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# Chapter 28

## Securities Regulation

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The nature of securities regulation
2. The Securities Act of 1933 and the Securities Exchange Act of 1934
3. Liability under securities laws
4. What insider trading is and why it's unlawful
5. Civil and criminal penalties for violations of securities laws

In Chapter 26 "Legal Aspects of Corporate Finance", we examined state law governing a corporation's issuance and transfer of stock. In Chapter 27 "Corporate Powers and Management", we covered the liability of directors and officers. This chapter extends and ties together the themes raised in Chapter 26 "Legal Aspects of Corporate Finance" and Chapter 27 "Corporate Powers and Management" by examining government regulation of securities and insider trading. Both the registration and the trading of securities are highly regulated by the Securities and Exchange Commission (SEC). A violation of a securities law can lead to severe criminal and civil penalties. But first we examine the question, Why is there a need for securities regulation?

## 28.1 The Nature of Securities Regulation

### LEARNING OBJECTIVES

1. Recognize that the definition of *security* encompasses a broad range of interests.
2. Understand the functions of the Securities and Exchange Commission and the penalties for violations of the securities laws.
3. Understand which companies the Securities Exchange Act of 1934 covers.
4. Explore the purpose of state Blue Sky Laws.
5. Know the basic provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

What we commonly refer to as “**securities**” are essentially worthless pieces of paper. Their inherent value lies in the interest in property or an ongoing enterprise that they represent. This disparity between the tangible property—the stock certificate, for example—and the intangible interest it represents gives rise to several reasons for regulation. First, there is need for a mechanism to inform the buyer accurately what it is he is buying. Second, laws are necessary to prevent and provide remedies for deceptive and manipulative acts designed to defraud buyers and sellers. Third, the evolution of stock trading on a massive scale has led to the development of numerous types of specialists and professionals, in dealings with whom the public can be at a severe disadvantage, and so the law undertakes to ensure that they do not take unfair advantage of their customers.

The **Securities Act of 1933** and the **Securities Exchange Act of 1934** are two federal statutes that are vitally important, having virtually refashioned the law governing corporations during the past half century. In fact, it is not too much to say that although they deal with securities, they have become the general federal law of corporations. This body of federal law has assumed special importance in recent years as the states have engaged in a race to the bottom in attempting to compete with Delaware’s permissive corporation law (see [Chapter 25 "Corporation: General Characteristics and Formation"](#)).

### What Is a Security?

Securities law questions are technical and complex and usually require professional counsel. For the nonlawyer, the critical question on which all else turns is whether

the particular investment or document is a **security**<sup>1</sup>. If it is, anyone attempting any transaction beyond the routine purchase or sale through a broker should consult legal counsel to avoid the various civil and criminal minefields that the law has strewn about.

The definition of *security*, which is set forth in the Securities Act of 1933, is comprehensive, but it does not on its face answer all questions that financiers in a dynamic market can raise. Under Section 2(1) of the act, “security” includes “any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a ‘security,’ or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

Under this definition, an investment may not be a security even though it is so labeled, and it may actually be a security even though it is called something else. For example, does a service contract that obligates someone who has sold individual rows in an orange orchard to cultivate, harvest, and market an orange crop involve a security subject to regulation under federal law? Yes, said the Supreme Court in *Securities & Exchange Commission v. W. J. Howey Co.*<sup>2</sup>. The Court said the test is whether “the person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.” Under this test, courts have liberally interpreted “**investment contract**” and “certificate of interest or participation in any profit-sharing agreement” to be securities interests in such property as real estate condominiums and cooperatives, commodity option contracts, and farm animals.

The Supreme Court ruled that notes that are not “investment contracts” under the *Howey* test can still be considered securities if certain factors are present, as discussed in *Reves v. Ernst & Young*, (see [Section 28.3.1 "What Is a Security?"](#)). These factors include (1) the motivations prompting a reasonable seller and buyer to enter into the transaction, (2) the plan of distribution and whether the instruments are commonly traded for speculation or investment, (3) the reasonable expectations of the investing public, and (4) the presence of other factors that significantly reduce risk so as to render the application of the Securities Act unnecessary.

1. Any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a security.

2. A commitment of money or capital to purchase financial instruments as a means to gain profitable returns in the form of income, interest, or the appreciation of the value of the instrument itself. It can be interpreted by the courts to be a security for purposes of the federal securities laws.

## The Securities and Exchange Commission Functions

The **Securities and Exchange Commission**<sup>3</sup> (SEC) is over half a century old, having been created by Congress in the Securities Exchange Act of 1934. It is an independent regulatory agency, subject to the rules of the Administrative Procedure Act (see [Chapter 5 "Administrative Law"](#)). The commission is composed of five members, who have staggered five-year terms. Every June 5, the term of one of the commissioners expires. Although the president cannot remove commissioners during their terms of office, he does have the power to designate the chairman from among the sitting members. The SEC is bipartisan: not more than three commissioners may be from the same political party.

The SEC's primary task is to investigate complaints or other possible violations of the law in securities transactions and to bring enforcement proceedings when it believes that violations have occurred. It is empowered to conduct information inquiries, interview witnesses, examine brokerage records, and review trading data. If its requests are refused, it can issue subpoenas and seek compliance in federal court. Its usual leads come from complaints of investors and the general public, but it has authority to conduct surprise inspections of the books and records of brokers and dealers. Another source of leads is price fluctuations that seem to have been caused by manipulation rather than regular market forces.

3. An independent federal regulatory agency whose primary task is to investigate complaints or other possible violations of the law in securities transactions and to bring enforcement proceedings when it believes that violations have occurred.
4. The process of bringing a legal action against a defendant for criminal behavior.
5. A judicial process or order requiring a person or entity to do a particular act or to refrain from doing a particular act.
6. A term used to describe when a state entity, government agency, or private party seeks monetary relief, fines, and/or restitution for wrongdoing by another.

Among the violations the commission searches out are these: (1) unregistered sale of securities subject to the registration requirement of the Securities Act of 1933, (2) fraudulent acts and practices, (3) manipulation of market prices, (4) carrying out of a securities business while insolvent, (5) misappropriation of customers' funds by brokers and dealers, and (4) other unfair dealings by brokers and dealers.

When the commission believes that a violation has occurred, it can take one of three courses. First, it can refer the case to the Justice Department with a recommendation for **criminal prosecution**<sup>4</sup> in cases of fraud or other willful violation of law.

Second, the SEC can seek a **civil injunction**<sup>5</sup> in federal court against further violations. As a result of amendments to the securities laws in 1990 (the Securities Enforcement Remedies and Penny Stock Reform Act), the commission can also ask the court to impose **civil penalties**<sup>6</sup>. The maximum penalty is \$100,000 for each violation by a natural person and \$500,000 for each violation by an entity other than a natural person. Alternatively, the defendant is liable for the gain that resulted from violating securities law if the gain exceeds the statutory penalty. The court is also authorized to bar an individual who has committed securities fraud

from serving as an officer or a director of a company registered under the securities law.

Third, the SEC can proceed administratively—that is, hold its own hearing, with the usual due process rights, before an **administrative law judge**<sup>7</sup>. If the commissioners by majority vote accept the findings of the administrative law judge after reading briefs and hearing oral argument, they can impose a variety of sanctions: suspend or expel members of exchanges; deny, suspend, or revoke the registrations of broker-dealers; censure individuals for misconduct; and bar censured individuals (temporarily or permanently) from employment with a registered firm. The 1990 securities law amendments allow the SEC to impose civil fines similar to the court-imposed fines described. The amendments also authorize the SEC to order individuals to cease and desist from violating securities law.

### Fundamental Mission

The SEC’s fundamental mission is to ensure adequate disclosure in order to facilitate informed investment decisions by the public. However, whether a particular security offering is worthwhile or worthless is a decision for the public, not for the SEC, which has no legal authority to pass on the merits of an offering or to bar the sale of securities if proper disclosures are made.

One example of SEC’s regulatory mandate with respect to disclosures involved the 1981 sale of \$274 million in limited partnership interests in a company called Petrogene Oil & Gas Associates, New York. The Petrogene offering was designed as a tax shelter. The company’s filing with the SEC stated that the offering involved “a high degree of risk” and that only those “who can afford the complete loss of their investment” should contemplate investing. Other disclosures included one member of the controlling group having spent four months in prison for conspiracy to commit securities fraud; that he and another principal were the subject of a New Mexico cease and desist order involving allegedly unregistered tax-sheltered securities; that the general partner, brother-in-law of one of the principals, had no experience in the company’s proposed oil and gas operations (Petrogene planned to extract oil from plants by using radio frequencies); that one of the oils to be produced was potentially carcinogenic; and that the principals “stand to benefit substantially” whether or not the company fails and whether or not purchasers of shares recovered any of their investment. The prospectus went on to list specific risks. Despite this daunting compilation of troublesome details, the SEC permitted the offering because all disclosures were made (*Wall Street Journal*, December 29, 1981). It is the business of the marketplace, not the SEC, to determine whether the risk is worth taking.

7. The presiding officer of an administrative hearing.

The SEC enforces securities laws through two primary federal acts: The Securities Act of 1933 and The Securities Exchange Act of 1934.

## Securities Act of 1933

### Goals

The **Securities Act of 1933**<sup>8</sup> is the fundamental “truth in securities” law. Its two basic objectives, which are written in its preamble, are “to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof.”

### Registration

The primary means for realizing these goals is the requirement of registration. Before securities subject to the act can be offered to the public, the issuer must file a **registration statement**<sup>9</sup> and **prospectus**<sup>10</sup> with the SEC, laying out in detail relevant and material information about the offering as set forth in various schedules to the act. If the SEC approves the registration statement, the issuer must then provide any prospective purchaser with the prospectus. Since the SEC does not pass on the fairness of price or other terms of the offering, it is unlawful to state or imply in the prospectus that the commission has the power to disapprove securities for lack of merit, thereby suggesting that the offering is meritorious.

The SEC has prepared special forms for registering different types of issuing companies. All call for a description of the registrant’s business and properties and of the significant provisions of the security to be offered, facts about how the issuing company is managed, and detailed financial statements certified by independent public accountants.

Once filed, the registration and prospectus become public and are open for public inspection. Ordinarily, the effective date of the registration statement is twenty days after filing. Until then, the offering may not be made to the public. Section 2(10) of the act defines *prospectus* as any “notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.” (An exception: brief notes advising the public of the availability of the formal prospectus.) The import of this definition is that any communication to the public about the offering of a security is unlawful unless it contains the requisite information.

The SEC staff examines the registration statement and prospectus, and if they appear to be materially incomplete or inaccurate, the commission may suspend or refuse the effectiveness of the registration statement until the deficiencies are

8. The first law enacted by Congress to regulate the securities market. This act regulates the public offering of new securities and provides for securities registration requirements, and prevention of fraudulent conduct.

9. A set of documents that a company must file with the SEC before it proceeds with an initial public offering.

10. A document that provides details about an investment offering for sale to the public—the facts an investor needs to make an informed decision.

corrected. Even after the securities have gone on sale, the agency has the power to issue a stop order that halts trading in the stock.

Section 5(c) of the act bars any person from making any sale of any security unless it is first registered. Nevertheless, there are certain classes of exemptions from the registration requirement. Perhaps the most important of these is Section 4(3), which exempts “transactions by any person other than an issuer, underwriter or dealer.” Section 4(3) also exempts most transactions of dealers. So the net is that trading in outstanding securities (the secondary market) is exempt from registration under the Securities Act of 1933: you need not file a registration statement with the SEC every time you buy or sell securities through a broker or dealer, for example. Other exemptions include the following: (1) private offerings to a limited number of persons or institutions who have access to the kind of information registration would disclose and who do not propose to redistribute the securities; (2) offerings restricted to the residents of the state in which the issuing company is organized and doing business; (3) securities of municipal, state, federal and other government instrumentalities, of charitable institutions, of banks, and of carriers subject to the Interstate Commerce Act; (4) offerings not in excess of certain specified amounts made in compliance with regulations of the Commission...; and (5) offerings of “small business investment companies” made in accordance with rules and regulations of the Commission.

### Penalties

Section 24 of the Securities Act of 1933 provides for fines not to exceed \$10,000 and a prison term not to exceed five years, or both, for willful violations of any provisions of the act. This section makes these criminal penalties specifically applicable to anyone who “willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading.”

Sections 11 and 12 provide that anyone injured by false declarations in registration statements, prospectuses, or oral communications concerning the sale of the security—as well as anyone injured by the unlawful failure of an issuer to register—may file a civil suit to recover the net consideration paid for the security or for damages if the security has been sold.

11. A ruling by the Supreme Court that allows individuals who have been defrauded to seek damages resulting from a violation of SEC rules.

Although these civil penalty provisions apply only to false statements in connection with the registration statement, prospectus, or oral communication, the Supreme Court held, in *Case v. Borak*, *Case v. Borak*, 377 U.S. 426 (1964). that there is an “**implied private right of action**”<sup>11</sup> for damages resulting from a violation of SEC



rules under the act. The Court's ruling in *Borak* opened the courthouse doors to many who had been defrauded but were previously without a practical remedy.

## Securities Exchange Act of 1934

### Companies Covered

The Securities Act of 1933 is limited, as we have just seen, to new securities issues—that is the **primary market**<sup>12</sup>. The trading that takes place in the **secondary market**<sup>13</sup> is far more significant, however. In a normal year, trading in outstanding stock totals some twenty times the value of new stock issues.

To regulate the secondary market, Congress enacted the **Securities Exchange Act of 1934**<sup>14</sup>. This law, which created the SEC, extended the disclosure rationale to securities listed and registered for public trading on the national securities exchanges. Amendments to the act have brought within its ambit every corporation whose equity securities are traded over the counter if the company has at least \$10 million in assets and five hundred or more shareholders.

### Reporting Proxy Solicitation

Any company seeking listing and registration of its stock for public trading on a national exchange—or over the counter, if the company meets the size test—must first submit a registration application to both the exchange and the SEC. The registration statement is akin to that filed by companies under the Securities Act of 1933, although the Securities Exchange Act of 1934 calls for somewhat fewer disclosures. Thereafter, companies must file annual and certain other periodic reports to update information in the original filing.

The Securities Exchange Act of 1934 also covers **proxy solicitation**<sup>15</sup>. Whenever management, or a dissident minority, seeks votes of holders of registered securities for any corporate purpose, disclosures must be made to the stockholders to permit them to vote yes or no intelligently.

### Penalties

The logic of the *Borak* case (discussed in [Section 28.1.3 "Securities Act of 1933"](#)) also applies to this act, so that private investors may bring suit in federal court for violations of the statute that led to financial injury. Violations of any provision and the making of false statements in any of the required disclosures subject the defendant to a maximum fine of \$5 million and a maximum twenty-year prison sentence, but a defendant who can show that he had no knowledge of the particular rule he was convicted of violating may not be imprisoned. The maximum fine for a

12. The market in which the money or capital for the security is received by the issuer of the security directly from investors (such as in an initial public offering transaction).
13. The market in which securities are bought and sold subsequent to original issuance and are typically held by one investor selling them to another investor.
14. A law that was enacted to provide governance of securities transactions on the secondary market and to regulate the exchanges and broker-dealers in order to protect the investing public. This act also established the SEC.
15. An attempt by a group or delegation to obtain the authorization from other individuals to vote on their behalf.

violation of the act by a person other than a natural person is \$25 million. Any issuer omitting to file requisite documents and reports is liable to pay a fine of \$100 for each day the failure continues.

## Blue Sky Laws

Long before congressional enactment of the securities laws in the 1930s, the states had legislated securities regulations. Today, every state has enacted a **blue sky law**<sup>16</sup>, so called because its purpose is to prevent “speculative schemes which have no more basis than so many feet of ‘blue sky.’” *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917). The federal Securities Act of 1933, discussed in [Section 28.1.3 "Securities Act of 1933"](#), specifically preserves the jurisdiction of states over securities.

Blue sky laws are divided into three basic types of regulation. The simplest is that which prohibits fraud in the sale of securities. Thus at a minimum, issuers cannot mislead investors about the purpose of the investment. All blue sky laws have antifraud provisions; some have no other provisions. The second type calls for registration of broker-dealers, and the third type for registration of securities. Some state laws parallel the federal laws in intent and form of proceeding, so that they overlap; other blue sky laws empower state officials (unlike the SEC) to judge the merits of the offerings, often referred to as **merit review laws**<sup>17</sup>. As part of a movement toward deregulation, several states have recently modified or eliminated merit provisions.

Many of the blue sky laws are inconsistent with each other, making national uniformity difficult. In 1956, the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act. It has not been designed to reconcile the conflicting philosophies of state regulation but to take them into account and to make the various forms of regulation as consistent as possible. States adopt various portions of the law, depending on their regulatory philosophies. The Uniform Securities Act has antifraud, broker-dealer registration, and securities registration provisions. More recent acts have further increased uniformity. These include the National Securities Markets Improvement Act of 1996, which preempted differing state philosophies with regard to registration of securities and regulation of brokers and advisors, and the Securities Litigation Uniform Standards Act of 1998, which preempted state law securities fraud claims from being raised in class action lawsuits by investors.

## Dodd-Frank Wall Street Reform and Consumer Protection Act

In 2010, Congress passed the **Dodd-Frank Wall Street Reform and Consumer Protection Act**<sup>18</sup>, which is the largest amendment to financial regulation in the

16. A state law that regulates the offering and sale of securities to protect the public from fraud.
17. Laws that regulate the disclosure and the substantive merits and fairness of the securities offerings to investors.
18. A federal law aimed at financial reform and designed to promote financial stability, it was established to enhance the power of regulatory agencies and add additional enforcement agencies.

United States since the Great Depression. This amendment was enacted in response to the economic recession of the late 2000s for the following purposes: (1) to promote the financial stability of the United States by improving accountability and transparency in the financial system, (2) to end “too big to fail” institutions, (3) to protect the American taxpayer by ending bailouts, and (4) to protect consumers from abusive financial services practices. The institutions most affected by the regulatory changes include those involved in monitoring the financial system, such as the Federal Deposit Insurance Corporation (FDIC) and the SEC. Importantly, the amendment ended the exemption for investment advisors who previously were not required to register with the SEC because they had fewer than fifteen clients during the previous twelve months and did not hold out to the public as investment advisors. This means that in practice, numerous investment advisors, as well as hedge funds and private equity firms, are now subject to registration requirements. For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173), see Thomas, “Major Actions,” Bill Summary & Status 111th Congress (2009–2010) H.R.4173, <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:HR04173:@@L&summ2=m&#major%20actions>.

### KEY TAKEAWAY

The SEC administers securities laws to prevent the fraudulent practices in the sales of securities. The definition of *security* is intentionally broad to protect the public from fraudulent investments that otherwise would escape regulation. The Securities Act of 1933 focuses on the issuance of securities, and the Securities Exchange Act of 1934 deals predominantly with trading in issued securities. Numerous federal and state securities laws are continuously created to combat securities fraud, with penalties becoming increasingly severe.

### EXERCISES

1. What differentiates an ordinary investment from a security? List all the factors.
2. What is the main objective of the SEC?
3. What are the three courses of action that the SEC may take against one who violates a securities law?
4. What is the difference between the Securities Act of 1933 and the Securities Exchange Act of 1934?
5. What do blue sky laws seek to protect?

## 28.2 Liability under Securities Law

### LEARNING OBJECTIVES

1. Understand how the Foreign Corrupt Practices Act prevents American companies from using bribes to enter into contracts or gain licenses from foreign governments.
2. Understand the liability for insider trading for corporate insiders, “tippees,” and secondary actors under Sections 16(b) and 10(b) of the 1934 Securities Exchange Act.
3. Recognize how the Sarbanes-Oxley Act has amended the 1934 act to increase corporate regulation, transparency, and penalties.

Corporations may be found liable if they engage in certain unlawful practices, several of which we explore in this section.

### The Foreign Corrupt Practices Act

Investigations by the Securities and Exchange Commission (SEC) and the Watergate Special Prosecutor in the early 1970s turned up evidence that hundreds of companies had misused corporate funds, mainly by bribing foreign officials to induce them to enter into contracts with or grant licenses to US companies. Because revealing the bribes would normally be self-defeating and, in any event, could be expected to stir up immense criticism, companies paying bribes routinely hid the payments in various accounts. As a result, one of many statutes enacted in the aftermath of Watergate, the **Foreign Corrupt Practices Act (FCPA)**<sup>19</sup> of 1977, was incorporated into the 1934 Securities Exchange Act. The SEC’s legal interest in the matter is not premised on the morality of bribery but rather on the falsity of the financial statements that are being filed.

Congress’s response to abuses of financial reporting, the FCPA, was much broader than necessary to treat the violations that were uncovered. The FCPA prohibits an issuer (i.e., any US business enterprise), a stockholder acting on behalf of an issuer, and “any officer, director, employee, or agent” of an issuer from using either the mails or interstate commerce corruptly to offer, pay, or promise to pay anything of value to foreign officials, foreign political parties, or candidates if the purpose is to gain business by inducing the foreign official to influence an act of the government to render a decision favorable to the US corporation.

19. A US law, enacted 1977, that in part prohibits US firms from bribing foreign officials to obtain or retain business.

But not all payments are illegal. Under 1988 amendments to the FCPA, payments may be made to expedite routine governmental actions, such as obtaining a visa. And payments are allowed if they are lawful under the written law of a foreign country. More important than the foreign-bribe provisions, the act includes accounting provisions, which broaden considerably the authority of the SEC. These provisions are discussed in *SEC v. World-Wide Coin Investments, Ltd.*, *SEC v. World-Wide Coin Investments, Ltd.*, 567 F.Supp. 724 (N.D. Ga. 1983). the first accounting provisions case brought to trial.

## Insider Trading

20. A corporate director, officer, or shareholder with more than 10 percent of a registered security who through influence of position obtains knowledge that may be used to gain an unfair advantage to the detriment of others. The definition has been broadened to include relatives and others.
21. Buying or selling securities of a publicly held company by those who have privileged access to information concerning a company's financial condition or plans.
22. 16(b) A section of the 1934 Securities Exchange Act that allows shareholders to sue corporate officers, directors, or owners of more than 10% of the company's shares for any profits made by insider trading. 16(b) is not enforced by the SEC, but by private parties, and covers profits made within a "short swing" (six month) period.
23. Any profits made from the purchase and sale of company stock if both transactions occur within a six-month period; insiders are required to return any profits made from the purchase and sale of company stock if both transactions occur within a six-month period.

**Corporate insiders**<sup>20</sup>—directors, officers, or important shareholders—can have a substantial trading advantage if they are privy to important confidential information. Learning bad news (such as financial loss or cancellation of key contracts) in advance of all other stockholders will permit the privileged few to sell shares before the price falls. Conversely, discovering good news (a major oil find or unexpected profits) in advance gives the insider a decided incentive to purchase shares before the price rises.

Because of the unfairness to those who are ignorant of inside information, federal law prohibits **insider trading**<sup>21</sup>. Two provisions of the 1934 Securities Exchange Act are paramount: **Section 16(b)**<sup>22</sup> and 10(b).

### Recapture of Short-Swing Profits: Section 16(b)

The Securities Exchange Act assumes that any director, officer, or shareholder owning 10 percent or more of the stock in a corporation is using inside information if he or any family member makes a profit from trading activities, either buying and selling or selling and buying, during a six-month period. Section 16(b) penalizes any such person by permitting the corporation or a shareholder suing on its behalf to recover the **short-swing profits**<sup>23</sup>. The law applies to any company with more than \$10 million in assets and at least five hundred or more shareholders of any class of stock.

Suppose that on January 1, Bob (a company officer) purchases one hundred shares of stock in BCT Bookstore, Inc., for \$60 a share. On September 1, he sells them for \$100 a share. What is the result? Bob is in the clear, because his \$4,000 profit was not realized during a six-month period. Now suppose that the price falls, and one month later, on October 1, he repurchases one hundred shares at \$30 a share and holds them for two years. What is the result? He will be forced to pay back \$7,000 in profits even if he had no inside information. Why? In August, Bob held one hundred shares of stock, and he did again on October 1—within a six-month period. His net

gain on these transactions was \$7,000 (\$10,000 realized on the sale less the \$3,000 cost of the purchase).

As a consequence of Section 16(b) and certain other provisions, trading in securities by directors, officers, and large stockholders presents numerous complexities. For instance, the law requires people in this position to make periodic reports to the SEC about their trades. As a practical matter, directors, officers, and large shareholders should not trade in their own company stock in the short run without legal advice.

### Insider Trading: Section 10(b) and Rule 10b-5

**Section 10(b)**<sup>24</sup> of the Securities Exchange Act of 1934 prohibits any person from using the mails or facilities of interstate commerce “to use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” In 1942, the SEC learned of a company president who misrepresented the company’s financial condition in order to buy shares at a low price from current stockholders. So the commission adopted a rule under the authority of Section 10(b). **Rule 10b-5**<sup>25</sup>, as it was dubbed, has remained unchanged for more than forty years and has spawned thousands of lawsuits and SEC proceedings. It reads as follows:

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

(1) to employ any device, scheme, or artifice to defraud,

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

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

Rule 10b-5 applies to any person who purchases or sells any security. It is not limited to securities registered under the 1934 Securities Exchange Act. It is not limited to publicly held companies. It applies to any security issued by any

24. A section of the Securities Exchange Act of 1934 that prohibits any person from using the mails or facilities of interstate commerce “to use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device...”

25. A rule by the SEC that applies to any person who purchases or sells any security and that prohibits fraud related to securities trading.

company, including the smallest closely held company. In substance, it is an antifraud rule, enforcement of which seems, on its face, to be limited to action by the SEC. But over the years, the courts have permitted people injured by those who violate the statute to file private damage suits. This sweeping rule has at times been referred to as the “federal law of corporations” or the “catch everybody” rule.

Insider trading ran headlong into Rule 10b-5 beginning in 1964 in a series of cases involving Texas Gulf Sulphur Company (TGS). On November 12, 1963, the company discovered a rich deposit of copper and zinc while drilling for oil near Timmins, Ontario. Keeping the discovery quiet, it proceeded to acquire mineral rights in adjacent lands. By April 1964, word began to circulate about TGS’s find.

Newspapers printed rumors, and the Toronto Stock Exchange experienced a wild speculative spree. On April 12, an executive vice president of TGS issued a press release downplaying the discovery, asserting that the rumors greatly exaggerated the find and stating that more drilling would be necessary before coming to any conclusions. Four days later, on April 16, TGS publicly announced that it had uncovered a strike of 25 million tons of ore. In the months following this announcement, TGS stock doubled in value.

The SEC charged several TGS officers and directors with having purchased or told their friends, so-called **tippees**<sup>26</sup>, to purchase TGS stock from November 12, 1963, through April 16, 1964, on the basis of material inside information. The SEC also alleged that the April 12, 1964, press release was deceptive. The US Court of Appeals, in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), decided that the defendants who purchased the stock before the public announcement had violated Rule 10b-5. According to the court, “anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.” On remand, the district court ordered certain defendants to pay \$148,000 into an escrow account to be used to compensate parties injured by the insider trading.

The court of appeals also concluded that the press release violated Rule 10b-5 if “misleading to the reasonable investor.” On remand, the district court held that TGS failed to exercise “due diligence” in issuing the release. Sixty-nine private damage actions were subsequently filed against TGS by shareholders who claimed they sold their stock in reliance on the release. The company settled most of these suits in late 1971 for \$2.7 million.

26. Someone who receives and acts on insider information.

Following the TGS episode, the Supreme Court refined Rule 10b-5 on several fronts. First, in *Ernst & Ernst v. Hochfelder*,<sup>27</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). the Court decided that proof of **scienter**<sup>27</sup>—defined as “mental state embracing intent to deceive, manipulate, or defraud”—is required in private damage actions under Rule 10b-5. In other words, negligence alone will not result in Rule 10b-5 liability. The Court also held that scienter, which is an intentional act, must be established in SEC injunctive actions. *Aaron v. SEC*, 446 U.S. 680 (1980).

The Supreme Court has placed limitations on the liability of tippees under Rule 10b-5. In 1980, the Court reversed the conviction of an employee of a company that printed tender offer and merger prospectuses. Using information obtained at work, the employee had purchased stock in target companies and later sold it for a profit when takeover attempts were publicly announced. In *Chiarella v. United States*, the Court held that the employee was not an insider or a fiduciary and that “a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information.” *Chiarella v. United States*, 445 U.S. 222 (1980). Following *Chiarella*, the Court ruled in *Dirks v. Securities and Exchange Commission* (see [Section 28.3.2 "Tippee Liability"](#)), that tippees are liable if they had reason to believe that the tipper breached a fiduciary duty in disclosing confidential information and the tipper received a personal benefit from the disclosure.

The Supreme Court has also refined Rule 10b-5 as it relates to the duty of a company to disclose **material information**<sup>28</sup>, as discussed in *Basic, Inc. v. Levinson* (see [Section 28.3.3 "Duty to Disclose Material Information"](#)). This case is also important in its discussion of the degree of reliance investors must prove to support a Rule 10b-5 action.

In 2000, the SEC enacted **Rule 10b5-1**<sup>29</sup>, which defines trading “on the basis of” inside information as any time a person trades while aware of material nonpublic information. Therefore, a defendant is not saved by arguing that the trade was made independent of knowledge of the nonpublic information. However, the rule also creates an affirmative defense for trades that were planned prior to the person’s receiving inside information.

In addition to its decisions relating to intent (*Ernst & Ernst*), tippees (*Dirks*), materiality (*Basic*), and awareness of nonpublic information (10b5-1), the Supreme Court has considered the **misappropriation theory**<sup>30</sup>, under which a person who misappropriates information from an employer faces insider trading liability. In a leading misappropriation theory case, the Second Circuit Court of Appeals reinstated an indictment against employees who traded on the basis of inside information obtained through their work at investment banking firms. The court concluded that the employees’ violation of their fiduciary duty to the firms violated

27. A legal term that refers to having intent or knowledge of wrongdoing.

28. Information that would be likely to affect a stock’s price once it became known to the public.

29. A provision that defines when a purchase or sale constitutes trading “on the basis of” material nonpublic information as any time a person trades while aware of material nonpublic information.

30. A theory based on the act of stealing, or misappropriating, confidential information and then trading securities based on the misappropriated insider knowledge.



securities law. *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). The US Supreme Court upheld the misappropriation theory in *United States v. O'Hagan*, *United States v. O'Hagan*, 521 U.S. 642 (1997). and the SEC adopted the theory as new **Rule 10b5-2**<sup>31</sup>. Under this new rule, the duty of trust or confidence exists when (1) a person agrees to maintain information in confidence; (2) the recipient knows or should have known through history, pattern, or practice of sharing confidences that the person communicating the information expects confidentiality; and (3) a person received material nonpublic information from his or her spouse, parent, child, or sibling.

In 1987, in *Carpenter v. United States*, *Carpenter v. United States*, 484 U.S. 19 (1987). the Supreme Court affirmed the conviction of a *Wall Street Journal* reporter who leaked advanced information about the contents of his "Heard on the Street" column. The reporter, who was sentenced to eighteen months in prison, had been convicted on both mail and wire fraud and securities law charges for misappropriating information. The Court upheld the mail and wire fraud conviction by an 8-0 vote and the securities law conviction by a 4-4 vote. (In effect, the tie vote affirmed the conviction.) *Carpenter v. United States*, 484 U.S. 19 (1987).

Beyond these judge-made theories of liability, Congress had been concerned about insider trading, and in 1984 and 1988, it substantially increased the penalties. A person convicted of insider trading now faces a maximum criminal fine of \$1 million and a possible ten-year prison term. A civil penalty of up to three times the profit made (or loss avoided) by insider trading can also be imposed. This penalty is in addition to liability for profits made through insider trading. For example, financier Ivan Boesky, who was sentenced in 1987 to a three-year prison term for insider trading, was required to disgorge \$50 million of profits and was liable for another \$50 million as a civil penalty. In 2003, Martha Stewart was indicted on charges of insider trading but was convicted for obstruction of justice, serving only five months. More recently, in 2009, billionaire founder of the Galleon Group, Raj Rajaratnam, was arrested for insider trading; he was convicted in May 2011 of all 14 counts of insider trading. For the SEC release on the Martha Stewart case, see <http://www.sec.gov/news/press/2003-69.htm>.

Companies that knowingly and recklessly fail to prevent insider trading by their employees are subject to a civil penalty of up to three times the profit gained or loss avoided by insider trading or \$1 million, whichever is greater. Corporations are also subject to a criminal fine of up to \$2.5 million.

31. A provision that includes a nonexclusive definition of circumstances and that establishes a duty of trust or confidence for purposes of the misappropriation theory of insider trading.

### Secondary Actor

In *Stoneridge Investment Partners v. Scientific-Atlanta*, *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008). the US Supreme Court held that "aiders and

abettors” of fraud cannot be held secondarily liable under 10(b) for a private cause of action. This means that **secondary actors**<sup>32</sup>, such as lawyers and accountants, cannot be held liable unless their conduct satisfies all the elements for 10(b) liability.

For an overview of insider trading, go to <http://www.sec.gov/answers/insider.htm>.

## Sarbanes-Oxley Act

Congress enacted the Sarbanes-Oxley Act in 2002 in response to major corporate and accounting scandals, most notably those involving Enron, Tyco International, Adelphia, and WorldCom. The act created the **Public Company Accounting Oversight Board**<sup>33</sup>, which oversees, inspects, and regulates accounting firms in their capacity as auditors of public companies. As a result of the act, the SEC may include civil penalties to a disgorgement fund for the benefit of victims of the violations of the Securities Act of 1933 and the Securities Exchange Act of 1934.

### KEY TAKEAWAY

Corrupt practices, misuse of corporate funds, and insider trading unfairly benefit the minority and cost the public billions. Numerous federal laws have been enacted to create liability for these bad actors in order to prevent fraudulent trading activities. Both civil and criminal penalties are available to punish those actors who bribe officials or use inside information unlawfully.

### EXERCISES

1. Why is the SEC so concerned with bribery? What does the SEC really aim to prevent through the FCPA?
2. What are short-swing profits?
3. To whom does Section 16(b) apply?
4. Explain how Rule 10b-5 has been amended “on the basis of” insider information.
5. Can a secondary actor (attorney, accountant) be liable for insider trading? What factors must be present?

32. A ruling by the Supreme Court stating that “aiders and abettors” of fraud cannot be held secondarily liable under 10(b) for a private cause of action.

33. A body created by Sarbanes-Oxley that oversees, inspects, and regulates accounting firms in their capacity as auditors of public companies.

## 28.3 Cases

### What Is a Security?

Reves v. Ernst & Young

494 U.S. 56, 110 S.Ct. 945 (1990)

JUSTICE MARSHALL delivered the opinion of the Court.

This case presents the question whether certain demand notes issued by the Farmer's Cooperative of Arkansas and Oklahoma are "securities" within the meaning of § 3(a)(10) of the Securities and Exchange Act of 1934. We conclude that they are.

The Co-Op is an agricultural cooperative that, at the same time relevant here, had approximately 23,000 members. In order to raise money to support its general business operations, the Co-Op sold promissory notes payable on demand by the holder. Although the notes were uncollateralized and uninsured, they paid a variable rate of interest that was adjusted monthly to keep it higher than the rate paid by local financial institutions. The Co-Op offered the notes to both members and nonmembers, marketing the scheme as an "Investment Program." Advertisements for the notes, which appeared in each Co-Op newsletter, read in part: "YOUR CO-OP has more than \$11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] insured but it is...Safe...Secure...and available when you need it." App. 5 (ellipses in original). Despite these assurances, the Co-Op filed for bankruptcy in 1984. At the time of the filing, over 1,600 people held notes worth a total of \$10 million.

After the Co-Op filed for bankruptcy, petitioners, a class of holders of the notes, filed suit against Arthur Young & Co., the firm that had audited the Co-Op's financial statements (and the predecessor to respondent Ernst & Young). Petitioners alleged, inter alia, that Arthur Young had intentionally failed to follow generally accepted accounting principles in its audit, specifically with respect to the valuation of one of the Co-Op's major assets, a gasohol plant. Petitioners claimed that Arthur Young violated these principles in an effort to inflate the assets and net worth of the Co-Op. Petitioners maintained that, had Arthur Young properly treated the plant in its audits, they would not have purchased demand notes because the Co-Op's insolvency would have been apparent. On the basis of these

allegations, petitioners claimed that Arthur Young had violated the antifraud provisions of the 1934 Act as well as Arkansas' securities laws.

Petitioners prevailed at trial on both their federal and state claims, receiving a \$6.1 million judgment. Arthur Young appealed, claiming that the demand notes were not "securities" under either the 1934 Act or Arkansas law, and that the statutes' antifraud provisions therefore did not apply. A panel of the Eighth Circuit, agreeing with Arthur Young on both the state and federal issues, reversed. *Arthur Young & Co. v. Reves*, 856 F.2d 52 (1988). We granted certiorari to address the federal issue, 490 U.S. 1105, 109 S.Ct. 3154, 104 L.Ed.2d 1018 (1989), and now reverse the judgment of the Court of Appeals.

\* \* \*

The fundamental purpose undergirding the Securities Acts is "to eliminate serious abuses in a largely unregulated securities market." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849, 95 S.Ct. 2051, 2059, 44 L.Ed.2d 621 (1975). In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299, 66 S.Ct. 1100, 1103, 90 L.Ed. 1244 (1946), and determined that the best way to achieve its goal of protecting investors was "to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Forman*, supra, 421 U.S., at 847-848, 95 S.Ct., at 2058-2059 (quoting H.R.Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)). Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of "security" sufficiently broad to encompass virtually any instrument that might be sold as an investment.

\* \* \*

[In deciding whether this transaction involves a "security," four factors are important.] First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a

“security.” Second, we examine the “plan of distribution” of the instrument to determine whether it is an instrument in which there is “common trading for speculation or investment.” Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be “securities” on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not “securities” as used in that transaction. Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

\* \* \*

[We] have little difficulty in concluding that the notes at issue here are “securities.”

### CASE QUESTIONS

1. What are the four factors the court uses to determine whether or not the transaction involves a security?
2. How does the definition of security in this case differ from the definition in *Securities & Exchange Commission v. W. J. Howey*?

### Tippee Liability

*Dirks v. Securities and Exchange Commission*

463 U.S. 646 (1983)

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

\* \* \*

Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. This standard was identified by the SEC itself in *Cady, Roberts*: a purpose of the securities laws was to eliminate “use of inside information for personal advantage.” Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there

has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

\* \* \*

Under the inside-trading and tipping rules set forth above, we find that there was no actionable violation by Dirks. It is undisputed that Dirks himself was a stranger to Equity Funding, with no preexisting fiduciary duty to its shareholders. He took no action, directly, or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirks's sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their Cady, Roberts duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty when he passed it on to investors as well as to the Wall Street Journal.

\* \* \*

It is clear that neither Secrist nor the other Equity Funding employees violated their Cady, Roberts duty to the corporation's shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. Dirks therefore could not have been "a participant after the fact in [an] insider's breach of a fiduciary duty." *Chiarella*, 445 U.S., at 230, n. 12.

\* \* \*

We conclude that Dirks, in the circumstances of this case, had no duty to abstain from the use of the inside information that he obtained. The judgment of the Court of Appeals therefore is reversed.

## CASE QUESTIONS

1. When does a tippee assume a fiduciary duty to shareholders of a corporation?
2. Did Dirks violate any insider trading laws? Why or why not?
3. How does this case refine Rule 10b-5?

### Duty to Disclose Material Information

Basic Inc v. Levinson

485 U.S. 224 (1988)

[In December 1978, Basic Incorporated agreed to merge with Consolidated Engineering. Prior to the merger, Basic made three public statements denying it was involved in merger negotiations. Shareholders who sold their stock after the first of these statements and before the merger was announced sued Basic and its directors under Rule 10b-5, claiming that they sold their shares at depressed prices as a result of Basic's misleading statements. The district court decided in favor of Basic on the grounds that Basic's statements were not material and therefore were not misleading. The court of appeals reversed, and the Supreme Court granted certiorari.]

JUSTICE BLACKMUN.

We granted certiorari to resolve the split among the Courts of Appeals as to the standard of materiality applicable to preliminary merger discussions, and to determine whether the courts below properly applied a presumption of reliance in certifying the class, rather than requiring each class member to show direct reliance on Basic's statements.

\* \* \*

The Court previously has addressed various positive and common-law requirements for a violation of § 10(b) or of Rule 10b-5. The Court also explicitly has defined a standard of materiality under the securities laws, see *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), concluding in the proxy-solicitation context that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”...We

now expressly adopt the TSC Industries standard of materiality for the 5 10(b) and Rule 10b-5 context.

The application of this materiality standard to preliminary merger discussions is not self-evident. Where the impact of the corporate development on the target's fortune is certain and clear, the TSC Industries materiality definition admits straight-forward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category.

\* \* \*

Even before this Court's decision in TSC Industries, the Second Circuit had explained the role of the materiality requirement of Rule 10b-5, with respect to contingent or speculative information or events, in a manner that gave that term meaning that is independent of the other provisions of the Rule. Under such circumstances, materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." SEC v. Texas Gulf Sulphur Co., 401 F.2d, at 849.

\* \* \*

Whether merger discussions in any particular case are material therefore depends on the facts. Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transactions at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value. No particular event or factor short of closing the transaction need to be either necessary or sufficient by itself to render merger discussions material.

As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. The fact-specific inquiry we endorse here is consistent with the approach a number of courts have taken in assessing the materiality of merger negotiations. Because the standard of



materiality we have adopted differs from that used by both courts below, we remand the case for reconsideration of the question whether a grant of summary judgment is appropriate on this record.

We turn to the question of reliance and the fraud on-the-market theory. Succinctly put:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available information regarding the company and its business....Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements....The causal connection between the defendants' fraud and the plaintiff's purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations. *Peil v. Speiser*, 806 F.2d 1154, 1160-1161 (CA3 1986).

\* \* \*

We agree that reliance is an element of a Rule 10b-5 cause of action. Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's misrepresentation and a plaintiff's injury. There is, however, more than one way to demonstrate the causal connection.

\* \* \*

Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult. The courts below accepted a presumption, created by the fraud-on-the-market theory and subject to rebuttal by petitioners, that persons who had traded Basic shares had done so in reliance on the integrity of the price set by the market, but because of petitioners' material misrepresentations that price had been fraudulently depressed. Requiring a plaintiff to show a speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made, would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.

Arising out of considerations of fairness, public policy, and probability, as well as judicial economy, presumptions are also useful devices for allocating the burdens of proof between parties. The presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act....

The presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations. It has been noted that "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" *Schlanger v. Four-Phase Systems, Inc.*, 555 F.Supp. 535, 538 (SDNY 1982)...An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

\* \* \*

The judgment of the Court of Appeals is vacated and the case is remanded to that court for further proceedings consistent with this opinion.

#### CASE QUESTIONS

1. How does the court determine what is or is not material information? How does this differ from its previous rulings?
2. What is the fraud-on-the-market theory?

## 28.4 Summary and Exercises

### Summary

Beyond state corporation laws, federal statutes—most importantly, the Securities Act of 1933 and the Securities Exchange Act of 1934—regulate the issuance and trading of corporate securities. The federal definition of *security* is broad, encompassing most investments, even those called by other names.

The law does not prohibit risky stock offerings; it bans only those lacking adequate disclosure of risks. The primary means for realizing this goal is the registration requirement: registration statements, prospectuses, and proxy solicitations must be filed with the Securities and Exchange Commission (SEC). Penalties for violation of securities law include criminal fines and jail terms, and damages may be awarded in civil suits by both the SEC and private individuals injured by the violation of SEC rules. A 1977 amendment to the 1934 act is the Foreign Corrupt Practices Act, which prohibits an issuer from paying a bribe or making any other payment to foreign officials in order to gain business by inducing the foreign official to influence his government in favor of the US company. This law requires issuers to keep accurate sets of books reflecting the dispositions of their assets and to maintain internal accounting controls to ensure that transactions comport with management's authorization.

The Securities Exchange Act of 1934 presents special hazards to those trading in public stock on the basis of inside information. One provision requires the reimbursement to the company of any profits made from selling and buying stock during a six-month period by directors, officers, and shareholders owning 10 percent or more of the company's stock. Under Rule 10b-5, the SEC and private parties may sue insiders who traded on information not available to the general public, thus gaining an advantage in either selling or buying the stock. Insiders include company employees.

The Sarbanes-Oxley Act amended the 1934 act, creating more stringent penalties, increasing corporate regulation, and requiring greater transparency.

## EXERCISES

1. Anne operated a clothing store called Anne's Rags, Inc. She owned all of the stock in the company. After several years in the clothing business, Anne sold her stock to Louise, who personally managed the business. Is the sale governed by the antifraud provisions of federal securities law? Why?
2. While waiting tables at a campus-area restaurant, you overhear a conversation between two corporate executives who indicate that their company has developed a new product that will revolutionize the computer industry. The product is to be announced in three weeks. If you purchase stock in the company before the announcement, will you be liable under federal securities law? Why?
3. Eric was hired as a management consultant by a major corporation to conduct a study, which took him three months to complete. While working on the study, Eric learned that someone working in research and development for the company had recently made an important discovery. Before the discovery was announced publicly, Eric purchased stock in the company. Did he violate federal securities law? Why?
4. While working for the company, Eric also learned that it was planning a takeover of another corporation. Before announcement of a tender offer, Eric purchased stock in the target company. Did he violate securities law? Why?
5. The commercial lending department of First Bank made a substantial loan to Alpha Company after obtaining a favorable confidential earnings report from Alpha. Over lunch, Heidi, the loan officer who handled the loan, mentioned the earnings report to a friend who worked in the bank's trust department. The friend proceeded to purchase stock in Alpha for several of the bank's trusts. Discuss the legal implications.
6. In Exercise 5, assume that a week after the loan to Alpha, First Bank financed Beta Company's takeover of Alpha. During the financing negotiations, Heidi mentioned the Alpha earnings report to Beta officials; furthermore, the report was an important factor in Heidi's decision to finance the takeover. Discuss the legal implications.
7. In Exercise 6, assume that after work one day, Heidi told her friend in the trust department that Alpha was Beta's takeover target. The friend proceeded to purchase additional stock in Alpha for a bank trust he administered. Discuss the legal implications.

## SELF-TEST QUESTIONS

1. The issuance of corporate securities is governed by
  - a. various federal statutes
  - b. state law
  - c. both of the above
  - d. neither of the above
  
2. The law that prohibits the payment of a bribe to foreign officials to gain business is called
  - a. the Insider Trading Act
  - b. the blue sky law
  - c. the Foreign Corrupt Practices Act
  - d. none of the above
  
3. The primary means for banning stock offerings that inadequately disclose risks is
  - a. the registration requirement
  - b. SEC prohibition of risky stock offerings
  - c. both of the above
  - d. neither of the above
  
4. To enforce its prohibition under insider trading, the SEC requires reimbursement to the company of any profits made from selling and buying stock during any six-month period by directors owing
  - a. 60 percent or more of company stock
  - b. 40 percent or more of company stock
  - c. 10 percent or more of company stock
  - d. none of the above
  
5. Under Rule 10b-5, insiders include
  - a. all company employees
  - b. any person who possesses nonpublic information
  - c. all tippees

- d. none of the above
6. The purpose of the Dodd-Frank Act is to
- a. promote financial stability
  - b. end “too big to fail”
  - c. end bailouts
  - d. protect against abusive financial services practices
  - e. all of the above

#### SELF-TEST ANSWERS

- 1. c
- 2. c
- 3. a
- 4. d
- 5. a
- 6. e