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Glossary of Important Securities Regulation Terms and Definitions

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This Glossary is designed to provide law students taking Securities Regulation with a tool that will assist them in learning the basic language of securities law and achieve a working knowledge of the fundamental principles and concepts which underlie securities regulation. The Glossary also may be useful to lawyers who are starting their practice in this area.

The Glossary it is not all inclusive, that is, it does not cover many of the more exotic and not-so-exotic terms and definitions which make up securities law. Moreover, given the infinite complexity and evolving nature of federal securities law, the Glossary is a living document in the sense that, as the students move through the course, terms and definitions may need to be added, supplemented or even corrected. In this regard, any corrections or suggestions for improvement are welcomed. The Glossary also goes a step further than most other compendia by providing discussion and analysis which places the term or definition in context. In other words, how the terms relate to a fundamental principle or principles of securities law. In this sense, the Glossary may be redundant of other course materials, but repetition in this area of the law is a good thing.

One further caveat: many of the terms and definitions identified in the Glossary are significantly more complex and nuanced than the discussions would indicate. For example, attempting to fully describe the Securities and Exchange Commission's ("SEC") administrative law court process or the myriad permutations of a Rule 10b-5 cause of action would require volumes of information and analysis. Indeed, the federal courts can differ widely in their interpretation of the federal securities laws, which only raises the level of complexity and nuance. What I have attempted to do is focus on the more important aspects of the terms and definitions to provide the students and new attorneys with enough information to get them started on their learning or at least pointed in the right direction. Securities law is daunting even for seasoned securities practitioners. The theory and class materials are one thing; application in actual practice is another matter altogether. Therefore, mastering the fundamental principles, concepts, and terminology which underlie securities law is a must.

Accredited Investor – Very important term in federal securities law which affects, *inter alia*, who may be solicited for offerings, who may invest, how much may be invested and even the status of the issuer for reporting and registration purposes. A good example of how this term is relevant can be seen in the threshold requirements for registration with the SEC under section 12(g)(1) of the Securities Exchange Act of 1934 ("the '34 Act"). As a general rule, unaccredited investors are afforded more protection than accredited investors under the **Federal Securities Laws**. Also, issuers can face stricter qualification and verification standards when dealing with unaccredited investors than accredited investors, although Rule 506(c) provides for fairly strict verification procedures. For example, the definition of "accredited investor" under Rule 501(a) [**Regulation D**] is based wealth as opposed to sophistication and level of information provided for non-accredited investors. The SEC is actively considering whether to change the definition of accredited investor including substantially raising the level of income or assets necessary to qualify.

Analyst – One of many sources of information for investors. Broadly defined, analysts are professionals who make a living from studying an industry and analyzing the performance and financial strength of public companies in that industry. They are often employed by an investment banking firm such as Merrill Lynch or Goldman Sachs. In addition to issuing research reports on specific companies, which can influence public offerings as well as stock prices, analysts may rate a stock as a "Buy", "Sell" or "Hold." "Overweight" essentially means they are holding a large amount of the rated security relative to the other securities in their portfolio; "Underweight" is the opposite. These same analysts also may identify a "price target," which is their opinion as to where the stock will trade in the next 12 to 18 months. Analysts can get a lot of the information they use from the companies themselves, which presents potential conflict of interest and insider trading concerns. Companies typically are not liable for false or misleading information contained in analyst reports unless they were the source of the information or "endorse" the reports by passing them on to investors. Unsurprisingly, public companies spend a fair amount of time "courting" the more influential analysts because of the impact they can have on the price of their securities. It is important to remember, however, that analysts provide only one source of information for investors, and not the most important one in many people's minds. Also, keep in mind that most analysts tend to cover large public companies only, which can present a problem for smaller companies seeking to attract investor interest.

Annual Report [Form 10-K] – Very important periodic report along with Form 10-Q (quarterly) and Form 8-K (gap filler for significant events arising between the prior two), which are mandated by sections 13(a)(2) and 15(d) of the '34 Act for U.S. **Reporting Companies** and foreign companies whose shares (*i.e.*, more than 50%) trade on a national exchange. Unlike the 10-Q, the Annual Report is required to contain audited financial information; otherwise the two reports contain basically the same categories of information. The 10-K and 10-Q reports contain a wealth of operational and financial performance information concerning the company. Responsible public companies devote a great deal of time, internal and external people, and money preparing these reports, and the SEC generally scrutinizes them closely. The problem with these reports, however, is that while they are generally written "in English" (see SEC "Plain English Rule" (Rule 421), which provides specific guidance for prospectuses), they can be

incredibly dense and contain a fair amount of technical information which requires a high level of sophistication to understand and interpret, especially if the goal is to determine the future growth prospects for the company. If an investor cannot read a balance sheet or interpret a profit and loss statement, for example, they can glean only so much from the 10-Qs and 10-Ks. There are related infirmities which the SEC has sought to address under the eXtensible Business Reporting Language ("XBRL") reporting system. See **Disclosures**, infra. Moreover, according to the SEC and others, the reports contain too much information, which only makes the unsophisticated or tired investor's attempt to ferret out useful information that much more difficult. Understanding these reports is an art form; ditto for preparing them. Nevertheless, they remain a crucial source of information for investors, analysts, and, unsurprisingly, plaintiffs' lawyers on the hunt for misleading or false statements. The two most important regulations that govern the content of the reports are: Regulation S-K (nonfinancial information) and Regulation S-X (financial information). The report forms also provide important instructional information. Refer to Textron's 2014 Annual Report for an excellent example of a 10-K that was the result of a rigorous internal and external review process. Note: Foreign companies whose shares trade on a national exchange (*i.e.*, less than 50% of the total shares) use Form 20-F, which, although ostensibly less rigorous in terms of the information provided, is nonetheless voluminous.

Anti-dilution Provision – Provision used to adjust the **Exchange Ratio** to protect holders and issuers of securities from increases in the number of common shares arising from stock splits, reverse splits, unusual or extraordinary dividends, mergers, and other transactions that could affect their interests unfairly; that is, reduce the value of their securities (actually, their percentage of ownership). Think of anti -dilution provisions as equalizers.

Antifraud Rules – The principal means of enforcing federal securities laws in the United States. Think of the antifraud rules as "The Hammer." Section 10(b) of the '34 Act and Rule 10b-5 promulgated there under are the most important federal antifraud provisions. Section 17(a)(1) of the '33 Act is the counterpart to section 10(b) and is a SEC-only statute; that is, it does not allow for private actions. In broad terms, these devices prohibit fraudulent and manipulative acts or statements in connection with the buying or selling of securities, although 17(a)(2) & (3) dispense with the scienter requirement and section 17(a) itself applies only to purchases of securities. Rule 10b-5, for example, sweeps in conduct that is broader than common law fraud. The scope of the rule has evolved considerably since its adoption in 1942. It is the chief source of U.S. insider trading law and the basis for most shareholder securities litigation alleging misstatements of material fact, as well as many SEC enforcement proceedings. Transactions or securities exempt from certain requirements of the securities laws remain subject to the antifraud rules, which is an important reason why you need to know what constitutes a **Security**. Many years ago the United States Supreme Court decided that private citizens have an implied right of action under Rule 10b-5, although subsequently the courts have placed some limitations on this right. For example, private parties cannot bring Rule 10b-5 actions against aiders and abettors unless the latter participated in the fraudulent scheme. By amendment to the '34 Act, the SEC has no such limitation for its enforcement actions. Interesting factoid: Section 10(b) does not make any action or statement *per se* unlawful, instead leaving it to the SEC to do so through rulemaking. One final point, civil damages lawsuits involving allegations under Section 10(b) and Rule 10b-5 are subject to exclusive federal court jurisdiction.

"Approval" [in quotes for a reason] – A misnomer when applied to the SEC because it actually does not approve, in a legal sense, any filings it reviews. For example, the SEC may declare the

Registration Statement "effective," which is not an approval per se. Failure to declare it effective, however, essentially stops the underlying public offering because it cannot proceed without an effective registration statement. See also **No-Action Letters**, which, if favorable, do not constitute approval of the issue at hand, but as a practical matter, they have close to this effect. In other words, the SEC would prefer to keep its options open. This is similar to antitrust clearance by either the DOJ or FTC. For example, a merger may be "cleared" for antitrust purposes but this does not mean that the government has approved the transaction as a legal matter. In other words, in theory they can later bring an antitrust proceeding, which is relatively rare, or private persons can file an antitrust suit.

On the other hand, boards of directors approve major corporate events and shareholders the same way through the voting process. But even here, dissident shareholders can withhold their approval and commence litigation (*e.g.*, appraisal rights) or commence breach of fiduciary lawsuits even if they approved of a transaction.

Arbitragers – Highly sophisticated investors who bet that a purchased security will increase in value and thus generate a profit when they sell their shares. For example, if an arbitrager learns of a pending merger or takeover, he or she may buy shares of the target immediately on the supposition that the share price will be greater when the deal closes, even if only by a small amount. Thus, they generally will buy large blocks of stock seeking to make profits on the volume as much as the gain. This is not the only way they make money. In any event, arbitragers generally think short-term. Like almost everyone else in the investment game, timely access to **Information** concerning the issuer is their life blood, but they also are willing to take huge risks. See also **High Speed Trading**, which can lead to huge profits from volume trading but is not arbitraging *per se*, and **Hedge Funds**, which share some characteristics of arbitragers, but are nonetheless a different species.

Asset Backed Security ["ABS"] – One of the myriad forms of **Securities** subject to regulation by the **Federal Securities Laws**. Interestingly, "asset backed security" is not specifically identified as such in the definitional sections of the '33 or '34 Acts (sections 2(a)(1) and 3(a)(10), respectively), but clearly fits under the category of "instrument commonly known as a security." Basically, an ABS is a bond or note backed by a financial asset such as auto loan or credit card receivable (payments of principle and interest). Pools of these assets are bundled into marketable securities, which is known as securitization. The benefit of this device to the originator of the loan is that it can take the receivable off its balance sheet (although **Dodd-Frank** appears to require that the originator retain 10% of the credit risk) in return for **Capital**. For the investor, the principal advantage appears to be relatively high interest payments which may round out an investment portfolio. Of course, if the debtor defaults, the investment can be worthless. Mortgage Backed Securities ("MBS") are a form of asset backed security but are treated somewhat differently under the securities laws. Asset backed securities fared pretty well during the recent recession. Mortgage backed securities, especially those which involved sub-prime loans were a disaster, and in most people's minds, their massive failure (defaults), including those instruments which backed them up (*e.g.*, insurance contracts [Credit Default Swaps] provided by AIG) was the major cause of the recession. Actually, it is more complex than this but this is not a subject for this course.

Bid and Ask – Dual price quotation that can be most graphically seen on a **National Exchange** quotation board for an individual stock. The "bid" indicates the highest price at which a security can be sold and the "ask" is the highest price at which it can be bought, both a given point in

time. Generally, the two prices are accompanied by the amount of shares available at each price. When the two prices converge (equilibrium), a trade occurs. The difference between the bid and ask prices is known as the "spread," which for highly traded companies such as Textron Inc., is generally very small (*i.e.*, pennies).

For example, Textron's shares open the trading day at $38.50. The company announces shortly after the market opens that it has made a major acquisition that will materially increase **Earnings**. On this news, the bid price moves to $40.00 per share; the ask price moves to $40.09 per share. Presumably, the available shares for each will be high. So one thing you already know is that the market views the acquisition favorably (significant economic information) in terms of Textron's future **Earnings** growth. Depending on the level of trading, the two quotes may move up or down and with it the price of Textron's shares as trades are made. At the end of the day, Textron's stock price will close somewhere above the opening price, all things being equal, which they often are not. The next day, the stock will open with the "Close Value," a new bid and ask, and the beat goes on. See **Dow Jones Industrial Average** during the trading day, specifically the stock chart for Textron [TXT], to see how this looks like real time. You can actually watch the bid and ask, etc., move on a minute by minute basis.

Black-Out Periods – Prescribed periods of time usually self-imposed by public companies where insiders [broadly defined] may not trade the stock of the company they work for, irrespective of whether or not they have material nonpublic information. For example, a public company releases its quarterly earnings statement on Monday; the insiders may not trade their shares in the company until 24 to 48 hours after the earnings statement is issued to provide the public time to digest the information. Many public companies will add on a one- to two-week period of no-trading prior to the earnings release. Certain securities laws provide for additional black-out periods. Black-out periods are yet another device to reduce the risk of insider trading and provide investors outside the company with a level playing field, all in the name of fairness.

Blue Sky Laws – State securities laws. The National Securities Markets Improvement Act of 1996 [amending section 18 of the '34 Act] exempts "covered securities" [that is, the securities themselves and transactions] from Blue Sky Laws, specifically those which would entail registration, qualification, merit review and similar requirements. However, the States may require that "covered securities" be registered (*e.g.*, filed) with the states where the offering will occur, periodic reports on the value of the securities if not provided in SEC filings, and fees. The states have more freedom to regulate brokers and dealers who operate in their jurisdictions and purely intrastate offerings. They also have their own antifraud rules which exist together with the federal antifraud rules. A majority of states have adopted the Uniform Securities Act. which is designed to establish a uniform body of statutory law for the states. Last time I checked, New York and California, among others, have not adopted the Act.

A major challenge for securities lawyers dealing with any securities offering is determining whether, and to what extent, state law applies. Obviously, the cost of an offering that is subject to state regulation can be an important factor in deciding on the offering, especially if multiple states are involved. See, e.g., Regulation D, Rules 504 and 505 limited offerings. Indeed, prior to the recent change to Regulation A, such offerings were mostly a dead letter because the limit on the amount of the offering and application of the blue sky laws made them cost prohibitive. Life can be further complicated by the fact that many state securities regimes incorporate certain "merit review" procedures which the federal securities laws do not require. Perhaps this can best be summed up this way: If your client is planning a securities offering, the blue sky laws of any

state where the securities will be offered must be checked for potential application.

Bonds – Typically refers to any long-term debt of a corporation or government entity. Corporate bonds include a maturity date (*i.e.*, when the face value [principal] is payable by the issuer), which may be fixed or serial [staggered maturity] and interest. Sometimes they will include warrants or the right to purchase the corporation's shares. Bonds are a very important source of capital and are a **Security**, although interestingly the bond market, which dwarfs the stock market, does not get nearly the attention the SEC gives to stocks, probably because **Retail Investors** generally do not directly purchase bonds. This may be changing, however. The rights of bondholders and other creditors are based solely on their contract, which is known as an **Indenture**. Except in private placements where bonds are generally sold to a few sophisticated investors, bond purchasers have little opportunity to negotiate the terms of the Indenture directly, which are largely set by the issuer and the underwriters. The terms of bonds are infinitely variable, ranging from unsecured bonds with almost no financial covenants [*i.e.*, Junk Bonds] to bonds that are secured by a pledge of assets as collateral [*e.g.*, mortgage bonds]. The more secure the issuer is, the higher the price and lower the interest rate. U.S. Treasuries are considered to be the safest bonds in the world because they are backed by the full faith and credit of the U.S. Government. Unsurprisingly, in times of economic distress, investors flock to these bonds, which drives interest rates down. Stated another way, you generally do not invest in U.S Treasuries to make meaningful profits; you do it to preserve capital. If a company gets in financial trouble and files for bankruptcy protection, bondholders generally have the most protection [owners of common equity shares, the least], although the bankruptcy plan for GM and Chrysler rammed through by the Administration would lead one to believe otherwise. The greatest risk with bonds is that the issuer can default, which means the principal is at risk along with interest payments. And if it is not clear from the above, bonds can be traded on exchanges just like stock.

"Bonfire of the Vanities Theory" – Named after the novel by Thomas Wolfe, this theory [actually mine] holds that if the amount of money involved [generally lost] is big enough, public interest is high enough [especially political interest], and the injured parties elicit sympathy, somebody is going to get sued no matter what the law says. Something of an overstatement, but not by much. The securities world is especially susceptible to this because the laws are complex, often ambiguous, and carry severe penalties for violations. The important point here is that securities lawyers and their clients should be focusing on ensuring that transactions comply with the securities laws to avoid such situations, or at least reduce the risk that they occur. Stated another way, there is a preventive aspect to transactional work that should not be ignored. Securing the desired capital does not do your client much good if they have to give it back in the form of defense costs and judgment or settlement costs.

Broker – *Contra* **Dealer** and **Investment Adviser**, although in practice, the distinction between the three tends to be blurred and this can lead to trouble for them and unwary investors who use their services. As defined in section 3(a)(4) of the '34 Act, the broker is any person who effects securities transactions for the account of others, which includes buying and selling securities for investors through **Exchanges** or **Over-the-Counter** markets. In this capacity, think of brokers as the quintessential middleman for trading transactions. Brokers may also: perform extensive research (*e.g.*, analyst reports) in order to make recommendations to their clients concerning securities to buy or sell; sell investment products to clients; and even provide general investment or retirement planning advice, often characterizing themselves as financial advisors. In short,

since the '34 Act, brokers have branched out into providing services not contemplated by the statute; specifically, they often provide investment advice. Brokers generally make their money from commissions on the trades they effect for their clients and when they have their salesperson hat on, commissions from the investment products they sell their clients, which often can include products offered by the brokerage firms or investment banks for which they work. This presents obvious conflict of interest issues. Unlike **Investment Advisers**, however, they are not fiduciaries, thus they are generally subject to a lesser standard of care ["suitability"] when providing investment advice. The law of broker-dealer liability is confusing and varies widely from state to state, but as a general proposition, absent fraud or actually acting as a fiduciary [which is often hard to prove], gross negligence needs to be proved for liability purposes, at least with respect to providing investment advice. **Investment Advisers**, on the other hand, are generally subject to the stricter "best interests of the client" standard.

There is considerable pressure on the SEC, as evidenced by section 913(g) of the **Dodd-Frank Act,** to adopt rules making brokers [and broker-dealers] fiduciaries when they provide investment advice. In April 2015 the Department of Labor, which has jurisdiction over qualified pension plans under ERISA and apparently IRAs, submitted for comment a proposed regulation which would hold brokers providing investment advice [broadly construed] to **Retail Investors** to a "best interest" of the client standard. The regulation provides for a "best interest contract exemption" which would allow brokers to collect commissions and other fees from the investment recommendations provided brokers [and other "advisors"] agree to be bound by the best interest standard and make certain disclosures [*e.g.*, commissions]. The measure is controversial. Various broker constituents argue that brokers and dealers are already subject to a myriad of regulations. They also claim it is unclear how smaller retail investors can afford the services of a broker once the commissions disappear, although the DOL believes that the contract exception will cure this problem.

It appears that the DOL will enact the new rule relatively soon. More expansive SEC rulemaking in the area of broker-deal selling practices in general also may be in the offing. Indeed, in May 2015, Mary Jo White, the SEC Chairwoman, endorsed a uniform fiduciary duty standard for brokers, dealers and investment advisors when dealing with retail investors.

The '34 Act requires brokers engaged in interstate commerce to register with the SEC, which explains why most investment banking firms which employ brokers register this status with the SEC. Brokers also are regulated by the industry **SOR**, FINRA, and any exchange of which they are members. In addition to policing its broker members, FINRA offers arbitration for disputes, the results of which are mixed.

It is standard practice for brokers to include arbitration clauses in their client agreements. Brokers are not Traders whose sole purpose is to buy and sell securities, generally for the investment banking firms they work for or themselves. Some would say that brokers are on the low end of the securities industry whereas Traders are at the top. Traders also are licensed under FINRA. Interesting fact: in 2013 the SEC filed 121 enforcement actions, mostly administrative proceedings, against broker-dealers targeting a wide range of violations. A major focus of the proceedings was failure to register.

Capital – For purposes of this course, we will confine the term to cash or other readily accessible funds. Capital is to a business as food is to a human. Without sufficient capital, businesses cannot sustain their operations, let alone grow their profits, the latter being the

sine qua non of most businesses. Thus, the issuance of securities is an important source of capital for businesses. Resist the temptation to think of the securities laws only in terms of limiting practices, endless regulations and rules and punishments for violators. Congress and the SEC recognize the importance of facilitating the free flow of capital as a means to achieve economic prosperity, although the overall weight and reach of the securities laws makes you wonder sometimes. As discussed, securities offerings are important sources of capital for businesses and government entities. There are other important sources of capital for non-governmental entities including funds derived from the business [organic growth], mergers & acquisitions, bank loans and **Venture Capital**, just to name four.

Capital Markets – Not an entity *per se* but a generic term referring to the means by which companies reach investors or other sources of capital. The term includes the structured market for stocks and bonds, nonpublic markets such as **Dark Pools**, **Private Placements**, private equity or even **Crowdfunding** [which is public]. If a company or government entity needs capital and it does not have access to the "capital markets," this generally means no one wants to buy its securities or lend it money. Not a good thing if your client needs cash to sustain or grow its business.

Cash Flow – As a practical matter, cash flow is nothing more than the amount of cash coming into a company during a particular period of time, less the amount of cash that is being spent. So, cash flow will typically be income plus depreciation and amortization less any capital expenditures, dividends and debt payments. Free cash flow is usually the term that is applied to the cash flows of the company above and beyond those cash flows associated with the need to pay dividends and spend maintenance capital. In other words, it is usually considered to be a measurement of the amount of cash that could be spent on other activities—such as an acquisition, stock buy-back, or operational endeavors such as research & development and new product development. For purposes of this course, understand that cash flow is an important indicator of a company's financial health, even though there is ample cash generated by the business and no profits! Stated another way, it is generally a good thing if a company generates lots of cash from its operations, assuming they are using the cash wisely. Even better if indications are that cash flow will continue to be strong in the future. Unsurprisingly, cash flow is yet another bit of **Information** that investors can factor into their investment decision.

Client Objectives – It is critical that the securities lawyer identify early the client's objectives when faced with the prospect of pursing a securities transaction. What is it that your client wishes to achieve? Raising the desired amount of capital generally is most important. There may be other objectives such as minimizing the transactional costs, including management time necessary to complete the transaction; understanding the likelihood of successful completion of the transaction [certainty]; completing the transaction within a specific timeframe [speed]; and avoiding liability. Additionally, for initial public offerings the issuer has to worry about the costs and potential loss of control that comes with being a public company. Understanding the client's objectives early allows the lawyer to identify and structure the transaction that will best meet the client's needs. In other words, all transactions are not equal, they all contain **Risks** and often the client has to balance the advantages and disadvantages of various alternatives in making its decision as to which transaction to pursue, if any. Maxim to live by: The securities lawyer must understand the client's objectives before embarking on the transaction and plan early for the important issues and **Stakeholders** which will affect the transaction. This also

applies to securities litigation, although the objectives may be different, or at least differ in terms of their priority.

Comment Letter [Officially: Letter of Comment] – Very important device used by the SEC as part of its review of required filings and reports. For example, the SEC staff may "request" a modification to a **Registration Statement** or the inclusion of missing information via a comment letter. Comment letters should not be treated in a cavalier manner. Indeed, periodic reports have a section for the listing of any open comment letters. Often they are helpful and disagreements often may be negotiated. Failure to satisfy SEC comments can delay or even negate a securities transaction or indicate some infirmity with the issuer or offering that could deter investor interest. Unless the filing is confidential, comment letters and the responses to them immediately become part of the public record, which means potential investors and plaintiffs' lawyers have access to them. In short, issuers who ignore comment letters or treat them cavalierly do so at great risk. See **No-Action Letters**, which serve a different but related purpose.

Compliance Programs [Preventive Law 101] – Internal, often highly formalized and detailed programs designed to prevent, detect and deter violations of federal and state laws and regulations through such vehicles as education and training, codes of conduct, hotlines and internal controls. In other words, compliance programs are intended primarily to promote compliant behavior, although in my experience, they can be overly bureaucratic and achieve mixed success. For companies that are subject to the securities laws, good compliance programs will include training employees as to the law and rules that need to be followed and reporting procedures to prevent and ferret out insider trading. Compliance programs became the vogue when the DOJ federal sentencing guidelines were enacted in the early '80s in part because having an effective compliance program which met the DOJ criteria could be a mitigating factor for penalties and sentencing under the federal laws. The Department of Defense also has "encouraged" compliance programs in the government contracts world, which is especially susceptible to fraud and abuse. Companies and financial institutions spend a small fortune maintaining compliance programs, and it is not unusual to have a member of senior management, usually the general counsel, designated as the "Compliance Officer." Increasingly, smaller companies and institutions which operate in highly regulated industries are adopting their own compliance programs, albeit on a smaller scale. So let's summarize the situation succinctly: The goal of any compliance program should be to prevent and detect noncompliant behavior; if all else fails, at least have a compliance program that meets the DOJ criteria [which may lead to reduced penalties]. Another often overlooked benefit is early detection of noncompliant behavior, which can come in handy if you subscribe to the maxim that some people will do bad things no matter how much training and education they have. Thus, the sooner the company learns of it, the better it can deal with it, ideally before the government gets involved. It is hard to imagine that anyone who practices serious corporate law today, especially in-house, will not get heavily involved with compliance programs at some point, especially if the company is public.

Control – An important concept in federal securities law [as well as M&A] because "control persons" can be subject to various securities laws as well as be "primary" persons for liability purposes. See, e.g., section 20(a) of the '34 Act. Rule 405 defines control as "the power to direct or cause the direction of management and policies of a person [*e.g.*, an issuer] whether

through the ownership of voting securities, by contract or otherwise." This is a very broad definition that can sweep in the chief executive officer, some or all directors, and even a single shareholder depending on how many shares he or she owns and the influence they have over management of the issuer. It also can include underwriters and even broker-dealers depending on the circumstances. For example, a shareholder can be a control person even though he or she does not own a majority of the company's common equity shares if he or she exercises cognizable control over management of the company. On the other hand, an **Institutional Investor** who owns 35% of an issuer's voting stock but is purely passive is not a control person *per se*. An underwriter by definition can be a control person in an offering given his or her superior knowledge of the issuer and the offering.

Corporate Governance – Generally a matter of state corporation law, but Congress has intruded somewhat in the securities area. A broad term which basically includes the laws, procedures, practices and guidelines, both external and internal, which create a framework for companies to govern themselves and their various constituencies, such as directors and shareholders, in the conduct of their businesses. The articles of incorporation [certificate of incorporation in Delaware] and bylaws are two of the most important corporate governance documents. Delaware General Corporation Law [DGCL] and case law also establish the requirements for how Delaware corporations are to be governed. Company codes of conduct, which are greatly in vogue today, are another example of a governance document.

The **Sarbanes-Oxley Act of 2002** ("SOX"), with its increased financial reporting, enhanced auditing and senior officer and outside auditor certification requirements, is typically regarded as a corporate governance law, although the SEC enforces it. Ditto for the Foreign Corrupt Practices Act ("FCPA") record keeping provisions that are incorporated into the '34 Act at section 13(b). These are two examples of how the federal securities laws intersect with state corporate governance laws. There are others, including the proxy related statutory provisions and rules. See section 14 of the '34 Act and Rule 14A. So much for the "internal affairs" doctrine as far as Congress and the SEC are concerned, at least for **Reporting Companies** under section 12 of the '34 Act.

Covered Security – As discussed above under **Blue Sky Laws**, a security or securities transaction which may not be "regulated" [*e.g.*, registration or qualification] by the States. See section 18(b) of the '33 Act, which incorporates the National Securities Improvement Act of 1996.

Crowdfunding – A recently created creature of federal statute [see Title III of the **JOBS Act** amending section 4(a)(6) of the '33 Act] which allows nonpublic U.S. companies, especially start ups and small businesses, to raise up to $1M over a 12-month period from investors including non-accredited investors [*e.g.*, most retail investors] by issuing securities to the public without registration under the '33 Act. The amount that can be sold to each investor is limited based on their income and net worth. Other requirements apply, such as advertising and selling the offered securities through broker-dealer or "Funding Portals," which themselves need to be registered. Restrictions on the resale of the securities also apply; other post-offering reporting and auditing requirements apply as well. Crowdfunding does have the benefit of being exempt from state **Blue Sky Laws**, however. The SEC final crowdfunding rules were released on October 30, and will be effective as of May 16, 2016, and, in addition, several states have

adopted their own crowdfunding statutes for purely intra-state offerings. Unfortunately, between Congress and the SEC, which in fairness was largely hamstrung by the dictates in the statute, it is unclear whether given the costs, regulatory hurdles and other adverse factors associated with federal crowdfunding; it is unclear whether there will be a market for these offerings.

Think of two eggheads in one of their parent's garage who have invented a bike with square wheels and need to get funding for their venture and cannot afford the costs associated with registration under the '33 Act, nor can they get the money from their family and friends as a loan or gift. Ostensibly, they now can raise capital from investors through equity crowdfunding without having to go through the cost and torture occasioned by the '33 Act registration requirements.

Critics of the JOBS Act view crowdfunding as a license to defraud unwary retail investors. Proponents of the legislation tout it as easing the '33 Act registration burdens in order to provide fledging businesses with easier access to capital. Crowdfunding under the JOBS Act is not to be confused with so-called "crowdfunding" platforms such as Kickstarter that do not involve the issuance of securities. For example, contributors to ventures advertised on such sites [*e.g.*, an Indie movie, a chi chi coffee shop in NYC's Upper West Side, a "whiz bang" espresso machine company, which turned out to be an absolute bust] do not get the right to any monetary return [*i.e.*, profit] or equity ownership based on their contribution. What they sometimes get are things like t-shirts or mugs, new products made by the venture (assuming it gets this far), free tickets and perhaps most importantly, the gratification of supporting a venture in which they have a personal interest. Kickstarter has raised approximately $1.4B for many ventures according to a recent article in *The New York Times*. It is fair to assume that the owners of the site get a healthy piece of [10% is a good rule of thumb] of the money raised, although they recently reincorporated as a public benefit corporation.

As mentioned, the SEC issued its rules on crowdfunding, which are daunting—it is fair to say the SEC is highly suspicious of crowdfunding. Exactly how effective this capital raising vehicle will be remains to be seen. There is already talk in Congress of further relaxing the rules. Indeed, one commentator reports that the SEC estimates that crowdfunding may entail costs as much as 12.9% to 39% of the amount raised from the offerings. In other words, our two eggheads may be out of luck when it comes to crowdfunding, at least if they are going to pursue an offering which implicates interstate commerce.

Dark Markets/Pools – Refers to largely unregulated or "private" trading done other than through public **Exchanges** such as NYSE and NASDAQ. Recently, an op-ed article in *The Wall Street Journal* stated that nearly 40% of all equity trading in the U.S. is taking place away from public exchanges and much of it is being done "off-exchange" by **High Speed Trading** firms which are also unregulated [soon to change with a proposed SEC rule to require such firms to register with **FINRA**]. For example, the typical **Retail Investor** calls a broker to place an order to trade stock at a set price. The investor assumes that the broker is going to make the purchase through a regulated exchange. This is not always the case—the broker may sell the trade to a Wall Street firm that has infinitely better and more current [*e.g.*, hour-to-hour] knowledge of how a particular stock is performing, or, more precisely, about to perform, and accumulates and trades tens of millions of shares per day with the hopes of getting a better price than the retail investor would get if his trade went through a regulated exchange. This is a form of dark trading

invented by all people, Bernie Madoff. A trading firm is closely watching a particular stock and believes it will tick-up imminently. The firm contacts brokers and pays them a price for the stock based on its present trading value, then, when the stock price moves up, turns around to find someone to buy it at the new, higher price, pocketing the gain as profit [*i.e.*, "flip it"]. Multiply this by millions of shares, and you can see how profitable this practice can be. The retail investor knows nothing of this and is happy that he or she sold the stock for the price they wanted. The broker is happy because he or she at least got a fee from the retail investor and a commission from the trading firm. This is entirely legal, and is not what Bernie Madoff went to jail for. In short, there are numerous trading platforms where stocks are traded away from the public eye. Interestingly, following the dictum of "If you can't beat them, join them," the NYSE and NASDAQ are looking at setting up their own version of dark trading, albeit in a more transparent and retail investor friendly manner. Last time I checked there were forty or so different dark pools.

D&O Insurance – Directors and Officers Insurance. Insurance intended to cover losses and expenses incurred by directors and officers who are subject to legal proceedings or under investigation [with some limitations] arising from the performance of their duties. For public companies, such policies have high deductibles or retentions [the company's money] and limits coverage to the $150–250M range, which is not a lot of money when you think about securities class actions. The first question most directors ask is whether the company has such coverage. The other protection directors and officers obtain is indemnification [and often advancement of defense costs] under the company's by-laws. Delaware General Corporation Law [Section 145] allows the most expansive indemnification terms, which is yet another reason why many corporations incorporate there. These two devices are particularly important to protect directors and officers when they are named as defendants in securities lawsuits, not to mention any lawsuit seeking personal liability. See also Del. Gen. Corp. Law § 102(b) (7), which allows limited protection to directors only from shareholder litigation [*i.e.*, "exculpation"]. Most states do not provide for this added protection for directors. Also, with respect to indemnification, the SEC appears to have taken the position that it is against public policy to indemnify directors and officers for certain violations of the federal securities laws. Interestingly, this goes hand in hand with the occasional requirement that issuers and management admit guilt as a condition of settlement.

Dealers – Under the '33 and '34 Acts, "dealer" basically means any person who engages in the business of offering, buying or selling or otherwise dealing or trading in securities for his or her own account. Also, like brokers, dealers are required to register with the SEC pursuant to the '34 Act and must join FINRA. As previously discussed, it is not uncommon for broker-dealers to engage in trading for clients and their own accounts.

Debt – Debt is nothing more than the liabilities of a company outside of trade indebtedness and accruals that it has formally borrowed from investors in order to invest in the business. Debt will normally be in the form of mortgages, notes payable, bonds, or subordinated debt. It is typical that the longer the maturity of the debt, the more likely it is to be considered "permanent capital" for the purposes of funding the business. It is a rule of thumb that one wants to finance long-term assets with either long-term debt or equity; that is to say, permanent capital. In any event, the size of the debt, especially when compared with capital (debt-to-capital ratio), can be another factor in evaluating a company for investment or acquisition purposes. Debt is not necessarily

bad *per se*, however, especially if the debt was incurred to grow the corporation.

Debt Security – Yet another way for a corporation to raise capital, a debt security is a security representing a corporation's promise to pay back borrowed money plus interest. Bonds, notes and debentures are examples of pure debt securities. The issuance of these securities is generally referred to as a debt offering.

Derivatives – Complex financial instruments that are designed as either speculation or insurance [*i.e.*, hedging] vehicles for the parties who enter into [*i.e.*, contract] them. For example, derivative contracts can be used to reduce risks between the parties by specifying the conditions under which payments are to be made between the parties. Derivatives are beyond the scope of this course other than the fact that they lack transparency to capital markets, especially where third party companies sell insurance on the contracts. Here is an example:

> *A* & *B* enter a derivative contract addressing the sale of rice by *A* to *B* at a set price and to be made at a set time. *A* is assured a price and buyer for its rice and *B* is similarly assured a price and the rice.

Generally, a third party provides the futures contract. If the price rises or falls, or no rice is available for whatever reason, the respective parties to the futures contract—counterparties—suffer or benefit. Where potentially big problems arise is if the third party provides insurance for the futures contract and one of the counterparties defaults, triggering the insurance. Multiply this by providing insurance for thousands of rice futures contracts and imagine the impact on the third parties' shareholders when there are not enough reserves or premium dollars (or both) to cover the insurance payments when the contracts fail. While the foregoing is over-simplified, this is basically what happened to many financial institutions [*e.g.*, AIG] during the financial crisis of 2008. Similarly, problems occurred when **Institutional Investors** and even **Retail Investors** invested huge sums of money in futures contracts that failed to perform as expected.

Derivative Suit – A suit, frequently a class action, filed by a shareholder on behalf of the corporation, alleging that the corporation's directors and officers wrongfully damaged [*e.g.*, wasted assets] or otherwise injured the corporation. For example, derivative lawsuits may allege that a debt offering carried too high an interest rate, was otherwise imprudent, or the CEO violated the '34 Act section 16(b)'s prohibition against "short swing" profits. When securities are involved, such suits are generally accompanied by a Rule 10b-5 securities fraud class action, which is generally more difficult to deal with. Derivative lawsuits are obviously more complex than this description [*e.g.*, "demand futility" doctrine].

Disclosures – Very broad term. Disclosures may be mandated under the federal securities laws or voluntary. Indeed, one of the major purposes of the **Federal Securities Laws** is disclosure. As discussed previously, 10Ks, 10Qs and 8Ks are the most important disclosure documents under the '34 Act. The **Registration Statement** and **Prospectus** are the major disclosure documents under the '33 Act. For these and similar mandatory disclosures, a myriad of regulations and rules [*e.g.*, Regulations S-K & S-X] set forth what should be disclosed, when it should be disclosed, and how it should be disclosed. **Materiality** is an important consideration for disclosures: the anti-fraud and other remedial provisions under the '33 and '34 Acts pivot off false or omitted material facts. Many public companies form disclosure committees which can include the CEO, CFO, GC and outside auditor(s), among others, to review important disclosure

documents before they are filed with the SEC for review.

Companies can disclose information in an infinite number of ways that are not mandated by the federal securities laws. Press releases, quarterly earnings calls, investor calls, meetings with analysts, and company websites are some of these disclosure vehicles. What they all share in common, however, is that they are subject to the anti-fraud rules and well as other rules [*e.g.*, **Regulation FD**]. It does not do much good to scrupulously manage the content of periodic reports or the registration statement if the company turns around in a press release or investor call and conveys false or misleading material information. In sum, companies subject to the federal securities law must be disciplined in all their disclosures, but that is easier said than done.

A related point which is foundational to the practice of securities law: A company is not required to disclose any information—no matter how important or material it might be—unless mandated by a legal requirement under the SEC rules and regulations, case law or statutes. Whether there is a duty to update information that was previously released remains an open question. For example, see the Time Warner Securities Litigation case, where the company decided to pursue a major plan that was contrary to what it previously announced. Also, the NYSE and NASDAQ require listed companies to promptly disclose material information to the public. In any event, Basic v. Levinson teaches that once a company discloses material information that it has no affirmative duty to disclose, the information may not be false or misleading [*i.e.*, must be accurate]. The disclosure also must be complete, which is another way of saying disclosures must be full and fair.

There is one final filing requirement for periodic reports: Since 2011 the SEC (and many similar regulatory agencies worldwide) has required that selected financial information contained in periodic reports also be filed in Extensible Business Reporting Language ["XBRL"] format. XBRL is an interactive software-based standardized language [taxonomy] reporting system that facilitates the identification, comparison, and analysis of financial information internally and across companies and industries, and, if necessary, worldwide. In other words, it greatly reduces the time necessary to sort data occasioned by manual, textual [*e.g.*, HTML or ASCII] reports. For example, an investor or analyst can compare historical inventory or profit data for several companies in the same industry with the "click" of a computer key. Actually, it is more complex than this but you get the point. All the XBRL reports filed with the SEC can be accessed at www.sec.gov/spotlight/xbrl/filings-and-feeds.shtml if you have nothing better to do. Last time I checked, foreign private issuers whose shares are registered on a national exchange that follow ISFR accounting standards are not required to submit financial data in XBRL format.

Dividends – Mostly quarterly, but occasionally "one-off" cash payments to holders of equity and preferred stock, approved by the board of directors. Income motivated investors like to see high dividends, as well as profits, from their investment. Additionally, they also want their security to be **Liquid**. Unlike investment gain (*e.g.*, stock price increases), dividends represent a drain on the corporation's assets, which is why they aren't handed out like candy. Under the business judgment rule, boards have almost unlimited authority to grant or not grant dividends to common stock owners. Preferred shareholders are entitled to dividends by contract. Absent rare circumstances, the board cannot be forced to grant a dividend to common equity owners, but, depending on the circumstances, the failure to do so can spur **Shareholder Activism** in an effort to force them to do so by threatening proxy contests and other means. See also **Yield**.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 – Incredibly dense and comprehensive piece of legislation primarily designed to eliminate many of the real or perceived evils associated with financial institutions that led to the Great Recession of 2008, and thus largely beyond the scope of this course. Certain sections, however, do have direct implications for securities law, such as: the "bad actor" disqualification for certain issuers and related parties seeking to pursue a private placement under Rule 506 of Regulation D or Regulation A+ offering; the expansion of the SEC's administrative law process to reach "all persons," as opposed to just brokers and investment advisors; and the expansion of the SEC's jurisdiction over alleged violations involving conduct abroad. The Act also requires new stock exchange listing standards, expanded disclosures for all public companies that solicit proxies, requirements for increased reporting on executive compensation versus performance ("Pay for Performance"), and the dubious provision that authorizes the SEC to promulgate a rule governing the mandatory disclosure of CEO compensation as compared to the median employee compensation [CEO/Median employee ratio]. Interestingly, section 926 of Dodd-Frank required the SEC to expand certain shareholder proxy rights for nominating directors, which the SEC promptly addressed by rulemaking; relatively shortly thereafter, the D.C. Circuit rejected this provision in the Business Roundtable decision, which we will discuss.

Dow Jones Industrial Average ["DJIA"] – Simply put, the average daily value of the thirty industrial stocks that make it up. The Dow is nothing more than an index that indicates the value of the companies which constitute it. The higher the Dow, the better investors feel [unless they have **Shorted** certain securities]; the lower, the worse they feel [especially if they have gone **Long** on certain securities]. What drives the Dow is the performance of the components' stock, which in turn is driven by investors' trading decisions, which in turn is driven by the flow of information into the market. Generally, large, well-known companies, such as GE, GM, and IBM, compose the Dow, and companies can be added to or subtracted from it based on certain criteria that escape me at the moment. Despite the tendency to do so by many, it would be incorrect to conclude that the Dow is an accurate bellwether of the overall state of the economy, nor is it the most "accurate" index in this regard. Indeed, during the winter and spring of 2015, the Dow traded regularly above 18,000, an all time high; yet, by any rational measure, the U.S economy was hardly robust. Quantitative easing and artificially low interest rates can do wonders for the stock market. See S&P 500, Russell 2000, and NASDAQ, which differ in composition and number of "members" from the Dow, but are nonetheless well-respected "indexes." The best place to access the Dow is Yahoo Finance, DJIA. This will provide you with a spring board to public company information, including: stock price, bid/ask, analyst reports, recent filings, important press releases, etc. Just type the trading symbol for the company [*e.g.*, TXT for Textron] in the little box at the upper left hand corner of the DJIA page, hit the button, and off you go.

Early Planning – Obviously not a term confined to the practice of securities law, but an important one nonetheless. The good securities lawyer will work with the client early to understand his or her objectives, the proposed transaction, and a myriad of other issues which may impact the transaction. A classic example is an **IPO**. These transactions don't just happen out of the blue or overnight. Successful **IPOs** involve extensive, early planning by key **Stakeholders** [*e.g.*, **Underwriters**] on the **Issuer's** side of the equation, which includes identifying and mitigating or managing any factors [**Risks**] that can adversely affect the

transaction and/or the issuer's transition to life as a public company. Even seasoned securities lawyers will use a checklist or some other device to identify important steps, requirements, deadlines, and issues that may arise. The point is that, even for minor securities transactions, early planning is a pre-requisite to success; and, even then, unanticipated issues may arise and affect the transaction. Think risk management when approaching a securities transaction.

Earnings – **Revenue** less expenses, or, at the risk of simplification, net income, often referred to as "profits." Most investors consider earnings, especially the potential for future earnings, to be the most important indicator of a stock's underlying value, or, more precisely, whether it will increase or decrease in price. Interestingly, in the so-called "dot-com" era, revenue growth was often a more important indicator than earnings early on. Why? The expectation was that revenues would come first and eventually strong earnings. So, what do you do, all things being equal, when a company's earnings report is solid but its revenues are slightly down? This might be an indication that the company is engaging in aggressive cost cutting that cannot continue, thus, the potential for future earnings is diminished. Analysts will typically reach a consensus on a company's projected quarterly and full-year earnings and revenues. Many public companies will aid and abet this process by forecasting their earnings and revenues. When the company does not meet the estimates, this can lead to a drop in share price and *vice versa* when the estimates exceed expectations. Turn on Squawk Box (CNN outlet) on your TV during the week starting at 6:00 AM and wait for an earnings announcement [generally towards the end of a quarter] and you can see how this plays out in real time.

Earnings Per Share ["EPS"] – A term frequently used by public companies and analysts as an indicator of profitability, and thus of significant importance to many investors. EPS represents part of a company's profits allocated to each share of outstanding common stock. Thanks to Investopedia, the formula for calculating EPS looks like this:

Net income less dividends on preferred shares

Divided by = EPS

Average number of outstanding shares

If a company has $30M in net income, pays out $2M in preferred dividends and 28,000,000 common shares are outstanding, its EPS is $1.00. The higher the EPS the better; predicted higher EPS numbers are even better because they indicate future growth, which is the primary driver of stock price in an efficient market. Thus, EPS is another important data point that investors may consider when making an investment decision. However, EPS can be manipulated: For example, if the issuer removes millions of shares from the market through a stock buyback, the EPS would be higher without any increase in revenues. Whether the average retail investor figures this out is an open question. This is yet another reason why investors should not rely on "isolated" information when making investment decisions.

Efficient Capital Market Hypothesis ["ECMH"] – Controversial but widely accepted basis for SEC regulation and many judicial decisions. As the text states: "It is the intellectual framework within which current disclosure obligations are formulated and their operation assessed." At root, it demonstrates the relationship between information and price. How to describe it? Well,

that's another story. Basically, the hypothesis states that the efficient market [not all markets are efficient, although you can assume national exchanges are] is the best possible measure of the value [price] of a security at a given moment. Financially-significant economic information made available to the market is quickly ["within 24 to 48 hours"] incorporated or absorbed into a security's price, and thus the "collective wisdom" of the market sets the price. In other words, the markets are "informationally" efficient; therefore, there can be no mispricing of securities, which of course doesn't mean that the securities necessarily reflect the true or **Intrinsic Value** of the issuers. Indeed, the markets are not totally "artificial" in terms of value. For example, if companies whose shares trade in the efficient market perform poorly, eventually the price of their shares will reflect this, which is an important lesson the Chinese government recently learned in its failed attempt to prop up their markets through mechanisms that have nothing to do with the companies' underlying value. Under the federal securities laws, the investor who buys or sells stock in an efficient market [note: an initial public offering does not involve an efficient market] is entitled rely on the price set by the market. See, e.g., Basic v. Levinson.

What this all means for securities regulation is that the information that makes its way into the market must be accurate and complete in order for the market to be efficient and so investors have a level playing field from which to make informed investment decisions. Hence, the federal securities laws' mandatory disclosure rules. The hypothesis also assumes that the market is not being manipulated by artificial forces [*e.g.*, "pumping and dumping" of stocks, or even certain **High Speed Trading** tactics, I suppose], which ties to the SEC's second mandate of maintaining market integrity and efficiency.

To make matters more confusing, there are three levels of ECMH: weak, semi-strong, and strong, which for me are too esoteric to spend any time trying to figure out in this course. Whether ECMH is "correct" remains the subject of much debate, especially because individual investors' behavior can be erratic and anything but rational, and the price of a stock may be influenced by other factors that have nothing directly to do with the issuer. Let's put it this way: Certain markets may be efficient, many investors are not (that is, not rational). In the recent Halliburton II decision, the U.S. Supreme Court came very close to jettisoning the ECMH as a basis for the "fraud on the market" theory that was first enunciated in Basic v. Levinson.

Frankly, I don't fully understand ECMH like most people, but what you need to take away from it is the fundamental proposition that significant economic information can move the price of a security one way or the other and investors are entitled to rely on the stock price set by an efficient market when making their investment decisions. False or misleading information that makes its way into the efficient market through issuers or their agents artificially distorts stock price and, consequently, is actionable.

Many of those who accept the hypothesis conclude that it makes little sense to attempt to beat the market through individual trading; that is, looking for under- or over-valued securities, which led to the "invention" of **Index Funds**. But, this is not a course on how to invest, so focus on the securities law implications of ECMH.

Electronic Data Gathering, Analysis & Retrieval ["EDGAR"] System – SEC database that contains the vast majority of filings, which are generally required to be filed electronically, by **Reporting Companies** and certain other companies. It is easily accessed and not difficult to

use: Just access the SEC website [http://www.sec.gov] or Google "EDGAR." The SEC website itself contains a massive amount of additional information concerning federal securities laws, the status of proposed rules and regulations, policy guidance, and even brief (but helpful) discussions of key terms and definitions. This is a valuable tool that you should use during the course and beyond if you practice securities law. If you are searching for a public filing such as a Form S-1 **Registration Statement** for an IPO or Rule 13-e3 "going private" filing, be prepared to copy a ton of paper unless you have Superman eyes. Another tool that investors find helpful is the XBRL interactive data reporting system discussed previously. Recently, EDGAR appears to have suffered a hiccup when a faux investment firm filed a fictitious takeover proposal for Avon with the SEC, which had the unfortunate effect of causing the company's stock to increase by a $1. No doubt, there was some arbitraging going on which means someone lost some money. See **Manipulation**.

Emerging Growth Company ["EGC"] – Another recent but very important creature of the **JOBS Act** [Title I]. An EGC is defined as an issuer of securities that has less than $1B in revenues in its most recently completed fiscal year. Under the JOBS Act, EGCs that seek to go public face relaxed registration requirements, including: two versus three years audited financials required in the registration statement, delayed outside auditor attestation of management's certification of internal controls [very popular among EMGs], and relaxed executive compensation related rules and procedures. Most important, EGCs have greater ability to communicate with potential investors [qualified institutional buyers ("QIBs") and accredited investor institutions] during the so-called "pre-filing" and "waiting" periods under section 5 of the '33 Act. This is the "test the waters" concept. EGCs also have the ability to make confidential filings of the proposed registration statement with the SEC. This offers several advantages which we will discuss. These filings are not considered registration statements per se, and thus, no registration fees are required. Of course, if the company eventually does decide to file a registration statement pursuant to an **IPO**, the confidential submission and SEC comments become available to the public and the registration fee is due. It is actually a little more complicated than this but this is sufficient for now.

The intent of this section of the JOBS Act was to create an easier and a less costly IPO "on ramp" for "smaller" companies to facilitate capital formation, promote job growth, and improve the economy. A major U.S. law firm recently reported that, in 2014, 85% of all IPOs involved EGCs, which also tells you that not every IPO is Facebook, Google or Alibaba.

Like every securities transaction, an EGC-IPO has advantages and disadvantages depending on the client's objectives. To summarize: EGCs still have to comply with many of section 5's registration requirements and the regulatory requirements associated with being a public company, but they have options available to them which can reduce the cost, uncertainty, and other burdens associated with the conventional registration process and subsequent life as a public company, at least until they are no longer eligible for EGC status.

Equity – Equity is the permanent capital that has been invested in the business by its owners. It can be in the form of common stock or preferred stock. **Preferred Stock** is a permanent ownership interest that entitles the owner to a fixed rate of return, whereas common stock connotes an ownership interest with no fixed rate of return. As a general rule, the more "equity" in the permanent financing structure of a company, the more stable it is, and the safer the

business. Equity also is frequently used to denote cash.

Equity Security – Generally refers to common stock, which includes ownership [the essence of equity] of a corporation and the right to vote on the affairs of the corporation, as well as the right to receive any dividends, participate in stock buy-backs and other benefits of ownership. Common stock is a claim on the cash flow and assets of a corporation, but unlike bonds or even preferred shares [which are an equity security/bond hybrid], common stock takes last in a bankruptcy, which often translates to nothing for the stock owners. Debt securities usually have a definite maturity date on which the debt must be paid; common stock is perpetual. Common stock may be viewed as the purest form of investment.

Exchanges [National or Public Exchanges] – Formal, highly regulated "places" where listed securities of public companies are traded through brokers. An exchange is nothing more than a marketplace for the buying and selling of securities. At root, securities such as common equity shares are traded in an auction setting, albeit a highly efficient process with several built-in protections [*i.e.*, Exchanges eliminate counter party risk, that is, the Exchange stands behind the trade as opposed to the individual brokers; rigorous admission requirements and governing rules]. The overriding benefit of Exchanges is that they provide strong **Liquidity** for listed securities, which makes the securities more valuable to investors, unlike private placements, whose securities may not trade on any market. In sum, security holders of public companies have infinitely greater certainty that they can get value for their securities when they need it through a national exchange. Exchanges are secondary markets; that is, the money passes between buyers and sellers. Today, there are sixteen national exchanges in the United States. The most famous is the New York Stock Exchange [NYSE], which is the largest exchange in the world. The NASDAQ is another prominent exchange but unlike the others, is entirely virtual, although the others are catching up. The DAX in Germany and the London Exchange are two of many international exchanges. It is not unusual for public companies to trade on more than one exchange either here or outside the U.S., which presents interesting opportunities for arbitragers when there are price disparities from one exchange to another. Shares of some public companies also trade on an **Over-the-Counter** market, discussed below.

Forget the trading room scenes in the movie Wall Street: Today, almost all trading on the national exchanges is done electronically, where millions of sell orders are matched with buy orders daily. In fact, the exchanges are efficient "places" for bringing buyers and sellers together so they can trade at prices that more closely reflect the actual supply-demand curve ["equilibrium price"]. Also, several of the exchanges have requirements for their listed companies that can impact securities and M&A transactions. Thus, they also can be important **Stakeholders** in these transactions.

So, what is an **Over-the Counter [OTC]** market? Well, there are three of them which divide issuers into three levels for quotation market purposes: OTCQB, OTCQX, and the so-called "OTC Pink Market." The OTC markets are not as highly regulated as national exchanges, with the Pink Market being the least regulated, ironically because the listed securities present the highest risk. Generally, less financial and operational information is available on issuers who are not reporting companies, although there has been a recent change in this regard for private companies whose shares trade on the OTCQB, with the Pink Market again bringing up the rear in this regard. Brokers operating in these markets provide counter-party protection as opposed to

the markets themselves. There are other important differences too numerous to mention here. Nevertheless, OTC markets provide a necessary and reasonable level of liquidity for security holders, and, in concept, function essentially the same as national exchanges, albeit generally less efficiently as you move down the list, although the principals for the OTCQB and OTCQX markets might take offense at this characterization. Transactions on the OTC markets take place across a network of broker-dealers, who, among other things, act as market markers by maintaining an inventory of securities and setting the price for the securities. The major difference is that, because there is a lack of high trading volume, information on the issuer, etc., arriving at the trading price can be time consuming and inexact, as opposed to a national exchange. Hence, while there is liquidity, the process it is not as efficient as it is under a national exchange. Whether OTC markets are efficient for purposes of the fraud on the market theory is an open question for some courts. Interestingly, securities listed on an exchange also can be sold through the OTC market but not vice versa. NASDAQ recently launched NASDAQ Private Market, LLC., which is intended to facilitate private company transactions, including accessing capital and trading of their securities.

In sum, national exchanges serve at least three important purposes for investors: (1) an efficient price discovery and liquidity mechanism, (2) clearing-house function to ensure the smooth processing and reconciliation of trades, and (3) quality control of members by imposing minimum capitalization and related requirements. Unsurprisingly, exchanges have several advantages over the OTC market in terms of reliability, speed of execution, and liquidity. Of course, if you are not a listed company—and there are large successful companies that do not seek this status or perfectly good smaller companies that can't afford the entry price or otherwise qualify for listing on a national exchange—your securities need to trade somewhere. This is why we have OTC markets. Do not forget that securities can be bought or sold privately without going through an exchange or OTC market, including, in some instances, directly from the issuer, such as dividend reinvestment programs. And, of course, there are **Dark Pools**.

Exchange Offer – A **Tender Offer** where securities (sometimes together with cash) are offered in exchange for a target company's securities. See **Williams Act**.

Exchange Ratio – The ratio at which the buyer's [acquirer's] stock is exchanged for the target's stock in a merger in which the consideration is a stock-for-stock transfer. The exchange ratio may be fixed (in which case the parties take the risk of market changes between signing and closing the transaction) or flexible (a/k/a floating), to be calculated based on a formula over a period closer to the date the transaction closes.

Exempt Transactions & Securities – Transactions or securities that are exempt from the registration requirements of the '33 Act. Section 4 of the '33 Act identifies exempt transactions [**Regulation D** limited offerings are an exempt transaction under section 4(a) (2,) but not the only type]; section 3 identifies exempt securities [*e.g.*, government bonds, "commercial paper"] and even at least one exempted transaction, interestingly enough. Some important points to keep in mind: (1) the section 4 exemption is transactional; that is, unless another exemption or **Safe Harbor** applies, any resale or distribution of the security is subject to '33 Act registration; (2) exempt transactions and securities are still subject to the antifraud rules; and (3) the SEC construes exemptions strictly and therefore, they can be lost easily with dire consequences for the issuer and others who participated or were involved with the offering. A good example of this latter point is the doctrine of integration, best seen with **Regulation D** limited offerings. Depending on the facts, two seemingly separate exempt offerings may be integrated [combined]

into a public offering and thus lose their exempt status. Therefore, the issuer can at least be subject to severe penalties under section 12(a) (1) of the '33 Act for failure to register the offering pursuant to section 5.

Federal Securities Law – The vast array of laws and amendments implemented and supplemented by SEC rules, regulations, releases and other devices. The main statutes for purposes of this course are the Securities Act of 1933 ["Securities Act" or "the '33 Act," which largely focuses on **Issuer or Primary Transactions**] and the Securities and Exchange Act of 1934 ["Exchange Act" or "the '34 Act," which focuses on a wider range of activity, including **Trading Transactions** and mandatory **Reporting Company** public disclosures]. Congress delegated broad power to the SEC under the statutes to promulgate rules and regulations to implement and enforce the statutes. We will see the SEC rulemaking process at work and its limitations when we examine the Business Roundtable v. SEC case. The **Sarbanes-Oxley Act**, **PSLRA**, **SLUSA**, **Williams Act**, and **JOBS Act** are five important amendments to the federal securities laws that we will be discussing in the course. **Dodd-Frank**, although primarily aimed at financial institutions, has certain securities regulation aspects to it. With the exception of class actions involving securities fraud, actions under the '33 Act may be brought in federal or state court; actions under the '34 Act are exclusive to federal courts. Importantly, the federal courts are hardly uniform in their interpretation of the federal securities laws; therefore, if presented with an issue, one of the starting points must be the relevant jurisdiction, which in itself can be a complicated inquiry.

Congress left a lot of the details to SEC rulemaking, which has resulted in a plethora [dictionary definition: excessive; not "a lot"] of rules and regulations that *have the force of law*. Consider the '33 and 34 Acts and the amendments to be the tree; consider the SEC rules and regulations to be the leaves and you will better understand how this all fits together. Of course, we can't exclude the federal court decisions, which I suppose are leaves as well, although they are not always the same shape as the SEC leaves. If you want to see the SEC rulemaking process at work start with section 10(b) of the '34 Act, which is the basic statutory antifraud provision and then Rule 10b-5, which essentially gives the SEC the power to forbid everything section 10(b) allows it to forbid. Then look at Rules 10b5-1 and -2 for further prohibited and permitted actions, all ostensibly in consonance with the rulemaking power bestowed on the SEC under section 10(b).

In the final analysis, the federal securities laws reflect three fundamental goals which form the SEC's mandate: (1) protect investors by providing for, *inter alia*, the accurate and complete disclosure of information; ensure the integrity and efficiency of trading markets and facilitate capital formation to support economic growth. See, e.g., '34 Act § 3(f) (stating that the SEC shall also consider "whether the action shall promote efficiency, competition and capital formation" in its rulemaking). The latter mandate often comes into conflict with one or both of the prior two. Rule 506(c) of Regulation D provides an excellent example of the tug of war within the SEC between the first and third goals.

Financial Statements – Generic term which refers to a company's various documents that present its financial and operational performance such as profit and loss statements, balance sheets and statement of earnings. **Sarbanes-Oxley** and the Foreign Corrupt Practices Act [federal anti-bribery statute] contain provisions designed to strengthen the integrity of financial record keeping and reporting. Obviously, financial statements are a critical source of information for investors and the focus of intense SEC scrutiny. By definition, financial statements reflect historical or current information and thus are not considered **Forward-Looking Statements** for purposes of **Safe Harbor** protection. The **Generally Accepted**

Accounting Practices ["**GAAP**], the common language of accounting, govern the accounting aspects of financial statements for U.S. corporations.

As discussed, financial statements are a critical source of information for investors. Equally important, financial information is important for senior management because it allows them to, among other things, assess how their company is performing, including whether their policies and programs are being carried out. Other persons, such as customers, creditors, suppliers, and even competitors, also may be intensely interested. And, of course, the SEC looms large through its review processes. Indeed, the SEC has recently increased its efforts to pursue enforcement actions against financial reporting and accounting fraud, including setting up a Financial Reporting and Audit Task Force in its Enforcement Division. At the same time, the SEC has begun to realize that reporting companies may be providing too much information [*e.g.*, immaterial and redundant information] which can confuse investors. Unfortunately, reporting companies are put on the horns of a dilemma because they are effectively being asked to police themselves based on ambiguous guidance, yet remain subject to SEC review and commenting, not to mention inventive plaintiffs' lawyers. For now, most will probably stick with the "better safe than sorry" philosophy when it comes to financial disclosures.

Form D – Required to be filed with the SEC fifteen days after the day of first sale of a security under a **Regulation D** limited offering and section 4(a)(5) of the '33 Act. Failure to file the form will not destroy the exemption, but may preclude future Regulation D private placements by the issuer.

Forward-Looking Statements – Generally, management's discussion of the company's future prospects [*e.g.*, earnings, revenues], industry trends, future liquidity, etc. Forward-looking statements tend to be nothing more than predictions, albeit from the perspective of the person who ostensibly understands his or her business and industry the best. Because forward-looking statements are predictions, they are inherently suspect, especially because they are generally qualified by numerous cautionary statements and risk factors. Nevertheless, depending upon the credibility of the speaker, generally the CEO or CFO, forward-looking statements can carry great weight with investors and thus influence stock price. For example, two years ago the CEO of Under Armour, the athletic clothing company, mentioned the word growth at least a dozen times during an **Investor Call**. The stock price rose 20% after the call. While there may have been other factors at work concerning the company's performance that influenced the increase, the CEO's bullish statements cannot be discounted. The SEC believes forward statements are important for investors and "urges" management to provide such insight in their public filings. See, e.g., Item 303 of Regulation S-K ["**MD&A**" section]. A good place to find forward-looking statements are 10Ks and 10Qs], although the latter often concentrate more on explaining past performance, investor calls, and quarterly reports, which often contain management's guidance on future earnings and related matters. Earnings forecasts are the purest form of forward-looking statements. Congress has provided a **Safe Harbor** for forward-looking statements which protect companies from private civil liability, and the courts have done the same via the "bespeaks caution" doctrine. See, e.g., '34 Act § 21El; Kaufman v. Trump's Castle Funding. See **Puffery**, which is a step below forward-looking statements and not a basis for liability *per se*, even if false or misleading.

Fund – For the securities law area, this term basically refers to a pool of money, often contributed to by many investors, which, in turn, is invested by a fund manager in one or more securities or business ventures. See, e.g., mutual funds, hedge funds, and even private equity

firms which invest limited partners' funds in acquisitions [often **Going Private** transactions]. Fund managers are fiduciaries for those who participate in a fund, and thus are subject to strict regulation by the securities laws, or at least are subject to the antifraud rules. See **Index Funds**.

Generally Accepted Accounting Principles ["GAAP"] – Reporting Companies are required to follow GAAP in the preparation of their financial books and records. See '34 Act § 13(b)(2)(B)(ii). Think of GAAP as a common language of accounting. The actual standards and rules for GAAP are promulgated by the Federal Accounting and Standards Board ("FASB"), a quasi-government agency. The purpose of GAAP is to establish reasonably uniform and reliable procedures for accounting and reporting. This facilitates business combinations, as well as investors' analyses. FAS5 is a GAAP rule that governs how companies should report and set reserves for litigation when the loss is "probable" and "estimable." This dovetails with the SEC disclosure rules concerning material losses, which are required to be set out in various required public filings and reports. GAAP rules are not always rigid; often, there is ample room for interpretation and "creativity." FAS5 provides an excellent example illustrating the room for interpretation, which we will discuss in the course.

There is another set of accounting rules that the securities lawyer and his or her clients may need to concern themselves with: Rules promulgated by the International Accounting Standards Board ("IASB"). This body issues accounting pronouncements called International Financial Reporting Standards ("IFRS"). IFRS is the generally accepted accounting language outside of the United States. There is an ongoing project between the IASB, the SEC, and the FASB to create one worldwide set of accounting standards, which is called the convergence process. Ultimately, GAAP may disappear, leaving IFRS as the dominant accounting standard throughout the world, although personally, I don't expect this to happen any time soon, if ever.

Gatekeeper – Refers to a person [internal or external to a company] who is tasked either directly or indirectly with ensuring that the company complies with the securities and other laws in the course of performing their normal duties. For example, the Controller, who is responsible for ensuring that the company's books and records, financial statements, etc. are prepared in accordance with applicable law, is considered to be a gatekeeper. More directly, the company's Compliance Officer is by definition a gatekeeper. Another example is outside independent auditors. And, yes, internal lawyers can be gatekeepers, especially when you consider the "reporting up" requirements under Rule 205. Recently, the head of the SEC announced that the agency's enforcement efforts would focus more on "deficient" gatekeepers including lawyers.

Glass-Steagall Act – A Depression era federal statute that required separation between commercial banks and investment banks that was repealed in 1999, thereby allowing commercial banks, such as Citibank, to acquire investment banks and become a securities industry behemoth, along with the likes of Bank America, Goldman Sachs, and J.P. Morgan. There has been considerable controversy surrounding the repeal of the Glass-Steagall Act. Many contend that its repeal was a major contributing factor to the Recession of 2008. Others would point out, however, that absent the repeal of Glass-Steagall, many of the major financial institutions which were troubled (*e.g.*, Bear Stearns, Merrill Lynch, Morgan Stanley, and Goldman Sachs) would not have survived. Bear Stearns was indeed acquired by J.P. Morgan. Had there been no repeal of Glass-Steagall, Bear Stearns would have gone bankrupt. Merrill Lynch was acquired by Bank of America. Had there been no repeal of Glass Steagall, Merrill Lynch probably would have

gone bankrupt. Both Morgan Stanley and Goldman Sachs were allowed to convert to bank holding companies to enable them to receive TARP money. It is questionable whether they would have survived had Glass-Steagall not been repealed. This debate as to whether the Act should have been repealed would occupy a class or two, but not in this course. Senator Elizabeth Warren [D-MA], a highly vocal critic of Wall Street, recently introduced legislation to re-enact Glass-Steagall, which I suspect will go nowhere, for the time being anyway.

Going Private – The opposite of going public; when a public company decides to delist from a stock exchange, that is, it no longer has outstanding registered securities. Such transactions generally take the form of a management buyout ("MBOs") accompanied by a leveraged buy-out ("LBO"), which often involves a private equity firm that is able to raise significant financing and a "minimum" amount of cash for the purchase price. The reasons for going private are numerous, but the commonly stated reasons include: (1) the stock price is under-valued by the market; and (2) the costs and time associated with the public disclosure rules, and the SOX and FCPA record keeping and accounting requirements are too burdensome. One important benefit of such transactions is that the owners of the newly formed company [generally owned by a relatively small number of shareholders] can concentrate on long-term growth strategies as opposed to having to show quarter-to-quarter growth, which can detract from long-term growth. See **Shareholder Value Maximization Model**. Another motivation, especially when private equity is controlling the transaction, is for the new owners to take the company public again or sell it at some point once it has been restructured, in either case for a nice profit. The **Williams Act** sets forth certain enhanced disclosure requirements for going private transactions. The Act and corresponding SEC rules require extensive disclosure of the facts and circumstances surrounding the decision to go private, as well as much of the other information required in a proxy statement, much of which can be incorporated in a Rule 13e-3 going private filing. The SEC has always been wary of going private transactions because they basically eliminate most of the shareholders.

Greed – Primary characteristic that is associated with most conscious efforts to subvert the securities laws in an effort to make money. Unsurprisingly, most people who engage in the securities business, whether securities professionals or investors, do so to make as much money as possible. Some would argue that greed is the primary motivator of human progress in almost any area, but this is an existential question beyond the scope of this course. Never underestimate the power of human greed in the securities world. With the exception of the unfortunate person who honestly makes a mistake trying to navigate through the often dense and confusingly complex securities laws and regulations, greed, along with hubris, is often the root cause of violations of the securities laws, or at least the ones you read about in the paper. And, the pull of greed and hubris is the primary reason that there will never be enough securities laws or compliance programs to prevent wrongdoing. There are an infinite number of ways to part unsuspecting people from their money with the promise of profits. In a nutshell, this is a primary reason why Congress enacted the federal securities laws and created the SEC to oversee, implement, and enforce them. Another related reason is that Congress and the SEC take a highly paternalistic view towards investors, especially **Retail Investors**, undoubtedly because they understand human nature.

Gun Jumping – Illegal communication of information regarding the **Issuer** that could influence a public offering before and during section 5 registration filing periods ["Quiet Period" and

"Waiting Period"]. Actually, limitations on communications are staged: No communications that can be construed as selling efforts in the "pre-filing period," with the exception of communications between the underwriter and the issuer, to start the offering process; limited selling efforts during the "Waiting Period" by the issuer's underwriter, for example, are allowed. The SEC takes an extremely broad view of what constitutes an offer to sell a security which often is counterintuitive. This is another area where there is no bright-line test. Unless a **Safe Harbor** is available, issuers need to carefully manage all communications during the "Quiet Period", and even need to exercise care when navigating the safe harbors. Gun jumping prohibitions are yet another example of the '33 Act's concern with the accuracy and completeness of information that could influence investors. In other words, until the SEC has declared the registration statement effective, it does not want the issuer or its advisers to "hype up" or "condition" the market by stimulating investors' interest, and it does not want any selling efforts to commence until some form of **Prospectus** is in effect.

Fortunately, in recognition of the realities associated with operating a business, the SEC has provided certain exemptions for specified communications in the form of **Safe Harbors**. See, e.g., Rules 135, 137, 138, 139, 163A, 168 &169. Congress provided some additional relief in this area in the **JOBS Act** for EGCs, allowing them to "test the waters"]. See '33 Act § 5(d); see also Regulation A+ (allowing testing of the waters before or during the filing period, at least for Tier 2 offerings). **Private Placements** do not trigger the equivalent of gun jumping. Indeed, with one limited, yet major exception, Rule 506(c), general solicitation and advertising is prohibited, so there is no "public" to condition.

Classic case of gun jumping: During the "Quiet Period" while the registration statement is pending SEC review, the CEO goes on "Morning Joe" and raves about the company's new widget and smiles when Joe Scarborough says: "Everyone needs to get one of these." The SEC is not smiling when it gets wind of this because its position will be that the CEO engaged in prohibited selling efforts for the offering, and penalties will likely follow. The Google executives found themselves in this unfortunate position after a media interview during the preliminary registration stage.

When does a company pursuing a public offering have to start worry about gun jumping? In other words, when is the issuer "in registration"? When does the gun jumping prohibition disappear? Good questions, which we will delve into during the course but look for the term "in registration" as a starter.

Hedge Fund – For purposes of this course, all you need to know is that hedge funds are an investment vehicle [they seek "actual returnsm" as opposed to just beating the market or doing less poorly than the market] loved by the people who run them [even if returns are not spectacular] and their investors when profits are good. The successful ones are run by extremely bright and sophisticated people. Unlike a private equity/venture capital firm, which can save businesses and jobs despite what some politicians say, hedge funds can lay little claim to promoting economic activity other than returns for their investors. They are pure investment vehicles, which, today, literally can and do invest in almost anything. The hedge funds that made a fortune from the Recession of 2008 did so by going **Short** on such devices as asset [e.g., sub-prime mortgages] backed securities. In other words, they bet that these financial devices would significantly decrease [including default] in value, which they did in dramatic fashion.

Hedge funds such as the Blackstone Group make lots of money through: (1) management fees from their investors [2% of the funds under management is standard]; (2) incentive fees when investments exceed "High Water" targets; and (3) investing in their own security holdings. Imagine a hedge fund that has a portfolio of $5B [many are infinitely larger] and charges a 2% annual management fee based on the quantum of managed funds and go from there. Get the picture? By the way, none of this makes hedge funds inherently evil or bad, especially because most of their investors are institutional investors, such as pension funds [although because of bad publicity some are beginning to divest themselves of their hedge fund holdings], which are constantly on the search for ways to increase their asset base because they are generally underfunded. To the extent the hedge fund they invest in achieves good returns, the better off the retirees who rely on their pensions to live.

The SEC doesn't quite know what to do with hedge funds. There is relatively little regulation of them, the antifraud rules being the big hammer, along with a recent reporting requirement added by Dodd-Frank for hedge funds of a certain size. Interestingly, in recent years several hedge funds have become shareholder activists that lobby for divestures—stock buy backs, dividends and the like—from companies in which they have significant holdings. This can be good or bad depending on your perspective, but under any analysis a lot of this activity has a short-term profit motive. *Apropos* of nothing, if it were up to certain politicians, most hedge funds would be run off the planet and every investment bank would revert back to the Glass-Steagall Act days, but I digress.

Highly Leveraged – Leveraged in the financial world generally means supported by debt. Highly leveraged means that a particular transaction [*e.g.*, purchase of a company] was completed by the issuance of a lot of debt and little equity [cash]. Private equity firms that are in the business of buying companies, "fixing them," and then selling them or taking them public for a substantial profit, will often put up a relatively small amount of their own cash or that of its investors [say 20-30%] and the rest in debt [money borrowed from one or more financial institutions] for the purchase price, using the newly formed company [Newco] as collateral. Hence, the term leveraged buy-out, and, in this case, highly leveraged buy-out. Low interest rates, which have been in effect for several years now, and the ability to flip the companies in a relatively short period of time make significant debt financing highly attractive. Some commentators are beginning to worry that the inventory of private equity companies that need to be sold has exceeded the demand, which obviously would not be a good thing for private equity firms.

High Speed Trading – There is high speed trading, which large investment and banking firms employ, and then there is higher speed trading, or what Michael Lewis, the noted financial author, calls High Trading Frequency ("HTF"). The latter is the latest *idée fix* of the SEC, Congress, **FINRA**, and anti-Wall Street crowd. Basically, less than fourteen years ago, most trading of securities was done through the NYSE and similar exchanges, and involved extensive human contact. Today, most of the trading is done electronically. In other words, most trader functions, with respect to the mechanics of trading, have been largely replaced by algorithms and servers, leaving human contact confined to pushing buttons to execute the trades. High speed trading is merely the latest technology employed [*e.g.*, fiber optic cable] to identify a profitable trading opportunity and execute the trade in milliseconds. Here is where the process gets dicey, however: The faster the link between the trading institution and the exchanges, the faster the

trade, which can be a huge advantage to those who have access to the technology. For example, a trader at a bank hits the button on the computer to buy 10,000 shares of Textron Inc. at $40 per share. But, the screen goes blank, that is, the 10,000 shares at $40 disappear before the trade can be executed and is replaced with a sell order for $40.05 per share. What happened? A trader with a faster link was able to buy the Textron shares first, and then offer them back to the original trader at pennies more per share. If the original trader then buys, the "higher speed" trader makes a small profit, which, when you multiply the practice by millions of trades each day, either on the buy or sell side, it can result in millions of dollars of profits or loss avoidance for the high speed trading firm. This is where the practice comes under particular scrutiny according to Lewis: Not all trading firms have access to the fastest technology or, more importantly, they have been locked out by "favored nation" deals made by certain exchanges and selected high speed trading firms. As a consequence, they, as well as their clients, allegedly suffer because they either get pre-empted entirely from a transaction or get fewer shares than they want. All very complex, but you get the basic idea.

Whether the practice is illegal depends on several factors including whether the practice is disclosed to the public. For example, at least one federal district court has held that high speed trading mechanisms coupled with advance notice of trading information from a national exchange is not illegal if it is disclosed. See the Barclays decision, which we will discuss. For the evils of "extreme" high speed trading, see Lewis, Flash Boys: A Wall Street Revolt (W.W. Norton & Company, 2014). A related practice that concerns Lewis and others is "flash orders." For a fee, an exchange will "flash" information it properly develops [*i.e.*, not confidential "insider" information] to a limited group of traders a few fractions of a second before the information is made available to the market, thereby allowing them to act on it sooner, which coupled with their high speed trading software, provides a "double" advantage. Lewis, *supra*, at 45. As discussed more fully below, **Information** is king when it comes to price setting and trading; the person who gets the information the soonest is able to act on it first. Do you see now what the root of Lewis' concern is? Recently, FINRA proposed changes to its regulations to enhance the safety and integrity of electronic trading, specifically by high speed trading firms registered with the **SRO**.

How Trades Are Made – For stock trading on a national exchange, the concept is simple: A buyer is matched electronically with a seller, and when the buyer's bid and seller's ask match, the trade is made automatically. The trade goes through a "middle man," a broker, who charges a commission for executing the trade. In reality, the process leading to the execution of trades on a national exchange is technologically more complex than this and involves several players more important than brokers, such as market makers, designated market makers, and specialists, all of which are largely beyond the scope of this course. Move from a national exchange to the OTC markets to individuals trading privately among themselves, and the concept is basically the same, but the process becomes slower and less certain, and potentially riskier.

Index Funds – As previously discussed, the logical extension of the efficient market hypothesis that basically says that attempting to pick under- or over-valued stocks as a basis for trading decisions is largely a fool's errand, although I suspect many hedge fund managers and other investment professionals would disagree. In other words, the opposite of value investing [see, e.g., Warren Buffet, perhaps the greatest value investor ever, although there are a few others in his league]. Index funds basically buy all or a representative sample of stocks or bonds from

various indexes [*e.g.*, DJIA; S&P 500]. Thus, the fund's returns closely track overall market performance, and, as a consequence, the returns are less volatile than most other forms of investing [*e.g.*, day trading, hedge funds, and even mutual funds]. Index funds are considered to be "passively" managed funds, in that the fund manager does not select individual stocks for the portfolio or engage in frequent portfolio turnover, which eliminates [or greatly reduces], costs for the fund participants. Think day trading on one end of the spectrum, index funds on the other end, and you get the picture in terms of investor risk, although, as the Great Recession of 2008 proved, no investment vehicle ever is entirely safe.

Indenture – The legal contract that sets forth the terms and conditions which govern corporate debt [*e.g.*, corporate bonds]. The indenture is entered into between the issuer and a designated trustee who acts on behalf of the debt holders. See Indenture Act of 1939.

Information – What every rational investor wants and can never get enough of quickly enough. Information concerning an issuer's prospect for future earnings growth in particular can drive the price of stock up or down, although other factors, rational and irrational, may come into play when investors make decisions. The more significant the economic information and the quicker the investor or trader gets it, the sooner he or she can make their trade before others do. Information is king to investors, especially **Institutional Investors**, and this is a primary reason why we have federal securities laws, especially the mandatory disclosure rules: to enhance the quality and availability of information to investors so they can make informed decisions. Of course, as previously discussed, not all investors are equal in terms of evaluating information or getting timely access to the information. And, lest we forget, not all information is equal and ultimately, the investment decision often is more complex than this discussion suggests.

Insider Trading – Speaking of the importance of information, here we have the classic case of illegal use of information to make profits or avoid losses. In short, insider trading entails trading while aware [SEC position] or based on the use of material nonpublic information in breach of a duty of trust or confidentiality to the source of the information and for personal [*i.e.*, some form of financial] gain. But see Rule 14e-3, which prohibits trading on such information in connection with a tender offer, even if the person doing the trading has no duty to the source of the information. Disclosure of the information to the public before trading obviously is one way to avoid insider trading liability, provided that the public has a reasonable time [48 hours is a good rule of thumb] to digest the information before the trading occurs. Obviously, this defeats the purpose of most insider trading in the first place. In any event, while some members of Congress and the SEC would love to ban all trading based on material nonpublic information in the name of fairness and asymmetry of information in the markets, the federal courts do not always see it that way, especially the Supreme Court, which often has been highly suspicious of expanded theories of insider liability under section 10(b). For example, if someone hacks into Textron's data base to obtain material nonpublic information and trades on it, it may be a lot of things, but it is not insider trading: There is no duty under Chiarella or O'Hagan ["Misappropriation Theory"]. This assumes that the hacker did not gain access by misrepresenting ["deception"] his or her identity, at least in the Second Circuit. If a confidential document with material nonpublic information flies out of the top floor of Textron's headquarters in downtown Providence, a passerby who finds it may trade on it and probably is not guilty of insider trading. Here, the person is not an "insider" and there is no duty of confidentiality to the issuer's shareholders or the corporation.

Insider trading law becomes more complex when tippers and tippees are involved, especially when the latter are far removed [remote tippees] from the initial source of the information. Recently, the Second Circuit, in a decision which plunged a dagger through the heart of the SEC and the U.S Attorney for the Southern District of New York—SEC v. Newman (2015)—ruled, *inter alia*, that a remote tippee could not be held liable for insider trading if the government cannot prove beyond a reasonable doubt that the tipper derived a personal benefit [*i.e.*, "a potential gain of a pecuniary or similarly valuable nature"; "career advice" in this case did not suffice] from the disclosure [relying on United States v. Dirks, although the government would say, going beyond Dirks] and the tippee had reason to know there was a personal benefit. The court's decision was based in part on the fact that section 10(b) is an antifraud statute, not a statute which was intended to ensure asymmetry of information in the market. The Newman opinion offers an excellent starting point for understanding insider trading law, especially as it relates to tippers and tippees, and also has the benefit of being reasonably short and well-written. Insider trading is to the SEC what antitrust violations are to the DOJ and FTC: anathema.

The SEC relishes civil and criminal insider trading prosecutions, which can entail disgorgement of profits, substantial fines and treble damages, and even harsh jail terms. Indeed, the increased use of wire taps and other bugging devices, careless emails, and informants, or "flipping" participants in the scheme to testify against the major players has paid huge dividends for the SEC. Its success rate is high, although in 2013 it suffered losses in two high-profile insider trading cases, one of which was against the billionaire entrepreneur and owner of the Dallas Mavericks basketball team, Mark Cuban. Early in 2014, the SEC lost another high profile insider trading trial; ditto in July. The Newman case was traumatic for the U.S Attorney, who had a streak of eighty-six successful insider trading prosecutions broken. In any event, despite the number of successful prosecutions, the incidence of insider trading likely remains widespread. Never underestimate greed and its frequent companion, hubris.

A few years ago, under Rule 10b5-1, which can be considered the basic insider trading rule, the SEC took the position that mere awareness of material nonpublic information when the purchase or sale was made is sufficient for insider trading liability. It is unclear whether the courts agree with this. In any event, this was in response to two federal court decisions that required the government to prove that the insider "used" the information as part of the trading decision. The presents an interesting question as to how far the SEC can go in making federal securities law. See the discussion under **Rules and Regulations**.

Insider trading does not directly harm other investors, nor is it clear whether it has any significant market impact in most cases, which is why some argue that insider prosecutions are unnecessary. Indeed, some contend that the practice actually makes the market more efficient in terms of allocating capital. Many also argue that the law of insider trading is a hopeless mess: Congress's legislation is imprecise, and the law is largely ineffective because so much of the practice is undetected and persistent, which means it is not much of a deterrent. What insider trading does, however, is lessen investor confidence in the market, and, in the eyes of Congress and the SEC, it is just plain unfair because the market [public] does not get the information at the same time. Who is right and who is wrong in this debate is largely irrelevant because the SEC is death on insider trading cases, especially those it believes it will win, which are almost always the ones it prosecutes. It is unclear whether Congress will address insider trading any time soon,

although some members would like to expand the definition to include trading on any material nonpublic information no matter how it is obtained. In light of Newman, however, things have gotten harder for the government, although subsequently, the 9th Circuit in United States v Salman came down with a decision that comes close to, if not outright, rejecting the Newman holding. This arguable "split in the circuits" [there also is a 1995 contra 7th Circuit decision] may have been the final development that persuaded the SEC/DOJ to file a cert. petition with the U.S. Supreme Court, which was not granted.

Institutional Investor – A large professional investor that invests money it holds as a fiduciary in stocks, bonds and other securities. Important examples are pension funds, insurance companies and mutual funds. Ditto for hedge funds. Depending on who you ask, at least 50% of all securities are owned by institutional investors. Compare **Retail Investors**, which range from family trust managers to people like you—let's call them households. By definition, most retail investors do not have the resources, the investment smarts, and/or the time to wade through the myriad of information sources concerning companies they are seeking to invest in or out of. This makes them especially susceptible to market manipulation, the effects of automated trading, and other schemes that separate them from their money, including reprobate brokers or financial advisors. As such, many retail investors will hire **Investment Advisers**, or more frequently, a hopefully competent broker, to provide advice on investment strategies and identify "hot" stocks." Interestingly, many institutional investors will do the same.

Internal Controls – Internal controls are formal policies and procedures designed to ensure the integrity of the company's financial accounting and reporting. They are especially important to public companies. See '34 Act 13(b)(2)(A)–(B). As previously discussed, the integrity of a public company's financial statements and reporting is critical for investors. If the presentation of the company's financial condition is not accurate, investors will receive false or misleading information. In most large corporations, the Controller's department is responsible for the day-to-day management of the internal control processes. In other words, they don't just manage the nuts and bolts of accounting and bookkeeping. For example, properly-run public companies will establish a delegation of authority schedule for approval of settlements, operational expenditures, or deals to ensure proper oversight. On a very basic level, dual signature authority for any disbursement in excess of $1,000 is another example of an internal control. Obviously, public companies' internal controls are significantly more complex and detailed than this. Sarbanes-Oxley upped the ante for public companies by requiring CEO & CFO certification of the efficacy of the company's internal controls and attestation by the outside auditor as to these certifications. Maintaining a compliant and effective internal control program can be very expensive and involves significant participation by all levels of the corporation. If a company lacks well-developed internal controls, potential investors should think twice about sinking their money in its securities.

Integrated Disclosure – For example, seasoned and well-known seasoned issuers ["**WKSI**"] may fulfill many of the '33 Act's mandatory disclosure requirements by reference or incorporation with their registration statement of previously filed disclosures, such as 10Ks & 10Qs. This is particularly useful, for example, when such companies are doing securities offerings post-IPO. Obviously, this can save a lot of time and money. Equally obvious is the fact that not every issuer is automatically "seasoned," let alone qualifies for the super-seasoned WSKI status. Some argue that integrated disclosure results in diminished disclosures because

there is less SEC review. Congress and the SEC have countered this by, in effect, requiring companies to shore up their corporate governance infrastructure to ensure greater quality in their filings, and enhanced liability schemes such as Rule 10b-5 to further incentivize companies to provide accurate and comprehensive filings. Another example of an integrated disclosure is incorporating proxy statements in Rule 13e-3 **Going Private** filings.

International – It is obvious what this means, but the point for purposes of this course is that the federal securities laws, including the antifraud provisions, can reach beyond the U.S., especially when securities listed on a national exchange are involved. See the Morrison case discussed in the text ("transactional test" for actions based on section 10(b)). Similarly, foreign companies subject themselves to many of the federal securities laws when they, for example, list their shares with a U.S. exchange [*e.g.*, American Depository Receipts]. It is also important to note that most countries around the world have their own securities laws and U.S. companies doing business there must comply with such laws. In many respects, they often mirror U.S. securities laws. It really is a small world today, both for securities and M&A transactions. Potentially one more thing to consider when planning a securities transaction.

Interstate Commerce – The federal securities laws require as a prerequisite, the use of instrumentalities or communications in "interstate commerce." By definition, the mail is interstate commerce. The term is obviously broad. "Purely" intrastate transactions are possible, however. In other words, don't automatically assume that a federal securities law applies to a particular transaction; some "means" of interstate commerce must be involved.

Intrinsic Value – Briefly stated, what the "true" economic value or worth a company has. The concept is easiest understood in the context of mergers and acquisitions, where the parties generally have the time and resources to assess the intrinsic value of a target or seller for purposes of establishing the purchase price, although they don't often get it right for reasons not relevant to this course. There are various metrics for assessing intrinsic value that also are irrelevant for this course, although, while we are on the subject, I must add that future cash flow discounted for present value is a frequent measure of value in the world of M&A. Even in M&A transactions, valuation involves a fair amount of guess work and assumptions despite algorithms and other fancy software programs that are used to analyze data. Assessing the intrinsic value of an individual issuer as a basis for investment decisions is even more difficult, although arguably ascertaining the issuer's growth potential requires a less extensive analysis than determining intrinsic value. Many investment gurus believe this is a futile exercise in the long run. Indeed, the average investor—and even many institutional investors—often have little idea what the intrinsic value of the issuer is because the variables are so complex. Thus, their track record at picking under- and over-valued securities for the purpose of making investment decisions is decidedly mixed. As previously discussed, this has led to the prominence of index funds as an investment vehicle. Why even try? The market, through the ECMH, sets the price of a security. This doesn't mean that identification of well-run companies with significant growth potential and staying power cannot be a basis for sound investment decisions. As previously discussed, Warren Buffet has made himself the second or third richest person in the world by engaging in such "value" investing. Value investing takes considerable time, analysis, and acumen. Having said all this, one of the reasons frequently given for **Going Private Transactions** is that the market is under-valuing the issuer's stock; that is, the stock should be trading at a higher price.

While we are at it, a **Security** itself has no intrinsic value, unlike real estate or cash, or the issuer. A security's value is derivative; that is, it is derived from the claim the holder has on the assets of the issuer, the price at which it can be traded, and certain other factors.

Investment Adviser – Those who are paid to advise others in the investment, purchase, or sale of securities, as well as general financial planning. They are considered fiduciaries, and thus, subject to higher standards of care ["best interests of the client," which includes disclosure of any conflicts] than broker-dealers, at least as of the date of this Glossary. Investment advisors are regulated under the Investment Advisers Act of 1940, which provides for registration with the SEC, similar to brokers and dealers under the '34 Act. The Act also provides for severe penalties for violations of the securities laws, and the registration and reporting requirements under the Act. As discussed above, broker-dealers can often cross the line into giving investment advice. Indeed, it is not unusual in this business for one person to provide financial advice and execute trades all at the same time, which can leave the unsophisticated **Retail Investor** in a precarious position, especially if the various conflict of interest aspects of the representation are not fully disclosed, which they oftentimes are not.

Investment Companies – Companies engaged primarily in the business of investing, reinvesting, or trading in securities, and offering their shares to investors. Think of a mutual fund, which is an investment [upon which the participants may have to pay a fee based on the value of the portfolio] in a diverse portfolio that is intended to minimize risk. The more diversified the investments, the less chance that, should one or a few fail to perform well, the entire investment [fund] will not perform well, or at least not as bad as an investment in an individual company [*e.g.*, Microsoft or Apple]. Contra hedge funds, which are much more aggressive than mutual funds and seek "actual returns" as opposed to just "beating the market" or not doing as poorly when the market is down. Investment companies are regulated under the Investment Company Act of 1940, and their managers are fiduciaries, which means they are held to a high standard of care. In 2013 the SEC brought 140 actions [over 20% of its filed cases] against investment advisors and investment companies. One of the primary areas of focus was deficient compliance programs, which the SEC deem important to protect investor assets.

Investment Thesis – Basically, the objective or goal an investor seeks to achieve from their investment. For the typical stock investor, it generally takes the form of investing capital with the expectation of achieving a level of profit or dividends or both. Other important factors that will be brought to bear include: (1) the stock's **Liquidity** including any restrictions on resale; (2) the growth prospects of the issuer; and (3) the availability of the securities at a price the investor is willing to pay. Obviously, an investor who purchases debt securities has somewhat different goals, because the principal is fixed and the gain is the interest, although opportunities exist to trade debt securities up or down. And, some invest for other reasons, such as supporting an environmentally responsible company or, for many day traders, "the sport of it."

Once the investor has a thesis, he or she can begin to analyze potential investment vehicles to determine which will best achieve his or her objectives. The federal securities laws attempt to facilitate this process by ensuring that investors receive timely, accurate, and complete information, upon which they can make informed decisions, and the market, where the securities trade is fair and efficient. What the federal securities laws do not do is speak to the merits of the investment or the issuer. Investors are on their own here. In fact, in some important judicial

decisions, courts have presumed that **Retail Investors** have a modicum of competence and intelligence, thus tempering the paternalism of the '33 and '34 Acts. It is not entirely clear that the SEC and many politicians fully embrace this viewpoint. See also **Risk**.

Investor Calls – Another vehicle for investors to obtain information concerning the current performance and future prospects of companies. Often, public companies will trot out the CEO and CFO immediately after quarterly earnings statements are released to provide their comments and analyses and answer a series of questions, generally asked by institutional investors and analysts. Such calls can reveal the tension between the CEO/CFO not wanting to disclose more unfavorable information than they have to yet still comply with the disclosure rules. The same is true with respect to favorable information; they want to disclose it for sure, but they need to be concerned that the information is accurate and complete but sufficiently qualified in terms of certainty, lest it later turns out that the information proved wrong. Plaintiffs' lawyers on the hunt for potential securities lawsuits will pay as much attention to these calls as they do to press releases and public filings such as 10Ks, 10Qs and 8Ks. The SEC also will pay attention to them and often cross-reference them against other information such as periodic reports filed with the agency. Investor calls are disclosures.

Unsurprisingly, investor calls make securities lawyers nervous; and, well, they should. But, keep in mind, they can be useful vehicles for your client to get important information out, which can bolster the share price or mitigate any bad news. The failure to engage in such dialogue can send a bad signal to the financial press, analysts, and the market. A dilemma. One suspects that most public company CEOs would rather do something else, like run their business successfully. Unfortunately, the analysts and investors have an insatiable appetite for information, whether they know what to do with it or not, and thus, the modern public company CEO often needs to be as much a salesperson as a businessperson. You might pay attention to the introduction for such calls where the investor relations representative will remind everyone that the statements may contain forward-looking statements and that numerous risk factors apply.

Issuer – Generally refers to the entity that offers its securities for sale or proposes to issue its securities for sale. Stated another way, it is the company that issues its securities; not the SEC, broker-dealers, or investment bankers acting as underwriters, although they all can play an important role in the offering. See '33 Act § 2(a)(4) (providing a thorough definition).

Issuer and Trading Transactions – As the text reveals, securities are bought and sold in two principal settings: issuer transactions and trading transactions. The '33 Act primarily focuses on issuer transactions, or **Primary Distributions**. The '34 Act focuses on, *inter alia*, protecting trading transactions, which are a form of **Secondary Distribution** exempt from the '33 Act's registration requirements. The key difference between the two forms of transactions is that in an issuer transaction, the money goes from the investor to the issuer; in a trading transaction (or any other secondary distribution), the money flows from the seller to the buyer.

JOBS Act – The Jumpstart Our Business Startups Act of 2012. Perhaps the most significant modification of the federal securities laws in the last ten years. This is a pro-business/capital formation statute that was designed to foster growth by eliminating or materially reducing the burdens associated with regulatory compliance, especially the registration process under the '33 Act for IPOs [EGCs] and general solicitation and advertising prohibitions for certain

transactions. The JOBs Act also brought us crowdfunding and the Regulation A+ "mini-registration" public offering. Congress left it to the SEC to draft the necessary rules and regulations to implement the Act [*e.g.*, general solicitation and advertising ban lifted for Rule 506(c) private placements, Regulation A+ regulations, and the crowdfunding rules]. The SEC is not entirely enamored with parts of the JOBS Act, especially crowdfunding and elimination of the general solicitation and advertising prohibition for Rule 506(c) offerings.

Junk Bonds – Bonds and other debt securities generally backed by little or no collateral that are not "investment grade" but pay high rates of interest to compensate for the high risk. Not something for the retail investor to dabble in, but despite the bad publicity in the 80's surrounding the activities of Michael Milken and others, they appear to be making something of a comeback. Junk bonds occasionally appear as part of the consideration or financing in mergers and acquisitions. Also, they are sparking more interest from investors because currently the interest rate on government bonds and similar investments are low.

Lawyers v. Businesspeople [The Client] – Lawyers are often risk averse to the point of paranoia, especially in the securities area because the advice is often subject to hindsight determinations and the penalties for noncompliance can be severe. Businesspeople are generally less risk averse, especially because they come from a different perspective; to wit, running a successful business, which requires more risk-taking than lawyers are comfortable with. Unsurprisingly, businesspeople often view lawyers warily, especially if they get the sense that their starting position is always "No," as opposed to how can the lawyer facilitate the transaction or resolve an issue within the parameters of the law. This dynamic and how it is managed by both parties can be important when it comes to addressing securities issues, especially in the disclosure area where **Materiality** is often the controlling issue. Stated another way, the successful securities lawyer often has to have a healthy dose of practicality as well as legal acumen. Corollary: The securities lawyer may be an important spoke in the transactional wheel—maybe the most important depending on the circumstances—but the client is always the hub. As much as some lawyers would like to think otherwise, the universe does not always revolve around them.

Liquidity – For purposes of selling securities, the ability of a security holder to sell the security for a desired price [value] when he or she wants to. Liquidity generally is not an issue for trading transactions involving shares of large public companies listed on national exchanges. The shareholder simply can place a sell order for a certain price, and if there is a matching buy order, he or she gets the cash less the broker's commission. As previously discussed, the spread between the bid and ask price is generally so low and the volume of trades is so high that trades at desired prices can be made immediately. Where liquidity becomes a problem is with other **Secondary Distributions**, including the resale of privately issued securities. Here, the market for the securities is not as transparent and often the difference between the "bid" and "ask" price or the equivalent is wide, or not easily ascertained. Such trading takes on the characteristics of brokered [*i.e.*, hire a broker to search for buyers or sellers] or at least a negotiated transaction. There also may be limitations on the security holder's ability to sell [liquidate] his or her securities when they want to do so ["restricted" and "controlled" securities], assuming there is even a "market" for the securities. Regulation D limited offerings present liquidity concerns for investors, which the SEC has sought to ameliorate through amendments to Rules 144 and 144A. Unsurprisingly, liquidity is an important consideration for investors, and the lack of it can result

in a discount for initial issues, a lower price for subsequent resale, or even avoiding the investment altogether. For example, one of the benefits of a public offering is that the shares will be more liquid; not so much for private placements. Congress and the SEC understand the importance of liquidity to capital formation, which "requires" them to give a certain amount of deference and support to liquidity mechanisms in the markets and otherwise.

Liquidity also refers to a company's ability to pay its ongoing obligations either through cash flow or the ability to sell off assets to raise the necessary cash. Companies with strong balance sheets are considered to be highly liquid, especially if they have high cash flow. Certain SEC disclosure rules require information concerning a company's liquidity. For example, the SEC requires issuers in an IPO to disclose in the **Prospectus** information concerning the company's liquidity. Forms 10Q and 10K contain required discussion of the issuer's liquidity, also in the **MD&A** section.

Long – When referring to securities, "long" generally means that the holder of a security [common stock mostly] or analyst or whomever believes that the security is going to increase in price. For example, "I am long on Apple." The opposite would be **Short**, of course. "The earnings reports for Widget Co. for the last four quarters have been increasingly bad and they probably will get worse, so I am going to short this stock." Get it? An investor can obviously short a stock by selling it before the price drops. The practice of short selling is infinitely more complicated. Here is how it basically works: You [not you; a professional because this practice is highly risky and unlike holding a security can result in unlimited losses] borrow stock through a broker, sell it immediately at the market price, put the cash in an account with the broker and hope that when the time has come to repurchase the shares the stock is trading at less than what you "paid" for it and thus you made a nice profit. In other words, short selling is a bet that the borrowed shares that were sold and have to be returned to the holder will decrease in value. Yes, the federal securities laws permit, with certain limitations, selling stock that you don't own, odd as this may seem. And, there are perfectly good reasons for allowing short selling such as facilitating liquidity and price point determinations. Securities that trade on the national exchange and OTC markets can be subject to short selling. Penny stocks, for example, cannot be the subject of short selling.

The SEC is not entirely enamored with short selling, so it amended the relevant regulation [Regulation SHO] a few years ago to place some limitations on the practice. Selling short can result in huge profits for those who know what they are doing and can handle risk. Indeed, certain hedge funds [*e.g.*, Paulson's fund] in late 2007 and early 2008 bet that mortgage-backed securities would fail, which they did, and shorted them, making billions of dollars, which is one of the reasons the SEC changed the rules as mentioned above. Also, under certain circumstances, short selling can constitute market manipulation in violation of the '34 Act. See '34 Act § 10(a)(1), which contemplates market manipulation from short selling, leaving it to the SEC to prescribe the rules. See, e.g., Rule 10b-21.

Management's Discussion & Analysis ["MD&A"] – Brought to you by Item 303(a) of Regulation S-K and a relatively new device prompted by the SEC's desire to require issuers to better explain their financial and operational information to investors. In sum, a discussion and analysis of the issuer's [must be a registrant] liquidity, capital resources, results of operations, and similar subject matter included in registration statements and section 13 periodic reports.

The MD&A section is a good place to look for forward-looking statements as well. Importantly, some of the information that is reported is required; other information, specifically forward-looking statements, is "encouraged." Think of this section as an opportunity to shed more light on the endless tables, charts and columns of financial data to investors, who presumably lack the acumen to figure it out for themselves, and who may have little insight on future industry trends and the like. Because investors and analysts crave information, they generally welcomed this addition. Not all issuers are enthusiastic about expanding upon or explaining reported information, and especially making forward-looking statements, and as such, the overall discussion in the MD&A section can be quite bland and not nearly as insightful or informative as the SEC and investors would like.

Mergers & Acquisitions ["M&A"] – Business combinations are primarily governed by state corporation law under the internal affairs doctrine. However, M&A transactions, especially those that involve public companies, can trigger application of the federal securities laws; for example: (1) if new stock is issued to provide consideration for a merger or some other combination; (2) a public company whose shares are registered with the SEC and listed on a national exchange goes private; or (3) the proxy process is necessary for a **Reporting Company** to obtain shareholder approval of a business combination. Also, the SEC has promulgated rules to govern [actually, they basically relax the more onerous '33 Act section 5 restrictions communications] relating to certain types of M&A transactions. Even in a private transaction such as the sale of the stock of a company which no federal securities law addresses, at least the federal antifraud provisions apply. This is the Landreth Timber Co. case discussed in the text.

Margin [Purchase of Stock] – A good way for investors and broker-dealers to get in trouble. Basically, margins are an extension of credit for the purchase of a security, generally stock [see Short Selling], provided by a broker-dealer to an investor. The investor puts up $X and the broker-dealer fronts the balance [margin]. A margin call is when the broker-dealer says it is time to pay up, in which case the value of the stock or the investor's cash position better be such that the call can be "covered." In the days of the "Wild West," broker-dealers were extending huge credit lines to investors who were unable to make the margin calls. Today, stringent limits have been placed on what investors can buy on margin. You will also see the term "margin" used to refer to profits for financial purposes. Here, high margins are obviously a good thing. **Short Selling** transactions, for example, often involve a margin account being set up with a broker to cover part of the stock purchase. In other words, the broker will lend the short seller part of the cash necessary to purchase the stock initially.

Manipulation of Stock Price – In a perfect world, the price of securities that trade on a market would rise or fall based on the unfettered forces of supply and demand; this contemplates legitimate information which has flowed into the market concerning the issuer. Unfortunately, we don't live in a perfect world and the price of securities, especially stock, is manipulated every day by practices unrelated to the actual value of the securities. Sometimes it is perfectly legal; other times it is illegal. See '34 Act §§ 9(a) [which prohibits certain manipulative practices but requires specific intent] and 10(b). Nowhere in the '34 Act is manipulation defined. The SEC definition is: "intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security." Clear as mud, and in practice, the line between legal manipulation and illegal manipulation can be blurred. "Pump and dump" schemes constitute illegal manipulation. Here, perpetrators accumulate a large stake in a company's stock [stock

traded on OTC markets is more prone to such schemes than stock traded on a national exchange], artificially inflate the price by such actions as getting the issuer, who the perpetrators now control, to make false statements concerning the issuer's growth potential; hiring brokers and analysts to tout the stock, boiler room sales practices to unwary investors, etc., and then when the price reaches a high enough level, sell at a nice profit leaving the investors who bought holding the bag. Remember, small profits coupled with high volume can result in lots of money. False disclosure statements by the issuer can be manipulative and are illegal if the intent is to deceive investors. These types of practices are sometimes referred to as "traditional manipulation." Certain forms of short selling, derivatives, and other practices such as late-day purchasing of shares in a low-volume stock, which sends a signal to the market that the current trading price may be too low and leads other investors to jump in the next day and drive the price up, may be manipulative but perfectly legal, or at least as far as most courts believe. Why? Because the means used are not themselves illegal. Such practices are sometimes referred to as "open market manipulation." Like I said: clear as mud. Indeed, there are an infinite number of ways to part unsophisticated investors from their money, and not all of them are illegal.

Markets – Where securities are traded; that is, bought and sold [*e.g.*, national exchanges and OTC markets]. Basically, a market is merely a mechanism for bringing buyers and sellers together to complete trading transactions in an efficient manner.

Materiality – All-important term that pervades federal securities law. Congress and the SEC have not defined the term; however, the SEC will occasionally provide guidance. See, e.g., Staff Accounting Bulletin No. 99 (1999) [rejects a bright-line quantitative test]; Selective Disclosure and Insider Trading Release (S7-31-99) [list of matters likely to be material for public disclosure purposes]. The definition of materiality most frequently used and adopted by the SEC is found in TSC Industries: "Information that a reasonable investor would consider important to making an investment decision in light of the total mix of information available." See also Basic v. Levinson, which reaffirmed TSC Industries and added the often maligned "fraud on the market" theory, which dispenses with the individual plaintiff reliance requirement for certification of 10b-5 class actions. Almost every materiality analysis starts with the TSC definition. It is foundational. Public filings must include material information as provided for in the relevant rules and regulations, to prevail in a 10b-5 lawsuit involving allegations of misleading or false disclosures the plaintiff must prove, *inter alia*, that the defendant's statements were material and to be guilty of insider trading, the information illegally obtained must be material. And the beat goes on.

Material information may be quantitative [*e.g.*, 20% of a business's revenues are affected] or qualitative [*e.g.*, the CEO was just arrested for insider trading]. The category of the communication will affect the materiality analysis [*e.g.*, historical facts versus speculative facts]. In short, the term is very broad and fact-specific, which means considerable judgment is required when determining what information is material, and ultimately a judge or jury may make the final determination. In other words, hindsight often comes into play, which greatly complicates matters for the securities lawyers and their clients. Indeed, because it is a fact-intensive inquiry, materiality often is not amenable to a motion to dismiss or even summary judgment, which raises the stakes for defendants. It is important to understand that a fair amount of securities law involves "after the fact" determinations of often impenetrable and confusing securities laws. Having said this, the cases discussed in the text illustrate some of the important general

principles developed by the courts which provide some guidance for analyzing materiality issues. There are some parameters. Query: Do the courts employ an objective or subjective test for determining materiality? If you are a defendant in a securities lawsuit where materiality is at issue, what standard would you prefer generally? Hint: It would be open season on defendants if the test were subjective.

One additional important point: The duty to speak or disclose and materiality are not the same. Once a disclosure is made, however, whether it is material can have serious consequences.

NASDAQ – The automated (computer) quotation system of the National Association of Securities Dealers, which oversees the OTC market. In practice, NASDAQ serves as a securities exchange without a trading floor for securities not listed on stock exchanges. Before NASDAQ, prices for OTC securities were only available by telephone and by printed sheets that quickly became stale. The development of NASDAQ has meant that there is no longer a great benefit from the standpoint of liquidity to being listed on a stock exchange. However, as discussed above, there still appear to be important reputational benefits from stock exchange listing, particularly on the New York Stock Exchange, and other issuers have moved from NASDAQ to a stock exchange because of perceived abuses in the bid/ask spreads maintained by NASDAQ dealers.

No-Action Letter – A form of written advice provided by the SEC staff to issuers based on and limited to a discrete set of facts. Generally, at issue is an ambiguity or an apparently illogical result under an SEC rule or regulation. If the request of the letter is granted, the letter may state that, based upon the facts described, it (the SEC staff) would not recommend to the Commissioners that the SEC take any action against the described conduct. No actions letters can directly address the specific issue at hand with a legal conclusion or provide an interpretation of the relevant rule or regulation. The distinction is often blurred. No-action letters do not reflect the Commission's views; they are prepared by the Staff. They do not foreclose private lawsuits or even preclude reconsideration if the representations or facts change, nor do they foreclose action by the SEC, although it latter is extremely rare, especially if the recipient acted in good faith based on the letter. Despite the fact that the scope of such letters is limited, many practitioners consider them to be an important secondary source on the application of the federal securities laws. The courts are somewhat uneven in their treatment of no-action letters in terms of their evidentiary and precedential value, although many give them great weight as legal authority. In any event, when in doubt, requesting a no-action letter can be a necessary "belt and suspenders" way to approach a securities transaction or some other matter. Of course, if you get an unfavorable answer your client has a problem because at a minimum you are on notice that the SEC disagrees with your client's position. Stated another way, action letters can be precarious and should be approached carefully. Occasionally, if the issue is important enough, issuers may not seek a no-action letter and file a declaratory judgment action against the SEC. Also, courts will occasionally overturn SEC no-action letters. Again, nothing is simple about federal securities law.

Nonpublic Information – Information concerning public companies that is not generally available to the public, and the focus of 10b5-1 insider trading enforcement proceedings and **Regulation FD**'s prohibition against selective disclosure of material nonpublic information.

Offer – Not a sale or a purchase, but nevertheless regulated by the '33 Act. Like many terms

under the federal securities laws, it is construed broadly by the SEC and the courts. See '33 Act § 2(a)(3). Technically, an offering of a security is just that: An offer to sell a security through a public or private offering, although what can constitute an offer might amaze you; the actual sale of the security is the culmination of the offering. The distinction becomes especially relevant under section 5 of the '33 Act.

Person – Defined term under the '34 Act to include natural persons, companies and the government, among others. In other words, an expansive term.

Preferred Stock – Preferred stock is a form of common equity or permanent capital. However, it is fixed in terms of its return to shareholders. That is to say, it will have a fixed dividend that normally cannot increase. Some forms of preferred stock, however, can be convertible into common stock (a convertible preferred stock). In this case, the investor gets a fixed rate of return until such time as the underlying common stock appreciates to a value that makes it attractive for the holder to exchange his or preferred stock for a fixed number of common shares. Preferred Stock is usually callable by the issuer after a certain time in accordance with a contract schedule of prices. It may have general voting rights or may have a vote only in special situations. As with all hybrid securities, the characteristics of Preferred Stock may be varied to meet different circumstances.

Press Releases – Yet another source of information for investors that generally highlights a current event or activity. Companies like to issue press releases when good things happen that can positively affect their stock price. For example, "Textron Inc. announces that Net Jets [fractional share aviation leasing venture] has placed an order for 150 Cessna X business jets over the next five years." And, if really bad things happen that could affect the stock price, Textron might issue a press release to clarify the situation, especially if the matter is not as bad as some might think. In either case, press releases are governed by basically the same disclosure rules as public filings in terms of the antifraud rules. Thus, care must be taken to ensure that any material statements are not false or misleading. Depending on their content, press releases may contain language stating that forward-looking statements are contained in the release and point to other filings that contain relevant "cautionary language" and risk factors to preserve any applicable statutory or common law defenses.

Price-to-Earnings Ratio [P/E Ratio] – The ratio between the price of a stock and the company's earnings, often referred to as the earnings multiple. This is an important indicator to many investors of whether a company's stock is a good value. For "large cap" stocks [*e.g.*, Apple or Microsoft], popular wisdom says under twenty is good; for all other stocks, under forty is good. To find the P/E for a particular stock [actually, the issuers], go to any stock table and it should be there.

Primary Distributions [or Primary Offerings] – The *sine qua non* of the '33 Act. It refers to the original or subsequent sale of a security from the issuer to investors with the proceeds going directly to the issuer, not accounting for underwriter or broker commissions depending on the transaction. This also is referred to as the primary market. *Contra* **Secondary Distributions** which are sales by investors with the money going to the selling investor, not the issuer. Trading transactions through a market are secondary distributions, but they are free from the '33 Act registration requirements. Buying and selling through exchanges or other markets is referred to

as the secondary market. I think I have made this more complex than it is, but there you have it.

Private Offering [or Private Placement] – A huge and widely-used source of capital formation by private and public companies, especially Rule 506 limited offerings under Regulation D. Basically, the opposite of a public offering in terms of the investor pool. Typically, a company will avail itself to this option by issuing securities to a small group of generally sophisticated and well-informed investors, such as financial institutions or accredited investors, in order to avoid the costs and other burdens associated with the '33 Act registration requirements, and, if a private company, remain private and hopefully avoid **Reporting Company** status under section 12(g) of the '34 Act. Private placements also have limitations on subsequent the "distribution" [*e.g.*, resale] of the issued securities, and, with one recent, major exception, may not entail general advertising and solicitation. Because private placements generally involve institutional investors and wealthy, ostensibly sophisticated individual investors, the SEC scrutinizes these transactions less carefully [*e.g.*, no prior review] because they assume the investors know what they are doing and do not require the enhanced information protection associated with public offerings; although, again, the antifraud rules apply. This does not mean, however, that issuers do not need to be careful about the information their investors receive and their level of sophistication. Private placements are an exempt transaction pursuant to section 4(a)(2) of the '33 Act.

If you practice in the securities area, most of you will be dealing with private placements; probably **Regulation D** "limited offerings." Private placements have advantages and disadvantages for clients seeking to raise capital. Avoiding the cost and time associated with registration is one major benefit, as well as staying private and avoiding of the '34 Act regulatory regime. On the negative side, in addition to limiting the potential pool for capital because the investor base is relatively limited, private placements present barriers to liquidity which are not present for public offerings. In 2007, Rule 144 was amended to ameliorate some of the confusion involved with resale of securities pursuant to a private placement by better defining who is an "underwriter" and shortening the holding periods for "restricted" securities, especially for so-called non-affiliated persons. In promulgating the rule, the SEC acknowledged that lengthy holding periods prior to the amendments provided a disincentive to investing in private placements. See also Rule 144A, which allows for immediate resale to Qualified Institutional Buyers ["QIBs"]. Also, the JOBS Act eliminated the prohibition against general solicitation and general advertising for accredited investors [not a particularly high hurdle to get over], which the SEC translated into Rule 506(c) offerings. Such offerings are theoretically more attractive than Rule 506(b) offerings that are not open to the "public," although the fairly onerous verification requirements for accredited investors established by the SEC may make this option unattractive. In any event, being able to advertise and solicit the public for an unlimited offering looks a lot like a conventional public offering without all the baggage, especially if a more fluid market for trading emerges, even with the Rule 144 remaining limitations on the holding period. It is important to note that violations of any of the requirements associated with private placements can cause a loss of the section 5 exemption, which can result in significant damages and penalties for the issuer and others. Rule 502 under Regulation D, for example, contains four conditions and, if any are not met, can lead to the loss of the exemption.

The **Regulation A+** public offerings [Tiers 1 & 2] are another mean of facilitating capital formation under the JOBS Act [Title IV]. Tier 2 ostensibly fills the "gap" between an IPO for an

emerging growth company and a Regulation D, Rule 506 private placement, combining some of the advantages of both. For example, Regulation A+ permits a public offering to retail investors [don't have to be accredited investors, although the amount non-accredited investors can invest is limited] without many of the costs and complexities of registration under section 5, while also enabling secondary trading by investors. This offering is available only to non-reporting U.S. and Canadian companies. Also, the securities that may be issued are limited to three types.

Tier 2 offerings are "covered securities" and thus not subject to state regulation. Issuers and other parties are subject to liability under section 12(a)(2). On the flip side, certain filings analogous to Form S-1 and certain periodic reporting requirements are mandated. Indeed, some refer to Regulation A+ as "mini-registration." The maximum amount that can be raised in an offering is $50M [Tier 2] in a twelve-month period. Form 1-A is the counterpart to Form S-1, and offering statements are "qualified" by the SEC as opposed to being ordered effective for registration statements, although the distinction is minor in the final analysis. The "offering circular," which is part II of the Form 1-A, is the functional equivalent of the **Prospectus**. Annual and semi-annual reports are required, although they are not as comprehensive as **Reporting Companies**' periodic reports. The SEC recently published its rules for Regulation A+ offerings. The SEC release discussing the regulations is extremely informative, especially as it pertains to the economic analysis that the agency was required to do. Most important, throughout the entire release, you can vividly see the agency's effort to balance the need to protect investors against the need to facilitate capital formation, including the dictates of Congress in the JOBS Act itself. Yet another potential securities transaction for your client to consider depending on their objectives, although there is some concern that Rule 506 offers will continue to be the option of choice for many early- and mid-stage companies because of the cost and time associated with the mini-registration process and follow-on reporting requirements.

Private Securities Liability Reform Act [PSLRA] – Major legislation amending the '33 and 34 Acts that provides a series of important and frequently-used defenses and limitations for private 10b-5 litigation, including class actions. The PSLRA reflects Congress's intent to curb vexatious securities litigation. The PSLRA's stringent pleading requirement for scienter [section 21D(b)(2)] played a prominent role in the dismissal of plaintiffs' complaint in the City of Roseville v. Textron Inc. 10b-5 class action lawsuit, which we will be discussing.

Profits – Another important accounting term with numerous permutations [*e.g.*, net profit, gross profit, margins]. Because this isn't an accounting course, think of profits simply as revenues [money generated from sales or services provided], less the costs and expenses of the business. Most important, the more profit a company is generating and the better the prospect of increased future profits, the more attractive its shares will be to investors, all things being equal, although sometimes they are not. For example, if increased profits are being driven by cost cutting [*e.g.*, reduced research and development] rather than increasing revenues, future profits may actually fall. Also, do not get lulled into thinking that just because a company is not profitable today, it is necessarily a bad company for investment or M&A purposes. Indeed, if the company is experiencing reduced profits because it is spending more on research and development that could lead to new and more profitable products, its future growth prospects may be strong. In any event, the market is driven largely by the potential for future growth. If a company has good prospects for future profits, it is more attractive to rational investors. So, what is the difference between profits and earnings? The answer appears to be that profits are used primarily as an

accounting term, and, for securities purposes, earnings are what everyone is interested in.

Pro Forma – Commonly misunderstood term which, in the world of accounting, refers to financial statements prepared as though the subject transactions or events have already occurred. For example, the **Registration Statement** may include a *pro forma* balance sheet that reflects the expected results of the offering. Query: Would this constitute a forward-looking statement and thus be subject to the PSLRA **Safe Harbor**?

Prospectus – As defined in the '33 Act, any written [including radio and TV] communication that offers any security for sale or confirms a sale. The prospectus is the primary selling document in a public offering. It is the first part of the **Registration Statement** [*e.g.*, Form S-1, Part 1], and includes financial and operational information concerning the issuer and other information concerning the offering itself [*e.g.*, underwriter compensation, offering price, use of the capital which is being raised]. The prospectus may take many forms, including a preliminary prospectus, summary prospectus, final prospectus or a "free writing" prospectus. Unsurprisingly, the SEC has strict requirements concerning what is to be included in a prospectus and carefully reviews them prior to release. For private placements, the private placement memorandum ["PPM"] fulfills a similar role, but is not subject to SEC prior review. For a Regulation A+ public offering, the "offering statement" includes a prospectus.

Section 12(a)(2) of the '33 Act provides a quasi-negligence based standard for material misstatements or omissions in the prospectus [public offering] for those engaged in the selling or offering of securities [*e.g.*, solicitation]. The SEC takes the position that issuers can be held liable under this provision. See, e.g., Rule 159A. Similar to section 11, section 12(a)(2) is not a fraud statute. The primary relief is rescission under section 12(a)(2); only purchasers of the securities or the SEC may sue. Also, section 12(a)(2) applies only to securities transactions that *require* a prospectus. See Gustafson. Based on Gustafson, it is arguable that section 12(a)(2) does not apply to false or misleading PPMs because private placements do not require a "prospectus." Subsequent lower court decisions seem to follow Gustafson in this area. In any event, the antifraud rules clearly apply to PPMs. Registration A+ offerings are exempt from section 12(a)(2) liability, even though the "offering circular" is similar to a prospectus.

Proxy & Proxy Statement – The proxy is the form that companies provide shareholders for voting purposes [*e.g.*, election of directors, corporate resolutions, and approval of mergers]. It is accompanied by a **Proxy Statement** explaining the matter or matters the shareholders are voting on and contains a significant amount of other information. The proxy process is subject to the same stringent disclosure rules as public filings under the '34 Act, including SEC review. **Reporting Companies** are subject to the SEC proxy disclosure rules under section 14 of the '34 Act and relevant SEC rules and regulations. Non-reporting companies conducting a Regulation A+ offering are not subject to the proxy disclosure rules. Recently, the SEC has proposed more extensive reporting on executive compensation versus performance in, *inter alia*, annual proxy statements.

Public – Key term in federal securities law that arises in a variety of contexts. Here is the thing: What a layman generally considers the "public" to be and what the SEC and the federal courts consider "public" can widely differ. The latter two take a considerably narrower view of the term, which has important implications for securities regulation, especially whether an offering is

a public or private placement. You might think that an offering made to thousands of people involves the public. Not necessarily. Moreover, for the SEC, it can be a much smaller number depending on the circumstances. Obviously, if an issuer solicits investments on the internet the public is involved. However, if an issuer makes an offering to ten non-accredited investors and provides little or no information concerning the offering itself, this is a public offering. This is a variation of the U.S. Supreme Court's 1953 decision in SEC v. Ralston-Purina and its progeny and related subsequent SEC rules, which we will discuss. At the risk of oversimplification, determining whether an offering is private or public depends on more than the number of investors solicited. The critical inquiry is whether the persons to whom the offer is being made require the protection of section 5 of the '33 Act. The SEC sought to ameliorate some of the confusion surrounding this issue by promulgating Regulation D, which, as discussed, offers a series of transactional safe harbors.

Public Company – Basically, a company with many shareholders whose securities are registered with the SEC and trade on one of the sixteen U.S. national exchanges, although technically, the shares could trade on an OTC market. *Contra* private company, which may have many shareholders but whose shares are not registered with the SEC and do not trade on a national exchange. Somewhat simplistic, but it will do for this course. Public companies are subject to the panoply of federal securities laws and the myriad of SEC rules and regulations, especially those that address mandatory disclosures. See **Reporting Companies**, which also can include private companies that meet the size and shareholder composition thresholds of section 12(g)(1)(A) of the '34 Act and thus become subject to the various section 13 periodic reporting and disclosure requirements. Obviously, private companies need to be careful about not slipping into reporting company territory.

Public Offering – A transaction that seeks to raise capital through the issue of securities to the public. In other words, a primary offering such as an **Initial Public Offering [IPO]** which is the first time a private company offers its securities to the public, converting the company from a private to public company. Subsequent offerings of securities are referred to as public offerings. Some people get confused. An IPO is an IPO, and a public offering includes an IPO as well as any subsequent public offerings. Note: Form 10 or Form 8-A, depending on the type of issuer or offering, must be filed with the SEC along with the Registration Statement [Form S-1 or, for domestic companies, S-3] if the securities are going to trade on a national exchange. The attractiveness of public offerings is that the issuer can access large amounts of capital, and from the investors' perspective, the shares are highly liquid. A private placement is by definition not a public offering. While "going public" often is the best way to access capital markets, it comes with the price of increased SEC oversight, loss of management control because of shareholder rights, effectively disclosing information to competitors, and the costs and burdens of being a public company, and so on. If you are advising your client about whether they should engage in an IPO, they need to know the regulatory consequences and costs associated with being a public company and must be prepared to operate as such, ideally before the offering. A "backdoor" route to public company status would be when a private company acquires a public company through a reverse merger. If structured correctly, this transaction can avoid many of the costs and delays associated with section 5 of the '33 Act. Often, the transaction will be accompanied by a capital-raising transaction, not to mention the fact that the target itself may have ample "capital" on its balance sheet [*i.e.*, free cash flow]. Of course, like every securities transaction, a reverse merger involving a private bidder and public target has advantages and disadvantages,

proving once again the adage that there is no perfect transaction for securities or M&A purposes, only the best transaction relative to your client's objectives. For an interesting and helpful discussion of the subject of going public through a reverse merger, see Laura Anthony, Direct Public Offering or Reverse Merger; Know Your Best Option for Going Public, (Jan. 21, 2014) [firm publication].

Important IPO terms you need to know: **Underwriter,** underwriter syndicate, underwriting agreement, road show, pre-filing conference, lock-up period, best efforts offering, auction, and fixed price commitment offering, for starters.

Puffery – Term often used by defense lawyers to describe statements made by executives concerning their companies' financial performance in an effort to diminish the statements importance and materiality relative to 10b-5 liability or **Regulation FD** selective disclosure requirements. In other words, "harmless," acceptable exaggerations that everyone understands them to be. Classic example: CEO says that he or she expects nothing but good things for their company in the future when in fact he or she knows the company is not doing so hot. Maybe not a perfect example, but you get the point. *Contra* **Forward-Looking Statements**, which are predictions of future performance but potentially protected from liability by certain statutory defenses and the common law "bespeaks caution doctrine." Trying to figure out what is puffery in many 10b-5 lawsuits can often be unavailing because the defendants make so many other alleged material misstatements of fact that it doesn't matter if a few statements are puffery.

Rating Agencies – Quasi-public agencies which, pursuant to certain standards, analyze and evaluate the credit worthiness of companies, financial institutions, federal, state, and local governments—you name it. An adverse rating [*e.g.*, AAA is the highest, and C refers to the fact that the company is about to default on its debt or is not credit-worthy in the first instance] can have a negative impact on a company's ability to borrow money, issue stock, increase capital reserves, and the stock price. Similarly, an unfavorable rating on a particular transaction [*e.g.*, new mortgage-backed security] can affect the success or failure of the transaction, and can even affect the particular market for the type of security at issue. Obviously, getting an unfavorable rating is generally not a good thing, although they sometimes have to be taken with a grain of salt. And, when two or more rating agencies "downgrade" a company's rating at the same time, it is not a good event. The ironic aspect to this is that the rating agencies receive a significant part of their funding from the very entities they rate, which raises the specter of a conflict of interest. Ratings agencies are subject to SEC oversight and regulation. Moody's and Standard & Poor's ["S&P"] are two of the more prominent rating agencies. When making a decision about whether to acquire a security, consideration should be given to any current rating of the issuer or the transaction. Keep in mind, however, that rating agencies are far from infallible. They have missed the weakness in financial institutions, especially those linked to the mortgage industry in the 2008 pre-Lehman Brothers collapse. In June 2012, the SEC commenced an investigation of S&P for its use of lax standards and pulling out of a $1.5B deal. See also bond rating, which is a measure of a company or government's ability to repay its debt, given what is known about the company, and the economy and business climate, among other factors.

Recapitalization [or Recap] – A change in the capital structure of a company and another way to raise capital, albeit often risky. Recapitalization entails substituting debt for equity on the company's balance sheet. In other words, increasing debt [and thus cash] and reducing equity.

Cash generated through financing [debt] can be used to fund a special dividend for shareholders or re-purchasing shares [self-tender] on the open market. The most important distinction between a recapitalization and a LBO is that public shareholders retain ownership [equity] in the recapitalized company, albeit their stock may be worth considerably less than pre-recapitalization, which is one reason why a stock buy-back will often accompany recapitalization. This puts cash in the shareholders' pockets and still allows them to retain a level of ownership. Recapitalization is heavily dependent on the availability of financing, and, most importantly, payment terms [interest], which can fluctuate from day-to-day. Recapitalization, like business combinations, can trigger certain requirements under the federal securities laws.

Record Holder – The record holder for stock is the person who has the rights of ownership, such as the right to dividends and shareholder voting, either because the stock is registered in their name or they are the bearer [*i.e.*, possess the security]. By definition, the record holder is the "beneficial owner" of the shares. Investors whose shares are held in a brokerage account are also beneficial owners. Basically, the same for the record holder of a bond: They have the right to the principal and interest. Once the security is sold, the holder ceases to be the record holder. Unsurprisingly, determining who is actually the record holder of a particular security can present problems depending on the number of shares outstanding and the relevant trading activity, especially if the issuer has poor record keeping. See **Transfer Agent** for how public companies keep track of and manage their securities.

Registration Statement – Section 5 of the '33 Act establishes the registration requirements for the sale of securities to the public; subject to, of course, section 3 and 4 exemptions. Registration is the cornerstone of the '33 Act and is consistent with the Act's focus on protecting purchasers only. The registration statement is the form that is used to register the securities with the SEC. To make a long story short, absent a registration statement that has been deemed effective by the SEC and a prospectus that meets the requirements of section 10(a), no security may be sold or delivered. The default registration form for U.S. companies is Form S-1. It can be used for IPOs and subsequent public offerings, although large public companies who qualify as "seasoned" issuers often use the shorter Form S-3. Bear in mind, it's the security that is registered, not the company. The company lists its securities on a national exchange and registers the securities with the SEC. As discussed previously, unless an exemption or **Safe Harbor** is available, any offering or sale of a security must comply with section 5. Offerings for municipal securities, non-profit securities, and private placements, for example, do not require a registration statement because they are exempt securities or transactions.

The registration statement contains volumes of financial and operational information designed to provide potential investors with accurate and complete information concerning the issuer, the offering itself, use of the proceeds, etc. Preparing these documents can take considerable time and money and are subject to intense review by the SEC, especially for first-time filers who have no track record. As such, companies need to weigh these costs in their decision as to which capital-raising transaction to pursue. Perhaps, as is pointed out by the authors of the textbook, an even greater cost is the "deflection of executive time to the offering, (possibly at the expense of managing the business)." See Schedule A [section 7] in the '33 Act, which addresses the information required in a registration statement; Regulation C (general requirements); Regulation S-K (non-financial disclosure requirements for all parts of the S-1); Regulation S-X (the form

and content of financial disclosures). See also Regulation S-T, which requires electronic filing through EDGAR, and Form S-1 itself, which provides further instructions for filling out the form. These do not exhaust the list of relevant rules and regulations that pertain to the registration process, but they are the primary ones relative to the registration statement itself and many other disclosures [see, e.g., Regulation A+ Tier 2 filings].

Note: There is a great deal of similarity between the mandatory content of registration statements, reporting company periodic reports, proxy statements, and Rule 13e-3 going private filings, which partially explains why the SEC adopted integrated or incorporated disclosure rules. In other words, for qualifying issuers, prior disclosures may be incorporated in certain filings, which saves time and money.

Section 11 of the '33 Act is an important civil remedy for the SEC and private persons relative to false or misleading statements contained in registration statements once they become effective. It applies only to purchasers of securities, unlike section 10(b), which applies to purchasers and sellers. Section 11 is a strict liability provision for issuers, and imposes varying due diligence liabilities on other participants in the offering depending on their status [expert; non-expert]. This is laid out in the Escott case in the text. The damages provision can be a little confusing, but basically comes down to the plaintiff having to prove diminished value for the securities purchased. The plaintiff need not show causation, but the defendant can use "negative" causation as a defense. Also, section 11 is not a fraud statute; the material statements at issue must merely be false or misleading. Section 11 has a relatively short statute of limitations, however. Also, the plaintiff need not show reliance on the registration statement during the first year after the offering; thereafter, yes. Final point: Standing under section 11 can be problematic when the securities are purchased on the secondary market as opposed to purchases directly from the public offering. This is the so-called "tracing" requirement.

Section 12(a)(1) addresses civil liability for the failure to register under section 5 absent an exemption. It applies only to the solicitation or sale of securities in violation of section 5. Section 17(a)(1) is the fraud counterpart to section 10(b) of the '34 Act, but is only available to the SEC. Sorting out which of these three provisions [including subsections 17(a)(2) & (3), not to mention section 10(b)], applies depending on the circumstances isn't easy. It is not unusual to see more than one remedy bundled together in a lawsuit involving a registration statement.

Regulation FD – Regulation Fair Disclosure prohibits issuers of registered securities, or those acting on their behalf, from selectively releasing material nonpublic information to certain market professionals or securities holders if it is reasonably foreseeable that the latter will to trade on the information, with certain exceptions. Consider this regulation to be the SEC's attempt to ensure asymmetry of information in the markets. If the disclosure is "intentional" [which may include disclosures made with reckless disregard], the information must be made available to the public "simultaneously," which means that, as a matter of physics, it is impossible not to violate Regulation FD if the selective disclosure is intentional. This certainly was the SEC's position in the release covering Regulation FD. I haven't done the research, but I suppose that the person making the disclosure, assuming he or she immediately realizes it was intentional and otherwise violated the regulation, could run to a computer and immediately blast the information to the world and be safe from prosecution as a practical matter. If the disclosure is unintentional, disclosure must be made available to the public "promptly" after the issuer

learns of the disclosure. "Promptly" appears to mean "no later than 24 hours or at the commencement of the next day's trading." See Rule 101(d). A violation of Regulation FD can result in injunctive relief, cease and desist orders, and substantial monetary penalties. A violation of Regulation FD is not the same as insider trading or otherwise a violation of Rule 10b-5 per se, although it can obviously lead to either depending on the circumstances. For example, an insider who, in disclosing information, breaches his or her duty of confidentiality is not acting on behalf of their corporation. See Rule 101(c). If the recipient of the information trades on it, this may constitute insider trading, and then both parties have a problem. The regulation provides for three exclusions, the first two of which require either a duty of confidentiality or an agreement to keep the information confidential. The other applies to sharing information as part of a securities offering under the '33 Act. One final point: The SEC recognizes that analysts and other market professionals play an important role in making information available to the public, and, if anything, encourages such activity. This acceptance is tempered, however, when Regulation FD situations arise.

Classic Regulation FD case: The CEO is addressing some analysts and provides them with an earnings forecast that has not yet been made available to the public or materially differs from what has been disclosed to the public. You might ask yourself why any CEO would ever get themselves into such a situation. The answer is: Analysts and institutional investors can influence stock price, as discussed previously. Thus, the temptation to provide analysts with "helpful" information is great during some quarters. Sometimes, the line is crossed, however, either on purpose or inadvertently. Regulation FD applies to issuers of securities registered under section 12 of the '34 Act and those required to file reports under section 15(d). Keep in mind here section 12(g)(1).

Remedies – The federal securities laws provide for a bewildering array of private and governmental remedies that the securities lawyer and his or her client need to be aware of and obviously, do their best to avoid. The major ones are: Sections 11, 12, 15 and 17(a) of the '33 Act, although the latter has application outside the contours of '33 Act matters, and sections 10, 18 and 20 of the '34 Act. The civil penalties can range from injunctive relief to disgorgement of profits or jail time, and the state of mind requirement ranges from strict liability to scienter. The criminal penalties speak for themselves. Lurking in the background is the authority the SEC has to bring civil liability proceedings in its administrative courts, which is hardly a favorable venue for defendants. The important point here is that, as draconian as these remedies can be, the problem is exacerbated for the securities lawyer and his client because the securities laws are often confusing and ambiguous; and, moreover, often subject to hindsight determinations by judges and juries, not to mention the SEC itself. For example, as previously discussed, there is no "bright-line" test for materiality, and, depending on the circumstances, even a good faith attempt to define it by the lawyer may be no defense to a lawsuit. This is not to suggest that the practice of securities law should be avoided; well, maybe the faint of heart should pick another area of practice. The point is that the practice of securities law requires rigor, knowledge, brains, and good judgment. Anything less is a recipe for disaster for the client and the lawyer.

For an extensive and insightful discussion of the panoply of the more important remedies, see Vizcarrondo, Liabilities Under the Federal Securities Laws (Watchtell, Lipton, Rosen & Katz 2013), which is available on the internet. I have incorporated parts of this publication in the remedies and related sections of this Glossary.

Reporting Company – Company subject to the '34 Act continuous disclosure and accounting and internal control requirements [section 13]. As the text points out, there are three categories of reporting companies: (1) public companies that list their securities on a public exchange [section 12(b)]; (2) private companies that meet the threshold requirements of section 12(g)(1) of the '34 Act; and (3) companies that have filed a '33 Act registration statement with the SEC that has since become effective [section 15(d)]. Query: What is the fundamental difference between a company that acquires this status under section 12 and one that acquires this status under section 15(d)? Is it where their shares trade? Arguably, Regulation A+ has created a fourth type of reporting company, the "Regulation A+ reporting company," but this is too esoteric of a subject to worry about in this course.

Restricted Stock – Securities that have limited transferability, most commonly seen in private placements, although there are other examples [*e.g.*, Tier 1 Regulation A+ offerings]. Frequently, even if there is an available **Safe Harbor** that relaxes transferability restrictions, the issuer may have the final say on whether a restricted security can be transferred. See Rules 144 & 144A for the SEC's effort to facilitate the resale of certain restricted securities. It should be apparent by now that issuing restricted shares can affect the liquidity of an investment.

Revenue – The amount of money a company receives in a specific period of time, derived from the sale of goods and services and other income-producing activity. For the government, the money generated from taxes and other revenue-producing activities. Basically, the subtraction of the costs and expenses of the business from the revenue number yields net income or earnings. Obviously, the government doesn't care so much about the latter. The accounting for all this can be incredibly complex, especially for large public companies, but, in the final analysis, earnings and revenues constitute the bottom line for most rational investors.

Risk – The essence of any security from the holder's perspective, although oddly enough, not necessarily a criterion for a financial instrument or interest to be a security. The obvious risk is whether the security will meet the holder's investment thesis, which can be exacerbated by the nature of the investment, including market variables. General rule of thumb: The greater the risk associated with a security, the greater the potential return, but the greater the chance of failure. See, e.g., **Junk Bonds**. The less the risk, the less the return. See, e.g., mutual funds or money market accounts at your local bank. which pay 0.000001% interest. However, "Black Swan" events such as the Great Recession of 2008, increased the risk of traditionally low-risk investments such as index funds, which is one reason gold and bonds became attractive investments and many retail investors stayed on the sidelines entirely. It is important to note that no security is entirely risk-free: If investors do not do their homework or find someone who does and is trustworthy, they may as well bury their money in their backyard because eventually they are going to lose it, despite the federal securities laws and regulations. Ah, but this is the beauty of capitalism: Investors have the right to fail or succeed as long as they are provided accurate and comprehensive information from which to make an informed decision in an market free from manipulation, at least under the federal securities laws. Ditto for issuers who embark on securities transactions that also contain risks, sometimes huge ones, in terms of achieving the client's objectives.

Rules & Regulations [SEC] – As discussed previously, the SEC has broad rulemaking authority

[even to the point of exempting certain transactions, persons and securities from the laws] under the federal securities laws it administers. Basically, a statute may provide specific authorization imposing specific requirements or a general grant of authority to make such rules and regulations as the agency deems necessary to carry out the statute, generally subject to public notice and comment. The rules and regulations have the force of law. We will discuss the rulemaking process which follows strict internal procedures and steps mandated by the Administrative Procedures Act, and, on occasion, is closely scrutinized by the courts. In the main, however, the SEC is given wide berth in its rulemaking; not so much in the D.C. Circuit, however. I have lost count of the number of SEC rules, but it wouldn't surprise me if they exceed 2000. Rulemaking should not be confused, however, with the SEC's inherent authority to provide interpretations of the federal securities laws that are generally exempt from notice and comment. See, e.g., SEC Releases. Although arguably rules do, whether Releases have the force of law is problematic. Applying the law, including rules and interpretive guidance, to specific securities transactions can be a daunting and complex undertaking which is one of the reasons the SEC issues no-action letters.

Rule 102(e) – Important SEC enforcement mechanism that prohibits individuals and companies who violate the securities laws, among other deficiencies, from "appearing and practicing before the Commission"; that is, participating in any actual proceedings before the SEC, as well as any filings, preparation of company disclosure documents, conducting audits, holding certain positions in a public company, etc. Historically, accountants and senior management [*e.g.*, CFOs] have been the focus of 102(e) sanctions, but recently the SEC has indicated that they may start to use it against lawyers. Along with the **Sarbanes-Oxley Act**'s "reporting up" requirements for lawyers and potential aiding and abetting situations [see the National Student Marketing case in the text], securities lawyers need to worry about themselves as well as their clients.

Safe Harbors – Affirmative defenses set forth in securities statutes (*e.g.*, PSLRA) or SEC rules and regulations. See, e.g., Rule 10b5-1's safe harbor for pre-arranged stock trades by insiders. See also the safe harbor provisions for forward-looking statements discussed previously, as well as certain safe harbors concerning communications before and during the registration process. The various safe harbors we will discuss during the course are important and generally reflect recognition by Congress and the SEC that certain aspects of the '33 and '34 Acts and their application require moderation, especially to facilitate capital formation.

Sarbanes-Oxley Act of 2002 ["SOX"] – Very important amendment to the '34 Act passed largely in response to the Enron [fabricated profits through off balance sheet accounting] and WorldCom [billions of dollars of overstated earnings over several quarters] debacles. SOX addresses a number of actions reporting companies must take in addition to ensuring the integrity of their financial statements and accounting and auditing practices. The Act also contains nettlesome "reporting up" requirements for attorneys and "modifies" the prior regime of allowing the states to solely regulate corporate governance through the internal affairs doctrine. In an interesting twist, SOX added the requirement that audited financial statements [that must conform to the GAAP requirement] "fairly represent" the company's financial performance and position. Stated another way, compliance with GAAP or even generally accepted practices may not be sufficient to meet the "fairly represent" requirement. This is the lesson of United States v. Simon, although it pre-dated SOX by more than thirty years. Unsurprisingly, the cost and time

associated with complying with SOX can be significant, which is one reason some companies decide to remain or go private. Finally, the Act makes any violation of its provisions a violation of the '34 Act, and thus subject to the Act's vast array of remedies and penalties, enforceable by the SEC.

Securities and Exchange Commission ["SEC"] – The United States Securities and Exchange Commission; created by the '34 Act and one of the most powerful and active executive agencies—not to be trifled with. The SEC establishes regulations and rules under the federal securities laws, acts as an administrative tribunal, and oversees and enforces the federal securities laws, although other agencies can promulgate rules, conduct investigations, and bring enforcement actions in limited areas as well [*e.g.*, Public Company Accounting Oversight Board in the accounting practices and auditing area and the Department of Labor, as discussed under **Brokers**]. The threefold mandate of the SEC is: (1) protecting investors primarily, but not exclusively, through mandatory disclosure requirements; (2) maintaining fair, orderly and efficient markets; and (3) facilitating efficiency, competition and capital formation. The five Commissioners are the generals; the Staff includes the day-to-day foot soldiers that do a variety of things, including reviewing and commenting on securities law filings, providing informal advice to lawyers, conducting informal and formal investigations, and issuing no-action letters. The important divisions for our purposes are the Corporate Finance Division, which reviews most of the required filings, and the Enforcement Division, whose names says it all. In addition to rules, regulations, forms, and schedules, the SEC also issues Releases, Staff Accounting Bulletins and other guidance documents, which are generally available on the agency's website. See http://www.sec.gov.

The SEC is empowered to bring civil enforcement proceedings in the federal courts and recommend criminal proceedings to the Department of Justice for filing. The agency also has its own administrative law court, which it has increasingly resorted to in recent years to obtain substantial judgments, especially at the urging of Dodd-Frank, which has expanded the list of potential defendants. The judges are appointed by the Staff and not the Commissioners, which is problematic. Indeed, recently federal district court judges in New York and Atlanta ruled that the in-house tribunal was "likely unconstitutional" for this reason. To say that the SEC has a home court advantage here would be an understatement. The Wall Street Journal recently analyzed SEC administrative court decisions over a five-year period and found that the agency won 90% of them compared to a 69% success rate in federal court actions. Unhappy defendants may appeal an adverse decision to the Commissioners, which stands an even less chance of success. Plus, the Commissioners can add new violations or even not take the appeal, in which case the decision is final. If still unhappy, defendants can appeal to the D.C. Circuit, assuming they still have any money left or haven't died of old age. Critics also point out that the administrative court system suffers from limitations on discovery and motion practice, relaxed rules of evidence, and lack of adequate time for defendants to prepare their case, among other due process failures. Of course, the WSJ article did not analyze the merits of the adverse rulings, and I suppose the SEC would say the evidence supported all of them. And, in fairness to the SEC, they are only taking advantage of a tool provided to them by Congress to do their job; and there are certain costs, timeliness, and other efficiencies associated with the administrative court process, at least at the trial court level. In any event, in response to widespread criticism, the SEC recently issued proposed changes to the administrative court process that provide some due process relief to defendants. Nevertheless, it is fair to say that defendants who find themselves

before the SEC administrative court system face a daunting task for at least three reasons: (1) they are up against an extremely competent and powerful adversary which (2) is litigating on its home turf with a court that arguably has an inherent pro-agency bias and lacks many of the protections afforded by the federal courts, and (3) has the authority to pursue significant remedies including injunctive relief, disbarment and monetary judgments. Yet another reason to tread carefully when dealing with matters within the province of the federal securities laws. And, yet another source of federal securities law along with rules and regulations, releases, and arguably, no-action letters.

Secondary Distributions – Simple concept, complicated application. Very confusing area of federal securities law. A secondary distribution entails the selling or transfer of a security after it has been issued. The complication stems from section 4(a)(1), which exempts transactions other than by the issuer, underwriter or dealer from the section 5 registration requirement. Trading shares on the open market [*e.g.*, NYSE] is a form of secondary distribution, but not one that requires registration under the '33 Act. In other words, it is a trading transaction done other than by an "underwriter." When you get beyond "pure" trading transactions, especially when dealing with private placements, including Regulation D offerings, the rules become more complex because of the lack of a clear definition of what constitutes "distribution" and the broad approach the courts and SEC take as to who is an "underwriter." For example, if you buy shares in a private placement and shortly thereafter sell them to your brother, you could be deemed an "underwriter" engaged in "distribution" in violation of section 5 for failing to register the securities. Cf., e.g., Ralston Purina and Chinese Consolidated Benevolent Association, Inc. in the text. Rules 144 and 144A represent the SEC's effort to clear up some of the confusion surrounding the resale of securities under section 4(a)(2), specifically who is an "underwriter" and how long the securities must be held before sale.

Secondary Liability – Sections 15 and 20 of the '33 and 34 Acts, respectively, as well as common law theories such as adding and abetting and conspiracy, can subject persons to secondary liability for primary violations of the federal securities laws. For example, section 20(a) effectively provides that if a person "controls" the primary violator, the controlling person can be jointly and severally liable for the violation, unless the controlling person acted in good faith and did not induce the act, directly or indirectly, which constituted the violation. Scienter? Negligence? Strict liability? The case law on what constitutes control and whether the alleged control person must be "culpable" is hardly uniform. Aiders and abettors are not control persons, but nonetheless may be subject to "direct" liability under section 20(e). The U.S. Supreme Court decision in Central Bank of Denver effectively negated aiding and abetting violations brought under section 10(b) and any other remedial provisions. Section 20(e) was added in response to the decision by Congress to permit the SEC to bring actions against those who knowingly or recklessly aid and abet primary violators. Central Bank remains a barrier to private parties seeking to purse aiders and abettors. Unsurprisingly, private parties are no longer able to pursue secondary actors [*e.g.*, lawyers and accountants] under aiding and abetting theories have sought to expand the primary liability doctrine here with varying degrees of success. This alone should tell you that the securities world can be perilous for all involved persons, especially when the stakes are high enough [version 37 of the Bonfire of the Vanities Theory].

Securities Litigation Uniform Standards Act of 1998 ["SLUSA"] – Like the PSLRA, an effort

by Congress to ameliorate the effects of class action securities lawsuits. Specifically, SLUSA requires that any class action alleging fraud through misstatements, omissions, manipulative or deceptive devices in connection with the sale or purchase of a "covered security" must be brought in federal court. Rule 10b-5 lawsuits are subject to exclusive federal jurisdiction independent of SLUSA. SLUSA addresses state lawsuits based on common law fraud or similar theories. In essence, SLUSA makes almost all securities fraud class actions exclusive to federal courts. In the Merrill Lynch v. Dabit case, the U.S. Supreme Court extended SLUSA's application to the prolonged retention of securities based on fraud, as well as the purchase or sale.

Security – Even though the '33 and '34 Acts identify many "interests or instruments" as securities [*e.g.*, stock, bonds, notes, investment contracts, debentures, and any instrument commonly known as a "security"], the inquiry often only begins there. Indeed, what constitutes an "investment contract" is largely subject to case law beginning with U.S. Supreme Court's Howey decision. Moreover, as will be seen in the Forman and Reeves cases, even though an instrument is labeled a "security" or "note," this is not necessarily controlling. Unfortunately, attempting to arrive at a definition or formula that will fit all financial "interests or instruments" is impossible. There are grey areas; although, we should be able to develop a list of "characteristics" to provide a baseline for analysis.

If you advise your client that an instrument or interest is a security and it is not, he or she may spend a lot of money and time complying with a bewildering array of rules and regulations for nothing. If you fail to advise your client that a financial interest or instrument is a security, well, good luck because then you have triggered the vast panoply of securities laws and regulations and the bewildering array of penalties that accompany failure to comply with them. Keep in mind that, on the one hand, the securities laws were intended by Congress to be construed broadly, and the SEC in particular has a history of doing just this when it comes to what constitutes a security. The courts, on the other hand, occasionally disagree.

Many of the states follow the Howey "test" for determining whether an investment contract is a security. Others, such as California, take a more expansive view [*e.g.*, the "risk capital" test adopted in the Silver Hills Country Club case in the text].

Interestingly, section 2(a)(3) of the '33 Act defines the sale of a security to include "for value." The definition of sale under the '34 Act does not have a "for value" qualification. See '34 Act § 3(a)(14).

Self-Regulation – An important concept in the securities field that refers to the second arm of federal regulatory authority—the first and most important being the SEC. Essentially, Congress has authorized several activities and persons engaged in the securities arena to form private organizations [SROs] to perform certain regulatory functions aimed at enforcing the federal securities laws. The rules and procedures of the NYSE are a good example of self-organization. FINRA, the Financial Industry Regulatory Authority, which, *inter alia*, regulates broker-dealers, is another important SRO. SROs are quasi-government agencies which provide them with limited immunity from liability. FINRA in particular is active in investigating its members, although its critics contend that it does a poor job of policing the broker-dealers in the first place, especially in terms of making their background complete and fully transparent to investors who

seek their services.

Self-Tender or Stock Buy-Back – When a public company goes on the open market to buy up its own shares, either to "reward" the shareholders with a higher price at which to sell their shares, or because the company concludes the stock is cheap and they want to hold it and sell it later at a higher price, or both. Occasionally, stock buy-backs are forced by activist shareholders that are out to make short-term profits for their investors. Also, self-tenders can be used as a takeover defense, although there are many other options that are more effective and less costly. Most importantly, the disclosure rules apply to stock buy-backs.

Shareholders – For corporations, the owners of equity securities. In effect, the owners of the corporation and thus a key **Stakeholder** for securities and M&A transactions. Under Delaware law and the law most other states, they have limited management rights because they basically empower the board of directors to act as their agent for managing and overseeing the corporation. In other words, in Delaware at least, corporations are director-centric as opposed to shareholder-centric in terms of the management of the corporation's affairs. This proposition was made clear in many Delaware decisions involving challenges to directors' actions to defeat or otherwise avoid hostile takeovers. See, e.g., Paramount v Time-Warner. Being a shareholder of a public company is not the equivalent of being the owner of a home, but this hardly means shareholders are powerless. Indeed, they have the power to elect members to the board and approve fundamental changes to the corporate structure or business [*e.g.*, merger], to name two important powers. They also have the power to sue the corporation, including enjoining transactions, and the directors and officers personally for breaches of their fiduciary duties. They also have the "power" to influence matters such as nomination of directors and share buy-backs through **Shareholder Activism**. See also **Shareholder Value Maximization**.

Shareholder Activism – When shareholder groups, which increasingly include institutional investors such as hedge funds or professional investors like Carl Icahn, pressure boards to undertake important actions such as spinning off nonperforming operations, granting dividends, conducting stock buy-backs, and revising executive compensation policies. The tools that they use include shareholder proposals under Rule 14a-8, the threat of proxy contests, or even threatening takeovers. A synonym for shareholder activism is "shareholder democracy," which, frankly, is often a misnomer or smoke screen. In any event, the mantra of this phenomenon is shareholder rights or "shareholder value," which can be a guise for achieving short-term profits for some of these groups or individuals. There is a raging debate concerning whether shareholder activism, as practiced by hedge funds and others, destroys value as opposed to creating it. Short answer: It depends. If shareholder activism is focused on short-term gain causes companies to reduce research and development or infrastructure improvement-projections in favor of returning money to shareholders, it's a bad thing. If improved management and operations result, then it is a good thing.

As the Wall Street Journal reported, in 2013, activists had over $100B in shares under management and won 68% of the proxy contests they entered, which is a dramatic increase over previous years. Generally, their targets are smaller companies but stalwarts such as Microsoft, DuPont, and PepsiCo have also been touched by this movement. Unsurprisingly, public companies have begun to pay more attention to shareholder activist initiatives, including how to preempt them, which is not necessarily a bad thing if it leads to improved performance and

shareholder value. Rule 14a-11 [direct proxy access for nominating directors], which was struck down by the Business Roundtable decision, was viewed by many as a shareholder activist provision. Recently, Marty Lipton, one of the leading corporate lawyers in the country and one of the most outspoken critics of shareholder activism, has advised his clients that, as a practical matter, most companies would be better off if they settled with activist shareholders [especially hedge funds] early to avoid a costly and drawn-out proxy contest. His solution: Give them a board seat. Interestingly, GE and Bank of America recently adopted shareholder nominating changes to their bylaws that are similar to the direct access provisions of Rule 14a-8. All I will say about this subject now is: "Be careful what you wish for." Corporations are not democracies or even republics for good reason.

Shareholder Litigation – The most important types of shareholder litigation in the securities world are class actions and derivative suits. Securities class actions almost always involve allegations of fraud under section 10(b) and Rule 10b-5. For example, the shareholders who bought and sold during a period will claim that the issuer [and its directors and officers] made materially false and misleading statements concerning the company's performance, causing them to suffer economic loss on their investment. Oftentimes, the named plaintiffs do not have an important economic interest in the case, but their lawyers do in the form of substantial fees if they win or settle, which is why securities class actions remain a growth industry. This is not to suggest that all shareholder class actions lack merit, however. Occasionally, large shareholders, such as institutional investors, bring such suits, but this is relatively rare. If the statistics are to be believed, a substantial number of 10b-5 class action suits get dismissed on the pleadings or on summary judgment, but there are enough that are settled for substantial sums and the occasional plaintiff's verdict, not to mention the cost of defense and potential adverse impact on the "corporate brand," to make companies take these suits very seriously.

It is not unusual for a derivative lawsuit [on behalf of the company] to be filed along with a 10b-5 class action, although the former is generally easier to deal with from the defensive side because the named plaintiff invariably cannot get over the "demand futility" requirement. In any event, shareholder litigation can be extremely disruptive for companies, and not something they like to see. See **D&O Insurance** and indemnification, which are protective measures for management. See also section '34 Act § 21D(b)(1)–(2) [PSLRA amendment], which provide the primary basis for dismissal of many securities 10b-5 actions at the pleadings or summary judgment stage.

Shareholder Value Maximization – The widely [but not universally] accepted principle that the primary objective of public company boards and senior management is to maximize shareholder value through increased share price, although not necessarily in the short run, especially if the board can demonstrate greater long-term returns. Indeed, many CEOs will tell you that an obsession with achieving short-term results as opposed to long-term gains is a mistake, which, frankly, it often is. For example, the desire for short-term results by shareholder activists can present a direct threat to long-term growth and viability of the corporation. Ironically, the shareholders may have little day-to-day say over the management of the company, but, under this principle, boards and senior management are fixated on keeping them happy through improved stock performance. This principle is best illustrated in the M&A context by the Revlon duty, which requires boards to obtain the highest reasonably attainable value for the shareholders when the company is subject to a change of control [*e.g.*, for sale].

Shelf Registration – Device whereby qualifying companies [*e.g.*, **WKSIs**] may register securities for issue, but hold off the actual issuance for a prescribed period of time. One advantage is in the area of debt instruments, such as notes and bonds, where a company registers these securities but waits for favorable interest rates before issuing them. Also, the issuer can take advantage of certain prior registration statements and other filings to ease the reporting and approval process [**Integrated Disclosure**]. There are other benefits, as well such as the ability to negotiate reduced underwriter fees and a ready store of securities to use as consideration for a merger or acquisition, which make this vehicle very attractive. See **WKSI** discussion, including Rule 415.

Short-Swing Trading – As defined in section 16 of the '34 Act, a purchase and sale or a sale and purchase, of an **Equity Security** within a six-month period by an Insider. Under section 16(b), if an Insider engages in short-swing trading, the profits belong to the company, but the defendant is on the hook for attorneys' fees if the plaintiff prevails. There are no criminal sanctions. Insiders are required by section 16(a) to file reports of trades of an **Equity Security**. This makes the statute easier to enforce or form the basis for litigation. An Insider is defined in the statute as a director, "executive officer," or 10% shareholder, which means **Institutional Investors** are at risk here. Section 16(b) is the only true insider trading rule in the United States because it applies to all insider short-swing trading. For purposes of **Insider Trading** actions, the term may be broader depending on the circumstances, but the penalties considerably more severe.

Stakeholders – The various internal and external persons or entities that can exert a major influence on the outcome of a securities transaction or defense of a securities proceeding. In approaching any securities issue, transactional or post-transactional, you need to identify the key stakeholders early, including how they can influence the matter and plan for how they will be dealt with. Experienced, highly competent securities lawyers probably do this instinctively as opposed to any rote exercise, but they do it. It is the same "paradigm" for M&A deal lawyers. At a minimum, every securities transaction governed by the federal securities laws has at least three critical stakeholders: the issuer, the investor(s), and the SEC.

Technology – Advances in technology play an important role in the securities world. The discussion of high speed trading, how markets work, and valuation algorithms and programs discussed above amply illustrate this point. Also, advances in communication and information mechanisms have made it much easier for issuers to communicate important information quickly and broadly. For example, the SEC has relaxed its rules concerning use of certain internet devices to disseminate important information to the public. Some issuers fully embrace these communication and information technologies; others less so for good and not-so-good reasons, which will become apparent in the course.

10b-5 Cause of Action – As previously discussed, section 10(b) and Rule 10b-5 are the general federal antifraud provisions which form the basis for a variety of private and governmental actions. The central requirement is some form of fraud or deceit whether it is an insider trading case or an action for damages arising from misstatements. A breach of fiduciary duty claim, for example, is not a basis for a 10b-5 proceeding per se. In the course, we will spend time on shareholder 10b-5 class actions involving allegations of fraudulent behavior [misstatements] "in connection with" the buying or selling of securities. The elements of a 10b-5 private cause of action for damages based on misstatements vary slightly if an individual is suing as opposed to a

class. For example, in Basic, the U.S.S.C. adopted the "fraud on the market" theory, which eliminated the requirement of proving reliance by the individual class members for class certification purposes, assuming, *arguendo*, an "efficient" market for the securities. Unsurprisingly, after Basic, the number of private 10b-5 class actions increased substantially. The presumption of reliance is generally not available in class actions involving an IPO because the offering and secondary market trading do not constitute an efficient market.

The materiality and scienter elements are fairly straightforward from an interpretive perspective. See Hochfelder, discussed in the text, concerning the scienter requirement, which courts have subsequently expanded to include reckless behavior. The remaining elements: reliance, loss causation, transaction causation, and damages, bedevil many courts and commentators and we don't have time to dwell on them. In this regard, however, a convenient way of looking at a 10b-5 private misstatement damages action once materiality and scienter have been established is provided by Professor Michael Patterson in a recent article that appeared in the Spring 2015 edition of The Business Lawyer at 441: "Did the misstatement inflate the price relative to what it would have been but for the misstatement, and if so, did the plaintiff suffer a loss as a result."

In response to the plethora of shareholder class actions, the PSLRA, *inter alia*, codified the heightened pleading requirement of FRCP 9(b) for fraud and introduced a heightened pleading requirement for scienter ["strong inference"]. See the Tellabs decision in the text for how the Supreme Court interprets this provision. Today, the battleground for defendants in 10b-5 class actions generally lies in attacking the plaintiffs' case on lack of specificity or scienter [occasionally materiality] at the pleadings or summary judgment stage. Whether the Supreme Court in Halliburton II has added another viable pre-certification defense [defendants may challenge whether the misstatements had any effect on the share price] remains to be seen.

SOX established the two-year/five-year statute of limitations for private 10b-5 actions, which is considerably longer than the statute of limitations for sections 11 and 12 causes of actions. There seems to be confusion in the courts as to the statute of limitations for SEC proceedings ranging from no statute of limitations to the default five-year period. As previously discussed, lawsuits brought under section 10(b) and 10b-5 are exclusive to the federal courts. Plaintiffs may be able to append state fraud causes of action that have the benefit of allowing for punitive damages, which may not be awarded under 10b-5. And, like almost every aspect of federal securities laws, the federal courts are not uniform in their treatment of the various aspects of 10b-5 actions, often varying dramatically in their rulings.

The '33 Act "counterpart" to section 10(b) and 10b-5 is section 17(a), which is the statute's general fraud provision. However, lower courts that have addressed the issue conclude that 17(a) does not allow for private actions. Section 17(a) applies to all sales of a security, not just public offerings. Moreover, in keeping with the overall theme of the '33 Act, it protects purchasers only. The interesting issue here is that subsections (2) and (3) are negligence based—no showing of scienter is necessary. In short, many actions that can be brought under section 10(b), may be brought under one of the section 17(a) subsections, which means the SEC has a powerful weapon at its disposal. For reasons too confusing to address here, it does not seem that the SEC has fully embraced the opportunities presented by (2) and (3).

Tender Offer – A public bid for shares of a public company. Often hostile, but can often start

as such and lead to a negotiated or friendly takeover when the bid price gets high enough for the board not to reject. Congress and the SEC have deliberately refrained from defining tender offer for fear that the innovative takeover market would find ways to circumvent a definition. The courts have provided guidance in the form of the "Wellman Factors," based on the case of the same name. Nevertheless, tender offers must comply with the various **Williams Act** provisions that address filing and disclosure when the bidder exceeds 5% ownership of the target's common shares and SEC disclosure and filing requirements when the tender offer is commenced. See sections 13(d) and 14(d) and a host of other SEC rules and regulations that govern tender offers.

Trading Transaction – Generally refers to the buying and selling of securities in all their various permutations through markets. As discussed previously, most trading is conducted through markets, often public or national exchanges, **Over-the-Counter Markets** or "**Dark Pools.**" Remember, however, that securities can "move" in ways other than trading. They can be pledged, for example, or even assigned, devised, or even sold privately.

Trading Plan – A "gift" from the SEC [Rule 10b5-1] that allows insiders to legally buy or sell their company's shares while they are aware of material nonpublic information if the trade was specifically set forth in a written document [with certain other qualifications such as fixed price or algorithm, no discretion by agent, volume] before the person acquired the information. It is important to note that a trading plan is an affirmative defense to insider trading. Also, such plans are fraught with potential mischief. For example, there is no impediment to discontinuing the trading plan, which presents an interesting dilemma for the SEC. The CEO has a trading plan to sell his or her shares at $25. Before the shares reach $25, the CEO learns that the company has just won a major contract which will probably drive the stock price well above $25. So, he or she withdraws the plan; apparently no harm, no foul under any securities law. Martha Stewart claimed that she had a trading plan in her unfortunate run-in with the SEC and DOJ. This isn't why she went to jail for twelve months, however: "Fencing" with the government concerning her trading is what did her in.

Transfer Agents – Public companies that issue securities generally use transfer agents [mostly banks or trust companies] to keep track of who owns their securities, especially stock. Other activities they engage in include issuing and cancelling stock certificates to reflect changes in ownership, acting as an intermediary to pay out interest [*e.g.*, bonds], dividends, sending out proxy materials and the like, and function as a place where security holders can go when they lose or misplace their certificates. Transfer agents also need to be contacted when sellers of securities need to lift any restricted labels on certificates when they want to sell a security. For example, a company has made a private placement or offering and the unaffiliated holder of the security wants to take advantage of the six-month holding period under Rule 144 to sell otherwise restricted securities. Generally, public companies will identify their transfer agents on their websites and periodic reports.

Underwriter – For securities transactional purposes, underwriting is the process by which capital is raised from investors on behalf of corporations and governments by issuing new securities directly to investors. The person doing the underwriting is, unsurprisingly, known as the underwriter. Most large scale underwriting is done by investment banks such as Morgan Stanley and Goldman Sachs, although, obviously, there a many smaller firms that engage in this practice. For large IPOs [*e.g.*, Facebook], the lead or managing underwriter puts together a

syndicate of investment bankers to underwrite the offering. They also build a case [*e.g.*, road show] for a particular issuance, which includes identifying a range for the security's price and the likely buyers of the securities, agreeing on the offering price with the CEO or board, securing commitments for potential investors [mostly institutional]—"building the book"—and purchasing securities from the issuer [if it's a "firm fixed commitment" arrangement, not all are]. They make most of their money on the difference between what they pay the issuer for the security and what they are sold for, as well as significant commissions from running the offering. This disjointed description only skims the surface of the important role underwriters can play in an offering. Simply put, underwriters can spell the difference between a successful and unsuccessful offering. They are a critical stakeholder in almost all major public offerings and even significant private offerings. Indeed, before the securities hit the secondary trading market, they are the "market-makers" for the price of the securities. Underwriters face certain legal risks under the federal securities laws [*e.g.*, section 11] although they do their best to limit liability through disclaimers and indemnification from issuers. One risk that they cannot limit, however, is if they purchase the securities from the issuer and the IPO results in a lower security price than what they paid. Some companies will self-underwrite their public offerings, ostensibly to save money on underwriting fees. This is referred to as a Direct Public Offering [DPO]. Announcement of successful underwritings by investment banks are referred to as Tombstones.

The term "underwriter" also comes up within the context of secondary distributions. Specifically, section 4(a)(1) of the '33 Act provides a securities registration exemption for persons other than an "issuer, underwriter or dealer." "Issuer" and "dealer" are relatively straightforward terms. Unfortunately, the definition of "underwriter" under section 2(a)(11) is broad and frankly confusing, but, in any event, sweeps in persons other than investment banks acting as underwriters for securities offerings. In other words, individuals who seek to resell securities purchased from an issuer could be considered underwriters. This is the Ralston case, which we will discuss including the ensuing confusion in the courts concerning who was an underwriter for resale or "distribution" purposes. Fortunately, the SEC improved the situation substantially when it amended Rules 144 and 144A to provide safe harbors from the definition of underwriter within the context of restricted or controlled securities.

Venture Capital Firms – Companies that provide seed money to emerging companies taking back an ownership interest and even providing management advice and talent, among other things, in exchange for the prospect of the companies going public and being highly successful, thus resulting in a high return on their investment. A long winded and convoluted way of saying a high-risk/high-reward investment strategy, albeit another important source of capital, especially for new ventures which have advanced beyond the preliminary stages. The term "angel investors" generally refers to wealthy individuals who invest early in startup companies.

Wall Street Journal – Widely read and well-respected daily publication [except Sunday, when they rest like God] that contains a wealth of information and commentary concerning international business transactions, including those that entail securities [Section C – "Money and Investing"] and M&A transactions [Section B – "Marketplace"]. Generally considered to be pro-business, the Journal is an excellent source of information for students who want to enhance their knowledge of and facility with key terms and definitions and see theory put into practice. The New York Times has beefed up its business section in recent years and provides an interesting counterpoint to the Journal, although the scope and analysis of the topics pale in

comparison. There are several other highly respected publications, such as the Economist and Forbes, to name two. Another source of very useful information for students and practitioners is the Corporate & Securities "blog" on LinkedIn.

Wells Notice or Letter – A letter from the SEC to a company or individual advising them that the SEC is planning on bringing a civil enforcement action, and provides the aforementioned with the opportunity to offer information as to why the action should not be brought. The SEC is not required to issue a Wells Notice, but, as a matter of practice, often does. Whether and how to respond to a Wells Notice—indeed, any SEC inquiry short of this—can be very tricky. For example, the recipient generally does not know what information the SEC has and runs the risk of providing harmful information in response to the notice or inquiry. Indeed, any information provided is evidence that can be used against the recipient. Failure to respond may effectively foreclose an opportunity to settle on favorable terms before the matter escalates. This raises an interesting point. Unless there is seriously egregious activity going on or the matter triggers political attention at a high level, the SEC is like any other enforcement agency. It has limited resources and will often be inclined to settle a matter rather than take it to litigation. In any event, Wells Letters or lesser inquiries need to be carefully handled, which generally means retaining a highly competent securities law firm.

Well-Known Seasoned Investor ["WKSI"] – An issuer who attains this classification enjoys significant advantages in offering its securities under the '33 Act. Generally, it entails a U.S. entity which has securities registered under the '33 Act and is eligible to use Form S-3 [less burdensome than Form S-1] for registration of a primary offering of securities, and has a worldwide public float of at least $700M or has at least $1B in the aggregate principal-amount of registered debt or other nonconvertible securities in primary offerings for cash. We can safely assume that Textron Inc. is a WKSI. The most significant advantage is the ability to file an automatic shelf registration statement on Form S-3, which avoids SEC review, contains less information than the S-1, incorporates other information by reference to the Form 8-K [integration], and has the added benefit of putting off the filing fee, which can be substantial, until the shares are actually sold. WKSI's can register an unlimited amount of securities as well. Seasoned issuers derive certain benefits not available to "standard" issuers, although not as many as WKSIs. Emerging growth companies are unlikely to be WSKIs or seasoned issuers, although they derive similar benefits, including the ability to make oral and written communications to certain potential investors prior to the effective date of the registration statement, as well as certain relaxed reporting requirements. Rule 405 addresses WKSIs, and like most other SEC rules, is far more complicated than this description.

Whistleblower – Generally, an employee of a "heinous" company, or at least what he or she believes to be a heinous company, who learns of conduct that he or she believes violates a law and takes the matter to the cognizant regulatory or enforcement agency, hence "blow the whistle." In the securities arena, there is specific legislation that protects whistleblowers from adverse action by their employers and provides for significant payments depending on the success and size of the outcome [generally settlement or judgment] of the underlying enforcement proceeding. It is not unheard of for whistleblowers to garner payments in excess of $10M, but sums of this size are rare. In any event, yet another reason to have a strong and effective compliance program, especially in the securities area, where whistleblowers are not even required to advise their companies of the specific wrongdoing and can go straight to the

SEC. The SEC has instituted a formal program to encourage whistleblowers, which the agency touts as being highly successful.

Williams Act – Sections 13(e) and 14(d) of '34 Act. These sections contain the federal filing and disclosure requirements relative to the accumulation of shares in a public company [5%+ threshold] and the commencement of tender offers themselves. Section 13 also addresses the disclosure requirements for going private transactions. The SEC has authority to prescribe rules to carry out the intent of these laws, which it has done in spades. Interestingly, neither the Williams Act nor the SEC defines a tender offer. A common test is the so-called "Wellman Factors," which we will discuss at some length in the course.

Yield – An important indicator for income investors in particular. Basically, the return you get on your investment. The higher the yield, the better the investment. For stocks, yield = (the annual dividend divided by the stock price). Dividends are generally viewed as income because they are more stable as a rule than a stock's price. Obviously, investors want both a good dividend and rising stock price, but you can't always have everything. For bonds, determining the yield is a little more complex, especially because many bonds are not held to maturity, that is, they are sold on the bond market. When a bond is bought at par [the face or stated value of the bond], the interest received is the yield. This is referred to as "yield to maturity." So, if you purchase a thirty-year bond and the interest rate is fixed at 5%, the latter is the yield. Life is not this simple, however, because bond prices can fluctuate, which can cause the yield up or down depending on whether the bond price goes up or down.