

--- SECURITIES REGULATION

EDITORIAL ADVISORS

Rachel E. Barkow

Vice Dean and Charles Seligson Professor of Law
Segal Family Professor of Regulatory Law and Policy
Faculty Director, Center on the Administration of Criminal Law
New York University School of Law

Erwin Chemerinsky

Dean and Jesse H. Choper Distinguished Professor of Law
University of California, Berkeley School of Law

Richard A. Epstein

Laurence A. Tisch Professor of Law
New York University School of Law
Peter and Kirsten Bedford Senior Fellow
The Hoover Institution
Senior Lecturer in Law
The University of Chicago

Ronald J. Gilson

Charles J. Meyers Professor of Law and Business
Stanford University
Marc and Eva Stern Professor of Law and Business
Columbia Law School

James E. Krier

Earl Warren DeLano Professor of Law Emeritus
The University of Michigan Law School

Tracey L. Meares

Walton Hale Hamilton Professor of Law
Director, The Justice Collaboratory
Yale Law School

Richard K. Neumann, Jr.

Alexander Bickel Professor of Law
Maurice A. Deane School of Law at Hofstra University

Robert H. Sitkoff

Austin Wakeman Scott Professor of Law
John L. Gray Professor of Law
Harvard Law School

David Alan Sklansky

Stanley Morrison Professor of Law
Faculty Co-Director, Stanford Criminal Justice Center
Stanford Law School

ASPEN CASEBOOK SERIES

SECURITIES REGULATION
CASES AND MATERIALS

TENTH EDITION

JAMES D. COX

BRAINERD CURRIE PROFESSOR OF LAW
DUKE UNIVERSITY

ROBERT W. HILLMAN

DISTINGUISHED PROFESSOR OF LAW EMERITUS
UNIVERSITY OF CALIFORNIA, DAVIS

DONALD C. LANGEVOORT

THOMAS AQUINAS REYNOLDS PROFESSOR OF LAW
GEORGETOWN UNIVERSITY

ANN M. LIPTON

MICHAEL M. FLEISHMAN ASSOCIATE PROFESSOR IN BUSINESS LAW &
ENTREPRENEURSHIP
TULANE UNIVERSITY



Wolters Kluwer

Copyright © 2022 James D. Cox, Robert W. Hillman, Donald C. Langevoort, and Ann M. Lipton.

Published by Wolters Kluwer in New York.

Wolters Kluwer Legal & Regulatory U.S. serves customers worldwide with CCH, Aspen Publishers, and Kluwer Law International products. (www.WKLegaledu.com)

No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or utilized by any information storage or retrieval system, without written permission from the publisher. For information about permissions or to request permissions online, visit us at www.WKLegaledu.com, or a written request may be faxed to our permissions department at 212-771-0803.

To contact Customer Service, e-mail customer.service@wolterskluwer.com, call 1-800-234-1660, fax 1-800-901-9075, or mail correspondence to:

Wolters Kluwer
Attn: Order Department
PO Box 990
Frederick, MD 21705

Printed in the United States of America.

1 2 3 4 5 6 7 8 9 0

ISBN 978-1-5438-3847-3

Library of Congress Cataloging-in-Publication Data

Names: Cox, James D., 1943- author. | Hillman, Robert W. (Robert William), 1949- author. | Langevoort, Donald C., author. | Lipton, Ann, author.

Title: Securities regulation : cases and materials / James D. Cox, Brainerd Currie Professor of Law, Duke University; Robert W. Hillman, Distinguished Professor of Law Emeritus, University of California, Davis; Donald C. Langevoort, Thomas Aquinas Reynolds Professor of Law, Georgetown University; Ann M. Lipton, Michael M. Fleishman Associate Professor in Business Law & Entrepreneurship, Tulane University.

Description: Tenth edition. | New York : Wolters Kluwer, [2022] | Series: Aspen casebook series | Includes bibliographical references and index. | Summary: "Casebook on Securities Regulation Law"— Provided by publisher.

Identifiers: LCCN 2021039422 | ISBN 9781543838473 (hardcover) | ISBN 9781543838480 (ebook)

Subjects: LCSH: Securities—United States. | LCGFT: Casebooks (Law)

Classification: LCC KF1439 .C69 2022 | DDC 346.73/0922—dc23

LC record available at <https://lcn.loc.gov/2021039422>

About Wolters Kluwer Legal & Regulatory U.S.

Wolters Kluwer Legal & Regulatory U.S. delivers expert content and solutions in the areas of law, corporate compliance, health compliance, reimbursement, and legal education. Its practical solutions help customers successfully navigate the demands of a changing environment to drive their daily activities, enhance decision quality and inspire confident outcomes.

Serving customers worldwide, its legal and regulatory portfolio includes products under the Aspen Publishers, CCH Incorporated, Kluwer Law International, ftwilliam.com and MediRegs names. They are regarded as exceptional and trusted resources for general legal and practice-specific knowledge, compliance and risk management, dynamic workflow solutions, and expert commentary.

To Bonnie, Olympia, Joni, and Estelle

SUMMARY OF CONTENTS

Contents	xi
Preface	xxxiii
Acknowledgments	xxxv
Chapter 1. The Framework of Securities Regulation	1
Chapter 2. The Definition of a Security	27
Chapter 3. Understanding Investors	85
Chapter 4. The Public Offering	103
Chapter 5. Exempt Transactions	231
Chapter 6. Secondary Distributions	305
Chapter 7. Recapitalizations, Reorganizations, and Acquisitions	367
Chapter 8. Exempt Securities and Public Finance	405
Chapter 9. Liability Under the Securities Act	425
Chapter 10. Financial Innovation: Trading Markets, Derivatives, and Securitization	481
Chapter 11. Financial Reporting: Mechanisms, Duties, and Culture	507
Chapter 12. Inquiries into the Materiality of Information	551
Chapter 13. Fraud in Connection with the Purchase or Sale of a Security	635
Chapter 14. The Enforcement of the Securities Laws	719
Chapter 15. The Regulation of Insider Trading	831
Chapter 16. Shareholder Voting	877
Chapter 17. Corporate Takeovers	899
Chapter 18. Regulation of Broker-Dealers	927
Chapter 19. Investment Advisers and Investment Companies	975
Chapter 20. Transnational Fraud and the Reach of U.S. Securities Laws	1007
Table of Cases	1035
Index	1053

CONTENTS

Preface	xxxiii
Acknowledgments	xxxv
Chapter 1 The Framework of Securities Regulation	1
A. Securities Transactions	1
1. Issuer Transactions	1
2. Trading Transactions	2
a. Introduction to Trading	2
b. The Structure of Trading Markets	3
B. The Legal Framework of Securities Regulation	4
1. The Federal Securities Laws	5
a. The Securities Act of 1933	5
b. The Securities Exchange Act of 1934	7
c. Federal Regulation Beyond Disclosure: The Sarbanes-Oxley Act of 2002 and Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	11
d. The Regulation of Investment Advisers and Investment Companies	13
e. The Organizational Structure of the SEC	14
f. The Mediums Through Which the SEC Speaks	14
g. The SEC: Some Critical Perspectives	15
h. Judging SEC Rulemaking	17
2. Blue Sky Laws	18
3. Self-Regulatory Organizations	20
C. Financing Startups	21
<i>Ibrahim, The (Not So) Puzzling Behavior of Angel Investors</i>	22
Notes and Questions	24
Chapter 2 The Definition of a Security	27
A. Introduction	27
B. The Development of a Framework for Defining an Investment Contract	28
<i>Securities and Exchange Commission v. W.J. Howey Co.</i>	29
Notes and Questions	32
	xi

C. <i>Howey</i> Applied	34
1. Investment Versus Consumption	34
<i>United Housing Foundation, Inc. v. Forman</i>	35
Notes and Questions	38
Problems	40
2. Common Enterprise and Profits Solely from the Efforts of Others	40
<i>Securities and Exchange Commission v. Edwards</i>	40
a. The Meaning of Common Enterprise	42
Problems	43
b. Profits from the Managerial Efforts of Others	44
Problems	46
3. Cryptocurrencies, Blockchains, ICOs, and Beyond	47
Problem	51
D. Associational Formalities: Interests in Corporations, Partnerships, and LLCs as Securities	52
1. Stock as a Security	52
Notes and Questions	54
Problems	55
2. Partnership and Limited Liability Company Interests as Securities	55
<i>United States v. Leonard</i>	56
Notes and Questions	59
Problems	62
3. The Policy Question: Should Investment Contract Status Be Elective?	62
E. Real Estate as Securities	63
<i>Salameh v. Tarsadia Hotel</i>	65
Notes and Questions	66
Problems	67
F. Notes as Securities	68
<i>Reves v. Ernst & Young</i>	69
Notes and Questions	75
Problems	79
G. Separate Securities and Pass-Throughs	80
Problem	82
 Chapter 3 Understanding Investors	 85
A. Institutionalization	85
B. The Efficient Market Hypothesis: Implications and Limitations	87

Contents	xiii
1. The Meaning and Mechanisms of Market Efficiency	88
Notes and Questions	90
Problems	92
2. The Debate over Efficiency of the Market	93
<i>Young, Brief of Financial Economists as Amici Curae in Support of Respondents, Halliburton, Inc. v. Erica P. John Fund, Inc., U.S. Supreme Court</i>	93
3. Headwinds to Market Efficiency?	95
a. Passive Investing	96
b. Algorithmic Trading	97
c. Behavioral Economics and Decisions by Individual Investors	98
d. Retailization	100
C. Globalization	101
 Chapter 4 The Public Offering	 103
A. Underwriting and Underwriters	104
1. Methods of Underwriting	104
<i>In re National Association of Securities Dealers, Inc., Exchange Act Release No. 17371</i>	104
Notes and Questions	106
2. Underwriters: Their Culture and Their Industry	111
a. Cultural Hierarchy	111
b. The Industry over Time	114
3. Underwriting Agreements: Contracting to Reduce Risk	116
a. Agreement with the Issuer	116
b. Agreement Among the Underwriters	120
4. Underwriters' Compensation	121
a. Review by FINRA	121
b. The Problems of Fixed Price Offerings	122
B. The Market for Initial Public Offerings	124
1. Irrational or Contrived Exuberance	124
2. Underpricing of Initial Public Offerings	127
3. Reforming the IPO Process	130
C. A Panoramic View of the Registration Statement	131
D. Registration of the Unseasoned Issuer	135
1. Preparing the Registration Statement for Filing	136
<i>Schneider, Manko & Kant, Going Public: Practice, Procedure, and Consequences</i>	136

2. Regulatory Dispensations for Emerging Growth Companies	138
a. Emerging Growth Companies	138
b. Is It a Supply or a Demand Problem?	139
3. Review by the SEC's Staff: The Letter of Comment	140
<i>Poliakoff, SEC Review: Comfort or Illusion?</i>	140
Notes and Questions	142
E. Gun-Jumping Concerns for the IPO	146
1. The Pre-Filing Period	147
a. Conditioning the Market	147
<i>Securities Act Release No. 3844</i>	148
b. Safe Harbors for Permissible Communications	152
c. Arrangements with and Among Underwriters	154
Problems	154
2. The Waiting Period	156
a. The Preliminary Prospectus	156
b. Tombstone Ads and Identifying Statements	157
c. Free Writing	158
d. Hyperlinks to the Prospectus	160
e. Road Shows	160
f. Dealing with the Media	161
g. Bookbuilding: Selling Practices During the Waiting Period	162
h. Gap Filling with Exchange Act Rule 15c2-8	163
Problems	164
3. The Post-Effective Period	165
Notes and Questions	167
Problems	168
F. Public Offers by Seasoned and Well-Known Seasoned Issuers	169
1. Integrated Disclosure for the Seasoned Company	169
Notes and Questions	173
2. Gun-Jumping Concerns for the Seasoned Issuer	175
a. Safe Harbors for Reporting Companies	176
b. Free Writing Prospectus	176
c. Research Reports	177
Problems	179
G. Shelf Registration Under Rule 415	180
1. The Regulatory Concerns and the "Traditional" Shelf Registration	180
2. Catching Market Windows	182

Contents	xv
3. Automatic Shelf Registration for Well-Known Seasoned Issuers	183
<i>Securities Offering Reform, Securities Act Release No. 8591</i>	183
4. Can Disclosure Be a Bad Thing?	184
Notes and Questions	185
Problems	187
H. Updating and Correcting the Registration Statement	188
Problem	188
1. Refusal Orders and Stop Orders	189
2. Post-Effective Amendments	190
a. Correcting Material Inaccuracy	190
b. Supplementing Information That Is Permitted to Be Omitted Prior to Effectiveness	192
3. Undertakings to Update	193
4. Withdrawal of the Registration Statement	193
I. The Trading Practice Rules	194
1. Purchases During a Distribution	194
Notes and Questions	195
Problems	195
2. Stabilization	196
Problem	197
Notes and Questions	197
J. The International Public Offering	199
1. Accommodating Foreign Issuers' Offerings in the United States	199
2. Offerings Outside the United States	201
a. Regulation S	201
<i>Regulation S, Securities Act Release No. 6863</i>	204
<i>Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities . . . Offshore, Securities Act Release No. 7516</i>	209
Notes and Questions	212
Problems	214
b. Offerings Falling Outside Regulation S	214
<i>Europe and Overseas Commodity Traders, S.A. v. Banque Paribas London</i>	214
K. Registration Under State Blue Sky Laws	215
<i>Securities and Exchange Commission Report on the Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not "Covered Securities"</i>	217
Problems	219
L. The Debate over Mandatory Disclosure	220

1. How Strong Are the Incentives to Disclose Voluntarily?	220
Problem	221
<i>Easterbrook & Fischel, Mandatory Disclosure and the Protection of Investors</i>	222
2. Regulatory Competition and Issuer Choice	225
3. Global Competitiveness of U.S. Capital Markets	227
4. Implications of Vanishing Listings	228
Notes and Questions	229
 Chapter 5 Exempt Transactions	 231
A. Introduction	231
B. The Private Offering Exemption: Section 4(a)(2)	234
1. Mapping the Scope of the Exemption	234
<i>Securities and Exchange Commission v. Ralston Purina Co.</i>	235
Problem	237
2. The Relevance of Numbers	237
3. Offeree Qualification: Sophistication and Access to Information	238
Problem	238
Notes and Questions	239
Problems	243
4. Resales of Securities Acquired in a Private Offering	243
C. Regulation D and the Limited Offering Exemptions	244
1. An Overview of Regulation D	245
Problem	246
2. Accredited Investors	246
Notes and Questions	248
Problems	251
3. The Sophistication Standard of Rule 506(b)	252
<i>Mark v. FSC Securities Corp.</i>	252
Problems	254
4. Calculating the Number of Purchasers	255
Problems	255
5. Limitations on the Manner and Scope of an Offering	255
a. In General	255
b. What Is “General Solicitation or General Advertising”?	256
c. Activities by Broker-Dealers	257
d. “Demo Days”	258
Problem	259

e. The Internet and General Solicitations	259
Problem	259
f. Eliminating the Ban on General Solicitations: Rule 506 Offerings Limited to Accredited Investors	260
g. A Recap: The Two Tracks of Rule 506	262
Problems	262
6. Determining the Aggregate Offering Price in Offerings Under Rule 504	263
a. Calculating the Aggregate Offering Price	264
b. Relevant Amount and Time Period	264
Problems	265
7. Disclosure Obligations in Offerings Under Rule 506	265
Notes and Questions	266
8. Additional Regulation D Requirements and Features	267
a. Limitations on Resale	267
b. “Bad Actor” Disqualifiers	267
c. Form D	268
d. FINRA Filing	268
e. Substantial Compliance	269
<i>Securities Act Release No. 6825</i>	269
<i>Securities and Exchange Commission v. Ishopnomarkup.com, Inc.</i>	270
Problem	272
9. A Comparative Perspective on Private Placements	272
D. The Crowdfunding Exemption: Section 4(a)(6)	273
Problems	277
E. The Intrastate Offering Exemptions	278
<i>Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 10238</i>	279
Notes and Questions	283
Problems	285
F. Employee Benefit Plans and Contracts Relating to Compensation: Rule 701	286
<i>Securities Act Release No. 33-7645</i>	286
Notes and Questions	288
Problems	290
G. Regulation A: Mini-Registration	291
Notes and Questions	293
Problems	294
H. Integration of Offerings	294
Problem	295

1. Rule 152: General Principle of Integration and Non-Exclusive Safe Harbors	296
a. Rule 152(b)'s Safe Harbors	296
b. Omnibus Approach to Integration	297
2. Rule 241 – Testing the Waters Exemption for General Solicitation of Interest	299
Problem	300
Note	301
I. State Exemptions	301
1. The Uniform Limited Offering Exemption (ULOE)	302
2. Nonuniform State Exemptions	303
Chapter 6 Secondary Distributions	305
A. The Underwriter Concept and Sales for an Issuer	306
<i>Securities and Exchange Commission v. Chinese Consolidated Benevolent Association</i>	308
Notes and Questions	310
Problems	312
B. Purchase from an Issuer	313
1. Investment Intent	314
Notes and Questions	315
Problems	316
2. Distributions and Trading Transactions Contrasted	317
Problems	318
3. Private Investments in Public Equity (PIPE)	319
<i>Sjostrom, Jr., PIPEs</i>	319
Notes and Questions	321
Problems	324
C. Control Person Distributions	324
<i>United States v. Wolfson</i>	326
Notes and Questions	328
Problems	331
D. Rule 144—Safe Harbor for Resales of Control and Restricted Securities	332
<i>Revisions to Rule 144</i>	332
Notes and Questions	336
<i>SEC v. Genovese</i>	342
Problems	343
E. Resales to Qualified Institutional Buyers (QIBs) and Accredited Investors	345

1. Facilitating an Institutional Market for Unregistered Securities with Rule 144A	345
<i>Resale of Restricted Securities, Securities Act Release No. 6862</i>	345
Notes and Questions	348
Problems	350
F. The Section 4(a) (1½) Exemption	352
<i>Ackerberg v. Johnson</i>	352
Notes and Questions	355
Problems	358
G. The Section 4(a) (7) Exemption	358
Problem	359
H. Direct Listing	360
I. Resales Under the Blue Sky Laws	363
1. Isolated Non-Issuer Resale	364
2. The Manual Exemption	364
3. Unsolicited Offer Exemption	365
4. Small Offering Exemption	365
Problem	366
Chapter 7 Recapitalizations, Reorganizations, and Acquisitions	367
A. The “For Value” Requirement	367
1. Value Is Not Always What It Seems	367
Problems	372
2. Shells and Spin-offs: Creating “Value”	372
a. Spin-offs and the ’33 Act	373
<i>Securities and Exchange Commission v. Datronics Engineers, Inc.</i>	373
Notes and Questions	375
b. The Regulation of Spin-offs Under the ’34 Act	377
<i>Publication of Submission of Quotations Without Specified Information, Securities Act Release No. 10842</i>	378
Problems	381
B. Mergers, Acquisitions, and Recapitalizations	382
1. Rule 145	382
2. Jumping the Gun in Business Combinations	383
<i>Excerpt from the Release Adopting Regulation M-A</i>	384
Notes and Questions	386
3. SPACs	388
4. Reverse Mergers	390
Problems	393

C. Exchanges Under Section 3(a)(9)	394
Notes and Questions	396
Problems	398
D. Reorganizations Under Section 3(a)(10)	399
1. Non-Bankruptcy Reorganizations	399
2. The Bankruptcy Act's Collision with the Securities Laws	401
a. Disclosure in Chapter 11 Reorganizations	401
b. Exemption for Sale and Exchange of Securities	402
c. Resales of Securities Received in a Chapter 11 Reorganization	402
d. Resales from Debtor's Portfolio	403
e. Raising Funds while in Bankruptcy?	403
Chapter 8 Exempt Securities and Public Finance	405
A. An Overview of Section 3	406
B. Municipal Securities	410
1. The Market and the Players	410
<i>The Importance of Disclosure for Our Municipal Markets</i>	410
2. Credit-Enhancing Devices	413
3. Disclosure Considerations	413
4. "Backdoor" Regulation of Offerings	414
a. The SEC and Rule 15c2-12	415
b. The MSRB and Rule G-17	418
Notes and Questions	419
Problems	420
5. "Pay to Play" Practices and Rule G-37	420
6. Public Financing for the Private Sector	421
Chapter 9 Liability Under the Securities Act	425
A. Section 11	425
1. Persons Bringing Suit	426
<i>Hertzberg v. Dignity Partners, Inc.</i>	426
Notes and Questions	427
2. The Defendants and Their Defenses	428
a. Registered Offerings Generally	428
<i>Escott v. BarChris Construction Co.</i>	431
Notes and Questions	442
Problem	445

b. Shelf Registrations and Other Seasoned Offerings	446
<i>In re WorldCom, Inc. Securities Litigation</i>	446
Notes and Questions	449
Problem	451
3. Damages	452
<i>Akerman v. Oryx Communications Inc.</i>	452
Notes and Questions	454
Problems	456
B. Section 12(a)(1)	457
<i>Pinter v. Dahl</i>	457
Notes and Questions	459
Problem	460
C. Section 12(a)(2)	461
1. By Means of a “Prospectus or Oral Communication”	461
<i>Gustafson v. Alloyd Co.</i>	461
<i>Hyer v. Malouf</i>	467
Notes and Questions	468
Problems	473
2. Liability Defense	474
Notes and Questions	476
D. Section 17	477
<i>Aaron v. Securities and Exchange Commission</i>	477
Notes and Questions	478
 Chapter 10 Financial Innovation: Trading Markets, Derivatives, and Securitization	 481
A. Technology and the Transformation of Securities Markets	481
<i>SEC Concept Release on Equity Market Structure</i>	481
<i>Stoll, Electronic Trading in Stock Markets</i>	484
Notes and Questions	485
B. Derivatives and Synthetic Investments	490
1. Why Derivatives?	490
2. Basic Forms of Derivatives	491
a. Options	491
b. Futures	491
c. Swaps	492
3. Clearing	494

4. The Regulation of Derivatives	495
a. Swaps and Security-Based Swaps Defined	496
b. Overview of Regulation of Swap Transactions and Their Participants	497
C. Structured Financial Products	498
1. An Overview of Securitization	498
2. Public Offerings of Securitized Products: Residential Mortgage-Backed Securities	500
<i>Federal Housing Finance Agency for Federal National Mortgage Ass'n v. Nomura Holding America, Inc.</i>	501
Notes and Questions	504
Chapter 11 Financial Reporting: Mechanisms, Duties, and Culture	507
A. The Disclosure Requirements of Public Companies	508
1. The Origins and Metrics for Financial Information	508
2. The Exchange Act's Periodic Reporting Obligations	510
a. Domestic Issuers	510
Problems	514
b. Foreign Issuers	515
c. Compelling Honesty in Mandated Reports Through Private Actions	516
B. The "Fairly Presents" Requirement	517
<i>United States v. Simon</i>	518
Notes and Questions	520
C. Internal Controls	522
1. The Meaning and Mandate for Internal Controls	522
<i>Securities and Exchange Commission v. World-Wide Coin Investments Ltd.</i>	523
Notes and Questions	527
2. Reporting on Internal Controls: SOX 404	528
Problems	529
D. Strengthening the Integrity of the Financial Reporting Process: The Marriage of the SEC and Governance	530
1. Audit Committees	530
Problem	531
2. Buttressing the Auditor's Independence	532
Problem	533
3. Executive Certifications and Directors' Signature Requirement	534
4. Reconstructing History with <i>Pro Forma</i> Financial Statements	534
Problem	535

E. Shining a Light on Risk?	535
1. Risk Factor Disclosures	535
<i>Jaroslavicz v. M&T Bank Corp.</i>	536
Notes and Questions	540
Problems	541
2. The Management Discussion and Analysis Section of SEC Filings: Is Past Prologue?	541
a. The Scope of Item 303 Disclosure Obligation	542
<i>Panther Partners Inc. v. Ikanos Communications, Inc.</i>	542
Notes and Questions	544
Problem	546
b. Enron's Contribution to the MD&A and Other Disclosures	546
c. The SEC, MD&A, and the Environment	547
<i>Prospective Information, Financial Reporting Release No. 36</i>	548
Problem	549
 Chapter 12 Inquiries into the Materiality of Information	 551
A. Materiality Orthodoxy	552
Notes and Questions	553
Problem	557
B. Speculative Information and Materiality	558
<i>Basic Inc. v. Levinson</i>	558
Notes and Questions	561
Problem	565
C. The "Total Mix" of Information and Market Efficiency	565
1. Truth on the Market	566
<i>Wielgos v. Commonwealth Edison Co.</i>	566
Notes and Questions	569
Problems	571
2. "Puffery"	572
<i>Eisenstadt v. Centel Corp.</i>	572
Problems	573
Note and Questions	574
3. Opinion Statements and Half-Truths	574
<i>Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund</i>	575
Notes and Questions	581
Problems	581
D. Forward-Looking Information	582

1. The “Bespeaks Caution” Doctrine	584
<i>Kaufman v. Trump’s Castle Funding</i>	584
Notes and Questions	588
2. Statutory Safe Harbor for Forward-Looking Statements	589
<i>Asher v. Baxter International, Inc.</i>	591
Notes and Questions	595
Problems	599
E. The SEC and Corporate Governance	600
1. Integrity and the Incentives of Managers	600
<i>In the Matter of Franchard Corp.</i>	600
Notes and Questions	605
Problem	611
2. Materiality Links to Corporate Governance	611
Notes and Questions	613
Problems	615
3. Materiality of Social Matters	615
4. Disclosure Bearing on Sustainability	617
<i>SEC Concept Release, Business and Financial Disclosure Required by Regulation S-K, 205-210</i>	617
Notes and Questions	622
Problem	626
F. The Materiality of Being a “Bad” Citizen: Violations of State or Federal Law	626
<i>Securities and Exchange Commission v. Jos. Schlitz Brewing Co.</i>	627
Notes and Questions	630
Problems	633
Chapter 13 Fraud in Connection with the Purchase or Sale of a Security	635
A. Private Rights of Action Under Rule 10b-5: Creation and Controversy	636
<i>H.R. Rep. No. 104-50</i>	637
B. Fraud “in Connection with” the Purchase or Sale of a Security	640
1. The Nature of the Fraud	640
Problem	642
2. Standing to Sue	642
<i>Blue Chip Stamps v. Manor Drug Stores</i>	642
Notes and Questions	645
Problem	645

C. Scierter: <i>Hochfelder</i> and Beyond	646
1. Defining Scierter	646
Problem	648
2. Pleading Scierter	648
<i>Tellabs, Inc. v. Makor Issues & Rights, Ltd.</i>	649
<i>Makor Issues & Rights, Ltd. v. Tellabs Inc.</i>	652
Notes and Questions	654
Problem	656
D. Falsity and The Affirmative Duty to Disclose	656
<i>Gallagher v. Abbott Laboratories, Inc.</i>	656
Notes and Questions	659
Problems	664
E. Who Is Liable?	665
<i>Janus Capital Group Inc. v. First Derivative Traders</i>	666
<i>Lorenzo v. Securities and Exchange Commission</i>	670
Notes and Questions	673
Problems	674
F. Reliance	674
1. Face-to-Face Transactions	674
<i>Affiliated Ute Citizens v. United States</i>	674
Notes and Questions	675
2. Open Market Frauds: The Fraud-on-the-Market Theory	676
<i>Halliburton Co. v. Erica P. John Fund, Inc.</i>	676
Notes and Questions	681
Problems	685
3. Fraud on the Market: Some Variations	686
4. The Reasonableness of the Reliance: Due Care	687
Problem	688
G. Loss Causation and Damages	689
1. Face-to-Face Transactions	689
<i>AUSA Life Insurance Co. v. Ernst & Young</i>	689
Notes and Questions	693
Problem	695
2. Open Market Transactions	695
<i>In re Vivendi, S.A. Securities Litigation</i>	695
Notes and Questions	699
Problems	700

3. Proportionate Liability	701
Problem	701
4. Securities Litigation Reform	702
H. Federalism and Rule 10b-5: The Problem of Corporate Mismanagement	703
Problem	706
I. Manipulation	706
1. Defining Manipulation	708
<i>United States v. Mulheren</i>	708
Notes and Questions	711
Problem	713
2. Issuer Repurchases	714
3. Short Selling	715
Chapter 14 The Enforcement of the Securities Laws	719
A. More on the Private Enforcement of the Securities Laws	719
1. Champion of the Little Guy: The Class Action	720
2. Securities Actions After the Private Securities Litigation Reform Act of 1995	721
Notes and Questions	722
3. Closing the Bypass: The Securities Litigation Uniform Standards Act	726
Problems	728
B. Secondary Liability Under the Securities Laws	729
1. Aiding and Abetting	730
<i>Securities and Exchange Commission v. Apuzzo</i>	730
Notes and Questions	734
Problem	735
2. Control Person and Respondeat Superior Liability	735
<i>Donohoe v. Consolidated Operating & Production Corp.</i>	736
Notes and Questions	739
Problems	743
C. Rescission and Restitution of Contracts in Violation of the Securities Laws	744
<i>Berkeley Inv. Group, Ltd. v. Colkitt</i>	744
Notes and Questions	750
Problem	751
D. Responsibility and Its Costs	752
1. Equitable Bars to the Plaintiff's Recovery	752
2. Indemnity and Contribution	755
Problem	758

E. Statutes of Limitations	758
Problem	760
F. Enforcement Actions by the SEC	760
1. Investigations	760
a. The Investigatory Process	760
b. Responding to the Investigation: White Papers and Wells Notices	762
Notes and Questions	764
Problems	766
2. Sanctioning in SEC Enforcement Proceedings	767
a. The Administrative Enforcement Proceeding	767
b. The Panoply of SEC Enforcement Sanctions	768
<i>KPMG, LLP v. SEC</i>	769
Notes and Questions	773
3. Injunctions	777
Notes and Questions	779
Problem	781
4. Discretion in SEC Enforcement	782
a. Whether to Charge, Who to Charge, and Waivers	782
<i>Report of Investigation Pursuant to Section 21(a) of the Securities</i>	
<i>Exchange Act of 1934 and Commission Statement on the</i>	
<i>Relationship of Cooperation to Agency Enforcement Decisions,</i>	
<i>Securities Exchange Act of 1934 Release No. 44969 (Oct. 23, 2001)</i>	782
Notes and Questions	784
Problems	787
b. Settlements	787
<i>SEC v. Citigroup Global Mkts.</i>	788
Problem	793
G. The SEC's Power to Discipline Professionals	793
Problems	796
H. The Duties of the Securities Lawyer	797
1. A Historic Step Toward Socializing the Securities Lawyer	798
<i>Securities and Exchange Commission v. National Student Marketing Corp.</i>	798
Notes and Questions	808
Problem	810
2. The SEC's Rules of Professional Conduct for Attorneys	811
<i>Implementation of Standards of Professional Conduct for Attorneys</i>	812
Notes and Questions	817
Problems	821

I. The Criminal Provisions of the Federal Securities Laws	823
<i>United States v. Dixon</i>	825
Problem	827
Notes and Questions	827
 Chapter 15 The Regulation of Insider Trading	 831
A. Introduction	831
B. The Source of a Duty to Abstain or Disclose	832
<i>Chiarella v. United States</i>	832
Notes and Questions	835
C. “Outsider” Trading: Corporate Connections	838
Problem	839
D. The Misappropriation Theory	839
<i>United States v. O’Hagan</i>	840
Notes and Questions	845
Problems	848
E. Tipplers and Tippees	848
1. Tipper/Tippee Liability Defined	848
<i>Dirks v. Securities and Exchange Commission</i>	849
Notes and Questions	852
Problems	854
2. Statutory Reform	854
3. Selective Disclosure: Regulation FD	856
<i>Securities Act Release No. 33-7881</i>	856
Notes and Questions	859
Problems	861
F. Rule 14e-3	862
Problem	863
G. Enforcement of the Insider Trading Prohibition	864
Problem	865
H. Insider Trading and Section 16	866
1. The Scope of Section 16(b)	867
<i>Huppe v. WPCS Int’l Inc.</i>	867
Notes and Questions	869
Problems	871
2. Executive Compensation	872
3. Pension Blackout Periods	873
4. Is There a Need for Reform?	873

Contents	xxix
Notes and Questions	874
I. Insider Trading Abroad	874
 Chapter 16 Shareholder Voting	 877
A. The Election of Directors and Other Routine Matters	878
1. Mandatory Disclosure	878
2. Shareholder Proposals	880
Notes and Questions	882
Problem	883
B. The Voting Process	884
C. “Solicitations”	885
Notes and Questions	887
Problem	888
D. Proxy Advisors	889
E. Proxy Fraud	890
<i>Virginia Bankshares, Inc. v. Sandberg</i>	891
Notes and Questions	893
Problem	896
 Chapter 17 Corporate Takeovers	 899
A. Introduction: The Policy Dilemma	899
B. The Early Warning System: Section 13(d)	900
<i>Wellman v. Dickinson</i>	901
Notes and Questions	905
Problem	909
C. Tender Offer Regulation: Controlling the Bidder	909
Problem	910
1. Disclosure by Bidders and the Antifraud Prohibition	911
2. Substantive Regulation	912
a. Duration	913
b. Withdrawal and Proration	914
c. The All-Holders/Best-Price Rule	914
<i>Epstein v. MCA Corp.</i>	914
Notes and Questions	917
Problem	918
3. “Tender Offer”	919
Problem	919

D. The Williams Act and the Global Tender Offer	920
E. Tender Offer Defense: Controlling Target Management	921
1. Disclosure and Enforcement	921
<i>Varjabedian v. Emulex Corp.</i>	921
Notes and Questions	925
Chapter 18 Regulation of Broker-Dealers	927
A. Regulation of the Broker-Dealer Industry: Structure and Oversight	928
1. Entry	928
Problems	930
2. Supervising the Conduct of Broker-Dealers and Their Associated Persons	930
a. Self-Regulation	930
b. Direct SEC Supervision of Brokers and Dealers	931
<i>In the Matter of John Gutfreund et al.</i>	932
Notes and Questions	934
Problem	935
B. The Responsibilities of Brokers to Their Customers	936
1. Acting in the Customer's Best Interest	936
a. Best Execution	936
b. Advice and Recommendations	938
<i>Regulation Best Interest: The Broker-Dealer Standard of Conduct</i>	939
Notes and Questions	941
Problems	942
2. Sales Practices: Litigation and Enforcement	943
a. "Know Your Security"	944
<i>Hanly v. Securities and Exchange Commission</i>	944
Notes and Questions	945
Problem	946
b. Investment Analysts and Their Conflicts of Interest	946
Problem	948
c. Suitability	948
i. The Basic Obligation	948
<i>Brown v. E.F. Hutton Group Inc.</i>	948
Notes and Questions	951
Problem	954
ii. Suitability, Risk Disclosure, and the Sophisticated Investor	955
<i>Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.</i>	955

Contents	xxxi
Notes and Questions	957
Problem	958
3. Churning and Other “Relational” Frauds	959
<i>Merrill Lynch, Pierce, Fenner & Smith v. Arceneaux</i>	959
Notes and Questions	962
Problem	964
4. Price Protection: Markups and Other Matters	964
5. Arbitration	965
C. Substantive Regulation: Credit and Financial Soundness	967
1. Margin Requirements	967
2. The Financial Soundness of Broker-Dealers	969
3. Dodd-Frank and Systemic Risk	970
4. “Fintech”	972
 Chapter 19 Investment Advisers and Investment Companies	 975
A. The Regulation of Investment Advisers	976
1. The Registration Requirement	976
2. Substantive Regulation	978
3. Conduct Regulation: Section 206	979
<i>Securities and Exchange Commission v. Capital Gains</i>	
<i>Research Bureau Inc.</i>	979
Notes and Questions	982
Problem	985
4. Investment Advice, Investment Information, and the First Amendment	985
<i>Lowe v. Securities and Exchange Commission</i>	985
Notes and Questions	988
Problem	988
B. Credit Rating Agencies	989
C. Mutual Funds and Other Investment Companies	990
1. The Structure and Governance of a Mutual Fund	992
<i>Investment Company Act Release No. 24,082</i>	992
Problem	994
2. Sales and Redemptions of Mutual Fund Shares	995
a. Prices and Distribution Charges	995
b. Abusive Trading Practices	996
c. Money Market Funds	997
3. The Compensation of Investment Company Affiliates	998
<i>Jones v. Harris Associates L.P.</i>	998

Notes and Questions	999
Problem	1001
4. Self-Dealing by Investment Company Affiliates	1001
5. The Definitional Problem	1002
6. ETFs	1004
D. Hedge Funds and Other Private Investment Vehicles	1004
Chapter 20 Transnational Fraud and the Reach of U.S. Securities Laws	1007
A. The Extraterritorial Application of U.S. Securities Laws	1007
1. In General	1007
2. Limiting the Reach of Securities Law: The <i>Morrison</i> Decision	1008
<i>Morrison v. National Australia Bank, Ltd.</i>	1008
Notes and Questions	1015
Problems	1017
3. <i>Morrison</i> Applied	1017
<i>Absolute Activist Value Master Fund Ltd. v. Ficeto</i>	1017
Notes and Questions	1020
Problems	1024
4. Choice of Law Options: The Relevance of Foreign Law in Securities Litigation	1025
<i>Bonny v. The Society of Lloyd's</i>	1026
Notes and Questions	1027
Problem	1030
B. Enforcement Challenges Presented by an Internationalized Securities Market	1030
1. Unilateral Enforcement Efforts	1030
a. Discovery and Information Collection	1030
b. The Reach for Assets	1032
2. Bilateral and Multilateral Enforcement Efforts	1032
Table of Cases	1035
Index	1053

PREFACE

This Tenth Edition keeps its content up-to-date with new cases, notes, and problems that reflect the changes that keep happening in Congress, the courts, and at the SEC. By far, the most dramatic developments—and the reason we wrote this new edition sooner than we had anticipated—was the abundance of rulemaking undertaken by the SEC in the second half of 2020 to alter the transactional exemptions under the Securities Act. This was the work product of a more conservative SEC, often with vigorous dissents from the Democratic commissioners. Now that political power has shifted, it will be interesting to see how these reforms are implemented going forward. And with that shift, new priorities emerge, especially on “ESG” disclosures. We have also made revisions in the book to take account of the SPAC phenomenon, the SEC’s approval of a liberalized Direct Listing procedure, and scores of other significant changes. As always, we have tried to bring clarity to these teaching materials in the face of (and without hiding) the complexities and nuances that challenge all who enter the field of securities law.

Once again, we are grateful to those who teach from our book and help us out with suggestions for the things we could do better and matters that need correction. As with all editions of our casebook, occasional case and statute citations have been omitted from quoted material without indication. Most footnotes have been omitted from cases and other cited materials, also without indication, but those that remain retain original numbering.

September 2021

James D. Cox
Robert W. Hillman
Donald C. Langevoort
Ann M. Lipton

ACKNOWLEDGMENTS

- ABA Committee on Ethics and Professional Responsibility, Formal Op. 366 (Withdrawal When a Lawyer's Services Will Otherwise Be Used to Perpetrate a Fraud). Reprinted with permission from the American Bar Association. Copyright © 1992. All rights reserved.
- Committee on the Federal Regulation of Securities, Report of the Task Force on Regulation of Insider Trading—Part II: Reform of Section 16, 42 Bus. Law 1087 (1987). Reprinted with permission from the American Bar Association. Copyright © 1987. All rights reserved.
- Cox, James, D., Insider Trading Regulation and the Production of Information: Theory and Evidence, 64 Wash. U. L.Q. 475, 493-495 (1986). Copyright © 1986 by the Washington University Law Quarterly. Reprinted with permission.
- Easterbrook, Frank, and Daniel Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 682-684 (1984). Copyright © 1984 by the Virginia Law Review Association. Reprinted with the permission of the Virginia Law Review Association and Fred B. Rothman & Co.
- Google IPO page. "Google" is a trademark of Google LLC, and this book is not endorsed by or affiliated with Google in any way.
- Ibrahim, Daniel. The (Not So) Puzzling Behavior of Angel Investors, 61 Vand. L. Rev. (2008). Reprinted by permission.
- Langevoort, D.C. Selling Hope, Selling Risk: Corporations, Wall Street, and the Dilemmas of Investor Protection. Copyright © 2016 Oxford University Press.
- Lowenstein, Louis, Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson, 89 Colum. L. Rev. 979-1014 (1989). Copyright © 1989 by the Directors of the Columbia Law Review Association, Inc. All rights reserved. Reprinted by permission.
- McClane, Jeremy. Boilerplate and the Impact of Disclosure in Security Disclosures, 72 Vand. L. Rev. (2019). Reprinted with permission.
- Poliakoff, Abba, SEC Review: Comfort or Illusion, 17 U. Balt. L. Rev. 40, 43-47 (1987). Copyright © 1987 by Abba David Poliakoff and Gordon, Feinblatt, Rothman, Hoffberger & Hollander. Reprinted with the permission of the University of Baltimore Law Review and the author.
- Schneider, Carl, Joseph Manko, and Robert Kant, Going Public: Practice, Procedure and Consequences, 22-23 (Bowne & Co, 1999). Copyright © 1999 by Carl Schneider, Joseph Manko, and Robert Kant. Reprinted with permission of the authors.
- Sjostrom, Jr., William K., PIPEs, 2 Entrepreneurial L. J. 381, 383-389 (2007). Copyright © 2007 The Ohio State University Entrepreneurial Business Law Journal. Reprinted with permission.
- Stoll, Hans R. Electronic Trading in Stock Markets 20 J. Econ. Persp. 153, 169-173 (2006). Reprinted with permission.

THE FRAMEWORK OF SECURITIES REGULATION

A. SECURITIES TRANSACTIONS

The securities laws exist because of the unique informational needs of investors. Unlike cars and other tangible products, securities are not inherently valuable. Their worth comes only from the claims they entitle their owner to make upon the assets and earnings of the issuer, or the voting power that accompanies such claims. Deciding whether to buy or sell a security thus requires reliable information about such matters as the issuer's financial condition, products and markets, management, and competitive and regulatory climate. With this data, investors can attempt a reasonable estimate of the present value of the bundle of rights that ownership confers.

Securities are bought and sold in two principal settings: issuer transactions and trading transactions. As we shall see, the federal securities laws are structured differently for each of these settings.

1. Issuer Transactions

Issuer transactions are those involving the sales of securities by the issuer to investors. They are the means by which businesses raise capital—to develop, to grow, or simply to survive. The successful business is one that grows. Growth in sales, assets, and earnings can occur without the issuance of additional securities that would add new claimants to the firm's assets and earnings beyond those of its founders, but, frequently, in order to grow a firm must expand its ownership base. The sole proprietorship may take on a partner, the partnership may add partners, the close corporation may become publicly owned, and the public corporation may issue more stock or bonds to become an even larger company or to acquire another company.

By far the most expedient form of issuer transaction is the private placement of securities. This entails the issuer selling securities to a select number of investors. On the small scale, a private placement includes a partnership or closely held corporation adding new owners. Large public corporations also engage in private placements when they raise large sums of capital through negotiated sales of securities to one or more financial institutions, such as an insurance company. In either

case, special exemptions exist under the securities laws that enable private placements to escape the rigors of regulation.

On the other hand, the firm may not be able to raise all the capital it needs from a small number of investors. In this case, it must make a public offering of securities to a large number of diverse investors. We shall refer to such a public offering as a *primary distribution*. Whenever a large amount of securities is to be offered to the public, the selling effort usually occurs through a syndicate of broker-dealers, known as *underwriters*. An offering on behalf of a company going public for the first time is called an *initial public offering* (IPO).

2. Trading Transactions

a. Introduction to Trading

In contrast to primary distributions, *trading transactions* are the purchasing and selling of outstanding securities among investors. Resales of securities may either be privately negotiated or occur through public markets. Those who hold securities in a small firm for which no public market exists generally can only dispose of their shares by privately negotiating with an interested buyer. An exception to this statement occurs when the amount of securities to be resold is so great as to support a public offering. This is called a *secondary distribution* and most frequently occurs when individuals who control the securities' issuer wish to sell some of their shares.

Resales of outstanding securities are much more easily accomplished when there is a preexisting public market for those securities. The facilities through which outstanding securities are publicly traded are known as *securities markets*. Trading activity on U.S. markets is immense; in 2019 average daily trading volume on all U.S. public markets was 7 billion shares (\$322 billion). By way of comparison, the total equity raised through all forms of public offerings in 2019 was \$228 billion. SIFMA 2020 Capital Market Fact Book 29. It should be apparent that investors engaged in trading transactions are in need of information just as are those who purchase securities in a primary distribution. The considerations of whether and at what price to purchase IBM common shares on an exchange are identical to the considerations that investors ponder when offered IBM shares in a primary distribution. As will be seen, the mechanics, practices, and rules for disclosure, as well as other activities, differ significantly for primary distributions and trading transactions.

American securities markets can be roughly divided among bond, equity, and derivative/options markets. Traders in bond markets are primarily large financial institutions. Although trading in corporate debt instruments is in absolute amounts significant, all trading in such instruments is dwarfed by the magnitude of trading in U.S., state, and municipal bonds. Even though trading in government securities, as well as original issues of government securities, involves significantly larger amounts than trading in and offerings of business issuers, government securities are exempt from the disclosure regulations. Regulation of government securities focuses upon those who sell government securities. Corporate bond issuances dwarf the issuance of stocks: In 2019, offerings of corporate bonds were nearly \$1.4 trillion, whereas

public offerings of equity involved \$228 billion (traditional IPOs represented only \$49.8 billion). SIFMA 2020 Capital Market Fact Book 10, 11 & 13.

b. The Structure of Trading Markets

The trading of a security begins with a customer instructing her representative, a broker, to purchase or sell a security either at the best available market price (“market order”) or at a stated price (“limit order”). With a limit order, the broker is not to execute the trade until the shares reach (or surpass) the price specified by the customer. Since 2007, all U.S. equity market transactions are executed at penny (\$0.01) increments, more commonly referred to as decimalization of pricing. The broker first will seek to match the customer’s order with that of another customer within the firm; if this is not possible, the broker may take the other side of the transaction so that the firm becomes a principal in the transaction—for example, buying from a selling customer. If the broker does not act as a principal and the order is not matched internally with another customer’s order, the order is routed to the floor broker at the *exchange* or to a *market maker*.

Securities trade on one or more competitive markets in the United States. By far the largest U.S. equity market is the New York Stock Exchange; indeed, NYSE listed shares represent nearly 80 percent of the capitalization of all U.S. equity markets. The next largest market is Nasdaq. There are many other exchanges that are registered with the Securities and Exchange Commission (SEC). Because securities listed on one market, such as NYSE, can also be traded in another of these markets, such as the BATS Exchange, competition among the markets is keen. For example, only about 25 percent of the securities listed on NYSE or Nasdaq are traded on their respective exchange.

Shares not “listed” on an exchange can be traded in the over-the-counter market. At the core of the over-the-counter market is an electronically connected network of broker-dealers who publicly and regularly publish “bid” and “ask” prices for a security. They are therefore referred to as “market makers,” as they attract investors’ orders. The orders are handled either on a principal or agency basis. If the market maker purchases for its inventory, or sells the security from its inventory, it is deemed to be acting as a principal; in contrast, if a market maker simply matches the willing buyer with a willing seller, it is acting as an agent. In either case, the commission derived by the market maker is the “spread” between the bid and the asked price. Nasdaq, although technically today an exchange as defined in the Exchange Act, evolved from this over-the-counter structure; it is a computer network that links brokers and market makers (and, more importantly, their bid and ask quotes).

Of special note is how limit orders can pose a particular challenge since the requested price may depart materially from the present market price. For example, a customer limit order may call for the purchase of a security at \$15 when the most recent transaction in that security occurred at \$16. Since the market professional can be expected to avoid selling personal inventory shares at a price below the then market price, the broker can leave the order in the limit order book. Thus, an alternative function of the intermediary is to maintain a limit order book in which unfilled orders are recorded and later filled by the intermediary as market conditions permit. In the preceding example, if the price of the security in the

limit order book declines to \$15, the intermediary will execute the order for the customer—receiving, of course, a commission on the trade.

We should take a moment to reflect on the multiple social benefits provided by public securities markets:

The modern regulated exchange has several roles. Its transparency provides a price discovery mechanism and liquidity so that investors, speculators, and hedgers can quickly create and liquidate positions at current market prices. . . . The exchange clearinghouses provide clearing and settlement functions that assure the smooth processing and confirmation of trades . . . within . . . [one day] on the securities exchanges. . . .

The stock exchanges and Nasdaq impose minimum listing requirements as quality control mechanisms. . . .

One service, and revenue source, for exchanges is fulfilling the demand for market data. . . . The exchanges' profitability from the dissemination of trade data is large; according to some researchers, market data fees accounted for 50% of the NYSE Group's total revenues in 2006 while those same fees represented about 80% of Nasdaq's total revenues. . . .

[Exchanges] are uniquely qualified to act as gatekeeper for membership, resolve disputes, establish codes for acceptable trading practices, and implement other policies that are applicable to the industry and its trading requirements and standards. . . .

Markam, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 J. Corp. L. 865, 882-885 (2008).

B. THE LEGAL FRAMEWORK OF SECURITIES REGULATION

Before learning more about the various legislative and administrative initiatives that have produced the American securities laws, consider the following regarding the challenges policymakers face in formulating sound regulation:

Investing is a choice; people can do many different things with their money. If people choose not to invest (or invest less), the capital markets—and the financial community—suffer. Given the inevitability and repeated salient examples of opportunism, the level of investment should vary based on how confident investors feel that they will not be exploited when parting with their hard-earned money. The standard economic justification for investor protection regulation is that some public commitment to fight marketplace abuses is necessary to offset fear of exploitation and instill investor confidence. Regulation at this base-line level can be cost-efficient and justifiable even to the most ardent free-marketeer, promoting the conservative trilogy (now baked into the law) of “efficiency, competition and capital formation.” But where that sweet spot is, no one knows. Economists, by and large, think we have too much—or at least too much of the wrong kind—of securities regulation.

As you read on, I want you to put yourself in the role of a securities regulator, perhaps the SEC chair. Here is the mental image with which

to begin: There are more than a hundred million investor households in the United States, all making difficult financial choices. There are tens of thousands of businesses and entrepreneurs seeking capital from investors. There are competing stock exchanges and electronic trading platforms facilitating the secondary trading of hundreds of millions of shares every day, and thousands of large institutional investors like mutual funds, hedge funds, pension funds that now dominate these financial markets, with massive conflicts of interest. Legions of brokers and investment advisers engage in a never-ending effort to get deeply into their clients' wallets. Much of this takes place globally, often outside the reach of any one domestic regulator. Imagine that you were asked to make this wide-open territory "safe" for investors, many of whom seem habitually disinclined toward prudence, and also to promote robust capital formation. How would you do it? How much in the way of resources would you insist on as a condition for taking the job and doing it well? How would you know whether you are succeeding or failing, or being used?

What does investor protection even mean?

D.C. Langevoort, *Selling Hope, Selling Risk: Corporations, Wall Street, and the Dilemmas of Investor Protection* 2-3 (2016).

1. The Federal Securities Laws

a. The Securities Act of 1933

Debate on the merits of a mandatory disclosure system began early in the twentieth century, but it was the Great Depression and the market collapse in October 1929 that provided the political momentum for congressional action that would over the course of a decade produce a collection of acts known as the federal securities laws. The first of the federal securities laws enacted was the Federal Securities Act of 1933 ('33 Act), which regulates the public offering and sale of securities in interstate commerce. The abuses prompting the legislation were legion:

During the postwar decade some 50 billion of new securities were floated in the United States. Fully half or \$25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise.

Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High pressure salesmanship rather than careful counsel was the rule in this most dangerous enterprise.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

Disclosure is the remedy the Securities Act embraces for this malady. The '33 Act and much of the federal securities laws are influenced by the regulatory philosophy championed by Justice Brandeis: "Sunlight is said to be the best of disinfectants: electric light the most efficient policeman." L.D. Brandeis, *Other People's Money* 62 (1914). The Act's disclosure demands apply to public offerings of securities that occur through the process of "registering" such an offering with the SEC. The following is a broad overview of the Securities Act's registration process; a much closer examination of that process occurs in Chapter 4.

Through the preparation of a registration statement, the Securities Act seeks to assure full and fair disclosure in connection with the public distribution of securities. The information issuers are compelled to disclose in their registration statements is set forth in the SEC regulations and covers all significant aspects of the issuer's business. The precise disclosure requirements are somewhat industry sensitive. In general, the registration statement must provide a thorough description of the issuer's business, property, and management. Extensive financial information must be disclosed, including certified financial statements for the current and several previous years as well as revenues and earnings for each significant product line. Management must also provide its analysis and review of the issuer's capital needs, solvency, and financial performance, including analysis of any variances in revenues or profits from the preceding year. A detailed description of the rights, privileges, and preferences of the offered security, as well as the existing capital structure of the firm, must be set forth in the registration statement.

Paternalism toward investors is evident throughout the SEC's instructions and guides to its disclosure regulations as it seeks to paint a somber picture of the issuer's prospects. This dimension of the '33 Act disclosure process is underscored by information appearing in the first section of the registration statement, where any "risk factors" that make the offering speculative must be described. Examples of such special risks are that there is no preexisting market for the security (i.e., it is an IPO), that the issuer has recently experienced substantial losses, and that the nature of the business the issuer is engaged in or proposes to engage in poses unusual risks. The information filed by an "unseasoned" issuer with the SEC undergoes several drafts and reviews under the watchful and demanding eye of the SEC's Corporation Finance staff. Most of the registration statement's substantive information is also required to be disclosed in the *prospectus*. The need for care and honesty in the preparation of the registration statement is underscored by the exposure of the issuer's underwriters, officers, directors, and certain experts to civil liability for omissions and misstatements in the registration statement.

As can be seen from the above, the objective of the registration process is the production of a prospectus that includes most of the information disclosed in the registration statement. The prospectus is designed to provide all material information necessary for investors to fully assess the merits of their purchase of the security; the prospectus is the vehicle for stationing investors on as nearly an equal footing with the issuers and their underwriters as possible, with the hope their purchase is neither worthless nor overpriced.

The underwriters' selling efforts cannot commence until the registration statement has been filed with the SEC, and no sales or deliveries of securities may occur until the registration statement is effective. Nevertheless, extensive selling efforts commence after the registration statement is filed, at which time investor

interest is orally solicited. Written offers during this period can be made through a preliminary prospectus that embodies all the substantive information then contained in the registration statement as well as through other materials if certain conditions, reviewed later in Chapter 4, are satisfied. Once the registration statement becomes effective, actual sales can be made, and the purchased securities can be delivered. The Securities Act's objective of full disclosure for public offerings of securities occurs through the registration process and the Act's compulsion for a prospectus to be available to investors.

As will be seen in later chapters, Section 3 exempts numerous categories of securities from the Act's registration requirements, the most significant being those issued by governmental bodies, banks, and insurance companies, and Section 4 exempts securities sold in certain types of transactions. Importantly, the Act provides both private and public remedies to assure compliance with its provisions. Thus, Section 11 provides a private right of action for materially false statements in the registration statement, and Section 12 imposes civil liability upon those who sell securities in violation of Section 5's registration requirement as well as upon anyone who sells any security in a public offering by means of a materially misleading statement. The SEC's enforcement powers include the power to issue administrative cease-and-desist orders under Section 8A as well as to prosecute violations civilly in the federal courts under Section 20.

b. The Securities Exchange Act of 1934

History and Philosophy. The disastrous market effects of the Great Depression were, of course, not borne solely by the purchasers of new issues. The decline in value of outstanding securities was dramatic and painful. For example, the total value of all New York Stock Exchange listed securities declined from a pre-crash 1929 high of \$89 billion to \$15 billion in 1932. Investor interest and confidence in markets evaporated overnight, and for many stocks, trading halted completely.

The causes of the crash were many, and most were unrelated to abusive practices. The pre-crash market was driven not by fundamentals, but by speculative frenzy. Speculating in stocks was something of a national pastime. For example, 55 percent of all personal savings were used to purchase securities. E.R. Willet, *Fundamentals of Securities Markets* 211 (1968). A significant amount of all investment was on margin, in which an investor borrowed most of the stock's purchase price. There was no limit on the amount of credit that could be extended to an investor for margin trading. Typically, the lender was the brokerage firm, which in turn borrowed the funds from a bank. So long as the stock price did not decline, substantial margin trading posed no harm to the investor or markets generally. However, once steam began to run out of the market in late 1929, lenders began making calls upon the investor to cover the amount that the securities' market value had declined below its purchase price. This produced a chain reaction as margin calls triggered sales of securities owned by overextended customers; sales made in response to margin calls further depressed stock prices, so that even more margin calls were made upon other investors, and so on.

A good deal of the content of the Depression Era securities laws, and particularly the collage of provisions that would become the Exchange Act, was shaped by the sensational hearings of the Senate Committee on Banking and Currency,

whose chief investigator, Ferdinand Pecora, presented in riveting detail the abuses visited on public investors. *See* Michael Perino, *The Hellhound of Wall Street: How Ferdinand Pecora's Investigation of the Great Crash Forever Changed American Finance* (2010). Much of the hearings leading up to Congress' enactment of the securities laws was devoted to accounts of trading practices by unscrupulous market manipulators. The hearings produced reports that the bull market of the 1920s was the heyday of the crooked stock pools. These were devices used by brokers and dealers to create a false appearance of trading activity by simultaneously buying the same security they were selling. Innocent investors were attracted to the manipulated stock by its price and volume changes. Eventually, unwitting investors' orders provided all the upward momentum to the stock's price. And, as the price rose, the brokers and dealers behind the scheme dumped their holdings at the higher price created by the unwitting investors' interest. More recent examination of market practices in the 1920s suggests that the congressional hearings greatly exaggerated the effect and existence of such abusive schemes, perhaps doing so for political purposes. *See* Mahoney, *The Stock Pools and the Securities Exchange Act*, 51 J. Fin. Econ. 343 (1999).

There also was plenty of evidence that stock prices were adversely affected by false and misleading information and that corporate insiders took advantage of their access to confidential inside information to further their own trading profits. Related to this was the absence of legal compulsion for publicly traded firms to make timely disclosures of material information or to publish even annual financial reports. A further problem was the belief that public corporations were not sufficiently responsive to their owners due to weaknesses in the proxy solicitation process.

An inventory of these market abuses is summarized in Section 2 of the Securities Exchange Act ('34 Act), which captures the popular and congressional view that stock prices reflected the actions of speculators, manipulators, and inside traders, as well as the gullible, but not the astute and the sophisticated. *See* Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385, 409 (1990). One of the great ironies of securities regulation is that, even though Congress when it enacted the '34 Act had a dim view of the overall sophistication of market participants, today many of the Commission's regulatory initiatives under the '34 Act are premised on the assumption that trading markets are dominated by sophisticated, resourceful investors. The irony of this underscores the breadth and flexibility of the '34 Act's provisions.

There is an important difference in style between the Securities Act and the Exchange Act. In the Securities Act, Congress empowered the Federal Trade Commission (FTC) to discharge a specific and well-defined task: the registration of public offerings of securities not otherwise exempt from the Act. The means, as well as the end result, are clearly and unequivocally defined in the Securities Act. In contrast, the Exchange Act is in large part a laundry list of problems for which Congress articulated neither the means nor the end objective. Instead, Congress, through Section 4 of the Act, created the Securities and Exchange Commission and delegated to it the task of grappling with the problem areas.

The contrast in style between the two acts bears witness to the fact that compromises were necessary to assure passage of the Exchange Act whereas that was not the case for the Securities Act. Recall that the Congress that enacted the

Securities Act also enacted in those heady first hundred days of Roosevelt's first term other legislative packages that greatly centralized the federal government's control over the economy, the most prominent piece being the National Recovery Act. Many of Roosevelt's advisers were urging upon him a similar approach to the regulation of securities practices. For example, then-Professor William O. Douglas, who would later become the third Chairman of the SEC before being appointed to the Supreme Court, was one who openly counseled Roosevelt that a disclosure-oriented approach was inadequate and that legislation was needed that directly involved the federal government in identifying the firms that should be permitted to approach investors with their public offerings and thus gave it an active role in channeling capital into industries the government preferred to nurture. *See, e.g.,* Douglas, *Protecting the Investor*, 23 Yale L.J. (N.S.) 521 (1934).

Despite the willingness of the New Dealers to embrace modes of direct government involvement in the economy's private sector, the Securities Act's exclusive orientation was disclosure, a clear victory for those who embraced a less intrusive federal role in capital markets. Landis, *The Legislative History of The Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29 (1959). On the other hand, the Exchange Act as originally proposed envisioned strong federal control of the trading markets as well as important structural changes for the securities industry and its participants. The radicalism of these proposals energized the securities industry, and its representatives came to Washington with their own proposals. In the end, the '34 Act reflects the many compromises necessary to assure its passage. Indeed, the creation of the Securities and Exchange Commission itself was a concession to the industry, which felt it would fare better under an agency whose energies were focused exclusively on capital markets and the securities industry—the industry had found the leading regulators at the FTC to be formidable and devoted regulators.¹ In the end, many of the pressing regulatory issues were unresolved in the '34 Act and were instead dumped into the lap of the newly created Commission, where the debate and compromise would continue. *See generally* J. Seligman, *The Transformation of Wall Street*, chs. 2 & 3 (3d ed. 2003).

Continuous Disclosure and Other Disclosure Provisions. Whereas the Securities Act grapples with the protection of investors in primary distributions of securities, the Exchange Act's concern is trading markets and their participants. An important contribution to efficient trading markets is the '34 Act's system of continuous disclosure for companies required to register under its provisions. Three categories of companies are subject to the '34 Act's continuous disclosure requirements: companies that have a class of securities listed on a national securities exchange (Section 12(b)); companies that have assets in excess of \$10 million and that have a class of equity securities held by at least 2,000 record holders (Section

1. The industry believed the creation of a separate commission would shield it from individuals such as James M. Landis, then an FTC commissioner and a strident proponent for regulation. With the creation of the SEC, the industry saw one of its own, Joseph Kennedy, appointed as its first chairman, but also found to its horror that Landis became one of its members and succeeded Kennedy as chair when Kennedy was appointment ambassador to Britain. When Landis left to become Dean of Harvard Law School, William O. Douglas, later Justice Douglas, became its third chairman.

12(g) and Rule 12g-1 —prior to 2012, continuous reporting was required for firms with 500 or more record holders); and companies that have filed a '33 Act registration statement that has become effective (Section 15(d)). A company that meets any one of these requirements is called a *reporting company*.

Reporting companies are required to register with the SEC and thereafter make timely filings of reports required by Section 13 of the '34 Act. Unlike the '33 Act's disclosure requirements, there is no additional requirement that '34 Act filings be forwarded to investors or market professionals. All registrants (domestic and foreign) are required to file with the SEC their '33 Act registration statements and their periodic reports under the '34 Act in electronic format (i.e., submissions occur through e-mail or the physical delivery of diskettes or magnetic tapes). The present system is called EDGAR (Electronic Data Gathering, Analysis, and Retrieval System). In its quest for facilitating investor decisionmaking, since 2009 the SEC has required filings to be pursuant to its Interactive Data Electronic Applications (IDEA), which itself builds on a software program, XBRL (Extensible Business Reporting Language), by which information is "tagged" by reporting companies so that users can thereafter sort information according to the pretagged codes. The XBRL system allows investors to compare discrete reporting items (e.g., research and development expenditures) across a range of companies without the necessity of serially accessing the forms of individual companies. Information filed with the SEC is available to anyone through its web site (www.sec.gov). A further benefit is XBRL allows most issuers to reduce the time to file periodic reports with the SEC. See Zhou, Does One Size Fit All? Evidence on XBRL Adoption and 10-K Filing Lag, 60 Acctg. & Fin. 3183 (2020).

The most significant of the compelled reports is the annual report on Form 10-K, which is required to include an extensive description of the company's business, audited financial statements for the fiscal year, and management's discussion and analysis of the position and performance of the company. Quarterly reports on Form 10-Q are also required to be filed with the SEC. The disclosures on Form 10-Q include unaudited interim financial statements for the company as well as management's analysis of financial operations and conditions. A further report compelled by Section 13 is Form 8-K, which must be filed within a few days of the occurrence of a material development of the type specified in the form, for example, a change in control, credit downgrade, the acquisition or disposition of a significant amount of assets, the commencement of insolvency proceedings, a change in auditors, or the resignation of a director in a dispute over policy.

The SEC in the early 1980s adopted the process of "integrated disclosure," whereby certain companies registering securities under the Securities Act could fulfill many of the '33 Act's disclosure demands by incorporating into the Securities Act registration statement information from their Exchange Act (e.g., Form 10-K) filings. As we see in Chapter 4, following sweeping reforms adopted by the SEC in 2005, today integrated disclosure is available to seasoned issuers, which is defined as a company that has filed an annual report with the SEC and is current in its filings. Integrated disclosure was the first step toward melding the Securities Act and Exchange Act so that their disclosure demands are complementary and their registrants' burdens lightened. Under integrated disclosure, issuers are required to file a registration statement with the SEC in advance of their offering, and for most

issuers there is a period of delay before the issuers can sell the registered securities. As will be seen, integrated disclosure reduces greatly the delay and costs that normally accompany registering securities.

The Act also requires those companies that are subject to the continuous reporting requirements because they fall within either Exchange Act Section 12(b) or Section 12(g), discussed above, to make full and fair disclosure whenever soliciting their stockholders' proxies and to otherwise comply with the numerous proxy rules the Commission has promulgated under Section 14(a). Through the Williams Act Amendments in 1968, disclosure by an outsider is required when more than 5 percent of a class of registered equity securities is or will be owned as a result of a tender offer or purchase. Other tender offer practices are also regulated as a consequence of the Williams Act Amendments.

Regulation of Exchanges, Broker-Dealers, and Market Abuses. Continuing its emphasis on regulating trading markets, the Exchange Act embraces a strong, active role for a variety of self-regulatory organizations (SROs). Two important types of SROs are each of the national securities exchanges and the Financial Industry Regulatory Authority (FINRA). As discussed in section B.3 below, the SROs' regulatory role is played under the Commission's watchful eye. Later, in Chapter 18, we examine the regulatory authority of FINRA and the SEC over brokers and dealers. The Exchange Act also seeks to protect the integrity of capital markets and investors by arming the SEC, as well as private litigants, with its antifraud and anti-manipulation provisions. Both the public and the private enforcement of the anti-fraud and anti-manipulation rules are closely examined later in this book.

c. Federal Regulation Beyond Disclosure: The Sarbanes-Oxley Act of 2002 and Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

In July 2002, the Sarbanes-Oxley Act was enacted and ushered in a new era of financial regulation for U.S. capital markets. As is seen throughout this book, many of the provisions Congress included in Sarbanes-Oxley depart radically from the securities laws' historical preoccupation of addressing investor protection via disclosure. Among other features, the Act sets forth broad prescriptions for corporate governance, authorizes the SEC to develop rules for professional conduct for lawyers, and regulates areas that have always been the province of the states, such as loans to officers and directors. The events that prompted Congress to act were many and are collectively referred to as the accounting and financial scandals of 2002. The scandals actually began in 2001 with the sudden collapse of Enron Corporation, the seventh largest American corporation.

Enron was a high-flying energy trading company whose aggressive management style consistently impressed Wall Street with ever-increasing profits and reports of an even brighter future. For five consecutive years before its collapse Fortune 500 executives had voted Enron as one of America's most innovative companies. But all that glitters is not gold. In early December 2001, Enron filed for bankruptcy protection, at that time the largest bankruptcy filing in American history. It was soon revealed that Enron's profits were fabricated by its executives, that its Big Five accounting firm, Arthur Andersen, had acquiesced in clear violations of

accounting and reporting principles, that it appeared that two national law firms that advised it had not appropriately advised their clients of possible misconduct by senior management, and that financial analysts were co-opted by pressures from their investment banking colleagues to support Enron with “strong buy” recommendations as a means to garner lucrative investment banking business from Enron. *See generally* Report of the Staff to the Senate Committee on Governmental Affairs, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs (Oct. 8, 2002). More information regarding the financial reporting frauds and other market abuses committed by Enron and others in the months leading up to Sarbanes-Oxley is presented in later chapters.

Sarbanes-Oxley would not have been enacted if Enron had been an isolated event. Enron’s bankruptcy was soon followed by the financial collapse of approximately a dozen large public companies where there was also strong evidence of reporting violations and audit failures even more egregious than that which occurred in Enron. Moreover, over the course of the five preceding years the number of earnings restatements by public companies quadrupled. The final culminating event propelling the enactment of Sarbanes-Oxley was the revelation in late June 2002 that WorldCom’s chief financial officer had overstated earnings over several quarters by several billions of dollars. Soon after making its own earnings restatements, WorldCom itself entered bankruptcy, supplanting Enron for the honor of the largest company ever to seek the protection of the bankruptcy laws. With the enactment of Sarbanes-Oxley the focus of the securities laws and the SEC is today significantly broader than disclosure. Sarbanes-Oxley does not alter the core features of the U.S. securities laws, but the Act introduces important procedural and substantive requirements for public companies as additional safeguards to protect investors. It is also apparent from this book’s review of the regulatory initiatives ushered in by Sarbanes-Oxley that important areas of corporate governance are no longer solely a matter controlled by state law.

Just as the Great Depression ushered in various New Deal regulators such as the SEC, the financial crisis that began in 2008 led to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. The seeds of this crisis can be traced to the housing bubble that had reached full bloom by mid-2005. As a result of extraordinarily low interest rates and questionable predatory lending practices, home mortgages were granted against what quickly became artificially heightened real estate values. Many of these mortgages were denoted “subprime” because their borrowers posed serious credit risks. Through the alchemy of asset-backed securitization, the mortgages were bundled together, given questionable “investment-grade” ratings, and then sold to financial institutions. When the bubble burst, which is a nasty tendency of bubbles, the financial institutions found that their investment-grade securities were hardly that, and many institutions failed or teetered at the edge of failure. Fear gripped all sectors of the financial markets. In fall 2008, the Dow Jones Industrial Average plunged dramatically, banks became unwilling or unable to lend to one another, and the once highly liquid and low-risk commercial paper market evaporated. This was followed by massive government bailouts of commercial banks, investment banks, and other financial institutions that on a worldwide basis exceeded \$2 trillion.

There were many culprits behind the credit crisis. Most of Dodd-Frank is aimed at the regulation of depositary institutions, derivatives, and consumer finance. These areas are not covered in this book as they involve institutions and regulatory paradigms that are outside the realm of securities regulation. However, Dodd-Frank does contain numerous provisions that impact the scope and content of U.S. securities laws such as mandatory disclosure related to “conflict minerals,” authorization for the SEC to adopt rules providing shareholders with a means to nominate directors of public companies, and clarification of the SEC enforcement authority with respect to foreign issuers. Each of these provisions, as well as many other Dodd-Frank securities-related provisions, are studied later. In broad overview, what is notable about Dodd-Frank’s interface with the securities laws is that many of its securities-related provisions, like those of Sarbanes-Oxley, transcend disclosure. One question is whether the strong bipartisan support the SEC and securities regulation has historically enjoyed is weakened by the content of U.S. securities laws that no longer focuses exclusively on disclosure and fraud, but includes as well procedures by which public companies govern themselves and their need to disclose information that is politically and socially sensitive, e.g., trafficking in conflict minerals or CEO pay versus pay of the average employee. In this sense, Congress through Sarbanes-Oxley and Dodd-Frank has moved the SEC into new and unfamiliar terrain.

d. The Regulation of Investment Advisers and Investment Companies

The bulk of the securities regulation course materials focus on the provisions of the Securities Act and the Securities Exchange Act. As is seen in Chapter 19, the SEC has an important regulatory role with respect to investment advisers and investment companies.

The Investment Company Act of 1940 and the Investment Advisers Act of 1940 were the culmination of a comprehensive four-year SEC investigation of investment companies and their advisers. *Investment companies*, simply defined, are companies formed for the purpose of buying, selling, and holding a portfolio of securities for investment, rather than for control purposes. Common versions of investment companies are money market funds and mutual funds. The Investment Company Act regulates the independence of the company’s board of directors; requires annual review of any management contract between the investment company and its investment adviser; conditions transactions between the company and its officers, directors, or affiliates upon approval by the SEC; and regulates the capital structure of investment companies. Even though investment companies are required to register under the Investment Company Act, they remain subject to the registration and prospectus requirements of the Securities Act when they engage in a public offering of their securities. They also are subject to the reporting requirements of the Exchange Act.

An *investment adviser* is one engaged in the business of rendering investment advice to others for compensation. The Investment Advisers Act of 1940 requires advisers to register with the SEC, establishes a few minimum requirements for fair dealings by investment advisers, and prohibits fraudulent and deceptive practices by investment advisers.

e. The Organizational Structure of the SEC

The SEC is an independent, nonpartisan agency created by the Securities Exchange Act of 1934; the '33 Act, until the creation of the Commission, was administered by the FTC. The Commission is composed of five commissioners appointed by the President to five-year terms. The terms are staggered so that one expires each June, and not more than three commissioners may be of the same party as the President. One of the commissioners is designated by the President to serve as the chairman of the Commission. The commissioners meet frequently as a deliberative body to resolve issues raised by the staff. The Commission's staff is organized into divisions and offices.

The SEC operates through four principal divisions. The Division of Corporation Finance has overall responsibility for administering the federal securities laws' disclosure requirements through its review of the registration statements for public offerings, quarterly and annual reports, proxy statements, tender offer statements, and other documents required to be filed with it. The Division of Trading and Markets has responsibility to oversee the operation of secondary trading markets, including the registration and behavior of exchanges and broker-dealers as well as rating agencies. Responsibility for administering the Investment Company Act and the Investment Advisers Act is with the Division of Investment Management. The Division of Enforcement is to the general public the most visible of all the divisions because of the publicity that frequently accompanies its investigations and prosecutions. Enforcement actions can occur via an administrative proceeding or in the courts. Criminal prosecutions, however, are within the exclusive authority of the Department of Justice attorneys, usually through the appropriate U.S. Attorney's Office, with assistance of the SEC enforcement staff. In 2009, the newest part of the SEC was established, the Division of Economic and Risk Analysis, which draws on a variety of disciplines to assist the SEC in policymaking, rulemaking, enforcement, and examinations.

f. The Mediums Through Which the SEC Speaks

The Commission and its staff's views on regulatory issues are communicated in a variety of mediums. Through the exercise of its broad rulemaking power, the Commission formally makes its position known on regulatory issues. In the releases that accompany its proposals and adoption of regulations, the SEC goes to great lengths to provide guidance regarding the content of the regulations it is considering. SEC releases are essentially press releases and invariably accompany the proposal, adoption, or modification of rules. The Commission, through its enforcement staff, plays an important role in expanding and refining the law through the enforcement actions it chooses to initiate and the theories under which the suits are maintained. The classic illustration of the Commission's impact in this regard was its success in proscribing insider trading through its early administrative proceedings, *see* Cady, Roberts & Co., 40 S.E.C. 907 (1961), and judicial proceedings, *see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). The Commission's positions are also presented in private litigation through amicus briefs the staff files on important issues.

Extensive guidance is provided through the SEC web site in its "Compliance and Disclosure Interpretations." These staff interpretations are focused on distinct

regulatory topics or rules and provide a good deal of guidance into how the provisions are administered by the staff. An especially important source of guidance occurs through the staff's issuance of *no-action letters*. Since the SEC's creation, its staff has been willing to respond to individual inquiries regarding the staff's interpretation of the federal securities laws' application to a specific transaction. The staff's responses to such inquiries are known as no-action letters because the key expression in a favorable response to an inquiry states that the staff "will recommend *no action* to the Commission" if the transaction is carried out as stated in the letter. Because the no-action letters express the views only of the staff involved with the day-to-day responsibility of administering that provision of the law, they do not represent the official view of the Commission. 17 C.F.R. §202.1(d). No-action letters are compliance oriented and designed to provide some measure of certainty to those planning securities transactions. Even though the Commission will not challenge that transaction as a violation of the law if the transaction is completed as represented in the no-action letter request, Securities Act Release No. 4553 (Nov. 6, 1962), a no-action letter is not binding on private parties, who can challenge the transaction. Also, the predictive value of relying on a no-action letter obtained by another is seriously weakened by the power of the Commission or its staff to reconsider the position it took in the earlier no-action letter.² In any case, there is a somewhat lengthy list of items the staff refuses to offer an opinion on through the no-action letter process. Securities Act Release No. 6253 (Oct. 28, 1980). Among those areas so excluded is the availability of a statutory exemption from registration, whether novel real estate interests are a security, and hypothetical questions. See Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and Proposed Framework*, 83 Cornell L. Rev. 921 (1998) (examining the conditions when it is appropriate for courts to defer to SEC no-action letters).

The SEC's web site, www.sec.gov, also contains a good deal of guidance on regulatory issues. Found there are guides ("Compliance and Disclosure Interpretations") addressing commonly asked questions as well as recent speeches of commissioners and agency personnel, enforcement releases, and other helpful publications.

Further guidance through the uncharted waters of the securities laws and regulatory discretion occurs informally by individual commissioners, division and office heads, and their assistants expressing their views and describing prevailing practices within the SEC in their speeches and during participation in securities programs. This medium also nurtures a professional bond between the regulators and the securities bar.

g. The SEC: Some Critical Perspectives

The SEC has long held a reputation for quality and vigor that sets it apart from many of its regulatory peers. This reputation is of considerable importance: It aids in the recruitment of new personnel and serves as a form of psychic compensation

2. SEC no-action letters are not judicially reviewable because they are not *orders* of the Commission. *Board of Trade of the City of Chicago v. SEC*, 883 F.2d 525 (7th Cir. 1989).

to the staff to help offset some of the financial sacrifices of government service. It also gives to the Commission a considerable level of public support from which to draw when it takes action.

The Commission is not without its critics, however. Much of the criticism comes from the perspective of economic theory and charges that the SEC has substantially over-regulated areas such as disclosure policy, with excessive and paternalistic focus on “investor protection” to the exclusion of equally compelling notions of cost justification and allocative efficiency. To state this concern, however, does not help explain *why* it is that the Commission might behave in a way that, in substance, seems short of optimal.

One explanation that has achieved a good deal of currency draws from the body of literature of public choice theory, as articulated by such notable economists as George Stigler and Sam Peltzman. Public choice theory posits that far from seeking some independent conception of the “public good,” regulators rationally seek simply to maximize their own level of political support and thus frequently allocate wealth (in the form of regulatory subsidies and/or restraints on competition) to those groups that offer the most in terms of such support. Often, this means regulation that actually favors some segment of the industry that the agency is supposed to control (sometimes referred to as the “capture” hypothesis), since that special interest is likely to be the best organized and most effective “rent-seeker.” Here we may ask whether securities lawyers and financial accountants, among others, who earn their livelihood through providing the compliance efforts related to mandatory disclosure requirements have a significant stake in the status quo. For a public choice perspective on the SEC, *see* Coates, Private vs. Political Choice of Securities Regulation: A Political Cost Benefit Analysis, 41 Va. J. Int’l L. 531 (2001); Macey, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty, 15 Cardozo L. Rev. 909 (1994).

There has long been concern with regulatory agencies regarding the “revolving door” whereby civil servants migrate from the regulator to the regulated. There indeed is a good deal of movement of staff of the SEC to the private sector, no doubt reflecting the valuable experience garnered by working with the Commission. But does it reflect more? Studies of SEC enforcement personnel who thereafter are retained by law firms reflect that the individuals moving to the private sector during their tenure at the SEC were associated with successful, even aggressive, enforcement efforts that involved more complex matters. *See* de Haan, Kedia, Koh & Rajgopa, The Revolving Door and the SEC’s Enforcement Outcomes: Initial Evidence of Civil Litigation, 60 Acct. & Econ. 65 (2015); Choi, Gulati & Pritchard, Should I Stay or Should I Go?: The Gender Gap for Securities and Exchange Attorneys, 62 J.L. & Econ. 427 (2019). A very different dimension of the revolving door is examined in Cox & Thomas, Revolving Elites: The Unexplored Risk of Capturing the SEC, 107 Geo. L.J. 845 (2019), reporting that during the first 50 plus years of its existence SEC division heads were selected from the existing SEC staff; however, beginning in the mid-1990s, the prevalent practice shifted so that division heads were recruited from outside the agency, generally from law firms who represent clients before the Commission. Thus, over the past 20 years nearly three-fourths of all directors came from outside the SEC. What might be the regulatory benefits sought by wooing outsiders to become SEC division heads?

Separate from the industry capture concerns expressed above are complaints of the SEC's disinclination to adopt or endorse bright-line rules, notwithstanding the value of such an approach in promoting, planning, and reducing the incidence of litigation. Inevitably claiming that such an approach provides a "blueprint for fraud," the Commission jealously seems to preserve the largest degree of discretion to sanction conduct that it determines, after the fact, to have been improper. One sees this in the Commission's preference for making policy through no-action letters or enforcement, rather than through rulemaking, and in its cautious approach to the development of safe-harbor rules in areas of considerable statutory ambiguity (such as the non-public offering exemption under the '33 Act). *See* R. Karmel, *Regulation by Prosecution* (1981). A further concern is that the agency tends to be "siloed"—referring to complaints that there is not sufficient communication and collaboration among divisions.

A final source of criticism focuses on the dominance of lawyers in policymaking roles at the SEC. Indeed, an overwhelming number of SEC commissioners and high-level staff persons have been attorneys. It has frequently been said that regulators have a natural bias toward the presence (or enhancement) of complex regulation, rather than its absence (or reduction),³ a function of institutional and personal self-esteem as well as economic self-interest. In many ways, this same bias is held by lawyers generally and is hence reinforced when lawyers assume the function of regulators. For a more detailed analysis of these issues, *see* Langevoort, *The SEC as Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 Wash. U. L. Rev. 1591 (2006).

h. Judging SEC Rulemaking

The rulemaking authority the SEC enjoys under each of the securities laws is subject to the statutory mandate that "the Commission shall . . . consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."⁴ In 2011, the SEC's modest rule authorizing stockholders to nominate a limited number of directors was struck down for failure to satisfy what the D.C. Circuit said was required in meeting this review standard:

Here the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.

Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). This defeat for the SEC comes on the heels of similar reversals the SEC has faced when its actions were

3. A. Downs, *Inside Bureaucracy* (1967), referred to this as the "Law of Increasing Conservatism."

4. Each of the four major securities laws administered by the SEC now contains the same review standard. Securities Act of 1933 §2(b), 15 U.S.C. §77b(b); Securities Exchange Act of 1934 §3(f), 15 U.S.C. §78c(f); Investment Company Act of 1940 §2(c), 15 U.S.C. §80a(c); and Investment Advisers Act of 1940 §202(c), 15 U.S.C. §80b-2(c).

challenged for their failure to consider a rule's impact on "efficiency, competition and capital formation." See *American Equity Investment Life Insurance Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005). While neither the express statutory language nor the legislative history calls for rigorous cost-benefit analysis, until the Supreme Court speaks, SEC rulemaking proceeds with a healthy respect that there is now ample precedent before the court where challenges to its rules most likely will occur. See Cox & Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 Tex. L. Rev. 1811 (2012). The SEC has therefore entered a most uncertain area in its history.

In *Business Roundtable's* wake, the SEC has provided guidance to the staff calling for future rulemaking to include the following four elements: (1) a statement of the need for proposed action; (2) a definition of a baseline against which to measure the likelihood of economic consequences of the proposed regulation; (3) the identification of alternative approaches; and (4) an evaluation of the benefits and costs, both quantitative and qualitative, of the proposed action and the main alternatives identified in the analysis. SEC, *Current Guidance on Economic Analysis in SEC Rulemaking* (Mar. 16, 2012). In an important article, Professor John Coates characterizes cost-benefit analysis in the context of financial regulation as "guesstimating" due to the degree of complexity and interconnectedness of financial regulation being deeply integrated so that the result depends on casual inferences, problematic data, and contestable assumptions. Coates, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 Yale L.J. 882 (2015); Coates & Srinivasan, *SOX after Ten Years: A Multidisciplinary Review*, 28 Acct. Horizon 627 (2014) (illustrating why it is easier to identify and measure the *direct* cost of a regulatory initiative than the measure's benefits and *indirect* costs).

In an earlier era, the SEC did not face the level of scrutiny in adopting rules that it faces today. Hence, as you progress through the course material and study specific rules consider the difficulty the SEC would have confronted if, when it adopted the rule, it was compelled to estimate the rule's likely compliance costs and expected benefits. Query, might this force the SEC to regulate via enforcement, since enforcement actions are not subject to the before mentioned review standard?

2. *Blue Sky Laws*

Sharp promoters and questionable investment opportunities have been a fixture of markets throughout their existence. State regulation of securities and their promoters began in the nineteenth century with requirements for registration of securities offerings by public utilities and companies engaged in the exploration and extraction of minerals, each being a fertile area of abusive practices. Kansas in 1911 enacted the first comprehensive system of registering securities brokers and offerings of securities of all types of enterprises. Similar reforms soon swept across America as part of the legislative agenda of the populist movement. At the time of the Great Crash, nearly all states embraced some form of regulation of brokers and securities. These laws reflected the prevalent view that hardworking common

men and women were frequently the victims of not just confidence men, but also slick investment bankers from Wall Street. *See generally* M.E. Parrish, Securities Regulation and the New Deal 5-20 (1970). A recent reexamination of the history of the causes leading to the states' enactment of their securities laws found they were driven by the interests of "state banking regulators, interested in protecting and expanding their regulatory turf and in advancing the financial interests of banks under their supervision . . . [as well as] farmers and small business owners who saw the suppression of securities sales as a useful means for increasing their own access to bank credit." Macey & Miller, Origin of the Blue Sky Laws, 70 Tex. L. Rev. 347, 351 (1991). *See also* Mahoney, The Origins of the Blue Sky Laws: A Test of Competing Hypotheses, 46 J.L. & Econ. 229 (2003) (concluding that the impact of blue sky laws adopted by states in 1911-1930 was to increase the profits of small banks).

State securities laws are generally referred to as *blue sky laws*, an expression rooted in their initial objective of curbing promoters who would sell interests having no more substance than "so many feet of blue sky." *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917) (upholding the constitutionality of blue sky laws under the Fourteenth Amendment and finding no burden on interstate commerce). The original author of the Kansas legislation explained that the term referred to rainmakers who promised rain but produced nothing but blue sky. *See* Fleming, 100 Years of Securities Laws: Examining a Foundation Laid in the Kansas Blue Sky, 50 Washburn L.J. 583 (2011).

As is discussed in Chapter 4, an important difference between the federal and the state approaches to securities regulations is that the former is exclusively disclosure oriented, whereas many state jurisdictions include within their blue sky laws a so-called merit regulation standard whereby qualification depends on convincing the state blue sky administrator of the substantive merits of the offering. Most state laws embrace some form of merit review. *See* SEC Report on the Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not "Covered Securities," 8 (1997).

The lack of uniformity among the states is a problem, if not a nightmare, for the attorney "blue skying" an offering that will be made in several states. The Uniform Securities Act was promulgated by the National Conference of Commissioners on Uniform State Law in 1956. The current version of the Act was adopted in 2002 (with some revisions in 2005). *See* Seligman, The New Uniform Securities Act, 81 Wash. U. L. Rev. 244 (2003). Most states have some version of the Uniform Securities Act. But there are two important caveats: Two notable non-adopting states are New York and California and in crafting their own blue sky laws, individual states vary widely in their deviations from the Uniform Securities Act.

The North American Securities Administrators Association (NASAA), a group composed of blue sky law administrators, has worked diligently to coordinate the approach and interpretations followed in each of the states. Nonetheless, the lack of uniformity remains a constant concern. A further blow to uniformity is that the budgets of blue sky regulators vary widely from state to state, with the individual state's population only partially explaining the different levels of funding and more of the resulting variance being accounted for by the importance a state's legislature places on the regulation of securities transactions. Some relief for the attorney facing multiple states in which an offering will occur is the 1996 enactment of the