and consumer reports from a national agency, or obtain a written representation that purchaser has disclosed all liabilities.

    - *Professional Certification* - The issuer may receive a written representation from a registered broker-dealer or investment advisor, licensed attorney, or CPA that such person has taken reasonable steps to verify that the purchaser is an accredited investor as of the last three months.

    - *Written Verification* - If the prospective purchaser is a previously verified accredited purchaser, a written verification that such person is still accredited.

- *Restricted Securities* - The shares received by the investor under the exemption are "restricted".

- *General Solicitation* - The rule allows for general solicitation in an issuance where all purchasers are accredited investors and the issuer takes reasonable care to determine that each investor is accredited.

- *Private Placement Memorandum* - Before consummating a sale, the issuer must provide the purchaser with adequate disclosures under Regulation D.

- *State Regulation* - Rule 506(c) are covered securities that are exempt from state regulation.

- ***Resource Video***: http://thebusinessprofessor.com/rule-506c-securities-exemption/

- ***Discussion***: Why do you think Congress felt the need to provides for a specific exemption to accredited investors that also allows for general solicitation? Do you feel that the ability to generally solicit purchasers of securities undermines the purpose of public disclosure? Why or why not?

- ***Practice Question***: ABC Corp is a wildly successful startup company that is growing by 300% per year. ABC needs about $100 million in investment capital reach its growth goals for the next 18 months. In a brief letter, can you summarize the benefits and drawbacks of seeking an exemption from securities registration under Rule 506? Specifically focus on the differences between rules 506(b) & 506(c).

**30. What is a "Rule 502(d)" and "Rule 144 Safe Harbor"?**

Rule 502(d) requires that issuers of securities pursuant to an exemption under Regulation D take the following three steps to make certain the shares are not resold during the restricted period:

- reasonable inquiry to determine if each purchaser is buying the security for himself or for someone else,

- written disclosure to each purchaser that the securities are restricted, and

- a legend on the securities noting the resale restriction.

The SEC promulgated Rule 144, which allows a "safe harbor" for purchasers to resell their shares after one or two years, depending on how much public information about the issuer is available. In any case, the issuer must make certain that the shares are not being purchased with the intent of immediate resale. This safe harbor rule provides additional comfort to a purchaser of the security. As such, it adds liquidity to the security by making it easier to later sell and trade in the market.

- ***Discussion***: What do you think is the underlying purpose or rationale for Rule 502(d) and Rule 144? Do you think these rules are adequate to achieve their objectives? Why or why not?

- ***Practice Question***: ABC Corp issues securities pursuant to Rule 505 registration exemption. Kerry is a purchaser of securities. He realizes that the shares are restricted for a substantial period. What should ABC Corp and Kerry do to make certain that later reselling the shares does not potentially violate the Rule 505 offering?

- ***Resource Video***: http://thebusinessprofessor.com/restricted-securities-and-rule-144/

**31. What are the general information disclosure requirements for companies seeking an exemption from registration?**

The perfection of an exemption does not completely relieve an issuer's disclosure requirements. The disclosure document that is generally used by businesses perfecting a registration exemption is the "private placement memorandum" (PPM). The issuer must disclose to potential investors at the time of the offer or prior to the business accepting any offer of investment funds. The PPM is very similar to the prospectus and is similarly demanding in its disclosure requirement. The PPM requirement requires extensive work and effort to prepare, but it is far less burdensome to the business than registering the issuance.

*Types of Disclosure*

Securities law breaks down the disclosure requirements for issuers of securities based upon the type of investor or purchaser of the securities. The relevant disclosure provision governing issuances is Rule 502(b)(2). It requires that issuers provide both financial and non-financial information. The company is required to provide the equivalent information as is required under SEC Form 1-A. It is important to note that the information disclosure or delivery requirements set forth in Rule 502(b) are only applicable to offerings under certain exemptions. Offerings to accredited investors do not require furnishing information.

- *Example*: Offerings under Rules 505 and 506 have to provide extensive information to non-accredited investors, while offerings under Rule 504 do not.

- *Note*: The issuer must always comply with state and federal anti-fraud laws, such as section 11(a), 12(a) and (b), and 10(b) under the '33 Act. Information that is factually untrue or misleading in any form runs the risk of violating one of these provisions. Generally, if the issuer is not a company that routinely provides reports to the SEC under Sections 13 or 15(d) of the Securities Exchange Act of 1934, it must furnish the following information to the purchaser of the securities.

*Non-Financial Information*

Non-financial information required by Rule 502(b) includes: the management team; the industry; the type and characteristics of the securities offered; any third-party facilitators in the offering process; and the risks involved in the type of security being offered. More precisely, the required information is listed in Part 1 of the registration statement that the business would be required to use, absent the applicable exemption. This information is deemed necessary to allow the investor to make an informed decision about whether to undertake the investment.

- *Note*: There is some flexibility in this disclosure requirement, as the introductory language in Rule 502(b)(2)(i) requires the issuer to furnish the specified information "to the extent material to an understanding of the issuer, its business, and the securities being offered."

*Financial Information*

Financial information about the business must be disclosed *via* the financial statements of the business. The extent of disclosure, which can be extremely detailed, depends on the size of the offering. The greater the dollar value the more extensive the disclosure requirements. The amount of required financial information varies between issuances below $2 million, between $2 million and $7.5 million, and above $7.5 million. Generally, the variation is the amount of financial data of the company and whether that information must be audited and certified by the company executives. The information requirement serves to provide the investor with information that may not be available because the business is not required to register the information with the SEC.

- ***Discussion***: Why do you think the information disclosure requirements vary between accredited and non-accredited investors? Why do you think the rules separate the requirements for financial and non-financial disclosures? Why do you think the amount of issuance matters with regards to the amount of information required to be disclosed to investors?
- ***Practice Question***: ABC Corp is attempting to sell securities pursuant to an exemption under Rule 506(c). ABC Corp wonders what actions it should take to remain within the confines of Rule 506(c). Can you explain the types of disclosures that ABC Corp must make?
- ***Resource Video***: http://thebusinessprofessor.com/disclosure-requirements-of-regulation-d/

**32. What is the requirement to file "Form D"?**

To claim an exemption from registering a securities issuance, the issuer must provide notice to the SEC of the issuance and claimed exemption. The entrepreneur provides notice by filing Form D with the SEC. Form D is currently filed in electronic format and must be filed within 15 days of the first sale of securities in the offering. The Form D is generally available through the SEC website (EDGAR). Form D makes basic disclosure about the issuance. This information includes the amount or value of the issuance and the names of company officers and directors.

- *Note*: The SEC disclosure requirement is less stringent than it sounds, as failure to file the Form D prior to the issuance will not hinder the ability of the issuer to claim an exemption. The negative side of failing to file is that, in the event of a challenge to the sale of securities, the SEC may stop the sale and deny the future use of exemptions due to the failure to file. Failure to file a Form D may also make it difficult for the issuer to comply with state securities laws.

- ***Discussion***: Why do you think the SEC requires notification of a claimed exemption from registering a securities issuance? Based upon your conclusions, why do you think the failure to file Form D has very little negative repercussions?
- ***Resource Video***: http://thebusinessprofessor.com/regulation-d-form-d-filing-requirement/

**33. What is the effect of failing to register an offering under Section 5 and failing to perfect an exemption to the registration requirement?**

Violating Section 5 of the '33 Act by failing to register an issuance or failing to carry out an issuance in accordance with an applicable exemption can subject the issuer to liability to purchasers of the securities. Specifically, Section 12(a)(1) allows any purchaser to bring a lawsuit to rescind the purchase of the securities (along with interest on the purchase funds) or, if the securities have been sold, to receive the damages suffered from the purchase. Rescinding the purchase transaction is often referred to as "buying a put," because the purchaser will have the right to force the seller to repurchase the security. The SEC may also have a civil cause of action against the issuer who sells securities in violation of Section 5.

The result of failing to comply with failing to comply with a relevant exemption can be detrimental to an issuer. Rule 508 provides some relief from these effects if an anticipated exemption under Rules 504 - 506 fail because of an insignificant reason. That is, the issuer may be able to defend an action for rescission by demonstrating the following:

- the issuer's deviation from the exemption requirement was insignificant with regard to the overall offering;
- the requirements were not specifically imposed to protect this type of purchaser's interest; and
- the issuer honestly (in good faith) attempted to comply with the exemption requirements.

An issuer who successfully demonstrates these elements may be relieved from liability to plaintiff investors or the SEC.

- ***Discussion***: How do you feel about the repercussions on an issuer for failure to comply with registration requirements or perfect an exemption? Is this provision overly advantageous to the purchaser or securities? Why or why not?
- ***Practice Question***: ABC Corp sells securities to a small group of investors in several states. ABC did not seek legal counsel and is unaware that its sale of securities is subject to regulation under the securities law?
- ***Resource Video***: http://thebusinessprofessor.com/result-of-failure-to-comply-with-securities-registration/

**34. What is "crowdfunding" and how is it affected by securities registration laws?**

The edition of Section 4(a)(6) to the '33 Act introduced equity crowdfunding as a viable option for seeking investors in a new business. Crowdfunding is a sort of mini-public offering that allows the general public to purchase securities directly from an issuer through authorized, private exchanges. Section 4(a)(6) provides for a Section 5 registration exemption for issuances conducted in accordance with specific crowdfunding methods. To qualify for the exemption under Section 4(a)(6), crowdfunding transactions by an issuer (including all entities controlled by or under common control with the issuer) must meet specified requirements, including the following:

- the amount raised must not exceed $1 million in a 12-month period (this amount is to be adjusted for inflation at least every five years);
- individual investments in a 12-month period are limited to:
    - the greater of $2,000 or 5 percent of annual income or net worth of an individual, if the annual income or net worth of the investor is less than $100,000;
    - 10 percent of annual income or net worth (not to exceed an amount sold of $100,000), if annual income or net worth of the investor is $100,000 or more (these amounts are to be adjusted for inflation at least every five years); and
    - transactions must be conducted through an intermediary that either is registered as a broker or is

registered as a new type of entity called a "funding portal."

Many entrepreneurs see the availability of crowdfunding as an important financing option for smaller companies that otherwise lack the resources to seek a public offering or to comply with statutory or rule-based exemptions. Section 4(a)(6) places the burden of compliance on the crowdfunding broker or portal. To become registered as a crowdfunding broker or funding portal, the entity must comply with the following:

- implement procedures to protect purchasers of securities against fraud;
- refrain from providing investment advice or soliciting purchasers;
- provide disclosures substantially similar to those required in a registration or disclosure document;
- allow for questions and feedback on securities being issued;
- file an offering statement with the SEC disclosing the terms and details of all issuances (which is also available to investors); and
- make annual filings with the SEC and make those fillings available to the public on the crowdfunding site or portal.

The qualified broker or portal must also make certain that all investors meet the accreditation standards laid out by Section 4(a)(6). It cannot employ intermediaries to sell securities on behalf of the broker or portal. It must make certain the securities are understood to be restricted and, with limited exception, cannot be sold within a 12-month period of purchase.

- ***Discussion***: Why do you think Congress decided to provide a statutory method for allowing crowdfunding that is exempt from Section 5 registration requirements? Do you think the limitations on investor and the requirements of brokers or portals are sufficient to protect investors? Why or why not?
- ***Practice Question***: ABC, LLC is a new company that is growing quickly. It believes that crowdfunding may be the best method for generating much-needed capital. Eric is an investor interested in investing in a startup fund. What are the securities law requirements for ABC to undertake crowdfunding? What are the limitations on Eric as an investor?
- ***Resource Video***: http://thebusinessprofessor.com/crowdfunding-and-securities-laws/

**LIABILITY UNDER THE SECURITIES EXCHANGE ACT OF 1933**

The 1933 Act provides for both criminal and civil liability for individuals who violate its provisions in the issuance of securities. Civil liability generally arises when a purchaser of securities sues the issuer (or its agent) for failure to comply with the registration or applicable exemption requirements under the '33 Act. This often includes (unintentionally) failing to make or making incomplete or erroneous disclosures of material information to purchasers of securities. Criminal liability generally arises when an issuer (or its agent) willfully violates the securities laws in a manner that defrauds or deceives a purchaser of securities. Remedies for civil and criminal violation range from the ability to recuperate the amount paid for the securities to fines and imprisonment.

**35. What is civil liability under "Section 11" of the '33 Act?**

Sections 11(a) and (b) of the '33 Act provide for strict liability (tort liability) for issuers who make material misstatements or omissions in the issuance of securities. This provision primarily applies to omissions and errors in disclosure pursuant to a public offerings. For example, an error in a private placement memorandum or registration statement could give rise to Section 11 liability.

*Requirements for Liability*

To be liable for a Section 11 violation, the issuer must make a material misstatement or omission of information in the transaction. An individual may be liable if the final registration statement contains any:

- untrue statement of material fact;
- omits material facts required by a statute or government regulation; or
- omits information that makes the stated information materially misleading.

The plaintiff does not have to demonstrate or prove any reliance on the statement. It is sufficient to demonstrate that the information was erroneous or misleading. The limitation is that the purchaser must not know that the information is erroneous or misleading at the time of purchase. Lastly, the securities the plaintiff purchased must be traceable to the registration statement or disclosure document at issue. This requirement is easy to meet in an IPO, but it may be difficult in subsequent purchases of shares issued in private offerings.

*Who is Potentially Liable?*

The issuer is potentially liable under Section 11. Further, Section 15 makes any person or entity that controls an issuer potentially liable. This provision provides for joint and several liability for the controlling person or entity under agency principles. Liability extends to those who endorse or signe their names ("signer") to assert the veracity of the information. This generally leads to potential liability for corporate directors, underwriters, and others who take part in the preparation of the registration statement or prospectus. Any "signer" has a due diligence defense, though an insider CEO and CFO will have hard time asserting this defense. The due diligence defense regards the amount of effort and care the signer exercised in verifying the erroneous or omitted information. Section 11(e) provides for rescission of the transaction (along with interest) or damages suffered (losses sustained) from the later sale of the securities.

- ***Discussion***: What do you think about Section 11 liability for omissions or errors in disclosure? Do you think these provisions adequately make officers accountable for public disclosures? Why or why not?
- ***Practice Question***: ABC Corp is going trough the registration process. It files the S-1 containing all relevant financial and non-financial information. It also translates this information into a prospectus that it distributes to potential purchasers. What is ABC Corp's potential liability if some of the revenue calculations are erroneous in the accompanying financial statements?
- ***Resource Video***: http://thebusinessprofessor.com/civil-liability-under-section-11-of-the-1933-act/

**36. What is civil liability under "Section 12" of the '33 Act?**

Section 12 of the '33 Act provides for civil liability for issuers of securities in two situations.

- *Section 12(a)(1)* - This provision provides a civil cause of action for purchasers of securities against issuers who sell securities without registering the securities or perfecting an exemption. Within the applicable statute of limitations, the purchaser must show that she purchased the shares from the issuer.
  - *Note*: This includes a situation where an issuer attempts to perfect one or more registration exemptions that fail.
- *Section 12(a)(2)* - This provision provides a cause of action for purchasers against issuers who makes a material misstatement or omission in a prospectus or other communication made as part of the sale of securities to the purchaser. The purchaser must not know that the information is incorrect at the time of purchase.
  - *Note*: Liability under Section 12(a)(2) is in addition to liability under Section 11.

As a remedy for violation under either subsection, the purchaser may rescind the purchase and receive interest on the money invested and any damages incurred by the investment. Generally, these causes of action are only available to purchasers in the original issuance of the securities. Individuals who purchase the securities in a subsequent sale cannot bring these actions. The issuer is potentially liable under Section 12, which makes anyone controlling the issuer potentially liable. The SEC may also bring a civil action against the issuer.

- ***Discussion***: Why do you think that failure to register or perfect an exemption may lead to civil liability for an issuer? Should a purchaser who is not negatively affected by a failure to register or a misstatement of material information be able to force the company to repurchase the securities? Why or why not?
- ***Practice Question***: ABC, LLC issues securities pursuant to a Rule 506(b) exemption. Unfortunately, some of the investors did not meet the accredited investor or sophistication requirements. No other registration exemptions apply to the offering. What does this potentially means for ABC?
- ***Resource Video***: http://thebusinessprofessor.com/civil-liability-under-section-12-of-the-1933-act/

**37. What defenses exist for issuers with potential liability under Sections 11 and 12 of the 33' Act?**

An issuer subject to claims by purchasers of securities under Sections 11 and 12 of the 33' Act has several available defenses that may relieve her of civil liability. These defenses are as follows:

- *Materiality Defense* - The defendant may argue that the false or misleading information is not material and thus should not have had an impact on the purchaser's decision-making process. Materiality is the kind of information that an average prudent investor would want to have so that she can make an intelligent, informed decision whether or not to buy the security.

- *Example*: ABC Corp fails to adequately identify the nature of certain operational assets held. While this disclosure is technically incorrect, the disclosure is not one that is likely to be the basis of a decision to purchase shares in the company.

- *Statute of Limitations* - The statute of limitation to bring an action against an issuer is one year. The statutory period does not start to run until the time of discovery of the actionable conduct or the conduct would have been made with reasonable diligence. In no case can a plaintiff bring an action more than 3 years after the security is properly sold to the public.

    - *Example*: ABC Corp issued securities pursuant to Rule 504. Eric, a purchaser of shares during the issuance, decides to challenge the issuance under Section 12 in order to force the company to repurchase his shares. His challenge is based upon violation of the general solicitation rules. The company may be able to defend against the action if the issuance took place more than 12 months ago and Eric was aware of the solicitation practices at the time.

- *Due Diligence* - An issuer may defend against liability under Sections 11 or 12 if she conducted adequate due diligence and such effort failed to uncover the misleading or omitted material information. With information included in a registration statement, the due diligence defense applies differently to portions of the registration statement that includes "expertised" information versus "non-expertised" information. Basically, the issuer is personally responsible for conducting a reasonable investigation of any information that is not reviewed or certified by a qualified expert. The issuer has a due diligence defense when relying on experts to identify and provide information in the disclosure statement. Courts have interpreted this defense to offer a sliding scale for determining the requirement of personal due diligence versus the ability to rely upon experts. In summary, a successful defense must show that a reasonable investigation of the financial statement of the issuer and controlling persons was conducted. Further, the expert must prove that there was no reason to believe any of the information in the registration statement or prospectus was false or misleading. In effect, this defense requires proof that a party was not guilty of fraud or negligence.

    - *Example*: ABC Corp discloses material in its registration statement. Some of the financial material is incorrectly recorded and thereby inaccurate. The issuance is now the subject of a Section 11 and 12 action by shareholders. The CEO signed the financial projections as being correct, but she depended largely upon the certification of the large outside-accounting firm hired to audit and certify the corporate books. This may be a defense to the shareholder action based upon the CEO's justifiable reliance upon the auditor's certification.

- *Negative Causation Defense* - Negative causation is a defense claiming that something other than the material misstatement or omission in a disclosure statement caused the damages (i.e., the value of the equity to fall).

    - *Note*: This is a difficult thing to prove. The party asserting the defense will often use professional experts to perform event studies to determine what actually caused the drop in price of the purchased security.

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    - *Example*: ABC Corp issued securities last year. The disclosure of information in the registration statement was inaccurate in certain aspects at the time of issuance. Mary, a purchaser of securities, is angry because the shares have dramatically dropped in value. ABC Corp may be able to defend an action by Mary by showing that the drop in value was due to new governmental regulations of the business activity. Further, ABC would have to show that the inaccurate reporting of information did not materially contribute to the

drop in value.

- ***Discussion***: Why do you think the SEC and courts allows for the above-referenced defenses? Do you think a 12-month statute of limitations is fair to issuer and purchaser? Why or why not?

- ***Practice Question***: ABC Corp is subject to a Section 11 and 12 action for a material misstatement of information in the company's registration statement. Several purchasers of securities in the initial public offering are angry that the value of the shares have declined. What are four major defenses that ABC Corp may be able to assert in response to the civil action?

- ***Resource Video***: http://thebusinessprofessor.com/defenses-in-section-11-and-12-securities-actions/

**38. What is liability under "Section 17" of the '33 Act?**

Section 17 of the '33 Act is an anti-fraud provision applicable to the initial sale or issuance of securities. It makes it illegal to "employ any device, scheme, or artifice to defraud … obtain money or property … engage in any transaction, practice, or course of business which operates or would operated as a fraud or deceit upon the purchaser." It is primarily a government enforcement provision and courts generally do not allow a private cause of action by purchasers against the issuer under this provision.

- *Note*: Section 17 is very similar in nature to Rule 10(b)(5) of the Securities Exchange Act of 1934, which is a common fraud prevention provision. The primary difference is Section 17 does not require the government to demonstrate a specific mental intent of the issuer to defraud purchasers of securities.

- ***Discussion***: Why do you think Congress provided specifically for a government civil action based upon fraudulent practices? Do you think the statute is sufficiently broad to cover all types of fraudulent conduct in the issuance of securities? Why or why not?

- ***Practice Question***: ABC Corp is issuing securities to finance its growth. The directors purposely generate false information to include in the financial disclosures provided to investors. These disclosures are instrumental in the investor's decision to invest in ABC Corp. What is the potential for director liability under Section 17 of the '33 Act?

- ***Resource Video***: http://thebusinessprofessor.com/liability-under-section-17-of-the-1933-act/

**39. What is the potential criminal liability for violations of '33 Act?**

Section 24 of the '33 Act allows the Department of Justice (DOJ) to bring a criminal action against anyone who knowingly and willfully violates the '33 Act. This normally only arises in situations where an issuer commits fraud in the sale of securities. The SEC cannot bring a criminal action itself, but it regularly works in hand with the DOJ to substantiate claims of securities fraud.

- *Note*: Conviction under this provision allows for up to a $10,000 fine and up to 5 years in prison.

- ***Discussion***: How do you feel about this consumer fraud statute? Why do you think the DOJ, rather than the SEC, is charged with pursuing criminal charges in securities actions under Section 24?

- ***Resource Video***: http://thebusinessprofessor.com/criminal-liability-under-1933-act/

**THE SECURITIES EXCHANGE ACT OF 1934**

Securities Exchange Act of 1934 ('34 Act) regulates transfers of securities after the initial sale. Basically, it picks up where the '33 Act leaves off. More specifically, it deals with regulation of securities exchanges, brokers, and dealers in securities. It also created the Securities and Exchange Commission. The '34 Act makes it illegal to sell a security on a national exchange unless a registration is effective for the security. Registration under the '34 Act requires filing prescribed forms in a timely manner with the applicable stock exchange and the SEC. The registered issuer must then file periodic reports as well as report significant developments that would affect the value of the security. The '34 Act contains several provisions allowing for civil liability of individuals trading securities. The most notable of these provisions are discussed below.

- *Note*: Most securities law violations under the '34 Act may be enforced civilly (bring a lawsuit) either by private plaintiffs or the SEC. The Private Securities Litigation Reform Act of 1995 (PLSRA) states that only the SEC can pursue claims against third parties not directly responsible for the securities law violation. The Department of Justice is primarily charged with bringing criminal actions for violation of securities laws.

- ***Resource Video***: http://thebusinessprofessor.com/securities-exchange-act-of-1934/

**40. When must a company register with the Securities Exchange Commission pursuant to the '34 Act?**

A company issuing securities must either register or perfect and exemption from registration. There are, however, other situations that subject a company to SEC public reporting requirements. The company becomes known as a "reporting company". A company is generally required to register with the SEC if it meets any of the following characteristics:

- it completes a public offering pursuant to the '33 Act;

- securities of the company are traded on a national exchange (such as the NYSE or CME); or

- it has 2,000 or more total shareholders (or 500 or more unaccredited shareholders) of unrestricted securities and a total asset value of more than $10 million.

The 2,000 (or 500 unaccredited) shareholder rule does not apply to shareholders who acquired shares through sanctioned crowdfunding or pursuant to employee compensation plans. Notably, if an issuer later drops below the shareholder limitation numbers, it may apply to the SEC to be exempted from the '34 Act reporting requirements.

- ***Discussion***: Why do you think the SEC requires a company to register in the above-referenced scenarios? Do you think the size of the company (number of shareholders or value of assets) should determine whether reporting is required? Why or why not?

- ***Practice Question***: ABC Corp is a private company that has been steadily growing over the past several years. They have gone through several private offerings and have a large number of accredited and unaccredited investors. They also have substantial land holdings as well as equipment. Under what conditions might ABC Corp be forced to registered with the SEC and become a reporting company?

- ***Resource Video***: http://thebusinessprofessor.com/requirement-to-register-securities-under-1934-act/

**41. What disclosures are required of registered companies under the '34 Act?**

A reporting company must make routine disclosures to the public by filing reports with the SEC. The information required to be disclosed is substantially as follows:

- *Reporting Company Initial Statement* - Similar to the registration statement required under the '33 Act, a company initially registering as a reporting company under the '34 Act must make an initial disclosure of information. This information primarily concerns the operations, equity structure, and securities issued by the company.

- *Annual Reporting* - Reporting companies are required to make detailed annual reports to the SEC, which are also provided to security holders. The disclosure takes place on Form 10-K and it contains all relevant operational data, an explanation of company performance, audited financial statement, and detailed information about corporate officers and directors.

- *Quarterly Reports* - The reporting company must file and disclose to shareholders a quarterly report on Form 10-Q. The quarterly report contains similar information to that contained in the annual report, but it only covers the most recent quarter of the fiscal year. Also, the financial statement included in the quarterly report is not audited.

- *Special Reports* - The reporting company must disclose to the SEC and shareholders *via* Form 8-K any major operational, structural, financial, or ownership changes in the company within a reasonable time of the occurrence. Major occurrences include: new security issuances, changes in corporate control (officer and directors), mergers, acquisitions, changes in auditor, etc.

The information disclosed in each of the above reports must be certified as accurate by corporate executives (including the company's CEO and CFO). These individuals must also attest to the operable status of controls over internal affairs and finances. This includes attesting that the company has in place an audit committee to examine the efficiency of internal controls.

- ***Discussion***: Why do you think the SEC requires such extensive, recurring disclosures for reporting companies? Do you think these reporting requirements serve the intended purpose?

- ***Practice Question***: What are the reporting requirements of companies that registered pursuant to The Securities Exchange Act of 1934?

- ***Resource Video***: http://thebusinessprofessor.com/reporting-and-disclosure-requirements-under-1934-act/

## LIABILITY UNDER THE SECURITIES EXCHANGE ACT OF 1934

### 42. What is liability under "Section 10(b)" and "Rule 10(b)(5)" of the 1934 Act?

Section 10(b) prohibits fraud in connection with the purchase and sale of any security. This provision applies whether or not the security is registered under the '34 Act. The SEC adopted Rule 10(b)(5) to implement section 10(b). Together, these anti-fraud provisions are the basis for most litigation under the '34 Act. These provisions make it unlawful to use most communication methods (such as the mail, internet, or wire) or any national securities exchange to defraud any person in connection with the purchase or sale of any security. Any party directly connected to the sale of securities is potentially liable; though there may be limits on the liability of certain professionals, such as auditors, bankers, accountants, etc. Rule 10(b)(5) allows for a cause of action by the SEC as well as private actions. Generally, Rule 10(b)(5) prohibits the following conduct in connection with the sale of a security:

- using any device, scheme, or other artifice to defraud purchasers;
    - *Example*: A device or scheme includes any sales or investment program, whether done in person or *via* distant communication, to defraud participants.
- making any untrue statement or failing to disclose any material fact that make the statement misleading; or
    - *Example*: This includes making false statements or failing to disclose relevant information in the process of selling or transferring a security.
- employing any practice that would deceive or defraud.
    - *Note*: This is a very broad, catch-all provision.

These prohibitions give rise to a potential cause of action for plaintiffs under Rule 10(b)(5), the elements of which are as follows:

- *Deceit* - A plaintiff must demonstrate deceit through the misrepresentation or omission of information. This must be done either intentionally or recklessly. Simple negligence is not enough to establish liability.
- *Material Information* - The information must be material to the purchaser of the security. That is, the information must be important to a potential investor in making the decision of whether or not to purchase the security. What is material information is interpreted very broadly and based on the individual situation of the company.
- *Purchase of Sale of a Security* - The information must directly related to the purchase or sale of a security. An individual who does not purchase or sell a security based upon the deceitful information cannot bring an action under this provision.
- *Reliance on the Information* - The actual purchaser must rely on the misrepresented information. Reliance is assumed if material information is omitted or broadly stated to the whole market.
- *Cause Damages* - The plaintiff must suffer some actual damages resulting from or caused by the omission or misrepresentation. This normally comes in the form of a diminution in the value of the shares purchased.

In summary, to recover under Rule 10(b)(5), a plaintiff, whether the SEC or a private plaintiff, must show that an individual trading in securities had an intent to deceive the purchaser. Intent to deceive may be inferred from a partial or untimely disclosure of important information.

- ***Discussion***: How do you feel about the extensive liability or breadth of potential actions available under Section 10(b) or Rule 10(b)(5)? Do you think these provisions are overly broad? Why or why not?
- ***Practice Question***: Bernie is the head of a new investment firm. His firm solicits money from investors and invests that money in short-term, high-risk securities. Bernie has been suffering substantial losses, but has been able to continue to pay investor returns from the funds invested by new investors. In order to attract new investors, he is falsifying much of the information on his investment returns. The DOJ gets word of his practices and begins an investigation. In the meantime, shareholders bring a civil action under Rule 10(b)(5) to recover their losses from Bernie. What elements will they have to demonstrate in Bernie's conduct to find him liable?
- ***Resource Video***: [http://thebusinessprofessor.com/liability-under-section-10-and-rule-10b5/](http://thebusinessprofessor.com/liability-under-section-10-and-rule-10b5/)

**43. What is "insider trading" under Rule 10(b)(5)?**

Insider trading is the sale or purchase of securities by individuals privy to non-public, material information of a firm based upon her special relationship with the firm. Generally, anyone who has material, non-public information must either disclose that information prior to trading the securities or abstain from trading in the effected or related security. Normally, insiders include officers, directors, and professionals in fiduciary relationships with the firm. The negative aspect of insider trading is that it provides individuals an advantage over others in the sale or purchase of securities and undermines the integrity of the market and the confidence of those investing in securities. Section 10 of the '34 Act has been broadly interpreted to prohibit the practice of trading securities based on material, non-public information received as an insider or from an insider of a company.

- *Note*: Trading securities on non-public information is most commonly addressed in 10(b)(5) actions. The SEC is charged with bringing civil actions under Rule 10(b)(5), while the Department of Justice is charged with bringing criminal actions against violators.

*Elements of a 10(b)(5) Action*

The insider or an individual receiving information from an insider is liable for trading securities based on the information. A "tippee" is a person who learns of nonpublic information from an insider. Upon receipt, this person is considered to be a legal, temporary insider. As a temporary insider, the tipee is subject to the prohibitions of Section 10(b) prohibiting the insider from trading securities based upon the inside information. The elements of a 10(b)(5) action are the same for criminal and civil actions and are as follows:

- *Information* - The insider must have material, non-public information.
  - *Note*: This type of information is generally the result of detailed knowledge of business performance or long-term plans that will affect the corporation's value in the market if it were publicly known.

  - *Example*: I am a director on the board of ABC Corp. I receive a report that demonstrates that the corporation's cost of production is going to drop dramatically in the near future due to a drop in materials cost. This information is not public and it will certain increase corporate profits.

- *Fiduciary Duty* - A core element of a 10(b)(5) action is the breach of a fiduciary duty. Insiders and third parties may have a fiduciary with regard to the material, non-public information.

  - *Insiders* - Corporate insiders have a fiduciary duty to the company.

    - *Example*: Corporate insiders who have a fiduciary duty include: board members, major shareholders, employees, and so-called temporary insiders, such as lawyers and investment bankers who are doing deals for the company.

  - *Third Parties* - A fiduciary duty exists for third parties in a personal relationship with an insider if:

    - the third party receives information and promises to keep the information secret;

    - the insider has a reasonable expectation that the recipient will not tell; or

    - the recipient has obtained the information from her spouse, parent, child or sibling.

- *Trading and/or Misappropriation* - Either the insider or third party may breach a fiduciary duty by trading on (i.e., using the information to make stock trades) or misappropriating the information.

  - *Insiders (Tippers)* - The insider breaches a fiduciary duty by trading on the information. Further, an insider misappropriates and breaches his fiduciary duty by transmitting information if:

    - he knows the information was confidential, and

    - he expected some personal gain.

  - *Third Parties (Tippees)* - Third parties misappropriate information obtained through a professional or personal relationship from an insider. Therefore, a third party violates a fiduciary duty to the rightful owner of the information by trading on the information if she knows:

    - the information is confidential,

    - that it was transmitted in breach of a fiduciary duty, and

    - the insider expected a personal gain from transmitting the information.

The idea of holding a third-party, recipient of material, non-public information liable for trading on that information is based on theory that the information is misappropriated from the rightful owners (shareholders). The third party has no duty to reveal the nonpublic information to the public, since she was not in a fiduciary position with respect to company.

Trading on that information, however, is effectively breaching a duty owed to those shareholders to either disclose that information or refrain from trading. In summary, anyone who has material, non-public information must either disclose the information prior to trading the securities or abstain from trading in the effected or related security.

- ***Discussion***: How do you feel about holding a tippee of insider information liable under Section 10(b)? Is it fair to consider a tippee to be a temporary insider? Why or why not? Do you think the knowledge requirement for third parties is fair? Why or why not?

- ***Practice Question***: Arnold is a director of ABC Corp. He is specifically involved in a committee that evaluates potential mergers and acquisitions. He becomes aware that a group of managers are considering a manager buyout that would allow the managers to purchase all corporate shares and make the company private (i.e., no longer publicly traded). This would ease the regulatory burdens of reporting to the SEC. Also, the buy-out will drive up the price of shares temporarily. What Arnold face liability if he purchased a large block of ABC shares based upon this knowledge? What if he provided this information to his brother-in-law who subsequently purchased a large block of shares?

- ***Resource Video***: http://thebusinessprofessor.com/liability-for-insider-trading-under-rule-10b5/

**44. What damages are available to a plaintiff under Section 10(b) and Rule 10(b)(5)?**

While both the SEC and a private plaintiff may enforce the antifraud provisions of Section 10 and Rule 10(b)(5), only purchasers or sellers of securities may bring a private action for damages under Rule 10(b)(5). A private plaintiff in a suit under 10(b)(5) may recover for the actual damages suffered as a result of purchasing the security. As part of the action, a buyer must allege specific damages due to the seller's fraud. The measure of damages is generally the difference between what is paid over the value of the security received. The measure of a defrauded seller's damages is the difference between the fair value of all that the seller received and the fair value of what he or she would have received had there been no fraud. In an SEC action under 10(b)(5), the civil penalty for gaining illegal profits with nonpublic information is three times the profits gained. The statute of limitation is 5 years from the wrongful transaction.

- *Note*: A purchaser may also be entitled to receive consequential damages from the purchase of securities. Consequential damages include lost dividends, brokerage fees, and taxes. The court may also order payment of interest on funds. Punitive damages for the conduct are not available.

- ***Discussion***: Why do you think the law allows for different calculations of damages for injured shareholders versus damages in actions by the SEC?

- ***Practice Question***: ABC Corp issues securities last year. The shares sold for $10 each. The S-1 that they filed contained some materially incorrect information supplied by the CEO. Since that time, the shares have dropped to $5 each on the public market, which reflects the real value of the shares at the time of issuance. Amy is a shareholder who purchased 100,000 shares. She and the SEC are bringing an action against ABC under Rule 10(b)(5). What are the potential damages against ABC?

- ***Resource Video***: http://thebusinessprofessor.com/damages-available-in-rule-10b5-action/

**45. What is "insider trading" under Section 14 of the 1934 Act?**

Rule 10(b)(5) is not the only securities law to target trading of securities by individuals with inside information. Rule 14(e)(3) is an insider tradition provision that applies specifically to corporate buyouts or takeovers. This provision prohibits anyone from trading on insider information if the trader knows that the information was obtained from either party to the proposed buyout. The information is effectively misappropriated from the companies. No fiduciary duty is required as in 10(b)(5) actions.

- ***Discussion***: Why do you think the securities laws provide for a special cause of action for insider trading based upon information obtained about a corporate takeover or buyout?
- ***Practice Question***: ABC Corp is in the midst of dealing with a proposed corporate buyout of ABC Corp by 123 Corp. Earl is a news reporter who learns from a low-level employee at ABC Corp that there are likely merger-acquisition talks happening. Earl seizes the opportunity to purchase a large block of ABC Corp and 123 Corp stock. The merger is likely to push up the share price of both entities. Is early potentially liable under the securities laws?
- ***Resource Video***: http://thebusinessprofessor.com/insider-trading-under-section-14-of-the-1934-act/

**46. What is liability under "Section 16" of the 1934 Act?**

Section 16 of the '34 Act governs the sale or transfer of securities by "insiders" of the corporation. An insider is an officer, director, or large shareholder (holding 10% or more of outstanding securities). Insiders must generally register with the SEC an indicate their ownership interest at the time of filing the registration statement or within 2 days of becoming an insider (i.e., acquiring a large ownership of shares). Section 16 prohibits insiders from making "short-swing" profits by trading their shares within 6 months of the registration or acquiring the shares. There is an assumption that insiders have material, non-public information during this period. As such, any trades during this period are *per se* illegal. Any profits derived from the sale are forfeited to the corporation.

- *Note*: The SEC does not enforce the short-swing profit rule; rather, this rule is enforced through civil action by the company or shareholders.

- ***Discussion***: Why do you think the securities laws absolutely prohibit insiders from earning short-swing profits from trading the business securities? Do you think that allowing for private civil actions for such profits is an effective manner of policing this practice? Why or why not?
- ***Practice Question***: McKenzie is the Chief Operating Officer of ABC Corp. She recently acquired a large block of stock as part of her executive compensation. There is a rumor in the market that 123 Corp is interested in partnering with ABC Corp for an international joint venture. The speculation has pushed up the stock price. McKenzie is considering selling most of the stock she recently acquired, which will yield a handsome profit for her. Does she face potential civil liability for this action?

- ***Resource Video***: http://thebusinessprofessor.com/insider-trading-under-section-16-of-1934-act/

**47. What is liability under "Section 18" of the 1934 Act?**

Section 18 of the '34 imposes liability on any person "who shall make or cause to be made any false and misleading statement of material fact in any application, report, or document filed under the act". Section 18 is based upon a theory of fraud. Unlike under rule 10(b)(5), however, Section 18 applies only to the documents required to be filed under the '34 Act. This includes annual, quarterly, and special reports. A plaintiff must prove that:

- the defendant knowingly made a false statement,
- the plaintiff relied on the false or misleading statement, and
- the plaintiff suffered damages as a result of that reliance.

Unlike the sections 11 and 12 of the 1933 Act, the defendant's good faith in making the written statement is a defense. Further, unlike sections 11 and 12, the Section 18 plaintiff must prove reliance by the plaintiff shareholder on that information.

- *Note*: The statute of limitations for bringing a Section 18 action was extended under Sarbanes-Oxley Act to 5 years from the wrongful act, and within 2 years of discovery.

- ***Discussion***: Why do you think that Section 18 provides a specific cause of action for material misstatements in a public disclosure document? How do you feel about the availability of a good faith defense? What about the requirement that the plaintiff prove reliance on the statement?
- ***Practice Question***: ABC Corp issues a Form 10-K annual report containing numerous material errors in the financial information. The errors drastically misstate the asset holdings of the company. If a group of shareholders learn of the misstatement and decide to bring a lawsuit, what must the shareholders show to hold ABC Corp liable under Section 18?
- ***Resource Video***: http://thebusinessprofessor.com/liability-under-section-18-of-1934-act/

**48. What is liability pursuant to the "Securities Enforcement Remedies Act"?**

The Securities Enforcement Remedies Act provides for additional civil liability for defendants found to have violated the securities laws. A judge may impose fines of up to $500,000 per institution and $100,000 per individual. This can also lead to a court prohibiting an individual from serving as an officer or director of a corporation.

- ***Discussion***: Why do you think congress decided to augment the level of civil fine or penalty associated with securities law violations?
- ***Practice Question***: http://thebusinessprofessor.com/securities-enforcement-remedies-act/

**49. What is criminal liability under the 1934 Act?**

The '34 Act provides for criminal sanctions for willful violations of its statutes or corresponding regulations. More specifically, it imposes liability for false, material misstatement in applications, reports, documents, and registration statements. Individuals face up to a 25-year sentence and business entities face fines of up to $25 million. Many professionals (accountants) have been found guilty for failure to disclose information. The common defense for this criminal charge is a lack of intent to deceive or defraud.

- *Note*: Most criminal prosecutions occur under Section 10(b) or Rule 10(b)(5).

- ***Discussion***: How do you feel about the possibility of criminal liability for violation of the securities laws? Should these penalties be reserved for intentional deceit? Why or why not?

- ***Practice Question***: http://thebusinessprofessor.com/criminal-liability-securities-exchange-act-of-1934/

**BLUE-SKY LAWS**

"Blue-sky laws" are state laws regulating the sale of securities within that state. These laws are so named from early laws passed in Kansas and in the Midwest to protect investors from undertaking investments that had no more substance than the blue sky. Issuers of securities must comply with these state laws as well as the previously discussed federal regulations. Blue-sky laws may allow for both civil and criminal penalties against violators. The requirements of state blue-sky laws will differ among the states, but they are all based closely on the Uniform Securities Act, promulgated in 1956.

**50. Are all issuers of securities required to comply with state blue sky laws?**

Generally, no. In 1996, Congress passed the National Securities Markets Improvement Act (NSMIA) with the purpose of simplifying the registration process for issuers of securities. The NSMIA preempted any state regulation of certain "covered securities". Covered securities include:

- those traded on a national exchange (such as the NYSE or CME);

- securities of registered investment companies, and

- offers of securities exempt from Federal registration under Regulation D, Rule 506.

NSMIA effectively limited the ability of states to regulate many security offerings. In addition to these preempted offerings, states also recognize any number of exemptions for certain issuances of securities:

- isolated transactions involving the issuance of securities;

- offers or sales to a limited number of offerees or purchasers within a stated time period;

- issuances qualifying as private offerings under Rule 504; and
- issuances to a predefined, but limited, number of purchasers.

Another optional model law is known as the Uniform Limited Offering Exemption. This provision excuses certain securities offerings, such as offerings issued pursuant to Regulation D, Rule 505.

- ***Discussion***: Why do you think federal securities law sought to exempt certain securities issuances from state regulation? Why do you think that some states choose to either adopt or not adopt the Uniform Limited Offering Exemption?
- ***Practice Question***: Under what circumstances does federal law limit the ability of states to regulate the issuance of securities?
- ***Resource Video***: http://thebusinessprofessor.com/securities-issuances-regulated-by-state-law/

**51. What are the registration requirements under state law?**

Registration pursuant to federal law focuses on disclosure of information to offerees and purchasers. States adopt this approach, but also may impose a test to make certain the security being issued meets certain quality standards. This is known as a “merit review”. The merit review examines certain qualities, such as the financial stability of the company making the issuance. Other examinations may focus on the terms or rights associated with the issued security. With this in mind, states generally employ one of three registration methods for issuers of securities:

- *Registration by Qualification* - Some states require issuers to undergo a full-blown registration, complete with a merit review. Issuers registering with the SEC must file duplicate documents with the state’s administrative agency regulating securities. Unless a state official objects, the state registration becomes effective automatically when the federal registration statement is deemed effective.
- *Registration by Notification* - Some states permit issuers with an established track record to simply file a notice before offering their securities. This allows issuers to offer securities for sale automatically after a stated time period expires unless the state administrative agency takes action to prevent the offering.
- *Registration by Coordination* - Some states permit issuers that have registered with the SEC to file copies of the federal registration statement (and perhaps some additional documents) with the state. This process requires a more detailed disclosure by the issuer. A security cannot be offered for sale until the administrative agency grants the issuer a license or certificate to sell securities.
    - *Note*: Alternatives forms of coordinated registration exist and are discussed below.

- ***Discussion***: Why do you think states employ the additional layer of registration beyond the federal requirements? How do you feel about state merit reviews? Should the Federal Government employ a merit review for issuances? Why or why not?
- ***Practice Question***: ABC Corp is issuing securities for sale in a number of states. ABC plans on seeking a federal

exemption from registration under Rule 505. ABC is curious about the different registration requirements that it could face in different states. Can you describe the three major types of state-level registration?

- ***Resource Video***: http://thebusinessprofessor.com/registration-requirements-under-state-law/

**52. What types of coordinated registration are available under state laws?**

There are two primary options for registration by coordination that ease the process of complying with state securities requirements.

- *Coordinated Review-Equity* - This type of review is designed for use during an IPO that is seeking registration (not seeking a statutory or rule-based exemption from registration). It is generally not allowed for limited registrations under Regulation A. Under this program, the issuer files to register its securities in Pennsylvania. Pennsylvania Securities Commission (PSC) acts as an administrator and collects the required disclosure documents. The PSC will also choose another state that requires a merits review and solicit this state to review the offering. The issuer may then register this disclosure and merit review in any other state in which it seeks to sell securities. One state takes the lead on all disclosure concerns, while another assumes responsibility for any merit issues.

    - *Note*: This process is advantageous, as it allows the issuer to only deal with two states in the disclosure and review process. The alternative is to undergo disclosure and review requirements in every state of issuance.

    - *Example*: ABC Corp is undertaking an IPO. As part of the IPO process, ABC will be forced to register its securities in each state in which it is directly offering securities for sale. ABC seeks to undertake the coordinated review-equity process to circumvent the need to comply with the disclosure and review requirements of every state.

- *Coordinated Review-Small Company Offering Registration* - Most states permit the use of CR-SCOR for offerings under Rule 504 or Reg A, Tier 1. Under this program, registration only requires a simplified disclosure form. The issuer would be able to submit this form in lieu of going through the standard state disclosure or merit review requirements. Also, the SCOR system separates the US into five filing regions. Rather than filing a SCOR disclosure in each state where securities will be sold, the issuer can file in a region to cover all the states in that region.

    - *Note*: The issuer would have to file a disclosure in each region in which an issuance state is located.

    - *Example*: ABC Corp is undertaking a small offering issuance. It is seeking an exemption from federal registration under Rule 504. ABC will primarily offer securities for sale in Delaware, District of Columbia, Maryland, New Jersey, Pennsylvania, Virginia and West Virginia. All of these states are part of the Mid-Atlantic SCOR regions. As such, ABC may file the SCOR disclosure documents with each state rather than going through the state-mandated disclosure and review processes.

- ***Discussion***: How do you feel about the coordinated-review programs available for IPOs and small offerings? What do you think is the state purpose behind allowing for these exemptions? Do you think these systems are effective in accomplishing those objectives? Why or why not?

- ***Practice Question***: ABC Corp is considering issuing securities pursuant to rule 504. It needs to raise approximately $1 million in funds to grow operations. ABC is concerned with having to comply with state disclosure and review requirements? What options may be available for ABC? Please describe any procedures necessary in this process.

- ***Resource Video***: http://thebusinessprofessor.com/coordinated-registration-under-state-securities-law/