INTRODUCTION TO FINANCE AND THE LAW

FMB558 Finance and the Law Syllabus 2014 Fall Semester

- **Professor: Robert J. Schairer**
- **Time: 14:30~15:50 Tuesday & Thursday (Week 9-16)**
- **Lecture Room :**

REQUIRED & SUGGESTED READING

- **Text Book: Managers and the Legal Environment 6th Edition, - Bagley & Savage**
  Individual chapters in e-book format can be purchase at: http://www.cengage.com
- **Suggested Reading:**
  Korean Business Law; The Legal Landscape and Beyond, Edited by Jasper Kim, Carolina Academic Press, Durham, North Carolina, 2010
  Korean Business Law, Edited by Hwa-Jin Kim, Edward Elgar Publishing Limited, Cheltenham, UK, Northhapton, MA, 2012
  Introduction to Korean Law, Edited by Korea Legislation Research Institute, Springer, Heidelberg, New York, Dordecht, London, 2013
  FINANCIAL INVESTMENT SERVICES AND CAPITAL MARKETS ACT
  [Enforcement Date 09. Dec, 2010] [Act No.10361, 08. Jun, 2010, Other Laws and Regulations Amended]
  자본시장과 금융투자업에 관한 법률
  [시행 2013.1.1] [법률 제9408호, 2009.2.3, 일부개정]

LECTURE SCHEDULE

- **Week 1: Introduction to Finance and the Law**
  - **A.** Required Reading:
    1. Managers and the Legal Environment ; Chapter 22: Public and Private Offerings of Securities
    2. Managers and the Legal Environment; Chapter 3: Courts, Sources of Law and Dispute Resolution, pages 59-74
    3. Managers and the Legal Environment; Chapter 6 Administrative Law
  - B. Suggested Reading:
    1. Korean Business Law: The Legal Landscape and Beyond; Chapter 1: "A Brief History of Post-1997 South Korea" by Jasper Kim pages 3-16
    2. Introduction to Korean Law; Chapter 1: "Overview" by Kipyo Kim

Week 2: Regulation of Public Offerings

- **A.** Required Reading:
  1. Managers and the Legal Environment ; Chapter 22: Public and Private Offerings of Securities
- B. Suggested Reading:
  1. Korean Business Law: The Legal Landscape and Beyond; Chapter 8: "Securities Laws for Korean Issuers: Accessing the International Capital Markets" by Youngjin Sohn and Kristina H. Kang pages 139-149
  2. Form S-1 REGISTRATION STATEMENT *Under The Securities Act of 1933* Facebook, Inc.

Week 3: Regulation of Private Placements and Venture Capital/Private Equity Financing

- **A.** Required Reading:
  1. Managers and the Legal Environment ; Chapter 22: Public and Private Offerings of Securities
- B. Suggested Reading:
  1. Korean Business Law: The Legal Landscape and Beyond; Chapter 8: "Securities Laws for Korean Issuers: Accessing the International Capital Markets" by Youngjin Sohn and Kristina H. Kang pages 154-158
  2. Korean Business Law; "Private equity in Korea: history, industry and policy" by Hwa-Jin Kim and Alice Z. Chen, pages 199-217
  3. Selections from a sample Private Placement Memorandum & Agreements

Week 4: Regulation of Publicly-Held Companies and the 1934 Act

- **A.** Required Reading:
  1. Managers and the Legal Environment ; Chapter 23: Securities Fraud and Insider Trading
- B. Suggested Reading:
  1. Korean Business Law: The Legal Landscape and Beyond; Chapter 8: "Securities Laws for Korean Issuers: Accessing the International Capital Markets" by Youngjin Sohn and Kristina H. Kang pages 149-154
  2. Korean Business Law; Chapter 11: "The Market for corporate control in Korea" by Hwa-Jin Kim, pages 218-236
  3. Korean Business Law; Chapter 12: "Issuance of new shares as a takeover defense and countermeasures" by Sang Gon Kim, 259-280

LECTURE SCHEDULE continued

- **Week 5: In-Class Group Presentations**
- **Week 6: Antifraud Provisions & Sanctions for Violations and Civil Liabilities**

A. Required Reading:

1. Managers and the Legal Environment ; Chapter 23: Securities Fraud and Insider Trading

B. Suggested Reading:

1. Korean Business Law: The Legal Landscape and Beyond; Chapter 8: "Securities Laws for Korean Issuers: Accessing the International Capital Markets" by Youngjin Sohn and Kristina H. Kang pages 160-168

2. 2012 Insider Trading Annual Review by Morrison/Foerster

Week 7: Regulation of Debt Financing

A. Required Reading:

1. Managers and the Legal Environment ; Chapter 24: Debtor-Creditor Relations and Bankruptcy**,** pages 935-950

B. Suggested Reading:

1. Sample Commercial Loan Documents

Week 8: Review and Final Exam

EVALUATION

- Attendance: 25%
- Presentation: 25%
- Final Exam: 50%

THIS IS KOREA, WHY ARE WE STUDYING U.S. SECURITIES AND FINANCIAL LAWS?

KOREAN BUSINESS & FINANCE LAW AND U.S. BUSINESS LAW

- U.S. business law is based upon common law that originated in Great Britain and is governed for the most part by state law.
- U.S. Securities Law is based in large part of Federal Statutes, Federal Agencies rule making authority and case law.
- Korean business and financial law is based upon civil law which it inherited from Japan which was based upon German corporate law.
- Since 1997 Korean corporate financial law has increasingly been influenced by the law of the United States.

KOREAN BUSINESS & FINANCE LAW AND U.S. BUSINESS LAW Continued

- "… Korea's system of corporate governance and financial markets is undergoing significant changes, strongly influenced by that of the United States. Korea could be a test case for the convergence thesis and also may be a good starting point for studying whether civil and common law systems can converge with each other through a globalizing market." Hwa-Ja Kim and Sung-Joon Park "Directors' duties and liabilities in Korean companies" Korean Business Law edited by Hwa-Jin Kim, 2012.

TRADITIONAL KOREAN LAW

- The Great Code for Governing the Country (Gyeong-guk-dae-jeon) in 1484 codified existing codes and was the fundamental framework of the legal system for the Joseon Dynasty and was influenced by “The Code of Great Ming” of the Ming Dynasty of China. (See Introduction to Korean Law)
- Modern legal system began to be formed with the Reforms for Modernization in 1894.
- Japanese colonization.

EVOLUTION OF KOREAN CORPORATE & FINANCE LAW

- Until 1962, Korea used Japanese corporate law which was a chapter of the Japanese Commercial Code that was enacted in 1899 and was based upon German corporate law and was completely revised in 1950 based upon the U.S. Illinois Business Corporation Act of 1933.
- 1962 Korea enacted Korean corporate law as a chapter of the Korean Commercial Code (KCC) (상법) which has been highly influenced by Continental European statutes, cases and scholarly works.
- KCC has been revised in 1984, 1995, 1998, 1999, 2001, 2009, 2011 which went into effect in April 2012.

EVOLUTION OF KOREAN CORPORATE & FINANCE LAW CONTINUED

- An additional important source of Korean corporate law was the Korean Securities and Exchange Act (KSEA) enacted in 1962.
- KSEA was repealed on Feb. 4, 2009 and partially replaced by the KCC and the Korean Financial Investment Services and Capital Markets Act (KCMA)
- Korean Civil Code also has rules and regulations applicable to partnership-type business entities.
- Code of Best Practice for Corporate Governance adopted by the Korean Committee on Corporate Governance in 1999 and revised in early 2003. (an informal guideline)

KOREAN COMMERCIAL ACT

- Article 1 (Applicable Rules to Commercial Matters)
  Where this Act does not provide for a particular commercial matter, commercial customary law shall apply; and if no such law exists, the Civil Act shall apply.

KOREAN POST 1997 REFORMS

- Following the 1997 Asian financial crisis, the Korean government has enacted reforms in order to:
  1) increase market transparency to meet global standards
  2) increase liberalization and deregulation
  3) increase generally the globalization of the Korean economy

FINANCIAL INVESTMENT SERVICES AND CAPITAL MARKETS ACT
자본시장과 금융투자업에 관한 법률

- Promulgated on August 3, 2007 and came into effect on February 4, 2009.
- Goal is to improve the legal framework of the capital markets and improve the competitiveness of financial investment companies by integrating several separate acts that had previously regulated the Korean capital markets including:
  a) The Securities Exchange Act
  b) The Futures Exchange Act
  c) the Indirect Asset Management Business Act
  d) the Trust Business Act
  e) the Merchant Bank Act

SUMMARY OF KOREAN LEGAL SYSTEM

- "Korean legal system was deeply influenced by the tradition of continental law, thus resembling the modern European civil law or Japanese legal system at the beginning of its modernization. However, with the growing interchange and influence of other countries, especially of the U.S., various laws and regulations were made or revised modelling the Anglo-American laws. In addition, many Korean customary laws or legal tradition were reflected and codified in the Civil Law of Korea. In this regard, Korean modern legal system absorbed and modified the necessary features of the European civil law system, Anglo-American law system and Korean customary laws altogether." (Introduction to Korean Law)

SOME IMPORTANT LEGAL TERMINOLOGY

COMMON LAW VS. CIVIL LAW

- **Civil Law**: Based mainly upon the written codes of Justinian and Napoleon. Attempts to create a system of legal rules in one comprehensive legislative enactment. Judicial decisions, or case law, are not a source of law but can be referred to when deciding cases. It is the basis of the legal system used in France, Spain, Germany, and other parts of Europe that were part of the Roman Empire or were colonized by European nations.

COMMON LAW

- **Common Law**: An accumulation of judicial decisions, also known as case law, that reflect the “ancient collection of unwritten maxims and customs” that developed in England. England, the United States, Canada, Australia, New Zealand, to some extent India and some other Asian, African and Caribbean countries that were colonized by Great Britain follow common law.

STARE DECISIS

- **Stare Decisis**: Courts follow their own precedents. Binds lower courts to determinations of the highest court in that jurisdiction. However, the highest court can amend it's own decision or it can be amended by the legislature.

COMMON LAW AND LEGISLATIVE STATUTES

- Unless prohibited by a constitution, legislatures may enact statutes that modify or supplement common law. These statutes are collected into codes. The codes along with case law create the law applied by the courts. These are also sometimes supplemented by administrative regulations and judicial interpretation.

EQUITY AND COMMON LAW

EQUITY: A parallel system that developed along side common law that gave ultimate judicial responsibility to the King. The equity system had exclusive jurisdiction over injunctive relief and specific performance of contracts and certain contract modifications. King's decisions were not based upon common law but on a sense of fairness. Gradually the common law system and the equity systems merged.

SUBSTANTIVE LAW

- **SUBSTANTIVE LAW** is a “body of law creating, defining, and regulating rights and obligations within the framework of a single subject, such as contracts, torts, crimes, or property.” (Barron’s Business Law)

PROCEDURAL LAW

- "**Procedural law** pertains to operating rules for obtaining substantive rights or defining substantive obligations in a court of law." (Barron's Business Law)

ATTORNEY'S ROLES

- Understand general legal principles, find particular cases, statutes and law applicable to a particular set of facts.
- Investigate, draft, negotiate, advise, and advocate.
- Attorney/Client Privilege: Maintain client confidences.

THE BUSINESSPERSON'S ROLE

- "The businessperson, armed with some knowledge of the legal system, the role of lawyers, and the substantive and procedural law, can play an active role in the lawyer's endeavors to resolve problems and/or prepare cases for litigation… Knowledge of the law should help him/her to realize when the services of a lawyer are necessary, and what assistance the attorney and client can provide on another." (Barron's Business Law)

GENERAL SOURCES OF LAW

- The U.S. Constitution
- Federal statutes, executive orders and treaties
- 50 state constitutions
- State statutes and executive orders
- Local ordinances
- Rules and regulations of federal, state, and local agencies
- Decisions by federal and state courts
- Private laws and customs such as contracts, leases, company rules, and standard business practices.

SOURCES OF FINANCE LAW

- Uniform Commercial Code Article 3: Negotiable Instruments
- Uniform Commercial Code Article 4: Bank Deposits and Collections
- Uniform Commercial Code Article 9: Secured Transactions
- Securities Act of 1933 (1933 Act)
- Securities Exchange Act of 1934 (1934 Act)
- Trust Indenture Act of 1939 (TIA)
- Investment Company Act of 1940 (IAA)
- Investment Advisers Act of 1940 (IAA)
- Securities Investor Protection Act of 1970 (SIPA)
- Sarbanes-Oxley Act of 2002 (SOX)
- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)
- Federal and State Banking Laws

WHAT WE WILL COVER IN THIS CLASS

- Securities Act of 1933 (1933 Act)
- Securities Exchange Act of 1934 (1934 Act)
- Trust Indenture Act of 1939 (TIA) (to a small extent)
- Investment Company Act of 1940 (IAA) (to a small extent)
- Investment Advisers Act of 1940 (IAA) (to a small extent)
- Securities Investor Protection Act of 1970 (SIPA)
- Sarbanes-Oxley Act of 2002 (SOX)
- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)
- UCC Article 9 (to a small extent)

LEGAL ANALYSIS -- IRAC

- **I**ssue: A statement of the issue or question to be decided.
- **R**ule: A statement of the General Rule, Sub Rules and Exceptions to the Rules.
- **A**nalysis: Applying the rules to the facts of the case.
- **C**onclusion: Based upon a statement providing an answer to the issue raised.

CORPORATE FINANCIAL STRUCTURE

SOURCES OF FUNDS

- *Debt*: Issuance or sale of debt
- *Equity*: Issuance of equity securities
- *Retained Earnings:* Earnings and profits not distributed to the shareholders as dividends but are reinvested into the corporation.

DEBT

- *Short Term*: Issuance of promissory notes or other commercial paper that is governed by negotiable instruments law.
- *Debt Securities*:
  a) Promissory Notes subject to the Uniform Commercial Code
  b) Bonds: a written promise to pay a certain sum of money at a fixed maturity date, at a certain interest rate.

BONDS

- *Debentures*: unsecured bonds
- *Secured Bonds*: bonds with personal or real property as collateral
- *Callable Bond*: One that the corporation can pay off early.
- *Convertible Bond*: A bond that the holder can convert, at its option, into other securities of the corporation such as common or preferred stock.
- *Indenture*: The contract that states the terms under which debt securities are issued.

EQUITY SECURITIES

- *Common Shares*: Owners of common shares participate in the management of the corporation.
- *Preferred Shares*: Owners of Preferred Shares are preferred to common shareholders in certain respects.

COMMON SHARES

- Common shareholders possess three interests in the corporation:
  1. can vote for directors and other fundamental matters.
  2. can participate in the distribution of dividends.
  3. can participate in the distribution of net assets after dissolution and liquidation.

PREFERRED SHARES

- Preferred to common shares:
  1. *Dividends*: If directors determine that dividends are to be paid, preferred shareholders receive a fixed dividend prior to any payment of dividend to the common shareholders.
     a) *noncumulative*: shareholders lose their right to dividends in any year in which dividends are not declared.
     b) *cumulative*: dividends accumulate during years in which not dividends are declared and are paid when dividends are declared.
  2. *Distribution upon liquidation*: After payment of debt, upon dissolution and liquidation, preferred shareholders receive the distribution of assets before common shareholders, provided that preference is stated in the articles of incorporation. Otherwise they participate on a pro rata basis with the common shareholders.
- *Participating Preferred Stock*: Owners of this have receive preference upon distribution of assets and then receive a pro rata share of the remaining assets together with the common shareholders.

OTHER CHARACTERISTICS OF PREFERRED SHARES

- *Redemption*: corporation is given the right to purchase or redeem the preferred shares, even if the owners object. The call price, or the price to be paid, is stated on the share certificate.
- *Conversion*: If provided for in the articles of incorporation, the corporation may, at its option, convert the shares into common shares or into another class of preferred shares. Shareholders may also hold these rights.
- *Voting Rights*: Depending upon state law, preferred shareholders generally do not have voting rights. However, the articles of incorporation may give them voting rights.

SHARE CLASSIFICATION

- *Authorized Shares*: shares that are issued in compliance with the number of shares the articles of incorporation allow the corporation to issue.
- *Issued Shares*: authorized shares that have actually been sold to shareholders.
- *Outstanding Shares*: Issued shares less shares that have been repurchased by the corporation.
- *Treasury Shares*: shares that have been repurchased by the corporation.
- *Canceled Shares*: shares that have been repurchased by the corporation and canceled. These shares no longer exist.
- *Stock Options*: Give the holder of the option the right to purchase stock at a particular time and a particular price. May be granted to employees, directors, and officers as incentive payments and to purchasers of other securities.

DIVIDENDS AND DISTRIBUTIONS

- *Dividend*: distribution of cash or stock or corporate assets.
- *Decision to Declare a Dividend*: Protected by the business judgment rule and once declared by the proper resolution of the board it becomes a legal debt of the corporation.
- *Stock Split*: an across-the-board distribution of shares to existing shareholders – does not change the total value of an individual shareholder's investment.

DIVIDEND RESTRICTIONS

- State Laws prevent the distribution of dividends if doing so will cause the corporation to be insolvent.
- Most states require dividends be paid from earned surplus.
- Sometimes loan agreements prohibit a corporation from paying dividends without prior approval of the creditors.
- Directors that vote for an illegal dividend are jointly and severally.

PAYMENT FOR SHARES

- May be paid for in cash, by check, by tangible or intangible property or by services already provided.
- Value of non-cash payments is up to the good-faith judgment of the directors.
- Some states do not allow future services or promissory notes, but the general trend has been to allow it as the Revised Modal Business Code does.

PAR AND NO-PAR SHARES

- *Par Share:* has a dollar amount written on the share certificate. The par value must be stated in the articles of incorporation is decided by the incorporators or the board. It does not necessarily equate to actual value.
- *No-par Shares:* Issued for payment of any amount that the board determines.
- *Capital Surplus:* the amount of payment received in excess of the par value or in excess of the value set by the board for no par value shares
- *Discounted Shares:* shares issued below the par value or stated value.

SHARE SUBSCRIPTIONS

- A promise to buy shares at a certain price.
- RMBCA states that “if the corporation is yet to be organized, a subscription is irrevocable for a period of 6 months unless the subscription agreement provides otherwise or unless all subscribers consent.”
- A share is a fractional interest in the ownership of the corporation.

BRIEF REVIEW OF AGENCY LAW

WHAT IS AGENCY LAW?

- **Agency**: A legal relationship in which one person is authorized to represent and act for another person.
- **Agent**: The person authorized to represent and act for another person.
- **Principal**: The person from whom the agent derives his authority and for whom the agent acts

Why is Agency Law Important?

- Without Agency Law every person would have to act for him or herself.
- Corporations can only act vicariously through its officers, employees and agents.
- Without Agency Law corporations could not operate and would cease to exist.
- Therefore understanding Agency Law is essential to understanding corporate and securities law.

FIDUCIARY DUTY OWED UNLESS MODIFIED BY CONTRACT

- Duty to obey instructions
- Duty to act with skill or care
- Duty of loyalty (avoid conflict of interest)
- Duty to protect confidential information
- Duty to notify
- Duty to account

DUTY TO ACT WITH SKILL OR CARE

- One standard: Agent must act with the degree of skill ordinarily expected from those undertaking such employment.
- Another standard: Use the same level of care a person would use when conducting his or her own affairs.
- Duty to avoid mistakes whether through negligence, recklessness, or intentional misconduct.
- For breach of contract, principal must prove:
  a) the proper standard of care of skill and
  b) failure of the agent's performance to meet that level of care or skill.

DUTY OF LOYALTY (Avoid Conflict of Interest)

- An agent acting for a principal cannot act for him/herself regarding the same matter
- An attorney cannot represent conflicting parties in a lawsuit or in a business transaction.
- Sometimes a conflict or possibility of a conflict can be resolved by full disclosure of all facts to the principal and their informed consent with realization of all consequences.

FIDUCIARY DUTIES

- Directors and Officers are agents of the corporation and owe fiduciary duties to the corporation.
- Sometimes a controlling shareholder owes a fiduciary duty to other shareholders.
- Two basic duties:
  a) duty of care: requires fiduciaries to make informed and reasonable decisions and to exercise reasonable supervision of the business.
  b) duty of loyalty: required fiduciaries to act in good faith and in the best interest of the corporation.
- This chapter examines the duty of care, the business judgment rule, duties of good faith and loyalty and concludes with the duties of directors and controlling shareholders.

DUTY OF CARE

- A director or officer of a corporation "must exercise that degree of skill, diligence and care that a reasonably prudent person would exercise in similar circumstances." Clark
- MBCA: "Each member of the board of directors, when discharging the duties of a director, shall act:
  (1) in good faith; and (2) in a manner the director reasonably believes to be in the best interests of the corporation."
- The standard of care is an objective standard (reasonable person in the director's position) as opposed to a subjective standard.
- However, if director has special skills that go beyond those of an ordinary director, he must utilize those special skills.
- Thus there can be no "accommodation" or "dummy" directors.

BUSINESS JUDGMENT RULE

- A court will generally not second-guess the actual business decisions made by a director or officer and not replace it with the court's own decision as long as those decisions are rational, made in good faith, and based on reasonable information.
- 3 requirements must be met:
  1) director or officer had no conflict of interest in the matter decided;
  2) director or officer made himself adequately informed about the facts relevant to the decisions;
  3) the decision of the director or officer was rational as of the time it was made.

BUSINESS JUDGMENT RULE NOT APPLIED WHEN

- Directors had a conflict of interest
- Directors failed to act in good faith
- Directors action had not rational purpose
- Directors decision was based upon grossly negligent processes or procedures

DUTY OF CARE AND BUSINESS JUDGMENT RULE COMBINED

- The combination of the Duty of Care with the Business Judgment Rule means that a court will look very carefully at the process by which an officer or director made a decision, but will not look very closely at the wisdom of that decision itself.
- Even when the procedures have been inadequate, most courts will only hold there is liability for gross negligence or recklessness.

RATIONALE FOR BUSINESS JUDGMENT RULE

- A certain amount of risk-taking is required for a business to develop and prosper and it is in the interest of the shareholders for directors to take rational risks.
- Directors and offices must constantly engage in risk/return judgments and courts are poor judges of business reality and not very good at making such decisions in hindsight.
- Shareholders can spread the risk of business decision mistakes by diversifying their portfolio, while directors can usually only serve on a small number of boards and thus cannot spread their risk as well.

FAILURE TO ACT AS DIRECTOR

- A Director may be liable when he fails to do what directors normally due such as:
  1) attend meetings
  2) learn anything of substance about the corporation's business
  3) fails to read reports, financial statement, etc. given to him by the corporation
  4) fails to obtain help from outside sources when he sees or should see signals that something is seriously wrong or
  5) fails to diligently go through the standard motions of behavior.

LIABILITIES FOR DAMAGES

- When a director or officer violates his duty of care to the corporation and this violation causes a loss to the corporation, the officer or director will be personally liable for money damages to the corporation.
- If the board has approved a transaction, but not yet carried it out, a shareholder or outsider can sue for an injunction to block the transaction.

DUTY OF GOOD FAITH

- "The plaintiff must make 'a strong showing of misconduct,' such as 'intentionally acting with a purpose other than that of advancing the best interests of the corporation,' acting 'with the intent to violate applicable positive law,' or 'intentionally failing to act in the face of a known duty to act.'"
- However, the Delaware courts have ruled that the obligation to act in good faith does not rise to the level of the duty of care and the duty of loyalty and that therefore by itself a violation of the duty of good faith does not seem to result in director liability.
- However, when directors "utterly fail to exercise oversight of the corporation" or "were conscious of the fact that they were not doing their job [as monitors]" they will be have breached the duty of loyalty.

DUTY OF LOYALTY

- Directors must act in good faith and place the interests of the corporation and the shareholders before their own interests.
- Courts will closely examine a transaction in which there is alleged self-dealing or self-interest.
- If found, traditionally such a transaction has been voidable and the interested actor may be required to pay damages to the corporation unless the director can show that the transaction was fair and reasonable to the corporation or unless the conflict was disclosed in advance.

KEY TO AVOIDING SELF-DEALING PROBLEM

- 1) Interested party must fully disclose the conflict and the nature of the transaction in advance and a majority of the disinterested directors or disinterested shareholders must pre-approve the transaction after receiving full disclosure.
- 2) The interested party can show that the transaction is basically fair to the corporation or the disinterested shareholders ratify the transaction after the fact after receiving full disclosure.

CORPORATE OPPORTUNITIES DOCTRINE

- Officers and directors must offer to the corporation an opportunity that is likely to be of interest to the corporation before he can take that opportunity for himself.
- Line of Business Test: "if an officer, director, or controlling shareholder learns of an opportunity in the course of his or her business for the corporation and the opportunity is in the corporation's line of business, a court will not permit the officer, director, or controlling shareholder to keep the opportunity for himself or herself.
- Other courts consider "whether (1) it would be fair for the fiduciary to keep the opportunity, (2) the corporation has an expectancy or interest growing out of an existing right in the opportunity, or (3) the interference by the fiduciary will hinder the corporation's purposes."

DUTY OF CANDOR

- Directors have a duty to disclose all material facts when requesting shareholder action.
- Delaware courts have gone even further stating that even when no shareholder action is sought, when directors disseminate information to shareholders they have a duty of care, loyalty and good faith.

INTRODUCTION TO SECURITIES MARKETS & REGULATION

OVERVIEW OF FEDERAL SECURITIES REGULATION

- Federal Securities Regulation was introduced as part of the New Deal in response to the collapse of the stock market from 1929 to 1933 and the following Great Depression.
- Prior to the New Deal regulation had primarily been done by Wall Street's self-regulation and by the states.
- However, the belief was that Wall Street's self-regulation was too weak and that there were gaps in state laws that needed to be filled.
- Nevertheless, the debate over the reasons for the financial collapse and how to prevent future failures continues to this day.

SECURITIES ACT OF 1933 DEFINITION OF SECURITY

- When used in this title, unless the context otherwise requires –

  The term “security” means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option or privilege on any security, certificate of deposit, or group index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

DEFINITION OF SECURITY UNDER THE SECURITIES EXCHANGE ACT OF 1934

- When used in this title, unless the context otherwise requires –

The term “security” means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option or privilege on any security, certificate of deposit, or group index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is like-wise limited.

WHAT IS THE PURPOSE OF SECURITIES LAW?

U.S. SUPREME COURT STATEMENT OF PURPOSE OF SECURITIES ACTS

"The fundamental purpose undergirding the Securities Acts is 'to eliminate serious abuses in a largely unregulated securities market.'" *REVES ET AL. V. ERNST & YOUNG,* 494 U.S. 56 (1990) quoting *United Housing Foundation, Inc. v. Forman,* 421, U.S. 837, 849 (1975)

SECURITIES ACT OF 1933

- **CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION**
  Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

SECURITIES EXCHANGE ACT OF 1934

- “For reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide regulation and control of such transactions and of practices related thereto, … in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:”

SECURITIES EXCHANGE ACT OF 1934

"4. National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit."

PURPOSE OF SECURITIES REGULATION

- To protect investors whether buying directly from the issuer, buying on the secondary market, voting their shares, or selling in a tender offer.
- Mostly a matter of Federal Law.
- Federal Regulation is based upon the idea that mandatory disclosure, liability for fraud, and regulation of securities intermediaries provides investors and their advisors with the information they need to evaluate risk and reward in their investments. This this results in capital flowing to its optimal use and this promotes a healthy economy.
- Federal Regulation is not based upon “merit regulation” and does not seek to evaluate whether or not a particular investment is a sound investment. The focus is disclosure.
- Federal power to regulate securities is based upon Congress’ power to regulate interstate commerce.

3 BELIEFS EMBODIED IN FEDERAL SECURITIES LAW

- Investors should be provided with all essential information.
- Prevent corporate insiders from taking advantage of nonpublic information for their own financial advantage.
- Even when not provided for by common law fraud, misled investors should receive adequate relief.

KOREAN FINANCIAL INVESTMENT SERVICES AND CAPITAL MARKETS ACT
자본시장과 금융투자업에 관한 법률

- Article 1 (Purposes) The purpose of this Act is to contribute to the development of the national economy by facilitating financial innovation and fair competition in the capital market, protecting investors, fostering the development of the financial investment business, and heightening the fairness, reliability, and efficiency of the capital market.
- 제1조(목적) 이 법은 자본시장에서의 금융혁신과 공정한 경쟁을 촉진하고 투자자를 보호하며 금융투자업을 건전하게 육성함으로써 자본시장의 공정성ㆍ신뢰성 및 효율성을 높여 국민경제의 발전에 이바지함을 목적으로 한다.

SECURITIES MARKETS AND PARTICIPANTS

THE SECURITIES MARKETS

- Markets: the facilities through which securities are traded.
- In dollar terms, the bond market – trading in debt instruments issued by the U.S. Gov., state and local governments, and corporations– is the largest securities market and this attracts participation primarily from professional and institutional investors.
- Federal, state, and local government obligations are exempt from most direct regulatory provisions of the federal securities laws.
- Thus the primary focus of securities regulation is on the markets for common stock.

PRIMARY & SECONDARY MARKETS

- *Primary Markets*: Sales of securities by issuers to raise capital for their business. These are issuer transactions.
- *Secondary Markets*: Buy-sale transactions among investors of securities that were already issued. These are trading transactions.

PRIMARY MARKETS

- *Issuers* raise capital by selling their securities in public markets or in negotiated private placements.
- *Private Placements* include:
  a) closely held company issues ownership interests to the founders of the company
  b) start-up issues preferred stock to venture capitalists
  c) public corporations issue trading-restricted securities, which is usually debt, but sometimes equity (PIPE) to institutional investors.
- *Public Offerings*: A primary distribution to the public when a company wants to raise funds from a wider pool of investors.
- *Initial Public Offerings (IPO*): raising capital from the public for the first time.
- In 2006 $3.9 trillion raised by selling equity and debt securities in U.S. primary markets:
  a) $3.3 trillion from public offerings
     -- $3.2 trillion from debt issues
     -- $188 billion from equity issues of which $46 billion was from IPOs
  b) $562 billion from private placements

SECONDARY MARKET

- Where already-issued securities are traded. This does not raise capital for the issuer.
- Investors get cash for their investments by selling to other investors in either privately negotiated transactions or in the public markets.
- Secondary markets provide liquidity to investors and this helps to promote primary markets.
- Trading on the secondary markets accounts for about 99% of all securities transactions.

PUBLIC MARKETS TO TRADE SECURITIES

- *Exchange Markets*: buy and sell orders arrive at a centralized location where specialists match buyers and sellers. It is a continuous auction. New York Stock Exchange (NYSE) is the largest one in the U.S.
- *Over-The-Counter (OTC) Markets*: buying and selling takes place between securities firms that have access to information on bidding and selling prices offered by other securities firm through computer terminals and price sheets. The most famous one in the U.S. is NASDAQ.
- *Electronic Communication Networks (ECNs):* computer-based trading systems that allow large institutional investors and securities firms to trade without additional intermediaries.
- In recent years the distinction between Exchange Markets and OTC Markets have been blurred by :
  a) the modern computer and communication technology; and
  b) stocks listed on the NYSE have been increasingly dominated by institutional investors and their use of ECNs.

FUNCTION OF SECURITIES MARKETS

- *Capital Formation*: Brings together investors, who have capital, with businesses that need capital.
- *Liquidity*: This is the ability to easily sell an investment instrument. Securities markets brings together investors who want to sell or liquidate their investment with investors seeking to buy.
- *Risk Management*: Allow investors to reduce risk by diversifying their portfolio and by purchasing derivatives to lock in gains and set floors on investment losses.
- *Information*: Reveals prices for specific companies and for the overall economy. This can provide a scorecard for management and valuation for tax and other purposes.

PARTICIPANTS IN SECURITIES MARKETS

- *Investors*: Individuals that own securities either directly or indirectly and institutional investors that own on behalf of others.
  a) about 50% of U.S. households own securities either directly or indirectly and these make up about 40% of their assets.
  b) institutional investors ownership share of equity securities markets has grown to about 75%.
- *Issuers*: This includes business organizations, federal government agencies, state and local governments, not-for-profit organizations and mutual funds.
  a) securitization: pooling together of many individual payment obligations such as mortgage payments. As a result even individuals have become indirect issuers.
- *Financial Intermediaries*: securities firms a/k/a broker-dealers that buy and sell securities for customers, investment advisors that provide information to investors, investment companies such as mutual funds that pool money, investment banks that advise and assist companies in issuing securities and raising capital and commercial banks that offer brokerage services through affiliates or act as agents for high-grade commercial paper placements to institutional investors.
- *Other Participants*: Accounting firms that audit financial statements in SEC filings, lawyers, and Credit Rating Agencies that assess the creditworthiness of companies.

U.S. REGULATORY FRAMEWORK

MARKETS

- *Public Securities Markets*: Subject to regulation by the Securities and Exchange Commission (SEC) that includes mandatory disclosure, heightened fraud standards, and regulation of market participants.
- *Private Securities Markets*: Subject to modified fraud standards, state regulation and specific federal exemptions.
- *Non-securities lending markets*: This is primarily bank lending and is subject to banking regulation and not securities regulation.
- *Derivatives Markets* (such as options and futures): regulation is divided between the SEC and the Commodities and Futures Trading Commission (CFTC).
- *Foreign Capital Markets*: Subject to U.S. regulation if they involve U.S. investors or flow back into the U.S. Otherwise foreign securities regulation applies.

REGULATORY COMPETITION

- If there is over regulation in a market, i.e. the costs of regulation outweigh the benefits, then issuer and investors move to other markets with a different regulatory regime.
- This is increasingly the case today in the age of global markets. In some cases you see financial institutions moving the Hong Kong or Singapore where there is less regulation.

REGULATORY OVERLAP

- Different regulators assert jurisdiction over the same transaction such as:
  a) when federal and state securities laws regulate a securities transaction; or
  b) U.S. and foreign regulators assert jurisdiction over the same tender offer; or
  c) New financial products combine characteristics of instruments subject to different regulatory regimes.

ADVANCE OF NEW TECHNOLOGIES

- A primary purpose of Federal securities regulation is to enable investors and securities professionals to obtain information so that prices in the securities markets reflect all available public information.
- With the advances in computer and communications technology the dissemination of information and its management has been made far easier and less expensive.
- Advances in finance theories and the new technologies have facilitated pricing and trading of securities.
- Advances in technology have been a major force behind the globalization of securities markets.

STOCK MARKET EFFECIENCY

- Informational Efficiency: prices at any particular time reflect fully all the information that is available to the public.

- Allocative Efficiency: stock markets and stock prices are efficient in allocating capital.

EFFICIENT CAPITAL MARKET HYPOTHESIS

- U.S. public securities markets are said to be informationally efficient in that prices at any particular time reflect fully all the information that is available to the public.
- Efficient Capital Market Hypothesis: In an efficient market, particular information effects the price of a company's stock as if everyone had the same information at the same time.
- Is it true that the securities markets impound all information into the prices of securities?

WEAK-FORM EFFICIENCY

- The stock market impounds information about historic trading patterns such that investors cannot draw charts of past prices to determine future prices. There is no way to guess future prices from past patterns.
- Stock price patterns are completely random.
- Studies of U.S. stock markets demonstrate this kind of a “random walk.”

SEMI-STRONG FROM EFFICIENCY

- The stock market promptly impounds all publicly available information. Markets behave like a stampeding herd of animals and instantly change course as when a few animals in the herd change direction.
- As a result ordinary investors cannot beat the market systematically by using public information.
- Evidence indicates that public stock prices for widely followed companies in U.S. change almost instantly in an unbiased fashion to new public information.
- Sophisticated buyers and sellers who control a critical amount of the trading volume move the stocks from “uninformed” to “informed” price levels so that new information is transformed almost instantly into a new consensus on the stock price.
- Thus the effect of many analysts and professionals trying to beat the market is that none of them are able to systematically do so.
- The fact that mutual funds on average perform only slightly better than the market and not enough to cover their fees illustrates this.
- However, the “irrational exuberance” of the late 1990s in the high-tech and telecommunications industries demonstrates that stock markets do not necessarily behave rationally.

STRONG-FORM EFFICIENCY

- *Strong-Form Efficiency*: Public stock markets impound all information that affects stock prices.
- However, this is not the case. Markets are not perfectly informationally efficient.
- Thus corporate insiders can exploit the market ignorance of their inside information to gain large trading profits.

ALLOCATIVE EFFICIENCY

- *Allocative Efficiency*: stock markets and stock prices are efficient in allocating capital.
- Weak and semi-strong forms of efficiency do not necessarily lead to allocative efficiency. The herd can run over a cliff.

OVERVIEW OF FEDERAL SECURITES STATUTES

SECURITIES ACT OF 1933

- Regulates public offerings of securities.
- Prohibits offers and sales of securities that have not been registered with the Securities and Exchange Commission (SEC)
- Requires a disclosure document known as a *prospectus*.
- Exempts certain kinds of securities and transactions from registration requirement.
- Prohibits fraudulent or deceptive practices in the offer or sale of securities and establishes a complex liability scheme

SECURITIES EXCHANGE ACT OF 1934

- Extended federal regulation to trading in securities that are already issued and outstanding.
- Established the Securities and Exchange Commission and transferred administration of the 1933 Act to it and gave it broad powers to enforce federal securities laws.
- Imposes periodic disclosure and other requirements on publicly held corporations.
- Prohibits manipulative or deceptive devices in connection with the sale or purchase of securities.
- Regulates margin or the amount of credit available for the purchase of securities.
- Regulates proxy voting by shareholders of public companies.
- Regulates insider trading in public companies.
- Requires brokers and dealers to register with the SEC and regulates their activities.
- Provides for SEC registration and supervision of national securities exchanges and associations, clearing agencies, transfer agents and securities information processors.

33 ACT AND 34 ACT INTEGRATED DISCLOSURE

- Originally the disclosure requirements of the 33 Act and the 34 Act were separate.
- In 1982 the disclosure requirements under the two acts were standardized and integrated.
- Items for nonfinancial disclosure are set forth in Regulation S-K.
- Items for accounting information are set forth in Regulation S-X.
- Forms under each act pick and choose the specific disclosure items required and set forth in those two regulations.

AUDITED FINANCIAL STATEMENTS

- The 33 Act and 34 Act required audited financial statements by public accountants.
- In the U.S., the accounting profession rather than government bureaucrats has historically been responsible for setting auditing standards.
- Sarbanes-Oxley Act of 2002 requires public auditors to register with the Public Company Accounting Oversight Board (PCAOB), which creates auditing standards and disciplines those who violate the rules.
- The members of the PCAOB are appointed by the SEC and its rules and disciplinary actions are subject to SEC review.

GLASS-STEAGALL ACT

- Separated commercial banking from investment banking.
- Commercial banking: the acceptance of deposits and the making of loans.
- Investment banking: the underwriting of securities for sale to the public.
- Purpose was to eliminate the conflict of interest when the same financial institution sells securities to a customer while at the same time lending them money to buy the security.
- At time went by, rulings by federal banking regulators and courts eroded this separation.
- Under the Gramm-Leach Bliley Act of 1999, Congress formally repealed the Glass-Steagall prohibitions on combining financial services and a financial services institutions various activities are subject to separate functional regulation.
- In response to the financial collapse of 2008, The Dodd-Frank Act of 2010 adopted the “Volcker Rule” to limit the ability of banks to engage in proprietary trading, but banks may still invest up to 3% of their core capital in hedge funds and private equity funds.

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

- forced the breakup of holding companies in the gas and electric utility industries.
- Required SEC to administer the restructuring of the industry.
- Utility rates and capital structure became subject to state regulation.
- Today some want to repeal the act.

TRUST INDENTURE ACT OF 1939

- Regulates indentures (contracts) between the issuer of debt securities and the administrator of the debt issue (the trustee which is usually a bank) whose purpose is to protect the debt holders.
- Indentures covering debt securities to the public of a certain size (today $5 million issued over a 36 month period) must contain certain terms and the trustee must meet certain requirements of independence and adhere to certain standards of conduct.

INVESTMENT COMPANY ACT OF 1940

- Requires investment companies with more than 100 investors to register with the SEC and have boards of directors made up of independent directors.
- SEC oversees operations of investment companies, which have modified registration and prospectus-delivery rules when they issue securities.
- Authorizes SEC together with the Financial Industry Regulatory Authority (FINRA) to regulate advisory fees and other charges of fund advisors.

INVESTMENT ADVISERS ACT OF 1940

- Requires the registration of anyone in the business of providing investment advice.
- Requires investment advisers to disclose their interests in transactions that they execute for their clients and prohibits fraud.

NATIONAL SECURITIES MARKETS ACT OF 1996 (NSMIA)

- This was enacted to increase the competitiveness of the U.S. in attracting issuers to U.S. securities markets.
- Allocated regulatory responsibility for certain securities offerings exclusively to the federal government.
- For covered offerings, states cannot require registration or qualification, impose conditions on offering documents or sales literature, or conduct merit regulation.
- For covered offerings, states may only require notice filings and collect fees to finance securities fraud policing.
- States are limited to regulation of small, regional or intrastate securities offerings.

COVERED SECURITIES UNDER NSMIA

- Listed Securities: No state registration, notice filings, sales reports, or filing fees are allowed for securities listed on a stock exchange or quoted on NASDAQ.
- Mutual Funds: Securities issued by registered investment companies.
- Private Placements: Securities sold to qualified purchasers as defined by the SEC who are presumed to be able to protect themselves.
- Exempt Offerings: Securities exempted from Securities Act registration unless exemption anticipates state securities registration.
- In the last 3 categories, states may require fees, consent to service of process, and fling of sale reports and other documents substantially similar to those required by the SEC.
- State may continue to apply their antifraud laws
- States may regulate investment advisors who manage less than $100 million.

SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998

- Requires that class actions involving allegations of securities fraud in publicly traded securities be litigated exclusively in federal court.
- “Delaware Carve Out”: permit securities fraud class actions alleging state fiduciary breaches to be brought in either federal or state court.

THE PUBLIC COMPANY ACCOUNTING REFORM AND INVESTOR PROTECTION ACT OF 2002 a/k/a SARBANES-OXLEY ACT

- Seeks to strengthen integrity of federal securities disclosure and to federalize certain aspects of public corporation law.
- It was a response to Enron's rise and fall and other bad actors.
- Enron's auditor publicly vouched for the company's financial statements while privately shredded incriminating documents.
- Finally Enron had to restate its income by $600 million, increase its debt by $628 million and filed for bankruptcy.
- WorldCom announced that it had reported $7 billion as assets that should have been treated as operating costs and then filed for bankruptcy.

SARBANES-OXLEY

- PCAOB: 5 person Public Company Accounting Oversight Board to establish auditing standards and regulate the accounting profession.
- Auditor Registration: Firms that audit public companies must register with PCAOB.
- Audit Standards: PCAOB is authorized to set audit standards for public companies and to enforce those audit rules.
- Auditor Sanctions: SEC is authorized to sanction auditors for intentional, reckless, and highly negligent conduct.
- Non-audit Services: Prohibits auditors from providing certain kinds of non-audit services and requires company's audit committee to preapprove certain permissible non-audit services.
- Auditor Rotation: Audit partner must be rotated every 5 years.
- Revolving Door: Prohibits within one year members of audit team from becoming financial/accounting officers of audit clients

SARBANES-OXLEY continued

- Audit Committee Composition: SEC can have stock exchanges change their listing requirements to require audit committees to be made up of only independent directors who have full authority over outside auditors.
- Financial Expert: Companies must disclose whether or not they have at least one financial expert on the audit committee
- Officer Certification: SEC must make rules requiring CEO and CFO to certify that SEC filings are true, complete, and fairly represented.
- Internal Controls: SEC must make rules regarding disclosure of internal controls, and requires that the top executives certify them.
- Auditor Influence: Company officials must not improperly influence outside auditors.
- Real-time Disclosures: Companies must make additional, real-time disclosures in plain English regarding current changes to its financial condition.

SARBANES-OXLEY continued

- Off-balance sheet Transactions: SEC must make rules requiring disclosure of off-balance sheet arrangements.
- SEC Review: SEC must review filings made by reporting companies at least every 3 years.
- Code of Ethics: Companies must disclose whether or not they have a code of ethics for senior financial officers and if not, why not.
- Director and Officer Bans: SEC may remove “unfit” officers and directors from their positions and bar them from taking similar positions in other public companies.
- Personal Loans: Prohibits personal loans to company directors and officers, except in the regular course of a company’s lending business.
- Clawbacks: If a company restates its financial statements due to misconduct, mandates the forfeiture of executive pay and trading gains that result.

SARBANES-OXLEY continued

- Blackout Periods: If there is a trading blackout period imposed on company employees, prohibits executives from selling stock during that period.
- Insider Reports: Corporate insiders must disclose their trading in the company stock within 2 business days.
- Up the Ladder Reporting: SEC must make rules requiring lawyers working for a company to report securities violations and fiduciary breaches up the internal corporate ladder.
- Lawyer Malpractice: SEC may bring enforcement actions against lawyers for malpractice.
- Analyst Reports: SEC must adopt rules regarding the independence and objectivity of securities analysts and protect them from retaliation for negative reports or ratings.
- Whistleblower Protection: Criminal liability is imposed upon those who retaliate against employees who provide evidence or assist in the investigation of business crimes.

SARBANES-OXLEY continued

- Whistleblower Action: Enables whistleblowers who experience retaliation to seek compensatory damages, reinstatement, back pay, and litigation costs.
- Hotlines: Audit committees must create procedures for handling anonymous complaints about accounting improprieties
- Statute of Limitations: Statute of limitations is extended.
- Criminal Sanctions: Criminal sentences are increased for destruction, alteration, or falsification of records in a federal investigation and for violating rules about document retention.
- Obstruction Crime: New crime is created for obstructing a proceeding, including tampering with documents.
- Heavier Sentences: Criminal sentences are increased for corporate officials who retaliate against whistleblowers, for those who commit mail and wire fraud, and those who falsely certify financial statements.
- New Crime: New crime of “knowing securities fraud” is created with a maximum prison term of 25 years.

DISCLOSURE VS. CORPORATE GOVERNANCE

- Some provisions of Sarbanes-Oxley strengthened disclosure, which is the core of federal securities regulation.
- However, other provisions deal with corporate governance which is traditionally the realm of state corporation law.

FEDERAL INCURSIONS INTO CORPORATE GOVERNANCE

- Securities Laws have traditionally focused upon disclosure.
- Corporate governance has traditionally been within the realm of state corporate law.
- The Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010 have moved the federal securities laws into the issues of the function of public companies once occupied primarily by state corporate law and have introduced corporate governance reforms to provide greater shareholder rights and oversight of executive compensation.

DODD-FRANK ACT CORPORATE GOVERNANCE REFORMS

New Shareholder Powers

- Advise on Executive compensation: creates right of shareholders to an advisory vote on pay packages and golden parachutes.
- Nominate Directors: Access to proxy statements to nominate directors to the board.

New Responsibilities of Corporate Gatekeepers

- For Directors:
  a) Compensation committees must be composed only of independent directors with authority to hire independent compensation consultant.
  B) Pay disclosure: Requires SEC to require more disclosure and charts on executive pay compared to stock performance over a 5 year period and a comparison of CEO's pay and the median pay of all the company's employees.
- For Officers:
  a) Pay clawbacks: Requires clawback provisions when financials statements must be restated because of misconduct by CEOs and CFOs.
  b) Chair-CEO: SEC must adopt rules requiring public companies to disclose whether the CEO and board chair are the same person and if so why.

New Regulation of Financial Intermediaries

- Credit rating agencies: subjects credit rating agencies to new duties and liabilities similar to those of securities firms that participate in securities offerings.
- OTC derivative: Authorizes SEC regulation of OTC derivatives such as credit-default swaps.
- Private Funds: Requires advisers of private funds such as hedge funds and private equity funds to register with the SEC.

New SEC Enforcement Powers

- Aiding and abetting: increases aiding and abetting enforcement powers for the SEC.
- Subpoena powers: grants nationwide subpoena authority to the SEC.
- Extraterritorial enforcement: Grants SEC enforcement powers over extraterritorial securities fraud.
- Collateral bars: Gives SEC authority to impose collateral bars on directors and officers committing securities fraud.

DODD-FRANK SECURITIES REGULATION REFORMS

Protection of Sophisticated Investors

- Bad Boy Issuers under Reg D: Requires SEC preclude certain “bad boy” issuers from raising capital in private markets using Reg D.
- Asset-backed securities disclosures: Requires SEC to establish additional disclosures on asset-backed securities even when offered to sophisticated investors in private markets.

STATE SECURITIES REGULATION – STATE BLUE SKY LAWS

- Originally federal securities laws did not preempt state law and left in place a parallel system of state securities registration and parallel system of state regulation of broker-dealers and advisors.
- State Blue Sky Laws: state laws that regulate the offering of securities, require the licensing of securities broker-dealers and investment advisors, impose civil penalties for false and misleading information, and establish state agencies to administer those laws.
- State laws may regulate the merits of a particular offering.
- State securities laws do not regulate securities exchanges or other interstate trading markets, or regulate disclosure by public companies in connection with shareholder trading or voting.
- 39 states have adopted the Uniform Securities Act, but state securities laws are not uniform.

SECURITIES AND EXCHANGE COMMISSION (SEC)

SECURITIES AND EXCHANGE COMMISSION

- Established by the Securities Exchange Act of 1934.
- An independent agency that is not part of the President's cabinet.
- Its tasks were originally assigned to the Federal Trade Commission (FTC), but Wall Street feared that the FTC would not be able to administer the Securities Act well.
- So a specialized and expert agency was created that exercises broad executive, legislative and judicial powers.

EXECUTIVE POWERS

- Administers and Enforces federal securities laws.
- Has broad investigative powers, can issue cease-and-desist orders, impose fines and order disgorgement of profits in administrative proceedings.
- Can initiate court action to seek injunctive relief and can refer matters to the Justice Department for criminal prosecution.
- Coordinates the enforcement of U.S. securities laws with securities administrators outside the U.S.

LEGISLATIVE POWERS

- Pursuant to congressional authority, promulgates rules and regulations that have the force of law.
- Issues interpretive letters and no-action letters that express its views and provides guidance. These are not binding on the SEC itself, but carry weight with private parties and the courts.
- In some areas these have come to make up a large body of administrative common law.

JUDICIAL POWERS

- Original tribunal mainly regarding disciplinary charges against securities professionals supervised by the SEC.
- Appellate tribunal to review disciplinary actions take by the stock exchanges, the Financial Industry Regulatory Authority (FINRA) and other self-regulatory organizations (SROs) against the members of those organizations.

STRUCTURE OF SEC

- Headed by 5 commissioners who are appointed by the President and confirmed by the Senate.
- One is designated as the Chair by the President.
- The commissioners serve staggered 5 year terms with one term expiring each year.
- No more than 3 commissioners can be from the same political party.
- The President cannot remove a commissioner except for misconduct.
- Commission meets several times each month.
- SEC staff consists of about 3,000 most of whom are lawyers, accountants, economists, financial analysts and engineers.
- SEC is headquartered in Washington DC and has 11 field offices throughout the U.S.

SEC REGULATION AND TECHNOLOGY

- Each year the SEC receives and processes more than 11 million pages of information from more than 28,000 corporate and investment company filers. Most of this information is available to the public.
- SEC now requires electronic filing of disclosure documents using the EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system.
- EDGAR filings are available to any member of the public at www.sec.gov/edgar.
- SEC rules now permit the dissemination of securities information by electronic media.

SEC PARTNERSHIP WITH SECURITIES INDUSTRY

- SEC relies upon a public/private partnership.
- SEC take responsibility for “big picture” areas.
- Securities market participants and private membership organizations (self-regulatory organizations or SROs) handle day-to-day regulation under SEC oversight.
- This allows the SEC to maintain a relatively small staff to oversee markets that have grown to more than $15 trillion.
- The key to making it work is effective SEC oversight.

PLAIN ENGLISH INITIATIVE

- In the late 1990s the SEC adopted rules requiring issuers to use “plain English” when providing investors with information in prospectuses, proxy materials, and tender offer documents.
- SEC published *A Plain English Handbook* to provide useful guidelines that can be downloaded at www.sec.gov/pdf/handbook.pdf.
- The Dodd-Frank Act requires the SEC to study how to improve the financial literacy of investors, and how disclosure documents can best transmit to investors the costs and conflicts of interest from investing in securities.

SEC EXEMPTION POWERS

- Congress gives the SEC authority to exempt particular individuals and transactions from regulation.
- Under NSMIA, the SEC has the authority to exempt “any person, security, or transaction, or any class or classes of persons, securities, or transactions” from any provision of the Securities Act or the Exchange Act or any rules or regulations promulgated under them.
- The purpose is to enable the SEC to deal with statutes, rules and regulations that have become obsolete and to adapt the regulations to changing market conditions and practices.
- The standard is that the action is “necessary or appropriate in the public interest, and consistent with the protection of investors.”
- However, NSMIA also compels the SEC to consider the promotion of “efficiency, competition, and capital formation” when it make rules under the public interest standard.
- This large amount of discretion granted to the SEC may result in it being politicized and the target of lobbying efforts.

INFORMATION DISCLOSURE

WHY IS MANDATORY DISCLOSURE REQUIRED?

- Relevant information is costly to create and produce.
- There is a lack of incentives for management to disclose the information voluntarily.
- Therefore, without mandatory disclosure, relevant information such as company earnings, management plans, and competitive risks would be under-produced and be insufficient for the functioning of a well-informed and efficient market.

THE REASON FOR UNDERPRODUCTION OF INFORMATION

- Securities information is a “public good” and therefore without mandatory disclosure it would be under-produced.
- Once it is obtained, it cannot be protected like other property rights.
- The person who obtained that information cannot exclude “free riders.”
- Also SEC gathering and dissemination of information reduces the cost of obtaining that information and increases the standardization of information.

PERVERSE MANAGEMENT INCENTIVES IN DISCLOSING INFORMATION

- There are circumstances in which management and investors have different disclosure interests.
- Issuers tend to have incentives to hide and delay bad news and overemphasize good news.
- Mandatory disclosure assumes a disequilibrium in bargaining power between investors and issuers and that unless required to management will underprovide information.
- To deal with disincentives to disclosure from litigation risks, securities laws put restrictions on securities fraud litigation and provides safe harbors from litigation for certain kinds of disclosures.
- Also because disclosure is expensive, there are exemptions for smaller firms.

SIDE EFFECTS OF MANDATORY DISCLOSURE

- Gives investors more confidence when buying and selling shares.
- As a result it becomes easier and less costly for companies to raise capital.
- Mandatory disclosure complements the exercise of shareholder rights under state corporate law by allowing shareholders to monitor management and effect change in control.
- Makes it harder for management to commit fraud.
- Competitors can take advantage of disclosure and the SEC does allow for some competitive-sensitive information not to be disclosed.
- Investors in other firms can use disclosures in publicly traded firms to make investment decisions.

THE REASSURANCE OF OVERSIGHT

- Mandatory disclosure provides assurance of coercive government oversight and protection and thus strengthens confidence in the securities markets.
- Can calm markets through the reassurance that more than just the invisible hand it at work.

LIABILITIES FOR SECURITIES FRAUD

- There is general agreement that *ex post* antifraud liability enforced by the SEC and courts is appropriate.
- The theory is that securities fraud is theft – misappropriation in a transaction to which one party would not have consented if fully informed.
- Also there is the social cost that without protection, investors would have to investigate on their own and demand costly assurances.
- Without a legal cost for lying, for those inclined to do so there would be an incentive to put more money into lying.
- Thus without anti-fraud liabilities, private capital markets would suffer and money would flow into safer less socially desirable investments.

DEFINITION OF SECURITY

IMPORTANCE OF DEFINITION

- The boundary of federal securities regulation is determined by the definition of “security.”
- A transaction in a “security” is subject to registration, mandatory disclosure, and heightened antifraud liability; while intermediaries in securities transactions are subject to the SEC’s registration, rules and supervision.
- Non-securities transactions are not.

IMPLICATIONS OF BEING A "SECURITY"

- Registration and disclosure requirements in public offerings, including secondary distributions
- Disclosure and other required conditions to claim exemption from registration
- Liability for selling un-registered securities, and liabilities for misrepresentations in a public offering.
- Registration by companies whose stocks are publicly traded.
- Disclosure by those who solicit votes from public shareholders
- Disclosure by those who offer to buy publicly traded securities
- Antifraud protection in federal court for those who buy or sell securities
- Limits on insider trading
- Disclosure by insiders and those holding certain amounts of publicly traded securities
- Registration requirements for those in the business of being intermediaries in securities transactions.
- Violation of securities laws results in administrative and judicial liability.

CONSEQUENCES OF FAILURE TO RECOGNIZE A SECURITY

- SEC and state securities commissioners may initiate a law suit.
- Private parties my initiate a law suit.
- Deal may fall apart.
- Lawyers may be sued.
- Even criminal liability may be possible

DEFINITION OF SECURITY UNDER THE SECURITIES EXCHANGE ACT OF 1934

- When used in this title, unless the context otherwise requires –

The term “security” means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option or privilege on any security, certificate of deposit, or group index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is like-wise limited.

SECURITIES ACT OF 1933 DEFINITION OF SECURITY

- When used in this title, unless the context otherwise requires –

  The term “security” means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option or privilege on any security, certificate of deposit, or group index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

TESTING FOR A SECURITY

- Even if an instrument falls within the definition above, the statute excludes those instruments when "the context otherwise requires."
- Courts have focused upon 2 questions:
  1) When does an unorthodox investment fall within the catchall terms, principally "investment contract"?
  2) When are instruments that nominally fall into an enumerated category actually not securities?
- Although there is no unified federal court approach, they tend to look at whether or not the investors have entrusted their money to another's management and whether or not they confront practical difficulties in collectively supervising the managers.

BOTTOM LINE QUESTION FOR TEST FOR SECURITY

- Is an investment or contract requires that investors be protected by the federal securities laws?

TWO ECONOMIC CONCEPTS COURTS APPLY

- Agency Costs: The cost to investors as they try to inform themselves, negotiate contracts, and monitor and discipline those who manage their money.
- Collective Action Problem: the problem for investors to coordinate among themselves when exercising their supervisory control.

WHAT IS AN AGENCY PROBLEM

- "For readers unfamiliar with the jargon of economists, an 'agency problem' – in the most general sense of the term – arises whenever the welfare of one party, termed the 'principal', depends upon actions takes by another party, termed the 'agent'. The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest." "Agency Problems and Legal Strategies, John Armour, Henry Hansmann and Reiner Kraakman, The Anatomy of Corporate Law: A Comparative and Functional Approach, 2nd Edition, 2009, Kindle edition, 926)

3 AGENCY PROBLEMS

- 1. Conflict between business owners and the managers.
- 2. Conflict between controlling owners and non-controlling owners.
- 3. Conflict between the business and other parties the firm contracts with such as creditors, employees and customers.

(See "Agency Problems and Legal Strategies, John Armour, Henry Hansmann and Reiner Kraakman, The Anatomy of Corporate Law: A Comparative and Functional Approach, 2nd Edition, 2009, Kindle edition, 944-954)

LEGAL STRATAGIES TO REDUCE AGENCY COSTS

- 1. Regulatory Strategies:
  Directly constrain an agent's behavior by means of prescribing substantive terms that control the principal-agent relationship.
  a) Rules and Standards
  b) Settling the terms of entry and exit
- 2. Governance Strategies:
  Facilitate the control by the principal over the agent's behavior.
  a) Selection and removal
  b) Initiation and ratification
  c) Trusteeship and reward

(See "Agency Problems and Legal Strategies, John Armour, Henry Hansmann and Reiner Kraakman, The Anatomy of Corporate Law: A Comparative and Functional Approach, 2nd Edition, 2009, Kindle edition, 944-954)

REGULATORY STRATEGIES vs. GOVERNANCE STRATEGIES

- For governance strategies to work, the principals must be able to exercise their control rights. However, if there are a large number of principals coordination costs among the principals make this more difficult.
- If coordination costs are high, then regulatory strategies may be more effective. However, this requires high quality regulatory institutions and high quality disclosure mechanisms that enable the regulator to verify the information.

INVESTMENT CONTRACTS – THE HOWEY TEST

- Supreme Court has defined an "investment contract" is any transaction in which:
  1) a person invests money
  2) in a common enterprise and
  3) is led to expect profits
     a) solely from the efforts of others.
- When applied in light of the economic realities of the transaction, courts seek to identify transactions in which investors are relying on others to manage a business that will provide financial returns on their investment. Ownership is separated from control.

FACTORS COURTS LOOK TO

- Investment: can be cash or noncash that is expected to produce income or profit and the investor is looking for financial gain and not to consume a commodity or service.
- Commonality:
  a) Horizontal commonality: multiple investors have interrelated interests in a common scheme. Three elements of horizontal commonality—pooling, profit sharing, and loss sharing
  b) Vertical commonality: for a minority of courts, even if a single investor has a common interest with the manager of the investment.
- Expected Profits: expected return must be the principal motivation behind the investment. Return must come from earnings or appreciation of investment based upon expected earnings, not merely from additional contributions.
- Efforts of Others: Efforts of managers must be predominant and the investors must be mostly passive.

RISK CAPITAL TEST

- Some state courts apply the risk capital test when applying their state blue sky laws.
- Focuses on the extent that the investors initial outlay is subject to the risks of the business, and those risks are ones that the investor has no control over.
- Does not require commonality nor that profits be derived from the efforts of others and is thus often easier to satisfy that the Howey Test.

4 PART RISK CAPITAL TEST FOR INVESTMENT CONTRACT

1) Offeree provides something with initial value to the enterprise
2) This initial value is subject to the risks of the enterprise
3) The offeree is induced to make this investment of initial value by representations that the offeree will realize a valuable benefit beyond the initial value
4) The offeree does not have practical or managerial control over the enterprise. (See Hawaii v. Hawaii Market Center, 52 Haw. 642, 485 P.2d 105, 109 (1971)

FOCUS IS NOT ON WHAT IS BEING OFFERED BUT HOW IT IS BEING OFFERED

- Focus is not so much what is actually being offered
- Focus is
  a) how it is being offered and marketed
  b) what is promised
- Thus offering investments that do not actually exist and receiving money for them violates the securities laws.

REAL ESTATE AS SECURITIES

- Sale of real estate without any collateral arrangements with the seller is not a securities transaction.
- Even if a speculative investment, it is not a security if the profits do not depend on the efforts of others.
- If marketing of real estate emphasizes that economic benefits are to be derived from the managerial efforts of others, then courts will find a security. (See *Hocking v. Dubois,* 885 F. 2nd 1449 (9th Cir. 1989) in which there was an offering of a rental condo along with a collateral management agreement)
- However, in a time-share arrangement in which rents from time-share condos were not pooled and the owners were free to use the property as they chose, there was no security involved. (*Wals v. Fox Hills Development Corp.,* 24 F.3d 1010 (7th cir. 1994))

BUSINESS INTERESTS AS SECURITIES

- Generally depends upon the legal form of the business organization
- Corporation: common shares and preferred shares are a security.
- In *Landreth Timber Co., v. Landreth,* U.S. Supreme Court held that the sale of a business through a stock transaction was a securities transaction even though the success of the business going forward depended upon the efforts of the buyer and not the seller.

LIMITED PARTNERSHIPS, PARTNERSHIPS & OWNERSHIP INTERESTS AS A SECURITY

- Limited Partnership: Generally, limited partner interests are a security and general partner interests are not a security.
- Partnership (joint ventures): Passive partner interests are a security and Active partner interests or Co-venturer interests are not a security
- However, this is not always the case. For example a nominal general partner can claim his interest is an investment contract by showing that he was so dependent upon the promoter that he could not exercise meaningful control by showing either
  1) No legal control: so little power in investor's hands that power is distributed like that in a limited partnership
  2) No capacity to control: partner is too inexperienced and unknowledgeable to exercise his partnership powers
  3) No practical control: partner is so dependent upon the unique managerial ability of the promoter that he cannot replace him or exercise meaningful partnership powers.

LLC MEMBERSHIP INTEREST AS SECURITY

- SEC and 35 or more states take the position that membership interests in LLCs are a security based upon either:
  a) The Howey Test; or
  b) They have the characteristics of stock.
- U.S. Court of Appeals for 4th Circuit ruled that an equity interest in an LLC was not an investment contract and thus not a security because he could exercise control over his investment based upon:
  a) large percentage of ownership interest
  b) treasurer of LLC
  c) member of the board
  d) right to appoint 2 of 7 members of the board of managers
  e) member of the company's executive committee
  f) ruled it did not have characteristics of a stock because he did not have the right to receive dividends based upon equity ownership percentage and his interest was not negotiable
- So in general: Passive member interests in a manger-managed LLC are securities and Active member interests (member-managed LLC) are not a security.

PYRAMID or PONZI SCHEMES

- Attracts investors by promising high returns, but pays those returns by using money from the original investors and from new investors.
- Eventually money runs out.
- In reality, they are a criminal taking of money under false pretenses, but often it can appear to be a legitimate business that went bad and thus is at times this is hard to prove criminal intent.
- So SEC often brings civil enforcement actions asserting the investments are a security.
- Using Howey Test, courts will find a Pyramid Scheme when it:
  1) seek to attract cash investments
  2) in an enterprise involving multiple investors and a promoter who organizes the scheme
  3) with a promise of future returns
  4) arising primarily from the efforts of the promoter to attract new investors while providing management services to a nominal business.
- Most famous example was Bernie Madoff

PENSION PLANS AS SECURITIES

- When an employee participates in an employer-funded pension plan, is the interest in the plan a security and is the employer's payments to fund the plan the purchase of securities?
- Using a modified Howey Test, an employer-funded, fixed-benefit pension plan in which employees make no direct contributions and their participation is compulsory is not a security. With fixed benefit, the return was based not so much on the efforts of others, but on the employee becoming eligible under the plan.
- Also employer-funded pension plans are regulated by the Employee Retirement and Income Security Act (ERISA) which would preempt securities laws.

NOTES AS SECURITIES

- Federal definition includes “any note.”
- Note: evidences a borrowers promise to repay a debt – the creditors investment in the borrower.
- However, many times courts will not treat a note as a security because “the context otherwise requires.”
- A note that arises of our a current transaction and matures within 9 months is exempt from registration. This was meant to cover commercial paper issued by large, financially sound companies to finance current operations and sold to institutional investors.
- Generally traditional consumer and commercial transactions are not securities and notes sold to numerous investors seeking an investment return are securities.

4 TYPES OF NOTES THAT ARE NOT SECURITIES

1) Notes given in connection with consumer financing
2) Notes secured by home mortgages
3) Notes to businesses that are short term and secured by business assets
4) Bank character loans

NOTES AS SECURITIES CONTINUED

- Howey Test is limited to the definition of investment contracts.
- Investment contract analysis is not used for those items specifically listed in the Act's definition of securities.
- If an item it listed as a security in the Act, there is a presumption that it is a security.

FAMILY RESEMBLANCE TEST FOR NOTES

- Rebuttable presumption that a note is a security unless it falls into category of instruments that are not securities such as notes used in consumer lending, notes secured by a mortgage on a home, and short-term notes secured by an assignment of accounts receivable.
- Under *Reves,* four factors to determine the "family" into which a note will fit and rebut the presumption that it is a security:
  1) Motivation of seller and buyer: If proceeds from note are used for general business purposes it is more likely to be a security, but if used for consumer goods it is more likely to not be a security
  2) Plan of distribution: If widely offered and traded, it is more likely to be a security
  3) Reasonable expectations of investing public: If investors generally view the type of note as a security it is more likely to be a security.
  4) Other factors reduce risk: if secured or otherwise regulated, it is more likely not to be a security

SALE-LEASEBACK FINANCING

- A financier nominally purchases an asset used by a business and receives fixed lease payments for a fixed period after which the lease terminates and the business must repurchase the asset.
- Lease payments are like interest payments.
- Buyback is like return of principal.
- If the leasing program lacks a common enterprise or is dependent upon the investor's management efforsts, this usually will not be viewed as a security but as a secured transaction.
- However, if the financier is not a commercial lender, but a group of individual speculators, it may be.

SEC V. EDWARDS, 540 U.S. 389 (2004)

- *Facts*: ETS sold payphones to the public through a package that included a site lease, a five-year leaseback and management agreement, and a buyback agreement at a cost of $7,000 and a guaranteed $82 per month for a 14% annual return. Also ETS guaranteed to pay the full purchase price at the end of the lease or within 180 days request. ETS was forced to rely on fund from new investors to meet its obligations and ultimately filed for bankruptcy.
- *Issue*: For purposes of the federal securities laws, does a moneymaking scheme fall outside of the definition of an investment contract simply because the promised rate of return is fixed rather than variable.
- *Rule*: Under Howey, an "investment contract" is any transaction in which: 1) a person invests money; 2) in a common enterprise and; 3) is led to expect profits solely from the efforts of others.
- *Analysis*: When investing public is attracted by representations about investment income, such as in this case, there is no need to distinguish between fixed returns and variable returns. Especially in this case where the investments were pitched as low-risk investments that make them attractive to those more vulnerable to fraud. If such a distinction were to be made, then securities laws could be evaded just by making the promised return fixed rather than variable.
- *Conclusion*: Edwards and ETS offered and sold securities.

BANK INSTRUMENTS AS SECURITIES

- Bank savings accounts and certificates of deposits (CDs) are exempt from registration requirements and private antifraud liability under the Securities Act, but there is not exemption under the Exchange Act.
- However, the Supreme Court has held that a CD issued by a national bank is not a security under the Exchange Act based upon the “unless the context otherwise requires” language.

STOCK AS SECURITY

- Stock is a security unless the "context otherwise requires."
- Noninvestment Stock: A security must reflect economic reality. Thus share in a cooperative housing corporation in which residents are required to purchase shares of stock to secure house are not a security.
- Sale of Business Doctrine: Lower courts held that the transfer of a majority of stock of a closely held corporation is not a securities transaction because the sale transfers control to the purchaser who becomes an owner-entrepreneur and not an investor. Other courts held that stock is stock. The Supreme Court rejected the Sale of Business Doctrine and accepted a literalist reading of stock.
- Lower Courts have still applied the Sale of Business Doctrine to LLCs and not treated LLC interests as "stock."

UNITED HOUSEING FOUNDATION v. FORMAN, 421 U.S. 837 (1979)

- *Facts*: Cooperative housing corporation required residents to buy stock in the corporation that owned the building to secure a residential lease. Shares were nonnegotiable and upon leaving the cooperative, the resident was required to resell the shares to the corporation at the original price.
- *Issue*: Were the cooperative's shares of stock "securities" under Federal Securities Law so that the residents sue for fraud under the Federal Securities law?
- *Rule*: Under Howey, an "investment contract" is any transaction in which: 1) a person invests money; 2) in a common enterprise and; 3) is led to expect profits solely from the efforts of others.
- *Analysis*: Shares did not have characteristics of a stock investment: no right to a dividend contingent upon profits; shares were not negotiable; voting rights were not proportionate to the number of shares held; shares could not appreciate in value. Court concluded that the shares were purchased to obtain housing and not with an expectation of profits.
- *Conclusion*: The shares of stock in a cooperative housing corporation are not securities.

DERIVATIVE INVESTMENTS: STOCK OPTIONS, INDEX OPTIONS AND FUTURES

- Both the 33 Act and the 34 Act include within the definition of security "any put, call, straddle, option, or privilege on any security."
- Therefore an investment that is a derivative of a security is a security.
- Index options are subject to SEC regulation
- Futures based on stock indexes are subject to Commodity Futures Trading Commission.
- Instruments subject to CFTC regulation such as many swap transactions but traded OFC by institutional and sophisticated participants created a gap in regulatory oversight that was part of the cause of the recent financial crisis.

KOREAN CAPITAL MARKETS DEFINITION OF SECURITY

(1) The term “security” in this Act shall mean a financial investment product issued by a domestic or foreign issuer, which imposes no obligation (excluding an obligation of investors to pay for the exercise of rights to complete a purchase and sale of underlying assets) on investors under any circumstances to pay anything in addition to the money, etc. paid at the time of acquisition.

(2) The security referred to in paragraph (1) shall be classified as any of the following subparagraphs:

1. Debt securities;
2. Equity securities;
3. Beneficiary certificates;
4. Investment contract securities;
5. Derivatives linked securities; or
6. Securities deposit receipts.

KOREAN CAPITAL MARKETS: INVESTMENT CONTRACT

The term “investment contract security” in this Act shall mean an instrument indicating contractual rights under which an investor invests money, etc. in a common enterprise with other person (including another investor; hereafter in this paragraph, the same shall apply) and profits and losses resulting from the common enterprise primarily run by other person are distributed to the investor.

OTHER DEFINITIONS

OFFER

- 1933 ACT DEFINITION: "The term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."
- This is a broader definition than contract law. An offer too vague for contract law can be an offer for Federal Securities Law.
- However, preliminary negotiations or agreements between an issuer and an underwriter or among underwriters do not constitute an offer to sell.

SALE

- 1933 Act Definition: "The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value."
- Courts have given "value" a broader definition than state corporation statutes which usually require that value be in the form of cash, property, or compensation for past services.
- 1934 Act Definition: "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of. For security futures products, such term includes any contract, agreement, or transaction for future delivery."

PERSON

- 1933 ACT Definition: “The term ‘person’ means an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof.”
- 1934 Act Definition: “The term ‘person’ means a natural person, company, government, or political subdivision, agency, or instrumentality of a government.”

ISSUER

- 1933 Act Definition: "The term 'issuer' means every person who issues or proposes to issue any security; except …."

- 1934 Act Definition: "The term 'issuer' means any person who issues or proposes to issue any security; except …."

MATERIALITY

HISTORICAL CONCEPT OF MATERIALITY

- Historically courts have been suspicious of those who try to use informational defects to avoid a transaction.
- In 2nd Restatement of Torts, materiality is an element of fraud and is used to corroborate the party's claim to have relied upon the alleged misinformation in entering into a transaction.
- It tests objectively, whether or not the misinformation was likely to have induced the transaction.
- It reduces unnecessary disclosure in commercial transactions by protecting parties from liability in informational defects that are not significant.

MATERIALITY IN SECURITIES LAW

- If too little information, investors will be less likely to invest and markets will dry up.
- If too much information is required and disclosure become too costly, businesses will seek financing outside of the securities markets and once again the markets will dry up.
- The concept of “MATERIALITY” sets the limits of mandatory disclosure.
- “Materiality” of information balances:
  a) mandatory disclosure costs, investor confusion risk, frivolous litigation possibility, or the revelation of competitive secrets,
  b) the availability of obtaining the information through non-regulated sources
  c) the effect disclosure has on compliance with other regulatory regimes.

"SUBSTANTIAL LIKELIHOOD" TEST

- A fact is material if "there is a substantial likelihood a reasonable investor would consider it important" in making a securities-related decision. *TSC Industries v. Northway, Inc., 426* U.S. 438 (1976)
  -- this test is used whether the disclosure involves shareholder voting, securities trading, a tender offer, or itemized disclosure in securities filings.
- Substantial Likelihood: the information probably would have been important to a reasonable investor and not just a mere possibility that it would be.
- It is not a "but for" test, just that it "would have assumed actual significance" in the investors deliberations.

REASONABLE INVESTOR?

- Unsophisticated investors, sophisticated securities analysts or both? It is not clear.
- However, it is not an irrational investor.
- Much of the disclosure in forms required by the SEC is intended for professional securities analysts. So some cases measure materiality based on what a professional analyst would consider price-sensitive.
- Some courts view the congressional intent to be to protect the average small unsophisticated investor. If it is a nonmarket transaction or if the market is not informationally efficient, this is more likely.
- Courts often say that materiality is a mixed question of law and fact, but often judges take it upon themselves to decide it as a matter of law.

MATERIALITY AND DUTY TO DISCLOSE

- *Duty* relates to *whether* and *when* information must be disclosed.
- *Materiality* relates to *what* information must be disclosed.
- So the first issue is always one of duty. If there is no duty, then materiality is not relevant.
- Disclosure Duties under federal securities laws arise in two ways:
  1) SEC filing obligations. Companies are required to include any other material information needed to make required line-item disclosure not misleading.
  2) Duty of honesty: when speaking about securities trading, voting, and tender offers for publicly traded shares there is a duty of honesty
- If there is not duty to speak, management may keep the information confidential, no matter how material.

DUTY OF HONESTY

- a) Do not to make false statements about material facts,
- b) Do not to make misleading statements about material facts,
- c) Correct materially false or misleading statements, and
- d) Update certain statements that have become materially false or misleading

MATERIALITY AND CATEGORIES OF INFORMATION

HISTORICAL INFORMATION

- For verifiable data such as past financial results, completed business transactions, executive compensation and shareholdings, etc., courts use the “substantial likelihood” test.
- Off-Balance Sheet Disclosures: Under Sarbanes-Oxley Act, reporting companies are required to disclose off-balance sheet arrangements and known contractual obligations reasonably likely to have a material effect on the company’s financial state in the MD&A section.
- Market Reaction Test for Materiality: Does the market price of the company’s stock change on the date the information is first disclosed?

SPECULATIVE INFORMATION

- Courts use a special version of the "substantial likelihood" test for information regarding a future event such as negotiations for a merger.
- **Probability – Magnitude Test**: Materiality "will depend on balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." *Basic, Inc. v. Levinson,* 485 U.S. 224 (1998)
- Measures the financial significance of the event, discounted by the chances of it actually happening.
- Puffery: Courts are reluctant to treat optimistic statements as misleading, based upon the common law notion that puffery is not actionable.

MERGER NETOTIATION INFORMATION

- Even if material, does not have to be disclosed
- May remain silent
- However, must not release false or misleading information

SOFT INFORMATION

- Voluntary disclosure of forward-looking information: SEC safe harbor rules allow this in SEC filings unless it can be shown that the statement was:
  a) "without reasonable basis" or
  b) that is was disclosed "other than in good faith."
- Subjective test -- what the management knew or should have known when it looked to the future.
- Mandatory disclosure of forward information: The MD&A section of certain SEC filings such as annual reports must describe trends and uncertainties that are "reasonably likely to result" in material changes to the company's financial state.

ACTIONABILITY OF FORWARD LOOKING STATEMENTS

- In *Virginia Bankshares, Inc.* Court held that in order for forward-looking statements to be actionable, the board both
  a) must have misstated its beliefs and
  b) misled about the “subject matter” of its opinion

INFORMATION ABOUT MANAGEMENT INTEGRITY

- SEC line item disclosure requires information about
  (a) management incentives (compensation, conflict-of-interest transactions, loans),
  (b) management integrity (lawsuits involving personal insolvency, criminal convictions, stock fraud) and
  (c) management commitment to the company (stock ownership, stock pledges as security for personals loans).

CODE OF ETHICS

- Sarbanes-Oxley Act requires that every public company disclose whether or not it has a code of ethics for its principal executive and financial officers that includes standards for promoting honesty and ethical conduct.
- NYSE and NASDAQ listing rules require a companies have a Code of Ethics and specify the contents. NYSE includes standard addressing corporate opportunities, confidentiality, protection of corporate assets, and insider trading.

SOCIAL/ENVIRONMENTAL DISCLOSURE

- The general disclosure policy of federal securities laws focuses on the financial relevance of the information to investors and not on broader social and environmental impact on the public.
- Recently the SEC has shown more interest in companies disclosing risks and opportunities presented by social and environmental issues especially climate change.

MATERIALITY IN DIFFERENT CONTEXTS

- Materiality of information and its disclosure is contextual.
- Buried Facts Doctrine: Disclosure may be misleading if it contains material information that is inaccessible or difficult to assemble.

TOTAL MIX TEST

- "There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976)
- Thus an omission was not material if reasonable investors already knew or were able to infer the omitted information from other disclosures.
- Omitted information already known to the market is not actionable even if material.
- Even false or misleading disclosure may not be material if those who set market prices such as professional securities traders knew the disclosure was false.

SAFE HARBORS FOR FORWARD-LOOKING STATEMENTS

- **Safe Harbor**: "Provision in a law that excuses liability if the attempt to comply in good faith can be demonstrated." *Barron's Dictionary of Finance and Investment Terms.*
- **Bespeaks Caution Doctrine**: a doctrine created by the courts that states that cautionary disclosure can negate the materiality of, or reliance on, an unduly optimistic prediction.

PSLRA SAFE HARBOR

- **Private Securities Litigation Reform Act:** If forward-looking statements comply with the Act's safe harbor provisions, public companies and their executives will be immune from civil liability, but not administrative liability.
- 3 safe harbors that prevent shareholder lawsuits based on written forward-looking statements that later turn out to be wrong:
  1) *No actual knowledge*: defendant must not have had actual knowledge the statement was false
     -- applies to written or oral statements.
  2) *Immateriality*: statement was immaterial and opens the door to the "bespeaks caution" doctrine.
  3) *Cautionary statements*: Identify the statement as forward-looking and have the statement accompanied by meaningful cautionary statements that identify important factors that could cause results to differ materially.

QUESTIONS TO DISCUSS pages 885-6

- #1: *Issue Presented:* **Are fractional interests in a pool of terminal patients' life insurance benefits (viatical settlements) securities?**
- #7: *Issue Presented:* **Do virtual shares in an enterprise existing only in cyberspace constitute securities?**