SECURITIES REGULATION
AND BANKRUPTCY
Definition of Security

- A security is *any transaction* in which the buyer (1) invests money in a business and (2) expects to earn a profit primarily via efforts of others.
- Not just “stocks & bonds”, but any share in a business.
In *SEC v. W. J. Howey Co.*, the court held that sales of plots in an orange grove plus a management contract were sales of securities because the investment contract was *an investment of money in a common enterprise with an expectation of profits solely from the efforts of others*. Known as the Howey test.
Common Enterprise Element

- All courts permit horizontal commonality to satisfy the common enterprise requirement
  - Investors’ funds must be pooled and profits of the enterprise must be shared pro rata by investors
- Some courts accept vertical commonality
  - Investors are similarly affected by efforts of person promoting the investment
The SEC

- **Federal law** regulates most securities
  - Securities and Exchange Commission (SEC; created under 1934 Act) is the regulatory agency that oversees the securities industry, with power to create and enforce law

- States also enact securities law
  - Aka “blue sky laws”
The 1933 Securities Act

- 1933 Securities Act requires that before offering or selling securities, the issuer must register the securities with the SEC unless exempt from requirement.
- Issuer files registration statement.
Filing With The SEC

- Most people make filings with SEC through EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system
- Once filed, the info is available on-line

www.sec.gov/edgar.shtml
1933 Act -- Public Offerings

- A company’s first public sale of securities is an *Initial Public Offering* (IPO); goal is to raise $\$

**Offering Process:**
- underwriting (agency agreement)
- registration statement
- prospectus (basic info, required disclosures)
- sales effort (includes “road show” closely regulated by SEC)
- going effective (begin selling stock)
Prospectus

- The *prospectus* is the sales document of an offering registered under the 1933 Act
- Most of the information in the registration statement must be in the prospectus
- A prospectus allows a potential investor to base an investment decision on all relevant data about the issuing company, not simply favorable information
Three important periods of time in the life of a securities offering:

1. Prefiling period
   - Issuer and any other person may not offer to sell or sell the securities to be registered
   - Marks start of the *quiet period*
     - continues until effective date
   - Must avoid publicity
Securities Offering Timeline

2. **Waiting period**

- Waiting period is the time between filing date and effective date of the registration statement
- Securities may be offered in accordance with certain limits, but may not be sold
- *Preliminary prospectus* used that omits price
- *Tombstone ad* permitted; must state “not an offer”
- Issuers typically send CEOs and other top officers on a *road show* to talk to securities analysts and institutional investors
3. **Posteffective period**

- After *effective date* (date on which SEC declares registration effective) and once buyer has a *final prospectus*, Sec. 5 permits the security to be offered and sold.
- Internet may be used during posteffective period.
1933 Act -- Exempt Securities

- Exempt securities include:
  - Government securities
  - Bank securities
  - Short-term notes (due within 9 mo.)
  - Non-profit issues
  - Insurance policies and annuity contracts
- Exempt securities are always exempt

Oil trading at NY Mercantile
1933 Act -- Exempt Transactions

- Exempt transactions, under Sec. 4(2) of 1933 Act. are those transactions by an issuer not involving a public offering (i.e., private offering) – three types
  - Rule 147 (intrastate): securities that are offered and sold only to residents of the state in which the issuer is incorporated and does business (safe harbor)
1933 Act -- Exempt Transactions

- **Rule 506, Regulation D**: Private offering to less than 35 unaccredited purchasers with sufficient investment knowledge and an unlimited accredited investor-purchasers

- **Accredited investors**: Institutional investors (banks, mutual funds), wealthy investors, and high-level insiders of issuer (exec. officers, directors, partners)

- General selling efforts prohibited
1933 Act -- Exempt Transactions

- **Rule 504, Regulation D: Small offering** -- nonpublic issuer may sell up to $1 million of securities in a 12-month period to any purchaser
  - General selling efforts permitted

- **Rule 505, Regulation D: Small offering** -- any issuer may sell up to $5 million of securities in a 12-month period to less than 35 unaccredited investors (unlimited accredited investors)
  - General selling efforts prohibited
1933 Act -- Exempt Transactions

- *Regulation A*: Nonpublic issuer may sell up to $5 million of securities in one year period
  - No limit on number of purchasers, no purchaser sophistication requirement, and no purchaser resale restriction
  - Disclosure document is the offering circular, which must be filed with the SEC

Even [nonprofit organizations](https://www.npo.org) offer investments
1933 Act -- Liability

- Seller of unregistered and non-exempt security is liable under 12(a)(1) of the 1933 Act
- Seller liable under 11 for material misstatement or omission in final registration statement
- *Due diligence* is the key to limiting liability
1933 Act -- Liability

- Seller of a security may also be liable for fraud (12(a)(2)) or a crime (24)

- Issuer must register with SEC if (a) a public offering, (b) securities traded on national exchange, or (c) at least 500 shareholders and assets > $10 million
- Requires ongoing, regular disclosures for firms with publicly traded securities
Periodic Reporting

- Issuers that also register securities under the 1934 Act must file several periodic reports:
  - Annual report (Form 10-K), quarterly report (Form 10-Q), and a monthly report (Form 8-K) when material events occur
  - Comparable reports must be sent to shareholders
- Issuers who must disclose under 1934 Act due to registered offering under 1933 Act must file same reports, but need not provide annual report to shareholders
The Reports

- **10-K annual report** includes:
  - Audited financial statements; current information about the conduct of business, management, and status of securities; management’s description and analysis of issuer’s financial condition (MDA section);
  - Names of directors and officers with compensation

- **10-Q quarterly report** requires a summarized, unaudited operating statement and unaudited figures on capitalization and shareholders’ equity
Anyone who willfully, knowingly, or recklessly makes a false or misleading statement (including omission of material fact) in a filing under 1934 Act is liable to buyers or sellers who relied upon such statements and can prove price was affected by false filing.
SEC Consent Orders

- Most SEC actions are resolved through *consent orders* rather than litigation
- Defendant promises not to violate securities laws in the future but does not admit to having violated them in the past
- SEC has power to impose civil penalties (fines) up to $500,000 and issue *cease and desist orders*
A person may contact the SEC in advance, propose a transaction or course of action, and ask the SEC to issue a no-action letter.

In a no-action letter, the SEC’s staff states it will take no legal action against the issuer or other person if the issuer or other person acts as indicated in the no-action letter.
Insider Trading

- Insider trading refers to a person who is a fiduciary (anyone who works for a company) uses confidential or “insider” information to profit from a securities transaction.

Frist & DeLay (left) accused of insider trading

US Attorney Garcia announces wide-scale insider trading arrests 4-11-06
Insider Trading

- Includes “tippers” (those who pass on confidential info even if they don’t trade themselves) & “tippees” (those who receive info)
- Misappropriation is the theory used for suit against the “insider”
- Example: SEC v. King Chuen Tang, et al.
Dirks v SEC

Facts:
- Dirks obtained nonpublic information from a former officer of Equity Funding (EF) and investigated.
- Finding evidence of wrongdoing, Dirks told clients, who sold their EF securities.
- EF share price dropped dramatically and Dirks voluntarily presented information to SEC, which then brought action against EF.
- SEC brought action against Dirks for a Rule 10b-5 violation, but censured him since he played a role in bringing the fraud to light; Dirks appealed.
**Dirks v SEC**

- **Supreme Court Reasoning & Holding:**
  - No duty to disclose if person trading on inside information was not firm’s agent or fiduciary.
  - Unless insider-tippers breached their duty to shareholders by disclosing the information to Dirks, he breached no duty when he passed the information along.
  - Tippers, motivated by a desire to expose fraud, did not breach their duty to shareholders, thus no derivative breach by Dirks.
  - Reversed in favor of Dirks.
Test Your Knowledge

- True = A, False = B
  - The SEC only has executive power to enforce congressional statutes.
  - Most SEC actions are resolved through consent orders rather than litigation.
  - The 1933 Act regulates the sale of securities while they pass from the hands of the issuer into hands of public investors.
  - Registration requires underwriting by corporate insiders and financial controllers.
Test Your Knowledge

- **True** = A, **False** = B
  - The Howey test is used to determine whether an investment contract is a security.
  - The registration statement is the sales document of an offering registered under the 1933 Act.
  - All securities are exempt from registration unless specifically required to be registered by statute.
  - Rule 506, Regulation D exempts a private offering to less than 35 unaccredited purchasers from registration requirements.
Test Your Knowledge

- **Multiple Choice**
  - The important time periods in the life of a securities offering are:
    - (a) The prefiling period
    - (b) The waiting period
    - (c) The posteffective period
    - (d) All of the above
    - (e) None of the above
Test Your Knowledge

- True=A, False = B
  - The 1934 Act requires periodic disclosure of material information by issuers with publicly held equity securities.
  - Periodic reports include the Form 10-K, the Form 10-Q, and Form 8-K.
  - Rule 10b-5 defines an insider as anyone with confidential corporate information for a corporate purpose.
Bankruptcy

Lehman Brothers
Applicable Law

- Article I, Section 8 of the U.S. Constitution. Federal jurisdiction
- Bankruptcy Reform Act of 1978, amended by Reform Act of 1994
Types of Bankruptcy Relief

- Bankruptcy code has 8 chapters
- 1, 3, 5 - general definitional provisions and provisions covering administration, creditors, debtor and estate
- Chapter 7 - liquidation proceedings
- Chapter 9 - adjustment of debts of a municipality
Types of Bankruptcy Relief

- Chapter 11 – reorganizations
- Chapter 12 - adjustment of debts of family farmers with regular incomes
- Chapter 13 - adjustment of debts of individuals with regular incomes
Bankruptcy -- Bottom Line

- If you operate Successfully and Ethically, bankruptcy *probably* will not be necessary.
- IF you think you need to consider bankruptcy, HIRE AN ATTORNEY WHO SPECIALIZES IN BANKRUPTCY & FOLLOW YOUR ATTORNEY’S ADVICE!
The End