

# Securities Regulation

## Chapter 20



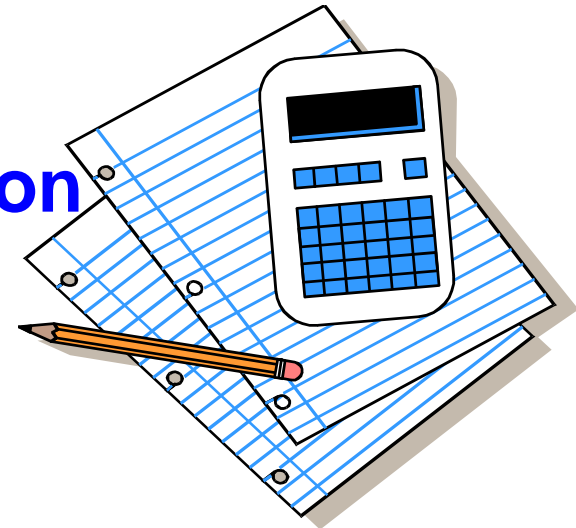
# Corporate Finance

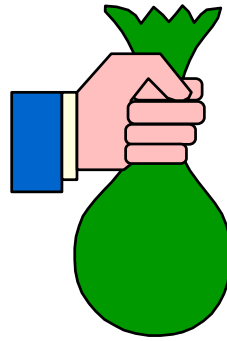
- **Securities**

- written document that provides evidence of:

- debt (corporate note or bond) OR

- equity (preferred or common stock)



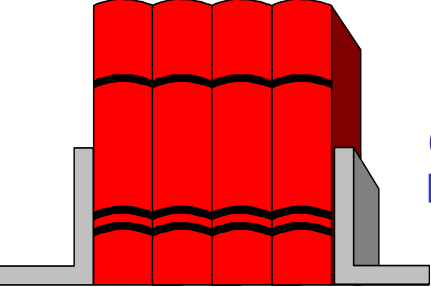


## • Debt

- selling bonds or borrowing money
- instrument usually specifies:
  - amount of debt
  - length of period
  - repayment method
  - rate of interest charged
- can usually be traded

## • Equity

- most often, the sale of company stock
- a claim to a share of future profits
- company is not obligated to repay shareholders specific amount
- can usually be traded

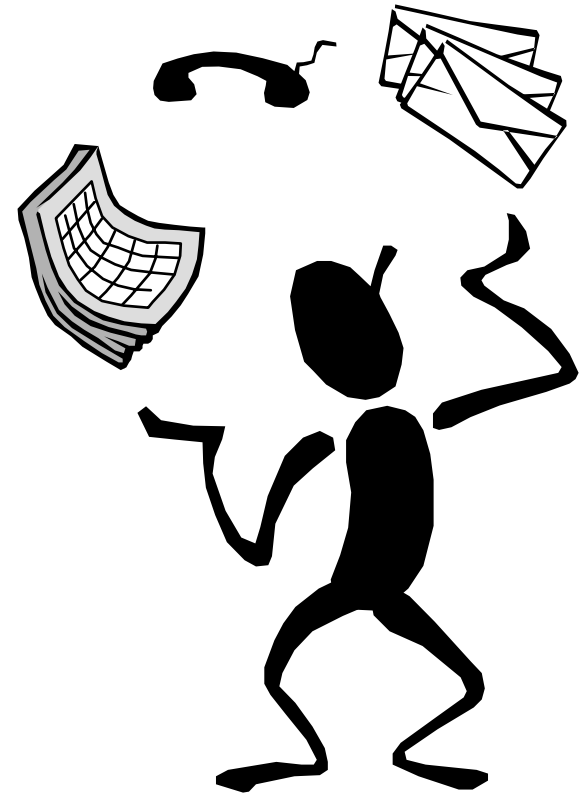


# Securities Regulation

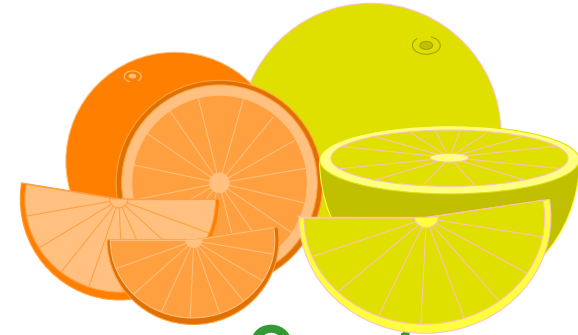
- States began with **blue sky laws** to deter fraudulent securities sales
- Most important federal laws are:
  - **Securities Act of 1933**
    - regulates initial public offerings of securities
  - **Securities Exchange Act of 1934**
    - regulates securities already issued, disclosure requirements, securities markets and professionals
- **Securities and Exchange Commission**
  - agency responsible for enforcement and administration of federal securities laws

# What Is A Security?

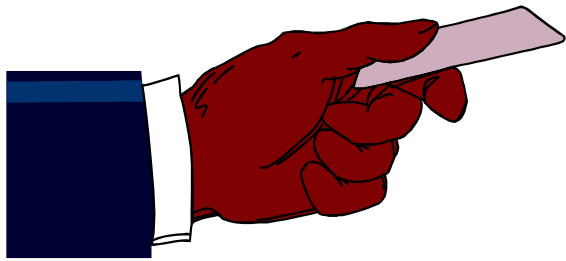
- Merely calling it a security does not make it so
- Have higher legal protection for securities
- Four basic elements (*Howey test*):
  - investment of money
  - in a common enterprise
  - with an expectation of profits
  - generated by efforts of persons other than the investors



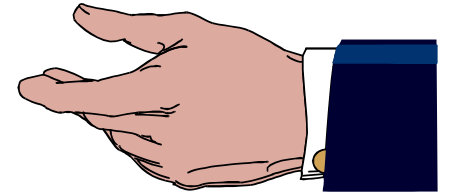
# *SEC v. W.J. Howey Co.*



- **Howey owned citrus groves in Florida, and offered acreage to the public along with a service contract under which Howey would harvest and sell the citrus.**
- **The SEC sued, claiming the sale of land and the service contract was a security that should have been registered with the SEC. Lower courts ruled for Howey.**
- **SEC appealed to the U.S. Supreme Court**
- **The Supreme Court reversed the lower courts**
- **The transactions meet the definition of an investment contract: An investment of money, in a common enterprise, with the intent of making profits, that come mostly from the efforts of others.**



# Offerings to Investors



- '33 Act requires full ***disclosure*** of all ***material*** information on security, issuers, and intended use of money before sale to public.
  - ***Material information*** is all relevant information an investor would want to know:
    - background
    - executives
    - plan of operation
- (“Securities Offering on the Web”: Outdated state laws tend to block web offerings, which are becoming more common and are cost-effective.)***

# 1933 Securities Act

- Regulates the initial offering of securities.

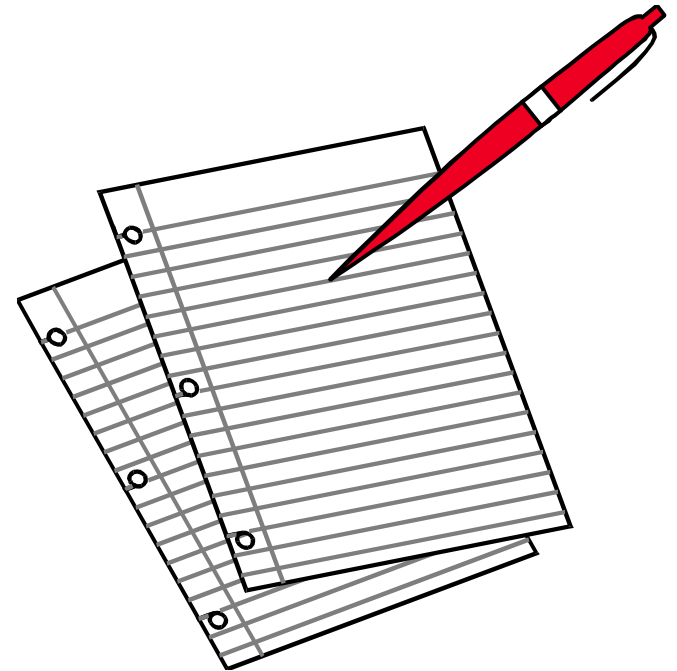


# Securities Registration

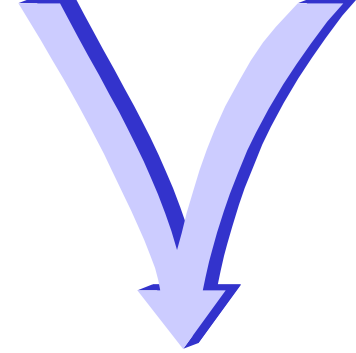
- Registration Statement must be filed with SEC.
- Prospectus, a smaller version of the registration statement, must be given to all offerees of the stock, BEFORE the stock is offered for sale.

# Registration Statement

- **Prospectus (SEC Schedule A)**
- **Provides material information about:**
  - issuer's finances and business
  - purpose of the offering
  - plans for funds collected
  - risks involved
  - promoter's managerial experience and financial compensation
  - financial statements certified by independent public accountants



# Registration Statement



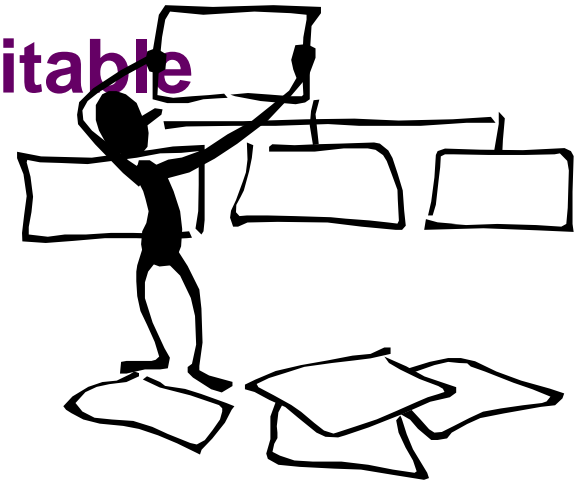
- Review by SEC
  - doesn't review likelihood of success
  - can issue stop order to prevent sale until examiners are happy that discussion of risk is adequate
- Costs of Registration
  - Expensive!
  - Need securities attorney, CPA, printer, underwriter, etc.

# Exemptions from Registration

- There are two types of exemptions:
- **Exempt Securities:** Securities which are exempt due to their nature or type.
- **Exempt Transactions:** Securities which are normal securities but are exempt due to the way they are issued.

# Exempt Securities

- Short-term commercial paper
- Issued or guaranteed by government
  - Federal, state or local
- Issued by banks
- Issued by religious and charitable organizations
- Insurance policies
- Annuity contracts





# Exempt Transactions

- **Some securities, while subject to securities laws, are exempt from registration requirements:**
  - **Government Bonds**
  - **Private Placements**
    - Not sold to public at large
  - **Intrastate Offerings**
    - Everything within the state
  - **Small Offerings**
    - Different rules: \$1mm or \$5mm.
  - **Secondary Trading**
    - Trading after the initial exemption (1934 Act)

# Violations

- **Can sue:**
  - **Company, directors of company, (even new or “working” directors.) CEO, CFO and accounting officers, accountants, lawyers, underwriters, but not stock brokers.**
- **SEC may also act against them with civil penalties and criminal charges**
- **Liability for MATERIAL misstatements or omissions about financial status of a business with publicly traded securities**
- **Due Diligence Defense: Did everything I could do make sure statements correct.**
  - **Cannot be used by issuer (company).**

# What is Materiality?

- A fact is material if a reasonable investor would consider it in deciding to buy or sell the security.
- *Escott v. BarChris Construction*
  - Assets and income overstated.
  - Expenses and liabilities understated.
  - Fictitious receivables.



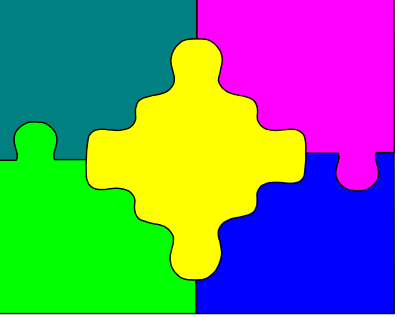
# Test on Wed., April 14

- Chapter 13, Business Organizations
- Chapter 14, Agency
- Chapter 20, Securities Regulation
  
- 50 multiple choice questions
- **CLOSED BOOK/NOTES**

# 1934

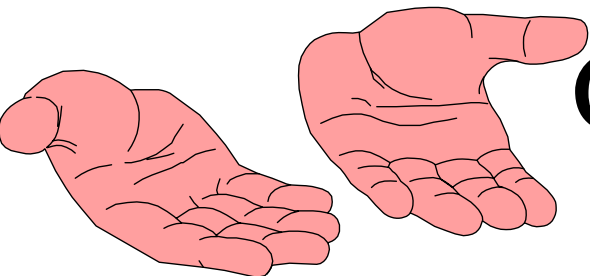
## Securities Exchange Act

- Regulates the trading of securities after the original issuance.
- Has various anti-fraud provisions.



# Regulation of Securities Trading

- If registered under '33 Act, must register under '34 Act; if exempt under '33 Act, must register if traded on an exchange or *over the counter (OTC)* and has >\$5M assets and 500+ shareholders
- **Publicly held company**
  - publicly traded stock
  - most traded OTC
  - must file 10-K annual report
- **Privately held**
  - less than 500 shareholders
  - not openly traded



# General Regulations

- **Regulation FD (Fair Disclosure)** tries to create a “level playing field” by requiring public companies to release information to the public rather than selective revealing of information to favored parties.
- **Proxies: Permission by shareholders given to someone else to vote their shares in the manner they instruct; must follow SEC procedure.**
- **Tender Offers: When one company attempts to take over another. Target company’s stock owners are offered stock in the acquiring company or cash in exchange for their stock. Must follow SEC procedure.**

# Publicly Traded Companies

- Must file 10-K, annual report.
- Must file 10-Q, quarterly report.
- Must file 8-K, material events report
  - Like changing auditors.

# General Regulations (cont)

- Short-Swing profits by insiders prohibited.
  - Any purchase or sale
  - Within six months
  - Profit automatically belongs to the corporation
  - Insiders are officers, directors, and >10% s/h.
- Insiders cannot sell short.
  - Want no incentive to drive stock price down.

# Securities Fraud (cont)

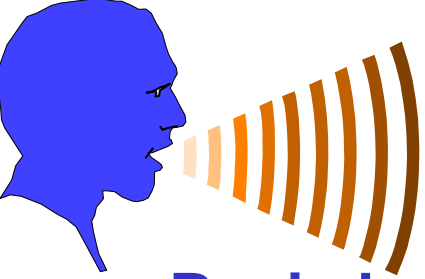
- Churning accounts by brokers is fraud.
- Zaretsky v. E.F. Hutton:
  - \$25,000 life saving to be conservatively invest.
  - During two years, had over 147 transacations.
  - Made \$11,700, but were charged commissions of \$24,664; almost entire account.
  - Activity amount was excessive.
  - Held: Fraudulent.

# Securities Fraud



- Investors often have trouble proving common-law fraud
- Usually rely on antifraud provisions of '33 and '34 Act for statutory fraud
- '33 Act misleading statements or material omissions
- Sec. 10(b)
- Rule 10b-5
- Broadest base for fraud; used more than other Act sections
- Unlawful to:
  - employ device, scheme to defraud
  - make untrue statement of material fact
  - engage in act, practice which operates a fraud in connection w/ purchase/sale of security





# *Basic, Inc. v. Levinson*

- Basic began merger talks with Combustion in 1976. Basic made statements denying it was engaged in merger negotiations.
- In 1978 Basic endorsed Combustion's offer of \$46 per share for Basic's common stock.
- Levinson sued Basic for violation of Rule 10b-5; asserting injury from not being told the truth about the merger talks.
- The Supreme Court had to decide if misstatements were material and would result in liability.
- The Supreme Court defined materiality.
  - “a substantial likelihood that a reasonable shareholder would consider it important.”
- The Court was worried that the wrong standard might “bury the shareholders in an avalanche of trivial information--a result that is hardly conducive to informed decision making.”

# Liability for Insider Trading

- **Most controversial application of 10b-5 is prohibiting insider trading**
- **Insiders have access to info not available to public**
- **May be liable to SEC for profits from such transactions**



# Insider Trading Rules

- Insiders have “fiduciary duty” to other s/h.
  - Present and future.
- No insider may trade on inside info.
- Insider must either disclose the info or refrain from trading.
- Info must be material
- Info must be “effectively disclosed”.
  - More than 20 minutes; maybe 3-4 days.

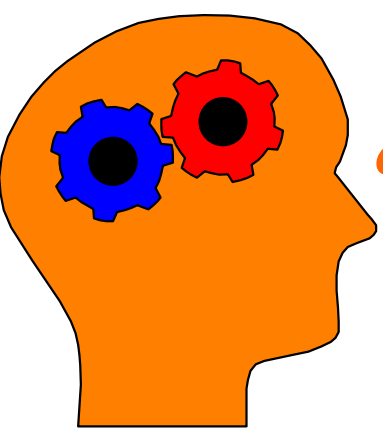
# Insider Trading (cont.)

- Clear that insiders cannot benefit from inside info.
- Question is to what extent “tippees” can benefit.
- If from job, illegal.
- If tippee got info from insider, he cannot use it (brother, partners, friend)
- Overhearing things in elevator is probably OK



# Insider Trading Sanctions Act of 1984

- **Gives SEC a statutory basis for prosecuting insider trading**
- **The law was strengthened by by the Insider Trading and Securities Fraud Enforcement Act**
  - **Increased the maximum fine to \$1(\$5) million per criminal action and set maximum prison term to 10 (20) years per violation. Corporate fines were raised to \$2.5 (\$25)million /criminal violation.**
  - **(Numbers) added by Sarbanes-Oxley, July 30, 2002.**



# *“Should We Restrict Insider Trading?”*

- **Opponents of insider trading say it is undesirable**
  - Insider trading destroys investor confidence in the stock market, especially small investors
  - Causes investors to move away from securities
- **Proponents argue that insider trading should be allowed**
  - It improves market efficiency by moving prices of stocks in proper direction sooner than later
  - It compensates corporate innovators

# Foreign Corrupt Practices Act

- Amendment to 1934 Act
- Basically, prohibits bribes of foreign govt. officials.
  - Applies to decision makers.
- Does not apply to “grease” payments.
  - Minor bribes given to minor officials just to get them to do their job: issue permits.

# Sarbanes-Oxley Act of 2002

- After the Enron/Arthur Andersen scandal, Congress passed this amend. To 1934 Act
  - Sets up an oversight board;
  - Makes it illegal for officers of a corporation to mislead or try to influence the auditors;
  - Audit partners must rotate every 5 yrs;
  - Auditor cannot perform conflicting services, such as setting up accounting system;
  - CEO must certify financial statements;
  - Took effect July 30, 2002.



End of Chapter 20



# Safe Harbor and Federal Exclusivity

- **Safe Harbor**

- Securities Litigation Reform Act of 1995
- Allows companies to predict future events as long as forecasts have “meaningful cautionary statements” that ID “important factors that could cause actual results to differ materially from those in the forward-looking statement”
- Gives immunity from liability

- **Federal Exclusivity**

- Securities Litigation Uniform Standards Act of 1998
- Requires securities suits that involve nationally traded securities to be brought “exclusively” in federal court under federal law

# *Dirks v. SEC*

- A former officer of Equity Funding (EF) told Dirks, a broker-dealer who studied insurance firms, that EF's officers were engaged in fraud so the stock was overvalued.
- Dirks told his clients, they sold their shares; he also told a WSJ reporter.
- The price of EF stock fell.
- The SEC charged Dirks with insider trading.
- The court of appeals upheld the decision.
- The Supreme Court reversed.
- The court found that Dirks was a stranger to EF, with no *fiduciary duty to its shareholders*. He also did not illegally obtain the info about EF.
- Thus, Dirks had no duty to abstain from use of the info he obtained.



# Investment Company Act

- **Primarily in business of investing or trading securities**
- **Three types of Investment Companies**
  - ***face-amount certificate companies*** - debt paying fixed rate of return
  - ***unit investment trusts*** - fixed portfolio of securities
  - ***management companies*** - most important type
    - ***open-end company*** known as a ***mutual fund***
      - no specific number of shares, expand as long as new investors
      - invested in portfolio of securities
    - **two kinds of mutual funds: *load* and *no-load***

# Investment Advisers Act (IAA)

- **“Person who, for compensation, engages in the business of advising others...as to the advisability of investing in, purchasing or selling securities”**





# IAA Regulates *Securities Professionals*



- **Brokers**
  - effecting transactions for the account of others
- **Dealers**
  - buying and selling securities for own account
- **Advisers**
  - charging fees for investment advice
- **Must be registered with SEC**
- **Can't *churn***
  - excessive buying and selling of client's account to get commissions
- **Can't *scalp***
  - buy stocks for personal benefit then urge clients to buy so price goes up

# Stock Market Regulation

- **Self-Regulation of Securities Markets**
  - SEC has power to monitor
  - includes stock exchanges such as NYSE, AMEX, NASDAQ
- **Regulation of Securities Transactions**
  - regulates actions of securities professionals who do actual trading
  - can't trade for their own benefit ahead of customers



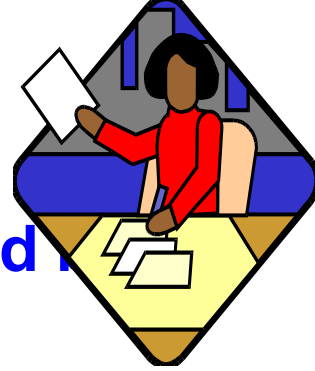
# Arbitration of Disputes

- **Usually investors with investment firms sign a standard form indicating disputes must be arbitrated, not litigated**
- **SEC rules govern the arbitration process**
- **The Supreme Court upholds the binding nature of arbitration agreements.**





# *Reves v. Ernst & Young*



- Farmer's Co-op sold promissory notes, not backed by collateral or insurance, to support operations.
- Co-op filed bankruptcy. Reves sued E&Y for not following generally accepted accounting procedures in its audit to uncover financial problems of Co-op.
- The U.S. Supreme Court stated: “Congress’ purpose in enacting the securities laws was to regulate *investments* in whatever form they are made.”
- Factors:
  - motivation in buying
  - plan of distribution - “common trading for speculation or investment”
  - reasonable expectations of public
  - existence of another regulatory scheme to reduce risk
- The notes were “securities” under the ‘33 and ‘34 Acts.