7. JUMPSTART OUR BUSINESS STARTUPS ACT OF 2012

Congress enacted the Jumpstart Our Business Startups Act (JOBS Act) in 2012 with the goal of increasing access to capital for emerging businesses. Proponents of the JOBS Act contended that private companies faced difficulties in raising capital due to restrictive private placement requirements (discussed in Chapter 9) and the costs imposed from the time consuming process of going public through a registered offering, with its significant liability risks (discussed in Chapters 7 and 8). For those companies that successfully sell securities in an initial public offering, the disclosure requirements, including those relating to executive compensation, imposed on public companies (discussed in Chapter 4) may prove intrusive. Those disclosure requirements are also costly, due the audit fees required to meet the various mandates of the Sarbanes-Oxley Act. Moreover, periodic disclosure requirements also expose a company to potential antifraud liability.

In response to these concerns, the JOBS Act created a new category of companies—“Emerging Growth Companies”—with a reduced level of required disclosures. We discuss Emerging Growth Companies in Chapter 4. The JOBS Act also increased the threshold number of shareholders of a class of equity securities necessary before a company becomes a public company and thereby subject to the SEC’s periodic disclosure filing system. We cover public company status in Chapter 4. Finally, the JOBS Act expanded the avenues for companies to raise capital outside of a registered public offering, including modifications to the existing private placement regime under Rule 506 of the Securities Act, the addition of a new mini-public offering in § 3(b) of the Securities Act, and the creation of an entirely new form of private-public financing regime commonly known as “crowdfunding.” We discuss these avenues to raise capital in Chapter 9.
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Replace Sections II.A and II.B on pages 170-173 with the following:

A. Public Company Status

Congress first defined the concept of “public” companies rather narrowly. Section 12(a), part of the original Exchange Act as it was adopted in 1934, prohibits broker-dealers from effecting transactions over a national securities exchange “unless a registration is effective” for that security. To accommodate constitutional concerns of the New Deal era, Congress (with a few minor exceptions) did not extend the prohibition to transactions not involving a broker-dealer. The process for registration is set forth in § 12(b) and the SEC has provided Form 10 as the basic form for registration. (Form 20–F is for foreign private issuers.)

Congress broadened the category of public companies in 1936 when it added § 15(d). That section requires companies registering securities for a sale in a public offering under the Securities Act to comply after the effective registration date of the offering with the periodic disclosure requirements of the Exchange Act at least until the next fiscal year after the effective date. Section 15(d) registrants are not required, however, to comply with the Exchange Act’s requirements for proxy solicitations and tender offers under § 14, nor are their insiders subject to the reporting of stock trades and short-swing profits rules imposed by § 16 (covered in Chapter 6).

The next big expansion came in 1964, when Congress adopted § 12(g) of the Exchange Act. The constitutional concerns of the New Deal were by that time of purely historical interest. Section 12(g) accordingly omits any reliance on broker-dealers as a jurisdictional hook. Instead, it requires all issuers having a nexus to interstate commerce to register with the SEC if they have more than a threshold level of assets and a threshold number of holders of their equity securities. This provision roped in many companies whose stock traded widely in the over-the-counter market but which had not listed on a national securities exchange or completed a public offering under the Securities Act. Thus, the 1964 amendment closed a loophole strongly disliked by both the exchanges and the SEC. The thresholds set by § 12(g)(1)(A), as recently modified by the Jumpstart Our Business Startups Act of 2012 (JOBS Act), are set at (1) $10 million in total assets and (2) either 2,000 shareholders of record for a class of equity security, or 500 shareholders of record for a class of equity who are not accredited investors. Accredited investors include, among others, certain institutions meeting minimum total asset requirements as well as natural persons who meet minimum income or net worth tests. We cover the concept of accredited investors in Chapter 9. Section 12(g)(1)(B) establishes a separate public company threshold for banks and bank holding companies based on total assets exceeding a threshold of $10 million in total assets and the number of shareholders of record of a class of equity securities exceeding 2,000 persons.

The minimum levels set by § 12(g)(1) are measured as of the last day of the issuer's fiscal year, so companies wishing to avoid the status of being a public company may seek
to sell assets or buy out some of their shareholders in order to avoid triggering § 12(g). (Combining the holdings of multiple owners in a trust or similar vehicle will not work—Rule 12g5-1(b)(3) directs issuers to count beneficial, rather than legal, owners, if the form of ownership is being used to circumvent the registration requirements.) Prior to the JOBS Act, private companies had to worry about stock options given to employees as compensation. If the number of employees receiving options grew too large, the company may find itself “going public” before it is ready to do an IPO. This occasionally created a problem for companies in the high-tech sector that are heavily dependent upon option-based compensation. In addition to establishing the threshold number of shareholders for public company status at 2,000 (or 500 non-accredited investors for non-bank and non-bank holding companies), the JOBS Act modified § 12(g)(5) to specify that shares “held of record” does not include securities held by persons “who received the securities pursuant to an employee compensation plan” in an exempt transaction. The exclusion in § 12(g)(5) obviates the need for private companies to worry about shares given to employees as part of an employee compensation plan. For those companies anxious to expose themselves to SEC requirements (a very small set, indeed, but Nasdaq now requires reporting status for issuers wishing to be quoted even in the lowest tier “Bulletin Board”), § 12(g) allows companies to register voluntarily even if the statutory minimums are not satisfied.

Section 12(g) sweeps in companies not listed on a national securities exchange into public company status. The most important of these companies used to trade on Nasdaq. Nasdaq originally was an over-the-counter market rather than an exchange. In August, 2006, however, Nasdaq was approved as a national securities exchange for Nasdaq-listed securities. As part of the transition, Nasdaq and FINRA became self-regulatory organizations. Because of Nasdaq's shift to become a national securities exchange, Nasdaq-listed companies now must register under § 12(b) of the Exchange Act, leading to public company status without reference to the § 12(g) standards for public company status. Today, over-the-counter trading is limited to the Over the Counter Bulletin Board (OTCBB) and the “pink sheets,” now known as OTC Link.

B. Escaping Public Company Status

A more common phenomenon is companies seeking to avoid the exposure and expense of public status, i.e., “going dark.” Escaping public company status, however, is not easy. A company seeking to go dark must escape public company status under all three routes to become public: first the company must delist if they are listed on a national securities exchange; second, the company must ensure they are not a public company under § 12(g); and third, if the company has filed a prior effective registration statement with the SEC (as part of a public offering), the company must meet the requirements of § 15(d) to suspend public company status.

Consider Scranton Paper, a company listed on the Nasdaq, a national securities exchange. To avoid status as a public company, Scranton Paper would first need to delist from the Nasdaq, incurring the corresponding drop in liquidity from leaving the Nasdaq. Delisting, however, is not sufficient to avoid public company status. Scranton Paper still is
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a public company pursuant to § 12(g) due to its substantial assets and dispersed group of shareholders. Under Rule 12g–4, an issuer may terminate registration as a public company only if it certifies to the SEC that it has fewer than 300 shareholders of record (with termination taking effect 90 days after the certification or such shorter period as the SEC may specify at its discretion). Alternatively, the issuer may show that it has fewer than 500 shareholders and less than $10 million in total assets on the last day of each of its prior three fiscal years. For a company such as Scranton Paper, with thousands of shareholders of record, reducing that number below the requisite minimum is simply not feasible. Scranton Paper can only avoid public company status through a “going private transaction” under which Scranton Paper buys back a considerable portion of its publicly-held shares, which would be an overwhelming expense. The JOBS Act modified § 12(g)(4), under which Rule 12g-4 is promulgated, to specify that banks and bank holding companies only need to reduce the number of shareholders of record for a class of equity securities below 1,200 to terminate registration under § 12(g).

Lastly, if Scranton Paper has filed an effective registration statement with the SEC, Scranton Paper must seek to suspend public company status pursuant to § 15(d). Section 15(d) provides that issuers may suspend their public company status if they show at the beginning of a fiscal year that the company has fewer than 300 holders of record (except for the fiscal year during which the registered public offering became effective). The JOBS Act modified § 15(d) to specify that banks and bank holding companies only need to reduce the number of shareholders of record for a class of equity securities below 1,200 to suspend reporting under § 15(d). Note that the suspension from § 15(d) is not permanent. Instead, at the beginning of any fiscal year in which the issuer has 300 or more holders of record, the issuer once again becomes public reporting company under § 15(d).

For foreign issuers seeking to escape the U.S. securities regime, the inability to terminate completely their public company status under § 15(d) proved problematic. Suspension for foreign private issuers from § 15(d) used to require the issuer to demonstrate that it had fewer than 300 U.S. resident holders of record at the beginning of a particular fiscal year. Once suspended, however, the issuer would have to keep track of the number of its U.S. resident investors indefinitely. Any increase to 300 or more U.S. resident investors would trigger the § 15(d) reporting duties.

In 2007, the SEC promulgated Rule 12h–6 of the Exchange Act to provide certainty to foreign issuers seeking to terminate their relationship with the U.S. securities laws. Rule 12h–6 allows a foreign private issuer of equity securities to terminate its public company reporting obligations under § 13(a) or § 15(d) of the Exchange Act provided certain conditions are met. Among other requirements, Rule 12h–6 bases termination on a quantitative benchmark of the level of U.S. market interest in the equity securities of a foreign private issuer. The quantitative benchmark turns on the average daily trading volume of a foreign private issuer's equity securities in the United States compared with the issuer's worldwide average daily trading volume. If less than 5% of the trading volume takes place in the United States, the foreign private issuer is eligible to terminate public company status pursuant to Rule 12h–6 regardless of the number of shareholders holding the issuer's equity. As an alternative quantitative benchmark, the
foreign private issuer may demonstrate that the number of shareholders of its equity is either less than 300 persons on a worldwide basis or 300 persons resident in the United States.
D. Emerging Growth Companies

The JOBS Act of 2012 created a new category of issuers called “emerging growth companies.” An emerging growth company is an issuer with total annual gross revenues of less than $1 billion (indexed for inflation) during its most recently completed fiscal year. Securities Act § 2(a)(19). Section 2(a)(19) provides that a company terminates emerging growth company status at the earliest of one of several events. First, a company ceases to be an emerging growth company on the last day of the fiscal year during which it had total annual gross revenues of $1 billion or more (indexed for inflation). Second, a company ceases to be an emerging growth company on the last day of the fiscal year following the fifth anniversary of the date of the first sale of common equity securities in a registered public offering. Third, a company ceases to be an emerging growth company on the date on which the company has issued more than $1 billion in non-convertible debt aggregated over the previous three-year period. Finally, a company ceases to be an emerging growth company the date on which the company is deemed to be a “large accelerated filer” as defined in Rule 12b-2 of the Exchange Act. Rule 12b-2 defines companies with over $700 million of worldwide equity float in the hands of non-affiliates, among other requirements, as a large accelerated filer (paralleling the equity float requirement for a Well-Known Seasoned Issuer that we discuss in Chapter 7).

Emerging growth companies enjoy benefits in both areas: the public offering process and continuing obligations imposed on public companies. For public offerings, emerging growth companies benefit from the ability to submit confidential draft registration statements to the SEC as well as the ability to “test the waters” through pre-offering communications with certain large investors, including qualified institutional buyers and accredited institutional investors (covered in Chapter 9). The JOBS Act also reduces public offering disclosure obligations for emerging growth companies and loosens restrictions on analyst reports on emerging growth companies in a public offering. We discuss the benefits for emerging growth companies in the public offering process in Chapter 7.

Once an emerging growth company has done its IPO and has become a public reporting company, the JOBS Act provides additional relief from ongoing for public company requirements. First, emerging growth companies are exempt from the “say on pay” requirement that shareholders must have the ability to vote on executive compensation once every 3 years (or a shorter time interval if approved by shareholders). Exchange Act § 14A. The JOBS Act also exempts emerging growth companies from the CEO Pay Disparity disclosures required for public companies pursuant to the Dodd-Frank Act (discussed above). Third, the JOBS Act exempts emerging growth companies from certain disclosure requirements under Items 301 (selected financial data) and 303 (Management Discussion and Analysis) of Regulation S-K. Fourth, the JOBS Act exempts emerging growth companies from the requirement that an external auditor must attest to the internal controls of a public company pursuant to § 404 of the Sarbanes Oxley Act (discussed below). Finally, the JOBS Act exempts emerging growth companies from any
rules promulgated by the Public Company Accounting Oversight Board requiring mandatory audit firm rotation or supplemental information to the auditor’s report. An emerging growth company may opt into any of the requirements from which the JOBS Act provides an exemption.

In enacting the JOBS Act of 2012, Congress sought to reduce the burdens of going public on companies as well as the disclosure obligations imposed after they go public. The costs of going public and complying with ongoing disclosure obligations are relatively fixed in the sense that compliance costs do not scale proportionately with the market capitalization of a company. The fixed nature of compliance costs therefore imposes a greater burden on smaller companies seeking to go public. One can wonder though whether the $1 billion in total annual gross revenue ceiling for a company to qualify as an emerging growth company is too high. Zynga, Inc., a developer of FarmVille and other mobile game software, had revenues of $597.5 million for example in 2010, the year before its initial public offering. Zynga went public at the end of 2011, raising $1 billion in its initial public offering. Although Zynga would have qualified as an emerging growth company at the time of its IPO, it is unclear whether Zynga needed relief from the fixed cost of going public. Zynga’s large offering and scale of operations and revenue put it in a better position than many already public companies to cover these fixed costs.

At the other end of the revenue spectrum, consider a small private company with revenues of only $100 million considering a public offering. Although such a company will undoubtedly face large costs from going through the public offering process, and therefore benefit from the relief provided under the JOBS Act for emerging growth companies, such a company also poses the greatest risks for investors. There is, of course, the ever present risk of fraud. Beyond fraud, investors—including in particular individual investors—may make poor investment decisions in an environment with less than full disclosure. Unlike more established public companies that have extensive and longstanding analyst coverage, emerging growth companies will typically have no analyst following. The reduced disclosures for emerging market companies will thus leave particularly individual investors with an information vacuum for which the private marketplace may not compensate due to the lack of analyst coverage.
Chapter 5: Rule 10b-5 Antifraud

Chapter 5 Supplement

Insert after Questions at p. 275; Replace Basic Inc. v. Levinson

In the next case, the Supreme Court addresses the question of reliance and class certification. The case follows a recent decision, Amgen, Inc. v. Connecticut Ret. Plans and Trust Funds, 133 S. Ct. 1184 (2013), in which the Court rejected the argument that plaintiffs should have to prove materiality in order to certify a class. The question in Halliburton II is how the reliance requirement applies when plaintiff seeks to certify a class based on affirmative statements made to the market generally.

Halliburton Co. v. Erica P. John Fund, Inc. (“Halliburton II”)
– S. Ct. – (2014)

ROBERTS, C.J.

Investors can recover damages in a private securities fraud action only if they prove that they relied on the defendant’s misrepresentation in deciding to buy or sell a company’s stock. In Basic Inc. v. Levinson, 485 U.S. 224 (1988), we held that investors could satisfy this reliance requirement by invoking a presumption that the price of stock traded in an efficient market reflects all public, material information—including material misstatements. In such a case, we concluded, anyone who buys or sells the stock at the market price may be considered to have relied on those misstatements.

We also held, however, that a defendant could rebut this presumption in a number of ways, including by showing that the alleged misrepresentation did not actually affect the stock’s price—that is, that the misrepresentation had no “price impact.” The questions presented are whether we should overrule or modify Basic’s presumption of reliance and, if not, whether defendants should nonetheless be afforded an opportunity in securities class action cases to rebut the presumption at the class certification stage, by showing a lack of price impact.

I

Respondent Erica P. John Fund, Inc. (EPJ Fund) is the lead plaintiff in a putative class action against Halliburton alleging violations of section 10(b) of the Securities Exchange Act of 1934, and Rule 10b–5. According to EPJ Fund, between June 3, 1999, and December 7, 2001, Halliburton made a series of misrepresentations regarding its potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the anticipated benefits of its merger with another company—all in an attempt to inflate the price of its stock. Halliburton subsequently made a number of corrective disclosures, which, EPJ Fund contends, caused the company’s stock price to drop and investors to lose money.

EPJ Fund moved to certify a class comprising all investors who purchased Halliburton common stock during the class period. The District Court found that the proposed class satisfied all the threshold requirements of Federal Rule of Civil Procedure
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23(a): It was sufficiently numerous, there were common questions of law or fact, the representative parties’ claims were typical of the class claims, and the representatives could fairly and adequately protect the interests of the class. And except for one difficulty, the court would have also concluded that the class satisfied the requirement of Rule 23(b)(3) that “the questions of law or fact common to class members predominate over any questions affecting only individual members.” The difficulty was that Circuit precedent required securities fraud plaintiffs to prove “loss causation”—a causal connection between the defendants’ alleged misrepresentations and the plaintiffs’ economic losses—in order to invoke Basic’s presumption of reliance and obtain class certification. EPJ Fund had not demonstrated such a connection for any of Halliburton’s alleged misrepresentations, the District Court refused to certify the proposed class. The United States Court of Appeals for the Fifth Circuit affirmed the denial of class certification on the same ground.

We granted certiorari and vacated the judgment, finding nothing in “Basic or its logic” to justify the Fifth Circuit’s requirement that securities fraud plaintiffs prove loss causation at the class certification stage in order to invoke Basic’s presumption of reliance. “Loss causation,” we explained, “addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.” We remanded the case for the lower courts to consider “any further arguments against class certification” that Halliburton had preserved.

On remand, Halliburton argued that class certification was inappropriate because the evidence it had earlier introduced to disprove loss causation also showed that none of its alleged misrepresentations had actually affected its stock price. By demonstrating the absence of any “price impact,” Halliburton contended, it had rebutted Basic’s presumption that the members of the proposed class had relied on its alleged misrepresentations simply by buying or selling its stock at the market price. And without the benefit of the Basic presumption, investors would have to prove reliance on an individual basis, meaning that individual issues would predominate over common ones. The District Court declined to consider Halliburton’s argument.

The Fifth Circuit affirmed. …

We once again granted certiorari, this time to resolve a conflict among the Circuits over whether securities fraud defendants may attempt to rebut the Basic presumption at the class certification stage with evidence of a lack of price impact. We also accepted Halliburton’s invitation to reconsider the presumption of reliance for securities fraud claims that we adopted in Basic.

II

Halliburton urges us to overrule Basic’s presumption of reliance and to instead require every securities fraud plaintiff to prove that he actually relied on the defendant’s misrepresentation in deciding to buy or sell a company’s stock. Before overturning a long-settled precedent, however, we require “special justification,” not just an argument that the precedent was wrongly decided. Halliburton has failed to make that showing.
Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission’s Rule 10b–5 prohibit making any material misstatement or omission in connection with the purchase or sale of any security. Although section 10(b) does not create an express private cause of action, we have long recognized an implied private cause of action to enforce the provision and its implementing regulation. To recover damages for violations of section 10(b) and Rule 10b–5, a plaintiff must prove “‘(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.’”

The reliance element “‘ensures that there is a proper connection between a defendant’s misrepresentation and a plaintiff’s injury.’ “The traditional (and most direct) way a plaintiff can demonstrate reliance is by showing that he was aware of a company’s statement and engaged in a relevant transaction—e.g., purchasing common stock—based on that specific misrepresentation.”

In Basic, however, we recognized that requiring such direct proof of reliance “would place an unnecessarily unrealistic evidentiary burden on the Rule 10b–5 plaintiff who has traded on an impersonal market.” That is because, even assuming an investor could prove that he was aware of the misrepresentation, he would still have to “show a speculative state of facts, i.e., how he would have acted ... if the misrepresentation had not been made.”

We also noted that “[r]equiring proof of individualized reliance” from every securities fraud plaintiff “effectively would ... prevent[ ] [plaintiffs] from proceeding with a class action” in Rule 10b–5 suits. If every plaintiff had to prove direct reliance on the defendant’s misrepresentation, “individual issues then would ... overwhelm[ ] the common ones,” making certification under Rule 23(b)(3) inappropriate.

To address these concerns, Basic held that securities fraud plaintiffs can in certain circumstances satisfy the reliance element of a Rule 10b–5 action by invoking a rebuttable presumption of reliance, rather than proving direct reliance on a misrepresentation. The Court based that presumption on what is known as the “fraud-on-the-market” theory, which holds that “the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” The Court also noted that, rather than scrutinize every piece of public information about a company for himself, the typical “investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price”—the belief that it reflects all public, material information. As a result, whenever the investor buys or sells stock at the market price, his “reliance on any public material misrepresentations ... may be presumed for purposes of a Rule 10b–5 action.”

Based on this theory, a plaintiff must make the following showings to demonstrate that the presumption of reliance applies in a given case: (1) that the alleged
misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed.

At the same time, Basic emphasized that the presumption of reliance was rebuttable rather than conclusive. Specifically, “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.” So for example, if a defendant could show that the alleged misrepresentation did not, for whatever reason, actually affect the market price, or that a plaintiff would have bought or sold the stock even had he been aware that the stock’s price was tainted by fraud, then the presumption of reliance would not apply. In either of those cases, a plaintiff would have to prove that he directly relied on the defendant’s misrepresentation in buying or selling the stock.

B

Halliburton contends that securities fraud plaintiffs should always have to prove direct reliance and that the Basic Court erred in allowing them to invoke a presumption of reliance instead. According to Halliburton, the Basic presumption contravenes congressional intent and has been undermined by subsequent developments in economic theory. Neither argument, however, so discredits Basic as to constitute “special justification” for overruling the decision.

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Halliburton’s primary argument for overruling Basic is that the decision rested on two premises that can no longer withstand scrutiny. The first premise concerns what is known as the “efficient capital markets hypothesis.” Basic stated that “the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” From that statement, Halliburton concludes that the Basic Court espoused “a robust view of market efficiency” that is no longer tenable, for “‘overwhelming empirical evidence’ now suggests that capital markets are not fundamentally efficient.” To support this contention, Halliburton cites studies purporting to show that “public information is often not incorporated immediately (much less rationally) into market prices.”

Halliburton does not, of course, maintain that capital markets are always inefficient. Rather, in its view, Basic’s fundamental error was to ignore the fact that “‘efficiency is not a binary, yes or no question.’” The markets for some securities are more efficient than the markets for others, and even a single market can process different kinds of information more or less efficiently, depending on how widely the information is disseminated and how easily it is understood. Yet Basic, Halliburton asserts, glossed over these nuances, assuming a false dichotomy that renders the presumption of reliance both underinclusive and overinclusive: A misrepresentation can distort a stock’s market price even in a generally inefficient market, and a misrepresentation can leave a stock’s market price unaffected even in a generally efficient one.
Halliburton’s criticisms fail to take Basic on its own terms. Halliburton focuses on the debate among economists about the degree to which the market price of a company’s stock reflects public information about the company—and thus the degree to which an investor can earn an abnormal, above-market return by trading on such information. That debate is not new. Indeed, the Basic Court acknowledged it and declined to enter the fray, declaring that “[w]e need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory.” To recognize the presumption of reliance, the Court explained, was not “conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.” The Court instead based the presumption on the fairly modest premise that “market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.” Basic’s presumption of reliance thus does not rest on a “binary” view of market efficiency. Indeed, in making the presumption rebuttable, Basic recognized that market efficiency is a matter of degree and accordingly made it a matter of proof.

The academic debates discussed by Halliburton have not refuted the modest premise underlying the presumption of reliance. Even the foremost critics of the efficient-capital-markets hypothesis acknowledge that public information generally affects stock prices. Halliburton also conceded as much in its reply brief and at oral argument. Debates about the precise degree to which stock prices accurately reflect public information are thus largely beside the point. “That the ... price [of a stock] may be inaccurate does not detract from the fact that false statements affect it, and cause loss,” which is “all that Basic requires.” Even though the efficient capital markets hypothesis may have “garnered substantial criticism since Basic,” Halliburton has not identified the kind of fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities.

Halliburton also contests a second premise underlying the Basic presumption: the notion that investors “invest ‘in reliance on the integrity of [the market] price.’” Halliburton identifies a number of classes of investors for whom “price integrity” is supposedly “marginal or irrelevant.” The primary example is the value investor, who believes that certain stocks are undervalued or overvalued and attempts to “beat the market” by buying the undervalued stocks and selling the overvalued ones. If many investors “are indifferent to prices,” Halliburton contends, then courts should not presume that investors rely on the integrity of those prices and any misrepresentations incorporated into them.

But Basic never denied the existence of such investors. As we recently explained, Basic concluded only that “it is reasonable to presume that most investors—knowing that they have little hope of outperforming the market in the long run based solely on their analysis of publicly available information—will rely on the security’s market price as an unbiased assessment of the security’s value in light of all public information.”
In any event, there is no reason to suppose that even Halliburton’s main counterexample—the value investor—is as indifferent to the integrity of market prices as Halliburton suggests. Such an investor implicitly relies on the fact that a stock’s market price will eventually reflect material information—how else could the market correction on which his profit depends occur? To be sure, the value investor “does not believe that the market price accurately reflects public information at the time he transacts.” But to indirectly rely on a misstatement in the sense relevant for the Basic presumption, he need only trade stock based on the belief that the market price will incorporate public information within a reasonable period. The value investor also presumably tries to estimate how undervalued or overvalued a particular stock is, and such estimates can be skewed by a market price tainted by fraud.

C

The principle of stare decisis has “‘special force’” “in respect to statutory interpretation” because “‘Congress remains free to alter what we have done.’” So too with Basic’s presumption of reliance. Although the presumption is a judicially created doctrine designed to implement a judicially created cause of action, we have described the presumption as “a substantive doctrine of federal securities-fraud law.” That is because it provides a way of satisfying the reliance element of the Rule 10b–5 cause of action. As with any other element of that cause of action, Congress may overturn or modify any aspect of our interpretations of the reliance requirement, including the Basic presumption itself. Given that possibility, we see no reason to exempt the Basic presumption from ordinary principles of stare decisis.

To buttress its case for overruling Basic, Halliburton contends that, in addition to being wrongly decided, the decision is inconsistent with our more recent decisions construing the Rule 10b–5 cause of action. As Halliburton notes, we have held that “we must give ‘narrow dimensions ... to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.’” Yet the Basic presumption, Halliburton asserts, does just the opposite, expanding the Rule 10b–5 cause of action.

Not so. In Central Bank and Stoneridge [eds.: excerpted below] we declined to extend Rule 10b–5 liability to entirely new categories of defendants who themselves had not made any material, public misrepresentation. Such an extension, we explained, would have eviscerated the requirement that a plaintiff prove that he relied on a misrepresentation made by the defendant. The Basic presumption does not eliminate that requirement but rather provides an alternative means of satisfying it. While the presumption makes it easier for plaintiffs to prove reliance, it does not alter the elements of the Rule 10b–5 cause of action and thus maintains the action’s original legal scope.

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Finally, Halliburton and its amici contend that, by facilitating securities class actions, the Basic presumption produces a number of serious and harmful consequences. Such class actions, they say, allow plaintiffs to extort large settlements from defendants for meritless claims; punish innocent shareholders, who end up having to pay settlements
and judgments; impose excessive costs on businesses; and consume a disproportionately large share of judicial resources.

These concerns are more appropriately addressed to Congress, which has in fact responded, to some extent, to many of the issues raised by Halliburton and its amici. Congress has, for example, enacted the Private Securities Litigation Reform Act of 1995 (PSLRA), which sought to combat perceived abuses in securities litigation with heightened pleading requirements, limits on damages and attorney’s fees, a “safe harbor” for certain kinds of statements, restrictions on the selection of lead plaintiffs in securities class actions, sanctions for frivolous litigation, and stays of discovery pending motions to dismiss. And to prevent plaintiffs from circumventing these restrictions by bringing securities class actions under state law in state court, Congress also enacted the Securities Litigation Uniform Standards Act of 1998, which precludes many state law class actions alleging securities fraud. Such legislation demonstrates Congress’s willingness to consider policy concerns of the sort that Halliburton says should lead us to overrule Basic.

III

Halliburton proposes two alternatives to overruling Basic that would alleviate what it regards as the decision’s most serious flaws. The first alternative would require plaintiffs to prove that a defendant’s misrepresentation actually affected the stock price—so-called “price impact”—in order to invoke the Basic presumption. It should not be enough, Halliburton contends, for plaintiffs to demonstrate the general efficiency of the market in which the stock traded. Halliburton’s second proposed alternative would allow defendants to rebut the presumption of reliance with evidence of a lack of price impact, not only at the merits stage—which all agree defendants may already do—but also before class certification.

A

As noted, to invoke the Basic presumption, a plaintiff must prove that: (1) the alleged misrepresentations were publicly known, (2) they were material, (3) the stock traded in an efficient market, and (4) the plaintiff traded the stock between when the misrepresentations were made and when the truth was revealed. Each of these requirements follows from the fraud-on-the-market theory underlying the presumption. If the misrepresentation was not publicly known, then it could not have distorted the stock’s market price. So too if the misrepresentation was immaterial—that is, if it would not have “‘been viewed by the reasonable investor as having significantly altered the “total mix” of information made available,’”—or if the market in which the stock traded was inefficient. And if the plaintiff did not buy or sell the stock after the misrepresentation was made but before the truth was revealed, then he could not be said to have acted in reliance on a fraud-tainted price.

The first three prerequisites are directed at price impact—“whether the alleged misrepresentations affected the market price in the first place.”

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Halliburton argues that since the Basic presumption hinges on price impact, plaintiffs should be required to prove it directly in order to invoke the presumption. Proving the presumption’s prerequisites, which are at best an imperfect proxy for price impact, should not suffice.

Far from a modest refinement of the Basic presumption, this proposal would radically alter the required showing for the reliance element of the Rule 10b–5 cause of action. What is called the Basic presumption actually incorporates two constituent presumptions: First, if a plaintiff shows that the defendant’s misrepresentation was public and material and that the stock traded in a generally efficient market, he is entitled to a presumption that the misrepresentation affected the stock price. Second, if the plaintiff also shows that he purchased the stock at the market price during the relevant period, he is entitled to a further presumption that he purchased the stock in reliance on the defendant’s misrepresentation.

By requiring plaintiffs to prove price impact directly, Halliburton’s proposal would take away the first constituent presumption. Halliburton’s argument for doing so is the same as its primary argument for overruling the Basic presumption altogether: Because market efficiency is not a yes-or-no proposition, a public, material misrepresentation might not affect a stock’s price even in a generally efficient market. But as explained, Basic never suggested otherwise; that is why it affords defendants an opportunity to rebut the presumption by showing, among other things, that the particular misrepresentation at issue did not affect the stock’s market price. For the same reasons we declined to completely jettison the Basic presumption, we decline to effectively jettison half of it by revising the prerequisites for invoking it.

Even if plaintiffs need not directly prove price impact to invoke the Basic presumption, Halliburton contends that defendants should at least be allowed to defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price. We agree.

There is no dispute that defendants may introduce such evidence at the merits stage to rebut the Basic presumption. Basic itself “made clear that the presumption was just that, and could be rebutted by appropriate evidence,” including evidence that the asserted misrepresentation (or its correction) did not affect the market price of the defendant’s stock.

Nor is there any dispute that defendants may introduce price impact evidence at the class certification stage, so long as it is for the purpose of countering a plaintiff’s showing of market efficiency, rather than directly rebutting the presumption. As EPJ Fund acknowledges, “[o]f course ... defendants can introduce evidence at class certification of lack of price impact as some evidence that the market is not efficient.”
After all, plaintiffs themselves can and do introduce evidence of the existence of price impact in connection with “event studies”—regression analyses that seek to show that the market price of the defendant’s stock tends to respond to pertinent publicly reported events. In this case, for example, EPJ Fund submitted an event study of various episodes that might have been expected to affect the price of Halliburton’s stock, in order to demonstrate that the market for that stock takes account of material, public information about the company. The episodes examined by EPJ Fund’s event study included one of the alleged misrepresentations that form the basis of the Fund’s suit.

Defendants—like plaintiffs—may accordingly submit price impact evidence prior to class certification. What defendants may not do, EPJ Fund insists and the Court of Appeals held, is rely on that same evidence prior to class certification for the particular purpose of rebutting the presumption altogether.

This restriction makes no sense, and can readily lead to bizarre results. Suppose a defendant at the certification stage submits an event study looking at the impact on the price of its stock from six discrete events, in an effort to refute the plaintiffs’ claim of general market efficiency. All agree the defendant may do this. Suppose one of the six events is the specific misrepresentation asserted by the plaintiffs. All agree that this too is perfectly acceptable. Now suppose the district court determines that, despite the defendant’s study, the plaintiff has carried its burden to prove market efficiency, but that the evidence shows no price impact with respect to the specific misrepresentation challenged in the suit. The evidence at the certification stage thus shows an efficient market, on which the alleged misrepresentation had no price impact. And yet under EPJ Fund’s view, the plaintiffs’ action should be certified and proceed as a class action (with all that entails), even though the fraud-on-the-market theory does not apply and common reliance thus cannot be presumed.

Such a result is inconsistent with Basic’s own logic. Under Basic’s fraud-on-the-market theory, market efficiency and the other prerequisites for invoking the presumption constitute an indirect way of showing price impact. As explained, it is appropriate to allow plaintiffs to rely on this indirect proxy for price impact, rather than requiring them to prove price impact directly, given Basic’s rationales for recognizing a presumption of reliance in the first place.

But an indirect proxy should not preclude direct evidence when such evidence is available. As we explained in Basic, “[a]ny showing that severs the link between the alleged misrepresentation and ... the price received (or paid) by the plaintiff ... will be sufficient to rebut the presumption of reliance” because “the basis for finding that the fraud had been transmitted through market price would be gone.” And without the presumption of reliance, a Rule 10b–5 suit cannot proceed as a class action: Each plaintiff would have to prove reliance individually, so common issues would not “predominate” over individual ones, as required by Rule 23(b)(3). Price impact is thus an essential precondition for any Rule 10b–5 class action. While Basic allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant’s direct, more salient evidence showing that the alleged misrepresentation did not actually
affect the stock’s market price and, consequently, that the Basic presumption does not apply.

2

The Court of Appeals relied on our decision in Amgen in holding that Halliburton could not introduce evidence of lack of price impact at the class certification stage. The question in Amgen was whether plaintiffs could be required to prove (or defendants be permitted to disprove) materiality before class certification. Even though materiality is a prerequisite for invoking the Basic presumption, we held that it should be left to the merits stage, because it does not bear on the predominance requirement of Rule 23(b)(3). We reasoned that materiality is an objective issue susceptible to common, classwide proof. We also noted that a failure to prove materiality would necessarily defeat every plaintiff’s claim on the merits; it would not simply preclude invocation of the presumption and thereby cause individual questions of reliance to predominate over common ones. In this latter respect, we explained, materiality differs from the publicity and market efficiency prerequisites, neither of which is necessary to prove a Rule 10b–5 claim on the merits.

EPJ Fund argues that much of the foregoing could be said of price impact as well. Fair enough. But price impact differs from materiality in a crucial respect. Given that the other Basic prerequisites must still be proved at the class certification stage, the common issue of materiality can be left to the merits stage without risking the certification of classes in which individual issues will end up overwhelming common ones. And because materiality is a discrete issue that can be resolved in isolation from the other prerequisites, it can be wholly confined to the merits stage.

Price impact is different. The fact that a misrepresentation “was reflected in the market price at the time of [the] transaction”—that it had price impact—is “Basic’s fundamental premise.” It thus has everything to do with the issue of predominance at the class certification stage. That is why, if reliance is to be shown through the Basic presumption, the publicity and market efficiency prerequisites must be proved before class certification. Without proof of those prerequisites, the fraud-on-the-market theory underlying the presumption completely collapses, rendering class certification inappropriate.

But as explained, publicity and market efficiency are nothing more than prerequisites for an indirect showing of price impact. There is no dispute that at least such indirect proof of price impact “is needed to ensure that the questions of law or fact common to the class will ‘predominate.’” That is so even though such proof is also highly relevant at the merits stage.

Our choice in this case, then, is not between allowing price impact evidence at the class certification stage or relegating it to the merits. Evidence of price impact will be before the court at the certification stage in any event. The choice, rather, is between limiting the price impact inquiry before class certification to indirect evidence, or allowing consideration of direct evidence as well. As explained, we see no reason to
artificially limit the inquiry at the certification stage to indirect evidence of price impact. Defendants may seek to defeat the Basic presumption at that stage through direct as well as indirect price impact evidence.

More than 25 years ago, we held that plaintiffs could satisfy the reliance element of the Rule 10b–5 cause of action by invoking a presumption that a public, material misrepresentation will distort the price of stock traded in an efficient market, and that anyone who purchases the stock at the market price may be considered to have done so in reliance on the misrepresentation. We adhere to that decision and decline to modify the prerequisites for invoking the presumption of reliance. But to maintain the consistency of the presumption with the class certification requirements of Federal Rule of Civil Procedure 23, defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.

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Justice GINSBURG, with whom Justice BREYER and Justice SOTOMAYOR join, concurring.

Advancing price impact consideration from the merits stage to the certification stage may broaden the scope of discovery available at certification. But the Court recognizes that it is incumbent upon the defendant to show the absence of price impact. The Court’s judgment, therefore, should impose no heavy toll on securities-fraud plaintiffs with tenable claims. On that understanding, I join the Court’s opinion.

Justice THOMAS, with whom Justice SCALIA and Justice ALITO join, concurring in the judgment.

The implied Rule 10b–5 private cause of action is “a relic of the heady days in which this Court assumed common-law powers to create causes of action.” We have since ended that practice because the authority to fashion private remedies to enforce federal law belongs to Congress alone. Absent statutory authorization for a cause of action, “courts may not create one, no matter how desirable that might be as a policy matter.”

Basic Inc. v. Levinson, demonstrates the wisdom of this rule. Basic presented the question how investors must prove the reliance element of the implied Rule 10b–5 cause of action—the requirement that the plaintiff buy or sell stock in reliance on the defendant’s misstatement—when they transact on modern, impersonal securities exchanges. Were the Rule 10b–5 action statutory, the Court could have resolved this question by interpreting the statutory language. Without a statute to interpret for guidance, however, the Court began instead with a particular policy “problem”: for investors in impersonal markets, the traditional reliance requirement was hard to prove and impossible to prove as common among plaintiffs bringing 10b–5 class-action suits.
Chapter 5: Rule 10b-5 Antifraud

With the task thus framed as “resolving” that “problem” “rather than interpreting statutory text, the Court turned to nascent economic theory and naked intuitions about investment behavior in its efforts to fashion a new, easier way to meet the reliance requirement. The result was an evidentiary presumption, based on a “fraud on the market” theory, that paved the way for class actions under Rule 10b-5.

Today we are asked to determine whether Basic was correctly decided. The Court suggests that it was, and that stare decisis demands that we preserve it. I disagree. Logic, economic realities, and our subsequent jurisprudence have undermined the foundations of the Basic presumption, and stare decisis cannot prop up the façade that remains. Basic should be overruled.

I

Understanding where Basic went wrong requires an explanation of the “reliance” requirement as traditionally understood.

“Reliance by the plaintiff upon the defendant’s deceptive acts is an essential element” of the implied 10b-5 private cause of action. To prove reliance, the plaintiff must show “transaction causation,” “i.e., that the specific misstatement induced “the investor’s decision to engage in the transaction.” Such proof “ensures that there is a proper ‘connection between a defendant’s misrepresentation and a plaintiff’s injury’”—namely, that the plaintiff has not just lost money as a result of the misstatement, but that he was actually defrauded by it. Without that connection, Rule 10b-5 is reduced to a “scheme of investor’s insurance,” “because a plaintiff could recover whenever the defendant’s misstatement distorted the stock price—regardless of whether the misstatement had actually tricked the plaintiff into buying (or selling) the stock in the first place.

The “traditional” reliance element requires a plaintiff to “show” that he was aware of a company’s statement and engaged in a relevant transaction ... based on that specific misrepresentation.” But investors who purchase stock from third parties on impersonal exchanges (e.g., the New York Stock Exchange) often will not be aware of any particular statement made by the issuer of the security, and therefore cannot establish that they transacted based on a specific misrepresentation. Nor is the traditional reliance requirement amenable to class treatment; the inherently individualized nature of the reliance inquiry renders it impossible for a 10b-5 plaintiff to prove that common questions predominate over individual ones, making class certification improper.

Citing these difficulties of proof and class certification, the Basic Court dispensed with the traditional reliance requirement in favor of a new one based on the fraud-on-the-market theory.

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II

Basic’s reimagined reliance requirement was a mistake, and the passage of time
Chapter 5: Rule 10b-5 Antifraud

has compounded its failings. First, the Court based both parts of the presumption of reliance on a questionable understanding of disputed economic theory and flawed intuitions about investor behavior.

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A

Basic based the presumption of reliance on two factual assumptions. The first assumption was that, in a “well-developed market,” public statements are generally “reflected” in the market price of securities. The second was that investors in such markets transact “in reliance on the integrity of that price.” In other words, the Court created a presumption that a plaintiff had met the two-part, fraud-on-the-market version of the reliance requirement because, in the Court’s view, “common sense and probability” suggested that each of those parts would be met.

In reality, both of the Court’s key assumptions are highly contestable and do not provide the necessary support for Basic’s presumption of reliance. The first assumption—that public statements are “reflected” in the market price—was grounded in an economic theory that has garnered substantial criticism since Basic. The second assumption—that investors categorically rely on the integrity of the market price—is simply wrong.

The Court’s first assumption was that “most publicly available information”—including public misstatements—“is reflected in [the] market price” of a security. The Court grounded that assumption in “empirical studies” testing a then-nascent economic theory known as the efficient capital markets hypothesis. Specifically, the Court relied upon the “semi-strong” version of that theory, which posits that the average investor cannot earn above-market returns (i.e., “beat the market”) in an efficient market by trading on the basis of publicly available information. The upshot of the hypothesis is that “the market price of shares traded on well-developed markets [will] reflect all publicly available information, and, hence, any material misrepresentations.” At the time of Basic, this version of the efficient capital markets hypothesis was “widely accepted.”

This view of market efficiency has since lost its luster. As it turns out, even “well-developed” markets (like the New York Stock Exchange) do not uniformly incorporate information into market prices with high speed. “[F]riction in accessing public information” and the presence of “processing costs” means that “not all public information will be impounded in a security’s price with the same alacrity, or perhaps with any quickness at all.” For example, information that is easily digestible (merger announcements or stock splits) or especially prominent (Wall Street Journal articles) may be incorporated quickly, while information that is broadly applicable or technical (Securities and Exchange Commission filings) may be incorporated slowly or even ignored.

Further, and more importantly, “overwhelming empirical evidence” now suggests that even when markets do incorporate public information, they often fail to do so
accurately. “Scores” of “efficiency-defying anomalies”—such as market swings in the absence of new information and prolonged deviations from underlying asset values—make market efficiency “more contestable than ever.” Such anomalies make it difficult to tell whether, at any given moment, a stock’s price accurately reflects its value as indicated by all publicly available information. In sum, economists now understand that the price impact Basic assumed would happen reflexively is actually far from certain even in “well-developed” markets. Thus, Basic’s claim that “common sense and probability” support a presumption of reliance rests on shaky footing.

The Basic Court also grounded the presumption of reliance in a second assumption: that “[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.” In other words, the Court assumed that investors transact based on the belief that the market price accurately reflects the underlying “‘value’ of the security.” ([“[P]urchasers generally rely on the price of the stock as a reflection of its value’”). The Basic Court appears to have adopted this assumption about investment behavior based only on what it believed to be “common sense.” The Court found it “‘hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?’ “

The Court’s rather superficial analysis does not withstand scrutiny. It cannot be seriously disputed that a great many investors do not buy or sell stock based on a belief that the stock’s price accurately reflects its value. Many investors in fact trade for the opposite reason—that is, because they think the market has under- or overvalued the stock, and they believe they can profit from that mispricing. Indeed, securities transactions often take place because the transacting parties disagree on the security’s value.

Other investors trade for reasons entirely unrelated to price—for instance, to address changing liquidity needs, tax concerns, or portfolio balancing requirements. These investment decisions—are made with indifference to price and thus without regard for price “‘integrity’”—are at odds with Basic’s understanding of what motivates investment decisions. In short, Basic’s assumption that all investors rely in common on “price integrity” is simply wrong.5

The majority tries (but fails) to reconcile Basic’s assumption about investor behavior with the reality that many investors do not behave in the way Basic assumed. It first asserts that Basic rested only on the more modest view that “‘most investors’ ‘rely on the integrity of a security’s market price. That gloss is difficult to square with Basic’s

5 The Basic Court’s mistaken intuition about investor behavior appears to involve a category mistake: the Court invoked a hypothesis meant to describe markets, but then used it ”in the one way it is not meant to be used: as a predictor of the behavior of individual investors.” The efficient capital markets hypothesis does not describe “how investors behave; [it] only suggests the consequences of their collective behavior.”” Nothing in the hypothesis denies what most popular accounts assume: that much information searching and trading by investors, from institutions on down, is done in the (perhaps erroneous) belief that undervalued or overvalued stocks exist and can systematically be discovered.”
plain language: “An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.” In any event, neither Basic nor the majority offers anything more than a judicial hunch as evidence that even “most” investors rely on price integrity.

The majority also suggests that “there is no reason to suppose” that investors who buy stock they believe to be undervalued are “indifferent to the integrity of market prices.” Such “value investor[s],” according to the majority, “implicitly rely on the fact that a stock’s market price will eventually reflect material information” and “presumably try to estimate how undervalued or overvalued a particular stock is” by reference to the market price. Whether the majority’s unsupported claims about the thought processes of hypothetical investors are accurate or not, they are surely beside the point. Whatever else an investor believes about the market, he simply does not “rely on the integrity of the market price” if he does not believe that the market price accurately reflects public information at the time he transacts. That is, an investor cannot claim that a public misstatement induced his transaction by distorting the market price if he did not buy at that price while believing that it accurately incorporated that public information. For that sort of investor, Basic’s critical fiction falls apart.

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III

Principles of stare decisis do not compel us to save Basic’s muddled logic and armchair economics. We have not hesitated to overrule decisions when they are “unworkable or are badly reasoned,” when “the theoretical underpinnings of those decisions are called into serious question,” when the decisions have become “irreconcilable” with intervening developments in “competing legal doctrines or policies,” or when they are otherwise “a positive detriment to coherence and consistency in the law.” Just one of these circumstances can justify our correction of bad precedent; Basic checks all the boxes.

In support of its decision to preserve Basic, the majority contends that stare decisis “has ‘special force’ ‘in respect to statutory interpretation’ because ‘Congress remains free to alter what we have done.’” But Basic, of course, has nothing to do with statutory interpretation. The case concerned a judge-made evidentiary presumption for a judge-made element of the implied 10b–5 private cause of action, itself “a judicial construct that Congress did not enact in the text of the relevant statutes.” We have not afforded stare decisis “special force” outside the context of statutory interpretation, and for good reason. In statutory cases, it is perhaps plausible that Congress watches over its enactments and will step in to fix our mistakes, so we may leave to Congress the judgment whether the interpretive question is better left “‘settled’ “or “‘settled right.’” But this rationale is untenable when it comes to judge-made law like “implied” private causes of action, which we retain a duty to superintend. Thus, when we err in areas of judge-made law, we ought to presume that Congress expects us to correct our own mistakes—not the other way around. That duty is especially clear in the Rule 10b–5 context, where we have said that “[t]he federal courts have accepted and exercised the
principal responsibility for the continuing elaboration of the scope of the 10b–5 right and the definition of the duties it imposes."

Basic’s presumption of reliance remains our mistake to correct. Since Basic, Congress has enacted two major securities laws: the Private Securities Litigation Reform Act of 1995 (PSLRA), and the Securities Litigation Uniform Standards Act of 1998 (SLUSA). The PSLRA “sought to combat perceived abuses in securities litigation,” and SLUSA prevented plaintiffs from avoiding the PSLRA’s restrictions by bringing class actions in state court. Neither of these Acts touched the reliance element of the implied Rule 10b–5 private cause of action or the Basic presumption.

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That is especially true here, because Congress passed a law to tell us not to draw any inference from its inaction. The PSLRA expressly states that “[n]othing in this Act ... shall be deemed to create or ratify any implied private right of action.” If the Act did not ratify even the Rule 10b–5 private cause of action, it cannot be read to ratify sub silentio the presumption of reliance this Court affixed to that action. Further, the PSLRA and SLUSA operate to curtail abuses of various private causes of action under our securities laws—hardly an indication that Congress approved of Basic’s expansion of the 10b–5 private cause of action. Congress’ failure to overturn Basic does not permit us to “place on the shoulders of Congress the burden of the Court’s own error.”

3

Basic took an implied cause of action and grafted on a policy-driven presumption of reliance based on nascent economic theory and personal intuitions about investment behavior. The result was an unrecognizably broad cause of action ready made for class certification. Time and experience have pointed up the error of that decision, making it all too clear that the Court’s attempt to revise securities law to fit the alleged “new realities of financial markets” should have been left to Congress.

QUESTIONS

1. How does reliance fit into the class certification decision for Rule 10b-5 class actions?

2. Do Basic and Halliburton II rely on an economic theory?

3. What type of companies are excluded as defendants because of the “fraud-on-the-market” presumption’s requirement of market efficiency?

4. What does it mean for an investor to rely on the “integrity of the market price”? What kinds of investors do you think rely on the “integrity of the market price”?
5. The plaintiff needs to allege loss causation and materiality in her complaint and prove those elements to win at trial, but she need not establish them at the class certification stage. Why does the plaintiff need to show reliance to certify a class?

6. How would a defendant show an absence of “price impact” from a misstatement? Does it matter that the defendant bears the burden of proof on this question?

7. How does price impact differ from materiality? From loss causation?

8. What would count as a “special justification” for overruling a prior Supreme Court decision?

Chapter 6 Supplement

Insert before Questions at p. 379

NOTES

1. Trial. In 2013, a jury cleared Cuban of insider trading. Cuban, testifying at trial, denied that he ever agreed to maintain the information relating to the PIPE offering in confidence.

Insert after Questions at p. 379

SEC v. Obus

693 F.3d 276 (2d Cir. 2012)

JOHN M. WALKER, JR., Circuit Judge:

The Securities and Exchange Commission filed this civil enforcement action against defendants Nelson J. Obus, Peter F. Black, and Thomas Bradley Strickland alleging insider trading in violation of section 10(b) of the Securities Exchange Act of 1934, and Rule 10b–5. The SEC alleges that Strickland learned material non-public information in the course of his employment and revealed it to Black, his friend and a hedge fund employee, and that Black in turn relayed the information to his boss, Obus, who traded on the information. …

BACKGROUND

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A. The Planned Acquisition of SunSource and GE Capital’s Financing Bid

In May 2001, Strickland worked as an assistant vice president and underwriter at General Electric Capital Corporation, a Connecticut-based company that provides corporate financing. That spring, Allied Capital Corporation had approached GE Capital about financing Allied’s planned acquisition of SunSource, Inc., a publicly traded company that distributes industrial products. Strickland was assigned to perform due diligence on SunSource as part of the GE Capital team working on the SunSource/Allied financing proposal. …

In the course of his work, Strickland learned non-public information about SunSource, including the basic fact that SunSource was about to be acquired by Allied. Strickland testified that he understood that Allied’s acquisition of SunSource was confidential. Each page of the transaction’s deal book, which Strickland received, was marked “Extremely Confidential.” In addition, Strickland had reviewed and annually signed GE Capital’s employee code of conduct, which required employees to “safeguard company property [including] confidential information about an upcoming deal.” GE
Capital also maintained a transaction-restricted list, containing the companies about which GE Capital and its employees possessed material non-public information, and which were therefore off-limits for securities trading. SunSource and Allied were not placed on the Transaction Restricted List until June 19, 2001, after Strickland and the GE Capital team had completed their due diligence work and submitted a financing proposal to Allied. The parties dispute whether, under GE Capital policies, SunSource should have appeared on the Transaction Restricted List at an earlier date, and whether it was among Strickland’s responsibilities to add SunSource to the list.

B. The Alleged Tip from Strickland to Black

In the spring of 2001, Black, a friend of Strickland’s from college, worked as an analyst at Wynnefield Capital, Inc., which managed a group of hedge funds. In the course of his due diligence research, Strickland learned from publicly available sources that Wynnefield was a large holder of SunSource stock.

On May 24, 2001, Strickland and Black had a conversation about SunSource. … The SEC and the defendants dispute what was said during this conversation. The defendants maintain that Strickland asked Black his opinion of SunSource’s management as part of Strickland’s due diligence work. Strickland testified that it was common to contact third parties while performing due diligence, and that his practice during such inquiries was to avoid revealing details by stating only that GE Capital was potentially doing business with the relevant company. The SEC maintains that Strickland revealed material non-public information by telling Black that Allied was about to acquire SunSource. The SEC relies on testimony that contacting large shareholders was not standard due diligence practice at GE Capital and that Strickland and Black discussed SunSource after GE Capital had completed its financing proposal. The SEC further argues that events following Strickland and Black’s May 24 conversation, described below, raise a strong inference that Strickland told Black about the SunSource/Allied acquisition.

C. The Alleged Tip from Black to Obus

Obus was Wynnefield’s principal and Black’s boss. Immediately after Black’s conversation with Strickland, Black relayed the information he had learned to Obus. Black maintains that Strickland’s general questions about SunSource’s management led Black to suspect (based on SunSource’s prior public actions) that SunSource was considering a transaction that would dilute existing shareholders. Black testified that he conveyed this suspicion to Obus. The SEC contends that Black told Obus that SunSource was about to be acquired by Allied.

D. Obus’s Call to Andrien

Later that same day, Obus called Maurice Andrien, SunSource’s CEO. As a large SunSource shareholder, Obus regularly spoke to Andrien about the company. Obus and Andrien gave different accounts of this phone call. Obus testified that the information from Black led him to believe that SunSource was considering a transaction that would dilute the value of its public shares, and he called Andrien to voice his concerns. Andrien testified that Obus informed him that Wynnefield had been tipped about SunSource’s imminent acquisition:
Chapter 6: Insider Trading

[I]t was a very funny conversation. And he [Obus] said that he never had a conversation like this before, and didn’t know whether he should be having it.

He said[,] I always knew you guys would sell SunSource Technology Services [a subsidiary of SunSource] if you could, but I never figured you’d sell the whole company.

And I said, Nelson, that’s just not the kind of thing that I could ever discuss under any circumstances with you. Whether we did, or we didn’t, I just refuse to comment about that.

He said, well, a little birdie told me that you guys are planning to sell the company to a financial buyer. I said, a little birdie; he said, a little birdie in Connecticut.

I said, a little birdie in Connecticut, and he said—I might have even said [,] who would tell you something like that. And he said GE.

The term “financial buyer” referred to a buyer planning to add SunSource to an investment portfolio, as opposed to a “strategic buyer” looking to acquire SunSource for its assets and business capabilities. Black overheard what Obus said on the phone to Andrien. Consistent with Obus’s testimony, Black testified that Obus said that a “guy” from “a big conglomerate in Fairfield” might be working with SunSource and that Obus hoped SunSource would not dilute shareholders.

In any event, whether the Obus call to Andrien was as described by Black and Obus or as described by Andrien, Black was “shocked” to hear Obus make the call, and tried to signal Obus to stop talking. After Obus hung up, Black said, “what are you doing? ... You realize, you know, my friend is going to be fired.” Obus then became “ashen” and “very upset” because he realized “it was a kind of call that could be traced back to” Strickland. Obus said if Strickland were fired, Obus would offer Strickland a job at Wynnefield or would help Strickland find another job on Wall Street.

E. Weber’s Call to Andrien

On the same day that Obus spoke with Andrien, Andrien also took a call from Alan Weber, a business acquaintance of Obus’s and another large investor in SunSource. On the call, Weber told Andrien he hoped that SunSource would not be sold to a financial buyer—the same term Andrien recalled Obus using in his phone call. The two calls from Weber and Obus led Andrien to be “fairly certain” that news of the planned SunSource/Allied acquisition had been leaked.

F. The June 8, 2001 Trade

On June 8, 2001, two weeks after the conversation between Strickland and Black, a trader at Cantor Fitzgerald contacted Wynnefield offering 50,000 shares of SunSource at $5.00 per share. Wynnefield counteroffered $4.75 per share, and ultimately purchased at that price a total block of 287,200 shares, about five percent of SunSource’s outstanding
common stock. Obus testified that he was unaware of the pending acquisition when he made the trade and that his decision to buy had nothing to do with Strickland’s conversation with Black. The June 8, 2001 purchase represented about the same number of shares as Wynnefield had bought in October 2000, the last time Obus believed he had seen such a large block of shares available for purchase. On June 11, 2001, Wynnefield sold 6,000 shares of SunSource.

G. Allied’s Acquisition of SunSource

On June 19, 2001, Allied publicly announced that it was acquiring SunSource for $10.38 per share in cash or stock. SunSource’s stock closed that day at $9.50 per share, an increase of $4.54 (or 91.5 percent) over the prior day’s closing price. Wynnefield’s June 8, 2001 purchase of SunSource stock nearly doubled in value (from the $4.75 purchase price to $9.50), producing a paper profit to Wynnefield of over $1.3 million. On June 19 and June 20, Wynnefield purchased another 150,000 shares of SunSource at prices over $9.40 per share.

H. Obus’s Call to Russell

In June or July 2001, Obus contacted Andrien to ask when the merger with Allied would close; Andrien referred Obus to Daniel Russell, Allied’s CFO. Obus and Russell’s recollections of their phone call differ. Obus testified that he called to express his preference to be paid in Allied stock, rather than in cash, and to ask that Allied extend the closing date of the merger to lower Wynnefield’s tax liabilities. Russell testified that Obus told him that Obus “was tipped off to the deal” between Allied and SunSource, and when Russell asked what that meant, Obus changed the subject.

I. The 2002 SEC Subpoenas

In July and August 2002, the SEC subpoenaed Obus and Black about the SunSource trades. On August 8, 2002, Strickland also received an SEC subpoena and contacted Black to arrange a meeting. Black told Obus about Strickland’s request to meet, realizing that Strickland might want to discuss the subpoenas. Obus and Black agreed that Black should try to avoid discussing SunSource or the subpoenas and encourage Strickland to be truthful.

At their meeting, Strickland told Black that he had informed GE Capital’s counsel that he did not recall any conversation about SunSource. Black reminded Strickland that they had discussed SunSource in May 2001, before the acquisition was announced. When Black told Obus about the meeting, Obus told Black to tell Strickland about Obus’s conversation with Andrien, and to encourage Strickland to tell GE Capital’s counsel about the May conversation between Black and Strickland.

J. GE Capital’s Internal Investigation

After receiving the SEC’s subpoena related to SunSource, GE Capital conducted an internal investigation into Strickland’s conduct. The internal investigation did not go beyond interviewing Strickland and other GE Capital employees and thus did not include statements from Andrien or Russell. The investigation concluded that while Strickland had “disclosed information outside of [GE Capital] pertaining to” SunSource, he “did not
Chapter 6: Insider Trading

discuss the nature of the specific transaction being contemplated.” Nevertheless, his conduct demonstrated a “disregard” of GE Capital’s “confidentiality restrictions.” Following the investigation, Strickland was denied a bonus and salary increase but was not terminated. A letter of reprimand was placed in his file stating that he should have consulted a manager or counsel before discussing SunSource with a third party. Testifying later, a representative of GE Capital said that the investigation concluded that Strickland “made a mistake” but was “trying to do some underwriting” when he called Black.

II. Prior Proceedings

The SEC filed a civil complaint against Strickland, Black, and Obus … alleging that the defendants were liable for insider trading in violation of section 10(b) and Rule 10b–5 under … the misappropriation [theory] of insider trading. … Under the misappropriation theory, the SEC claimed that Strickland had a duty to GE Capital, his employer, to keep information about SunSource’s acquisition confidential, and that he breached that duty by tipping Black.

The district court granted the defendants’ summary judgment motion…. In the portion of its decision addressing [the misappropriation] theory, the district court held that, even assuming Strickland told Black material non-public information about the SunSource/Allied deal, the SEC had failed to establish a genuine issue of fact as to whether Strickland breached a fiduciary duty to his employer, GE Capital. The district court based this finding on GE Capital’s internal investigation, which concluded that Strickland had not breached a duty to his employer, and on the fact that SunSource was not placed on GE Capital’s Transaction Restricted List until after the SunSource acquisition was publicly announced. … Because the district court found that Strickland had not breached a duty, neither Black nor Obus could have inherited that duty, and thus they also could not be held liable under the misappropriation theory. Finally, the district court held that the SEC failed to present sufficient evidence that Obus “subjectively believed that the information he received was obtained in breach of a fiduciary duty.”

DISCUSSION

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II. Legal Background

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B. Tipping Violations of Insider Trading Laws

The insider trading case law is not confined to insiders or misappropriators who trade for their own account. Section 10(b) and Rule 10b–5 also reach situations where the insider or misappropriator tips another who trades on the information. In Dirks, the Court … held that a tipper like the analyst in Dirks is liable if the tipper breached a fiduciary duty by tipping material non-public information, had the requisite scienter (to be discussed momentarily) when he gave the tip, and personally benefited from the tip.
Chapter 6: Insider Trading

Personal benefit to the tipper is broadly defined: it includes not only “pecuniary gain,” such as a cut of the take or a gratuity from the tippee, but also a “reputational benefit” or the benefit one would obtain from simply “mak[ing] a gift of confidential information to a trading relative or friend.” When an unlawful tip occurs, the tippee is also liable if he knows or should know that the information was received from one who breached a fiduciary duty (such as an insider or a misappropriator) and the tippee trades or tips for personal benefit with the requisite scienter. The Supreme Court’s tipping liability doctrine was developed in a classical case, but the same analysis governs in a misappropriation case.

C. Scienter

Liability for securities fraud requires proof of scienter, defined as “a mental state embracing intent to deceive, manipulate, or defraud.” ... We read the scienter requirement ... (and the recklessness variation ...) to apply broadly to civil securities fraud liability, including insider trading (under either the classical or misappropriation theory), and to tipper/tippee liability. In every insider trading case, at the moment of tipping or trading, just as in securities fraud cases across the board, the unlawful actor must know or be reckless in not knowing that the conduct was deceptive.

With this background, we turn to the scienter requirements for both tippers and tippees under the misappropriation theory.

1. Tipper Scienter

To be held liable, a tipper must (1) tip (2) material non-public information (3) in breach of a fiduciary duty of confidentiality owed to shareholders (classical theory) or the source of the information (misappropriation theory) (4) for personal benefit to the tipper. The requisite scienter corresponds to the first three of these elements. First, the tipper must tip deliberately or recklessly, not through negligence. Second, the tipper must know that the information that is the subject of the tip is non-public and is material for securities trading purposes or act with reckless disregard of the nature of the information. Third, the tipper must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty. While the tipper need not have specific knowledge of the legal nature of a breach of fiduciary duty, he must understand that tipping the information would be violating a confidence.

As the Supreme Court and commentators have recognized, the first and second aspects of scienter—a deliberate tip with knowledge that the information is material and non-public—can often be deduced from the same facts that establish the tipper acted for personal benefit. The inference of scienter is strong because the tipper could not reasonably expect to benefit unless he deliberately tipped material non-public information that the tippee could use to an advantage in trading. The third aspect of scienter, that the tipper acted with knowledge that he was violating a confidence, will often be established through circumstantial evidence. Because the act of misappropriation itself is deceitful, evidence that the tipper knowingly misappropriated confidential information will support an inference that the misappropriator had “a mental state embracing intent to deceive, manipulate, or defraud.”
Because a defendant cannot be held liable for negligently tipping information, difficult questions may arise when a tip is not apparently deliberate or when the alleged tipper’s knowledge is uncertain. The line between unactionable negligence and actionable recklessness is not a bright one. But, we have held that a tipper cannot avoid liability merely by demonstrating that he did not know to a certainty that the person to whom he gave the information would trade on it. “One who deliberately tips information which he knows to be material and non-public to an outsider who may reasonably be expected to use it to his advantage has the requisite scienter.... One who intentionally places such ammunition in the hands of individuals able to use it to their advantage on the market has the requisite state of mind ...” Moreover, conscious avoidance can be sufficient to establish tipper scienter. By the same token, there is a valid defense to scienter if the tipper can show that he believed in good faith that the information disclosed to the tippee would not be used for trading purposes.

Assume two scenarios with similar facts. In the first, a commuter on a train calls an associate on his cellphone, and, speaking too loudly for the close quarters, discusses confidential information and is overheard by an eavesdropping passenger who then trades on the information. In the second, the commuter’s conversation is conducted knowingly within earshot of a passenger who is the commuter’s friend and whom he also knows to be a day trader, and the friend then trades on the information. In the first scenario, it is difficult to discern more than negligence and even more difficult to ascertain that the tipper could expect a personal benefit from the inadvertent disclosure. In the second, however, there would seem to be at least a factual question of whether the tipper knew his friend could make use of material non-public information and was reckless in discussing it in front of him. Similarly, there would be a question of whether the tipper benefited by making a gift of the non-public information to his friend or received no benefit because the information was revealed inadvertently through his poor cellphone manners.

2. Tippee Scienter

Like a tipper, a liable tippee must know that the tipped information is material and non-public. And a tippee must have some level of knowledge that by trading on the information the tippee is a participant in the tipper’s breach of fiduciary duty. This last element of tippee scienter was addressed in Dirks, which held that a tippee has a duty to abstain or disclose “only when the insider has breached his fiduciary duty ... and the tippee knows or should know that there has been a breach.” In such a case, the tippee is said to “inherit” the tipper’s duty to abstain or disclose. The parties dispute whether the Dirks rule is in conflict with Hochfelder’s holding that negligence does not satisfy section 10(b)’s scienter requirement because the “knows or should know” rule ... sounds somewhat similar to a negligence standard. We think the best way to reconcile Dirks and Hochfelder in a tipping situation is to recognize that the two cases were not discussing the same knowledge requirement when they announced apparently conflicting scienter standards. Dirks’ knows or should know standard pertains to a tippee’s knowledge that the tipper breached a duty, either to his corporation’s shareholders (under the classical theory) or to his principal (under the misappropriation theory), by relaying confidential
information. This is a fact-specific inquiry turning on the tippee’s own knowledge and sophistication and on whether the tipper’s conduct raised red flags that confidential information was being transmitted improperly. Hochfelder’s requirement of intentional (or … reckless) conduct pertains to the tippee’s eventual use of the tip through trading or further dissemination of the information. Thus, tippee liability can be established if a tippee knew or had reason to know that confidential information was initially obtained and transmitted improperly (and thus through deception), and if the tippee intentionally or recklessly traded while in knowing possession of that information.

D. Tipping Chains

One last question presented by this case is how a chain of tippers affects liability. Such chains of tipping are not uncommon, and follow the same basic analysis outlined above. A tipper will be liable if he tips material non-public information, in breach of a fiduciary duty, to someone he knows will likely (1) trade on the information or (2) disseminate the information further for the first tippee’s own benefit. The first tippee must both know or have reason to know that the information was obtained and transmitted through a breach and intentionally or recklessly tip the information further for her own benefit. The final tippee must both know or have reason to know that the information was obtained through a breach and trade while in knowing possession of the information. Chain tippee liability may also result from conscious avoidance.

To summarize our discussion of tipping liability, we hold that tipper liability requires that (1) the tipper had a duty to keep material non-public information confidential; (2) the tipper breached that duty by intentionally or recklessly relaying the information to a tippee who could use the information in connection with securities trading; and (3) the tipper received a personal benefit from the tip. Tippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tippee improperly obtained the information (i.e., that the information was obtained through the tipper’s breach); and (3) the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit.

III. Application

Applying these standards to the defendants in this case, we conclude that the SEC presented sufficient evidence to create genuine issues of material fact as to Strickland’s, Black’s, and Obus’s liability under the misappropriation theory.

A. Strickland

Turning first to Strickland, the SEC presented sufficient evidence to survive summary judgment. First, it is undisputed that Strickland, an employee of GE Capital, owed GE Capital a fiduciary duty. Moreover, the SEC presented sufficient evidence that Strickland knew he was under an obligation to keep information about the SunSource/Allied deal confidential, including Strickland’s testimony that he knew it was confidential, the deal book that had every page marked “Extremely Confidential,” and Strickland’s annual review of GE Capital’s employee code of conduct, which contained provisions on confidentiality. While the defendants make much of SunSource’s absence from GE
Capital’s Transaction Restricted List until after the deal was publicly announced, this fact is not determinative to our analysis. Moreover, whether it was Strickland himself who should have added SunSource to the list at an earlier date is a separate question of fact. Thus there is sufficient evidence that Strickland knew he owed GE Capital a duty to keep information about the SunSource/Allied acquisition confidential and not to convert it for his own profit.

More hotly disputed is whether the SEC presented sufficient evidence to allow a jury to conclude that Strickland told Black that SunSource was about to be acquired—i.e., whether the alleged tip actually occurred. As is often the case, there is no direct evidence that Strickland tipped Black; both maintained in depositions that Strickland asked Black general questions about SunSource’s management as part of his due diligence work but revealed nothing about a sale to Allied. However, we have never held that a tip needs to be established by direct evidence (indeed, such a requirement would restrict successful tipping cases to those in which at least one party cooperated with the government or where the government had a court-authorized surreptitious recording). In United States v. McDermott, 245 F.3d 133 (2d Cir. 2001) we found that the government had presented enough evidence to prove the content of a tip beyond a reasonable doubt based only on evidence that the tipper and tippee were having an affair and frequently spoke to each other on the phone; the tippee greatly increased her trading activities after the affair began; the tippee frequently traded in stocks about which the tipper had confidential information; the timing of the phone calls and trades was consistent with tipping; and the tippee’s trades were profitable. Here, the SEC presented the following evidence:

(1) Strickland and Black, who were college friends, had a conversation about SunSource on May 24, 2001, three days after GE Capital submitted its financing proposal to SunSource. Strickland’s superiors stated that contacting shareholders was not part of due diligence, and Strickland himself had never done so in the past.

(2) Black immediately told his superior, Obus, about the conversation, and Obus immediately called Andrien to tell him, as Andrien testified, that he had heard from “a little birdie in Connecticut” that SunSource was planning to sell the company to a financial buyer. When Andrien asked who the little birdie was, Obus responded that it was GE.

(3) Wynnefield purchased a large block of stock about two weeks after the conversation by increasing a broker’s offer of 50,000 shares to an actual purchase of 287,200 shares. After SunSource’s acquisition was publicly announced, this investment nearly doubled in value.

(4) In a later conversation between Obus and Russell, Obus told Russell that he had been “tipped off about the [SunSource] deal.”

(5) Black and Strickland met to discuss the case immediately after Strickland was subpoenaed by the SEC. They subsequently provided very similar accounts of the May 24 conversation (contradicted by the testimony of Andrien and Russell). Prior to the
meeting with Black, Strickland had told GE Capital’s counsel that he did not remember having any conversation with Black about SunSource.

To be sure, the defendants challenge the credibility of much of this evidence and point to other facts that suggest a more innocent explanation. However, on summary judgment, the district court was required to credit the testimony relied on by the SEC and to draw all inferences in its favor. A rational jury could reasonably infer from the SEC’s evidence that Strickland did tell Black that SunSource was about to be acquired.

In addition, the SEC presented sufficient evidence for a jury to find that Strickland knew the material non-public information “ammunition” that Black was in a position to use. Strickland knew that Black worked for a hedge fund that traded in stocks (sufficient knowledge in itself) and, additionally, that Black’s hedge fund traded in SunSource shares. This evidence easily supports a finding of knowing or reckless tipping to someone who likely would use the information to trade in securities.

The district court relied on GE Capital’s internal investigation to determine that Strickland breached no duty by tipping Black, reasoning that the alleged victim of the breach of fiduciary duty did not consider itself a victim. This was error, however, because the internal investigation was not indisputably reliable, and because its conclusions were contradicted by other evidence. GE Capital’s investigation was based only on interviews with Strickland and other GE Capital employees; it did not have the benefit of evidence from outside sources such as Andrien or Russell, the primary witnesses relied on by the SEC. More broadly, the GE investigation was motivated by corporate interests that may or may not coincide with the public interest in unearthing wrongdoing and affording a remedy. And finally, the conclusion of such an internal investigation cannot bind a jury, which will make its own independent assessment of the evidence. The jury, after reviewing the evidence, might conclude that Strickland simply “made a mistake” and did not breach his duty of confidentiality to GE Capital, or that Strickland breached his duty by tipping. That factual dispute cannot be resolved on summary judgment.

Next, although the district court did not reach the issue, it is readily apparent that the SEC presented sufficient evidence that, if the tip occurred, Strickland made the tip intentionally and received a personal benefit from it. Dirks defined “personal benefit” to include making a gift of information to a friend. Here, the undisputed fact that Strickland and Black were friends from college is sufficient to send to the jury the question of whether Strickland received a benefit from tipping Black. This same evidence creates a question of fact with respect to whether Strickland intentionally tipped Black. And it is sufficient for a jury to conclude that Strickland intentionally or recklessly revealed material non-public information to Black, knowing that he was making a gift of information Black was likely to use for securities trading purposes. …

The SEC thus presented sufficient evidence to establish a genuine issue of material fact with respect to whether Strickland tipped Black, whether Strickland knowingly or recklessly breached a duty to his employer by doing so, whether Strickland knew there was a high likelihood that the tip would result in the trading of securities, and whether
Strickland tipped for his own personal benefit. The district court therefore erred in granting summary judgment to Strickland.

B. Black

Assessing Black’s tippee liability requires us to determine whether Black inherited Strickland’s duty of confidentiality. Black’s liability therefore depends first on whether Strickland breached a duty to his employer in tipping Black. For the reasons already stated, we hold that there is sufficient evidence for a jury to so conclude.

Next, the SEC must establish that Black knew or should have known that Strickland breached a fiduciary duty when he passed along the tip, and thus inherited Strickland’s duty to abstain or disclose. Black, a sophisticated financial analyst, testified that he knew Strickland worked at GE Capital, which provided loans to businesses; that he knew Strickland was involved in developing financing packages for other companies and performing due diligence; and that information about a non-public acquisition would be material inside information that would preclude someone from buying stock. This is sufficient for the jury to conclude that Black knew or had reason to know that any tip from Strickland on SunSource’s acquisition would breach Strickland’s fiduciary duty to GE Capital. Such a conclusion of course would be reinforced should the jury find that Black deliberately lied to the SEC about his conversation with Strickland.

Because, according to the SEC, Black himself did not trade on the SunSource information but instead tipped his boss, Obus, the SEC must also present evidence that Black derived some personal benefit from relaying the tip. In light of the broad definition of personal benefit set forth in Dirks, this bar is not a high one. Based on the evidence that Black worked for Obus and that Wynnefield traded in SunSource stock, a jury could find that by passing along what he was told by Strickland, Black hoped to curry favor with his boss. If a jury could find that Black conveyed Strickland’s tip in order to improve his standing with Obus, it could also find that Black acted recklessly or intentionally in passing on the information. Moreover, because Black was well aware that Wynnefield held SunSource stock, the jury could find that he knew that there was a reasonable expectation that Obus would trade in SunSource on Wynnefield’s behalf while in possession of the tip. The SEC thus presented sufficient evidence to send the question of Black’s liability to a jury.

C. Obus

As the final alleged tippee in the chain, Obus’s duty to abstain or disclose is derivative of Strickland’s duty. Therefore, his liability depends first on Strickland having breached a duty to GE Capital. As explained above, the SEC has presented sufficient evidence on this issue. Next, the SEC must show that Obus knew or had reason to know that the SunSource information was obtained through a breach of fiduciary duty. While there was evidence that Black was aware of Strickland’s precise position at GE Capital, there was not evidence that Obus had the same level of knowledge. We need not decide if Obus’s bare knowledge that Strickland worked for GE Capital (of which there was evidence), along with Obus’s status as a sophisticated financial player, was enough for Obus to have had reason to know that Strickland breached a duty to GE Capital by
talking to Black. Here, there is the additional evidence of Obus’s call to Andrien and his conversation with Black about the call. From this, a jury could infer (1) that Obus believed Black’s information was credible and thus knew that it originated from someone entrusted with confidential information; and (2) that Obus recognized that Strickland might lose his job as a result of the information he had conveyed to Black, demonstrating Obus’s knowledge that Strickland had acted inappropriately. Taken together, this evidence is sufficient to allow a jury to infer that Obus was aware that Strickland’s position with GE Capital exposed Strickland to information that Strickland should have kept confidential. The defendants counter by arguing that Obus’s recollections of the conversation with Black and the call with Andrien would not permit the inference that Obus knew Strickland had breached a duty. But when the evidence is conflicting, it is the jury’s task to decide whose testimony to credit and what conclusions to draw from that testimony.

Finally, the SEC must establish that Obus traded while in knowing possession of material non-public information. Obus argues that the June 8, 2001 SunSource purchase was not unusual for Wynnefield, that the trade was not initiated by Obus, and that Obus sold back some of the SunSource shares before the Allied deal was publicly announced. None of these facts are relevant to whether Obus was in knowing possession of material non-public information when he traded on June 8. The SEC’s evidence that Obus told Andrien and later Russell that he bought the shares on a tip is sufficient for the jury to find that Obus subjectively knew he possessed material non-public information when he made the June 8 purchase, whether or not his purchase was directly caused by his knowledge of the pending acquisition. Accordingly, the SEC has established genuine questions of fact about whether Obus knew that Strickland had breached a duty to GE Capital and whether Obus traded in SunSource stock while in knowing possession of the material non-public information that SunSource was about to be acquired.

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NOTES

1. In 2014, a jury cleared Obus of insider trading. Obus told the *New York Times* that he spent $9 million in legal fees battling the SEC.

QUESTIONS

1. Did Obus have reason to believe that Strickland breached a fiduciary duty in communicating with Black?

2. Should recklessness be sufficient to establish liability for a tippee? Does it matter how far down the chain the tippee is?

3. Could Strickland have bought shares of SunSource prior to GE Capital placing SunSource on its Transaction Restricted List?
4. If GE Capital had a policy that its employees could freely trade the securities of its clients’ acquisition targets based on confidential information, how would that affect the application of the misappropriation theory to Strickland? Why does the court not give the same weight to GE Capital’s conclusion after its internal investigation that Strickland did not breach his fiduciary duty to GE Capital?

5. What hazards does *Obus* create for hedge fund managers and other active traders?
Chapter 7 Supplement

Insert right before “B. Waiting Period” at p. 421

3. Emerging Growth Companies

The JOBS Act of 2012 created a new category of issuers called “emerging growth companies.” An emerging growth company is an issuer with total annual gross revenues of less than $1 billion (indexed for inflation) during its most recently completed fiscal year. Securities Act § 2(a)(19). In Chapter 4 we examined the how the JOBS Act reduces the ongoing obligations imposed on newly public companies that qualify as emerging growth companies. The JOBS Act also bestows significant advantages on emerging growth companies within the public offering process itself.

First, the JOBS Act provides that emerging growth companies only need to report two years of audited financial statements in the registration statement. Securities Act § 7(a)(2). Form S-1 normally provides that registrants must provide three years of audited financial statements. The JOBS Act also reduces disclosure obligations under Items 301 (Selected Financial Data) and Item 303 (Management Discussion & Analysis).

Second, the JOBS Act provides that emerging growth companies may submit registration statements to the SEC staff on a confidential basis. The SEC has established a secure e-mail system for issuers to use in submitting a draft registration statement confidentially. Normally, at least for U.S. domestic issuers, the SEC makes all versions of filed registration statements available to the public. Keeping an initial registration statement filing with the SEC confidential gives the issuer the ability to hide information contained in the registration statement from competitors. This ability to keep information from competitors is particularly important for new IPO issuers with little public information otherwise available. Confidentiality also gives issuers the ability to withdraw from the public offering process without sending a signal of failure to the marketplace. The JOBS Act allows issuers to maintain the confidentiality of their draft registration statements until twenty-one days prior to the date on which the issuer conducts a road show at which time the issuers must file “the initial confidential submission and all amendments thereto” with the SEC. Securities Act § 6(e).

Third, the JOBS Act establishes a new “test the waters” regime for emerging growth companies. Under § 5(d) of the Securities Act, an emerging growth company and those acting on its behalf may engage in oral or written communications with either Qualified Institutional Buyers or institutions that are accredited investors at any time during the public offering process. Qualified Institutional Buyers include institutions that own and invest on a discretionary basis at least $100 million of securities. Institutional accredited investors include institutions with a minimum of $5 million of total assets. We discuss accredited investors in Chapter 9 and Qualified Institutional Buyers in Chapter 10.

One wrinkle for the test the waters provision is the prohibition on selective disclosures under Regulation FD that applies for Exchange Act reporting issuers. Although
Regulation FD exempts certain communications that occur as part of a public offering. Regulation FD does apply to oral communications in the Pre-Filing Period. Because testing the waters communications must occur selectively – only to QIB or accredited investors – test the waters would technically run afoul of Regulation FD. It is unclear whether the SEC will adjust Regulation FD to accommodate the new test the waters communications. In any case, Regulation FD does not apply to private companies, which are the companies most likely to avail themselves of testing the waters during an initial public offering.

Finally, the JOBS Act provides that an emerging growth company may choose to comply with any provision for which the JOBS Act would otherwise provide an exemption. JOBS Act § 107(a).

EMERGING GROWTH COMPANY HYPOTHETICAL

Ewing Oil had total revenues of $900 million for the prior fiscal year. Prior to the filing of its registration statement with the SEC, Ewing Oil proposes to make contact with a number of individuals, each with a net worth of over $10 million–sufficient wealth to be considered “accredited investors.” Ewing Oil plans to discuss its upcoming public offering with the accredited investors to get their opinion about possible pricing for the offering. Will the communications with the accredited investors violate § 5(c)?
The JOBS Act of 2012 implemented an important change in the treatment of analyst research reports. The JOBS Act of 2012 excludes analyst research reports by a broker or dealer about an emerging growth company from the definition of an offer under § 5(c) and a prospectus under § 2(a)(10) during a public offering. The exclusion covers reports even by broker and dealers participating in a public offering. Securities Act § 2(a)(3).
Chapter 8 Supplement

Insert before Hypothetical Three on page 479


719 F.3d 498 (2013).

COLE, Circuit Judge.

Plaintiffs, all Omnicare investors, appeal the dismissal of their securities suit under § 11 of the Securities Act of 1933, against Defendants Omnicare, Inc., its officers, and directors. Plaintiffs allege that Defendants made material misstatements and/or omissions in a Registration Statement filed with the Securities and Exchange Commission in connection with a December 2005 public stock offering. The district court held that Plaintiffs had not adequately pleaded knowledge of wrongdoing on the part of Defendants and dismissed the complaint for failure to state a claim upon which relief can be granted. …

I.

Defendant Omnicare is the nation’s largest provider of pharmaceutical care services for the elderly and other residents of long-term care facilities in the United States and Canada. …

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According to the Third Amended Complaint, Omnicare was engaged in a variety of illegal activities including kickback arrangements with pharmaceutical manufacturers and submission of false claims to Medicare and Medicaid. Plaintiffs allege that representations in the Registration Statement were material, untrue and misleading because they effectively concealed Omnicare’s illegal activities from its investors. According to the Plaintiffs, the Registration Statement stated “that [Omnicare’s] therapeutic interchanges were meant to provide [patients with] ... more efficacious and/or safer drugs than those presently being prescribed” and that its contracts with drug companies were “legally and economically valid arrangements that bring value to the healthcare system and patients that we serve.” Plaintiffs claim that given Omnicare’s alleged illegal activities, these and other statements indicating compliance with the law were misleading. Specifically, Plaintiffs allege that these statements of “legal compliance” made in the Registration Statement were material, false and misleading, and therefore in violation of § 11.

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While notice pleading requirements are based on Rule 8 [of the Federal Rule of Civil Procedure], claims for fraud are held to the heightened pleading standard of Rule 9(b). …
Although § 11 claims do not require pleading of scienter, Rule 9(b) pleading standards still apply to § 11 claims that sound in fraud.

Plaintiffs argue that they have abandoned all claims “that could be construed as alleging fraud or intentional or reckless misconduct” and that, as a result, Rule 9(b) no longer applies. They base this argument primarily on a disclaimer that has been added to the complaint stating: “Plaintiffs expressly exclude and disclaim any allegation that could be construed as alleging fraud or intentional or reckless misconduct, as this claim is based solely on the theories of strict liability and negligence under the Securities Act.” This one-sentence disclaimer, however, does not achieve Plaintiffs’ desired result. The basis of Plaintiffs’ allegations has not changed … and therefore the heightened pleading standard of Rule 9(b) still applies to the § 11 claims.

Complaints subject to Rule 9(b) must plead “with particularity the circumstances constituting fraud or mistake.” In order to meet the “particularity” requirement of Rule 9(b), “a plaintiff [must] allege the time, place, and content of the alleged misrepresentations on which he or she relied; the fraudulent scheme; the fraudulent intent of the defendants; and the injury resulting from the fraud.” “Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.”

The district court held that Plaintiffs were required to plead that Defendants knew that the statements of legal compliance were false at the time they were made. Because the court found that Plaintiffs failed to plead knowledge of falsity, it dismissed the complaint for failure to state a claim. On appeal, Plaintiffs argue that § 11 provides for strict liability and it was therefore inappropriate for the district court to require them to plead state of mind. We agree.

Section 11 provides for the imposition of liability if a registration statement, as of its effective date, “contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” … Section 11 provides for strict liability, and does not require a plaintiff to plead a defendant’s state of mind. Plaintiffs contend that the argument should end here and that the district court erred by requiring them to plead state of mind.

Defendants respond, however, that the issue is not so simple. … Legal compliance statements are “soft information.” Soft information includes matters of opinion and predictions. There is no duty to disclose soft information unless it is “virtually as certain as hard facts.” Because there is generally no duty to disclose soft information for purposes of § 10(b) and Rule 10b–5, a defendant corporation that chooses to keep completely silent regarding soft information cannot be held liable for a material omission under those provisions.

A thornier issue arises when a defendant chooses to disclose some soft information, as occurred in the instant case. Defendants were not completely silent, but instead spoke
on issues of legal compliance.

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[A] company that chooses to disclose soft information assumes the duty to do so fully and truthfully, but only to the extent that facts are known at the time the statements are made. ... [I]n § 10(b) and Rule 10b–5 cases, a plaintiff must plead knowledge of falsity because there can be no liability for a material misstatement if a defendant was not aware there was anything further to disclose in order to correct the misstatement.

Defendants now argue that the same reasoning should apply under § 11 to the case at hand. We do not agree. Section 10(b) and Rule 10b–5 require a plaintiff to prove scienter, § 11 is a strict liability statute. It makes sense that a defendant cannot be liable for a fraudulent misstatement or omission under § 10(b) and Rule 10b–5 if he did not know a statement was false at the time it was made. The statement cannot be fraudulent if the defendant did not know it was false. Section § 11, however, provides for strict liability when a registration statement “contain[s] an untrue statement of a material fact.” No matter the framing, once a false statement has been made, a defendant’s knowledge is not relevant to a strict liability claim.

It is immaterial that this issue has been framed as a disclosure requirement. Disclosed information can nevertheless be indisputably wrong. Under the language of § 10(b) and Rule 10b–5, a defendant may take shelter in the fact that she did not know there was anything further to disclose; it was not fraudulent for the defendant to fail to disclose anything further. A plaintiff therefore fails to state a claim if she has not pleaded knowledge of falsity. Under § 11, however, if the defendant discloses information that includes a material misstatement, that is sufficient and a complaint may survive a motion to dismiss without pleading knowledge of falsity.

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NOTES

1. The Supreme Court has granted certiorari in Omnicare, and will hear oral argument in the case in the 2014 term.

QUESTIONS

1. Is § 11 a fraud claim? Does the “sound in fraud” doctrine undermine the deterrent value of § 11? How does Rule 9(b) of the Federal Rules of Civil Procedure differ from the pleading standards that the PSLRA imposes on Rule 10b-5 claims?

2. What is “soft information”? Why are legal compliance statements “soft information”?

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Chapter 9: Exempt Offerings

Chapter 9 Supplement

Insert before Hypothetical Five on Page 564

The JOBS Act, enacted in 2012, directed the SEC to adopt rules removing the Rule 502(c) prohibition against general solicitation and general advertising. Congress ordered the repeal of the general solicitation ban, however, only for Rule 506 offerings sold solely to accredited investors. To ensure that offerings were so limited, Congress also directed that the SEC adopt rules requiring issuers to take “reasonable steps” to verify that the purchasers are in fact accredited investors. JOBS Act § 301(a)(1). The JOBS Act specifies that the use of general solicitation or general advertising shall not result in the Rule 506 offering being deemed a public offering. Securities Act § 4(b).

In 2013, the SEC adopted a rule implementing Congress’s directive to permit general solicitation if all of the investors in a Rule 506 offering are accredited investors. Issuers relying on the new rule to take reasonable steps to verify that the purchasers are accredited investors. The changes are found in a new provision, Rule 506(c).

Note that the JOBS Act and Rule 506(c) do not do away with the prohibition on general solicitation completely. The prohibition still applies to all Rule 505 offerings as well as Rule 506 offerings if not all purchasers are accredited (Rule 506(b) offerings). Issuers are therefore faced with a choice. The first option is that they can structure their offerings to sell only to accredited investors to avoid the prohibition on general solicitation and general advertising. This option under Rule 506(c) comes with a cost, however, as it requires that the issuer verify the accredited investor status of participants in the offering. The second option, under Rule 506(b), does not allow for general solicitation, but it does allow the issuer to rely on self-verification of accredited investor status by participants in the offering.

Replace Hypothetical Eight, Scenario One on p. 570 with this Scenario

1. Scenario One: Trendy is contemplating a private placement to raise $10 million to fund its Lean Green drink expansion campaign. Trendy wants to raise this money through sales using a broker-dealer that has contacts with 35 individual investors (non-accredited but sophisticated) who want in the aggregate to purchase about $5 million of common stock. Trendy also plans on making cold calls to 35 individual investors (assume accredited) to sell the remaining $5 million of common stock. If there were no integration doctrine, how could Trendy structure its transactions within Regulation D, allowing it to raise all this money in the next month?
Insert before “Section IV: Regulation A” at p. 579 (and then renumber Section IV as Section V, Section V as Section VI, and Section VI as Section VII)

IV. Crowdfunding

As part of the JOBS Act of 2012, Congress enacted the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (the CROWDFUND Act). Crowdfunding has its roots outside of the formal capital markets, with the rise of the Internet. The Internet allowed groups of people to pool their money through websites, such as kickstarter.com, to fund various artistic and other creative endeavors. People typically contributed money without regard to investment return, for projects such as the development of a video game, the filming of documentaries, or the writing of a first novel. In return for their funding, project sponsors typically promised contributors copies of the completed video game, a digital download of the finished documentary film, or first edition copies of their book.

The JOBS Act piggybacks on the concept of groups of individuals pooling their money informally to provide a new, less regulated method for companies to raise capital from individuals seeking an investment return. The crowdfunding exemption from § 5 is found in § 4(a)(6) of the Securities Act. Unlike § 4(a)(2) or the Regulation D private placement exemptions, the JOBS Act does not restrict the types of investors who may participate in crowdfunding. Retail investors are welcome to invest their money through crowdfunding.

The JOBS Act does, however, limit the quantity that both issuers can sell and investors can buy. The JOBS Act limits issuers to no more than $1 million in crowdfunding sales during any 12-month period. Securities Act § 4(a)(6)(A). Section 4A(h) of the Securities Act provides that the SEC must adjust the $1 million threshold at least every five years to account for inflation. The $1 million limit parallels the $1 million aggregate offering price limitation in Rule 504 and severely limits the appeal of crowdfunding for most established issuers. Consequently, we predict that typically only smaller, lesser-known companies—for example new Internet startups—will take advantage of crowdfunding.

The JOBS Act also limits the aggregate amount that may be sold by all issuers to any particular investor during a 12-month period. Section 4(a)(6)(B) creates two separate individual investor limits. The first limit is defined as “the greater of $2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000.” For example, if an investor has an annual income of $50,000 and a net worth of $25,000 then the first limit would equal $2,500 (5% of $50,000). The second limit is defined as “10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.” For the investor with an annual income of $50,000 and a net worth of $500,000, the second limit equals $50,000. Notably, the individual investor’s limit is aggregated during any 12-month period for all issuers using the § 4(a)(6) crowdfunding
exemption. Section 4A(h) of the Securities Act provides that the SEC must adjust the dollar amounts in § 4(a)(6)(B) over time “in accordance with any rules of the Commission under this title regarding the calculation of the income and net worth, respectively, of an accredited investor.” As we covered earlier in the Chapter, the Dodd-Frank Act requires the SEC to determine whether the definition of an accredited investor should be adjusted every four years.

Note that the crowdfunding limit on the amount that all issuers may sell to a particular investor in a 12-month period does not distinguish between retail and institutional investors. We doubt that institutional investors will have much interest in crowdfunding transactions. It simply is not worth the effort for institutional investors to research and investigate a new investment if the maximum investment is $100,000. The result is likely to be that retail investors will dominate crowdfunding transactions.

Given the likely composition of the crowdfunding market, Congress had to contend with the problem that individual retail investors purchasing securities from relatively unknown startup companies would, at best, face highly risky investment choices without the information or sophistication to make informed decisions and, at worst, face a sea of fraudsters. Congress's solution was to employ third party gatekeepers. The JOBS Act requires that issuers selling based on the crowdfunding exemption must rely on either a broker or a “funding portal.” Securities Act § 4(a)(6)(C). Funding portals are defined “as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(a)(6).” Exchange Act § 3(a)(80). Section 3(a)(80) excludes those who offer investment advice or recommendations, engage in solicitations relating to the securities offered, or compensate others for such solicitations. In addition, those who hold, manage, possess, or otherwise handle investor funds or securities cannot act as a funding portal. Given this list of exclusions, what can a funding portal do? At a minimum, a funding portal may act as a venue for issuers and investors to find one another and enter into securities transactions. Presumably, a web-based funding portal may advertise itself generally to investors seeking a location to participate in crowdfunding transactions, as long as it does not solicit investors for any particular offering.

Section 4A imposes a number of requirements on brokers and funding portals that seek to act as an intermediary in a § 4(a)(6) crowdfunding transactions. First, the broker or funding portal must register with the SEC and applicable self-regulatory organization (FINRA in the case of brokers). Securities Act § 4A(a)(1), (2). The broker or funding portal must also provide investors with disclosures, including disclosures related to risks as well investor education materials as the SEC determines appropriate. Securities Act § 4A(a)(3). What form will these investor education materials take? Would it be too negative to point out that IPO investors in Facebook lost more than 25% of their value in the first week of trading after the IPO and that crowdfunding investors may potentially experience even greater losses? Should education materials report on the actual performance of all prior crowdfunding investments made through a specific broker or funding portal in the past year (including median, mean, and variance)? Or should the
investor education materials simply contain platitudes about the fact that investments in equity are not as safe as putting money in an FDIC-insured bank account?

The JOBS Act goes beyond mere disclosure and investor education. In keeping with the view of brokers and funding portals as gatekeepers, § 4A requires these intermediaries to ensure that each investor reviews the investor-education information. Securities Act § 4A(a)(4)(A). We wonder how this will be accomplished. Is a signed certification from the investor enough (which many investors will sign even if they haven't read the investor education materials) or does the broker or funding portal need to monitor the investor to make sure they actually read the investor education materials? Moreover, § 4A(a)(4)(B) requires that the broker or funding portal “positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss.”

Section 4A also imposes an investor test requirement. Most investor screens within the securities laws rely primarily on objective metrics based on assets, amount invested in securities, net worth, and income to distinguish among investors. For example, individuals may be deemed accredited investors if, among other things, they meet certain net worth or income requirements. In contrast, § 4(A) requires that the broker or funding portal ensures that investors are able to answer questions that demonstrate an understanding of the risks of investing in startups and illiquidity. Securities Act § 4A(a)(4)(C). Should the questions on such a test include questions about the efficient capital markets hypothesis and basic knowledge on the time value of money? Should they be multiple choice? Once we go down the path of requiring investors to take tests, should the SEC centralize such tests, essentially licensing investors to participate in crowdfunding? Or can each broker or funding portal make up its own questions to test investors?

Not content with requiring investor testing, Congress also directly imposes investigation requirements on brokers and funding portals. Section 4A requires the brokers and funding portals must take measures to reduce the risk of fraud. This includes obtaining background checks as well as checking the securities enforcement regulatory history of the officers, directors and twenty percent equity holders of issuers. Securities Act §4A(a)(5).

Investors care greatly whether an issuer raises enough capital to follow through on its business plans. If a company needs $1 million to open a new factory and the company raises only $700,000 investors may worry that the factory will not open and the company will use the $700,000 for other purposes, less likely to generate profits for investors. Addressing this fear, § 4A(a)(7) requires that a broker or funding portal transmit offering proceeds from a crowdfunding offering only when the aggregate capital raised is equal to or exceeds the target offering amount (as established by the issuer). Investors are also given the right to cancel their commitment to invest for such time period as the SEC through rulemaking deems appropriate.

Brokers and funding portals must also make efforts to ensure that investors do not exceed the § 4A individual investor limits described above (§ 4A(a)(8)), protect the private of information collected from investors (§ 4A(a)(9)), and not compensate promoters and
Crowdfunding poses a dilemma for securities regulators. Its explicit goal is to increase capital market access for those companies, typically small and unknown startups, that otherwise would have difficulty getting raising capital. Yet in inviting small and unknown startups, crowdfunding also invites fraudsters and con artists eager to bilk unsophisticated investors of their money. Due to the small dollar amounts within the crowdfunding market, institutional investors are unlikely to participate in crowdfunding, leaving the market primarily to individual, retail investors. Will disclosures, investor tests, and background checks adequately offset the increased risk of fraud posed by those issuers that self-select themselves into the crowdfunding market (i.e., those issuers unable to raise capital through more traditional means from institutional investors)? Time will tell.

A. Offering Disclosures

Section 4A imposes a number of disclosure requirements directly on issuer seeking to sell through a crowdfunding transaction. Issuers must make information available to investors, potential investors, the broker or funding portal intermediary assisting in the crowdfunding, and the SEC. Required disclosures include identifying information on the issuer (including its physical and website addresses), the names of directors, officers, and shareholders with more than 20 percent of the shares of the issuer, the intended use of proceeds, the target offering amount, the price (or method to determine the price provided that investors will be provided the final price in writing prior to sale), a description of the issuer's business and anticipated business plan, and certain information on the financial condition of the issuer (varying based on the specific target offering amount thresholds adjusted for inflation). Securities Act § 4A(b)(1)(A)-(G). Business plans typically include earnings projections for the issuer; investors in a crowdfunding transaction may therefore receive more mandatory disclosure than investors in a registered public offering that does not require any earnings projections in the registration statement.

A crowdfunding issuer must also provide a description of its ownership and capital stock. As part of this disclosure, issuers must disclose the terms of the securities being offered in the crowdfunding transaction, how the exercise of rights by the principal shareholders could harm the crowdfunding investors, how the offered securities are being valued, and the risks to investors from minority ownership in the issuer and the risks associated with corporate actions (including for example the issuances of additional shares in the future). Securities Act § 4A(b)(1)(H).

B. Limits on Issuer Communication

Issuers are prohibited from advertising the terms of an offering using the crowdfunding exemption except for notices that direct investors to a funding portal or broker. Securities Act § 4A(b)(2). The limitation on advertisements containing the terms
of the offering appears less stringent than the limits provided under the gun-jumping rules for a registered public offering. For example, if an issuer sends one-on-one communications to specific investors prior to sale commencing, is this allowable because such communications are not advertisements? If an issuer sends out a broad advertisement that mentions the offering generally without discussing specific terms is this allowable because “terms of the offering” are not mentioned? We will have to wait for SEC rulemaking to clarify the limits on issuer communications during a crowdfunding transaction. Regulation FD would limit selective disclosures to potential investors, but it only applies to Exchange Act reporting issuers, who are unlikely to avail themselves of the crowdfunding exemption. Private companies may communicate selectively without regard to Regulation FD (see Chapter 4).

Issuers are also limited in their ability to hire others to promote a crowdfunding transaction. Section 4A(b)(3) requires issuers disclose compensation paid to brokers or funding portals for promoting the offering. What are the limits of this provision? May an issuer hire a third party to promote its offering outside of communication channels provided by a broker or funding portal, or would that constitute impermissible advertising? If third party assistance is permitted, are such communications free of any disclosure requirements regarding compensation from the issuer to the third party?

C. Periodic Disclosures

Issuers must file with the SEC and provide to investors “reports of the results of operations and financial statements of the issuer” at least annually. The JOBS Act also empowers the SEC to establish what disclosures are appropriate and create exceptions as well as termination dates. Securities Act § 4A(b)(4). The ongoing disclosure obligation creates an important reason for issuers to eschew crowdfunding. A private company that chooses to raise capital through a § 4(a)(2) or Regulation D private placement faces no ongoing disclosure obligations after the close of the offering. But the same private company will face ongoing disclosures after a crowdfunding transaction.

D. Antifraud Liability

Rule 10b-5 applies to crowdfunding transactions, as it does to all transactions in connection with the purchase or sale of securities assuming the use of an instrumentality of interstate commerce. Nonetheless, Congress felt the need to apply heightened antifraud liability for crowdfunding transactions—most likely in response to the types of investors (retail) and issuers (smaller, lesser-known) that will participate in crowdfunding. To help ensure the accuracy of information disclosed in a crowdfunding offering, Congress enacted a private antifraud liability provisions specifically for crowdfunding.

Crowdfunding antifraud liability closely follows § 12(a)(2) liability as its model. Like § 12(a)(2), only those who purchase securities have standing to bring a private suit under § 4A(c). Section 4A(c) provides that a person who purchases securities in a § 4(a)(6) transaction may bring a private action against an “issuer.” Unlike § 12(a)(2), however, § 4A(c) provides an expanded list of possible defendants. Although only an “issuer” may be
a defendant, § 4A(c)(3) defines an issuer to include directors, CEOs, CFOs, and “any person who offers or sells the security in such offering.” Securities Act § 4A(c)(3).

Like § 12(a)(2), § 4A(c) provides liability if an issuer makes “an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading” as part of an offering or sale of securities under § 4(a)(6). Also like § 12(a)(2), § 4A(c) does not impose a scienter or reliance requirement as part of the plaintiff’s cause of action. Moreover, § 4A(c) does not require plaintiffs to demonstrate loss causation.

Several defenses are available to issuers. Purchasers that knew of the untruth or omission at the time of the offer or sale are barred. Securities Act § 4A(c)(2)(A). Section 4A(c)(1)(B) also provides that § 12(b)’s loss causation defense applies to the § 4A(c) private actions. Section 4A(c)(2)(B) provides for a reasonable care defense for the issuer. The statute of limitations provision of § 13 applies. Securities Act § 4A(c)(1)(B). Finally, § 4A(c) provides similar remedies. Purchasers receive rescission as their remedy, adjusted for any income received, or damages if they no longer own the securities.

E. Resales

As we saw in our discussion of § 4(a)(2) and Regulation D, investors who purchase securities through an exemption from § 5 are are limited in their ability to resell these securities. These privately placed securities are referred to as “restricted” securities because of the restriction of resale. On the one hand, the restriction of resale reduces the value of the securities to the investors. Without the ability to resell, investors cannot convert these securities into cash and will demand an illiquidity discount. On the other hand, the restriction on resales helps protect the public offering process. If issuers can sell securities through an exempt offering that investors can immediately resell freely, issuers will have less incentive to proceed through the public offering process.

Congress followed the path taken for other forms of exempt offerings by imposing resale restrictions on securities purchased in crowdfunding transaction. Securities sold pursuant to § 4(a)(6) “may not be transferred by the purchaser of such securities during the 1-year period beginning on the date of purchase.” Securities Act § 4A(e). Section 4A(e) provides several exceptions from the restriction on resales, allowing sales back to the issuer, to accredited investors, sales through a registered public offering, sales to family members, among other circumstances.

The 1-year limitation on resale may not be the most important limitation on resales. Only smaller, little-known issuers are likely to take advantage of crowdfunding. Moreover, issuers can raise only up to $1 million in a 12-month period using crowdfunding. The volume of securities sold by a typical crowdfunding issuer generally will be insufficient to support a liquid trading market, even after the 1-year holding period has expired. Without such a market, retail investors will have difficulty reselling their securities. Of course the retail investors could always try to resell the shares back to the issuer (likely at a discount if
Chapter 9: Exempt Offerings

this option is even available) or hope that the issuer eventually sells a large number of shares in a registered public offering.

F. Disqualification

While crowdfunding exposes retail investors to the offerings of smaller, little-known issuers, Congress took steps to make sure that repeat offenders of the securities laws would be barred from using crowdfunding. The JOBS Act provides for disqualification through SEC rulemaking of issuers, brokers, and funding portals, “substantially similar” to the disqualification provision contained in Rule 262 of Regulation A. JOBS Act § 302(d).

Disqualification under Rule 262 is based on the presence of specified bad acts, including being the subject of an SEC proceeding or examination under § 8 of the Securities Act or the subject of a stop or refusal order within five years of the first sale of securities (in the case of disqualification under the JOBS Act—the first sale of crowdfunding securities). Other bad acts include being convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving a “false filing” with the SEC within five years prior to the first sale of securities or being subject to any “order, judgment, or decree of any court of competent jurisdiction” entered within five years of the first sale of securities that enjoins the issuer from making a false filing with the SEC.

In addition to Rule 262 disqualification, Congress added two other circumstances that SEC rulemaking should treat as a disqualifying. First, persons are disqualified if they are subject to certain orders from specified state regulatory authorities, a federal banking regulatory agency, or the National Credit Union Administration. JOBS Act § 302(d)(2)(B). These orders include, among others, bars on persons from associating with an entity regulated by one of these agencies.

Congress has moved increasingly toward using ex post disqualification after a securities law violation to protect investors from future violations. The move is somewhat piecemeal. As we have seen, Congress recently implemented disqualification for Rule 506 (enacted as part of Dodd Frank Act of 2010) and for the new crowdfunding regime (enacted as part of the JOBS Act of 2012). Other funding avenues do not have disqualification, however, including § 4(a)(2) private placements and registered public offerings. Will disqualification in certain types of funding simply shift fraudsters to other types of offering that lack a disqualification provision?

G. Public Company Status

We saw in Chapter 4 that private companies seeking to raise capital through exempt offerings must worry about becoming a public company even without an initial public offering. The JOBS Act of 2012 greatly alleviated the risk of becoming a creeping public company by: (1) increasing the threshold number of shareholders of record of a class of equity to become a public company from 500 to 2,000 (or 500 non-accredited investors); and (2) specifying that employees are not counted as shareholders of record simply because
they receive equity securities through exempt transactions pursuant to an employee compensation plan.

Crowdfunding poses a heightened risk to startups of becoming a public company. Assuming total assets of a startup company are above $10 million, the startup must worry that crowdfunding is likely to attract a relative large number of retail investors, each purchasing a relatively small number of shares. For purposes of avoiding public company status, it is much better to have one institutional investor purchase 200,000 shares than to have 2,000 retail investors each purchase 100 shares. The fear of public company status may chill the use of crowdfunding by startups. Congress addressed this concern by requiring the SEC to engage in rulemaking to specify that securities acquired under a § 4(a)(6) crowdfunding offering are excluded from the provisions of § 12(g) of the Exchange Act and thus the numerical shareholder threshold to become a public company. Exchange Act § 12(g)(6).

CROWDFUNDING HYPOTHETICAL

Redeye, Inc. is a startup company based in New York City that manufactures highly caffeinated energy drinks. Jeff, the CEO, founder, and sole shareholder of Redeye, hopes to break out of the Northeast region and market the energy drinks out on the west coast in direct competition with Trendy, Inc. Redeye is a low budget operation and Jeff calculates that Redeye needs only $500,000 to start an Internet-based word-of-mouth campaign to raise awareness of Redeye on the West Coast. What are the pros and cons for Redeye of raising capital through crowdfunding? What alternative methods of raising capital would you suggest to Jeff?
C. JOBS ACT of 2012 and § 3(b)(2)

Viewing the $5 million ceiling on Regulation A offerings as inadequate, Congress enacted § 3(b)(2) as part of the JOBS Act of 2012. Section 3(b)(2) directs the SEC to adopt rules creating a new exemption from § 5. Instead of Regulation A’s $5 million offering amount limit over a 12-month period, § 3(b)(2) allows $50 million in sales over a 12-month period. Section 3(b)(2) provides for SEC review of the offering amount limitation every 2 years to determine whether to increase the amount as the SEC determines appropriate.

Like Regulation A, § 3(b)(2) provides for the creation and distribution of an offering statement with audited financial statements. Section 3(b)(2) allows issuers to solicit interest in the offering prior to the filing of an offering statement, paralleling Regulation A’s test the waters provision. Section 3(b)(2) similarly provides a disqualification provision.

Under § 3(b)(2), issuers may offer and sell securities publicly. Only equity, debt, and debt securities convertible or exchangeable to equity interests, including any guarantees of such securities, may be exempted. Investors purchase unrestricted securities and thus are able to freely resell the securities, the same as if the issuer had sold through a registered public offering. Section 3(b)(2) therefore retains the mini-public offering benefits of Regulation A while raising the offering amount limit tenfold. Although § 12(a)(2) antifraud liability (covered in Chapter 8) likely applies to a Regulation A offering because it is a public offering, the JOBS Act is explicit that § 12(a)(2) liability applies to any person offering or selling securities in a § 3(b)(2) offering.

Unlike Regulation A, § 3(b)(2) provides for ongoing, periodic disclosure after the completion of the offering. Rather than piggyback onto the existing periodic disclosure regime, Congress instructed the SEC to create a new periodic disclosure regime. Issuers must file audited financial statements to the SEC annually. The SEC may also require other disclosures it deems appropriate. Although $50 million is more than the current $5 million cap under Regulation A, the amount remains small by public capital market standards. An issuer with a public float of $50 million will likely have securities that trade only infrequently in the OTC market. Given the illiquid nature of many of the secondary markets for the typical § 3(b)(2) issuer, it is unclear whether ongoing disclosures will be worthwhile in such markets. Although § 3(b)(2) limits offerings to $50 million per year, there is no overall limit, so repeated offerings might lead to a company with a substantially larger market capitalization and correspondingly greater liquidity.
Chapter 10 Supplement

Replace the first paragraph after “A. Offers and Sales to a Qualified Institutional Buyer” with the following on page 644.

Rule 144A(d)(1) requires that all sales be made only to qualified institutional buyers or those the seller reasonably believes to be qualified institutional buyers. Qualified institutional buyers are defined to include an entity (investing for their own account or for the accounts of other QIBs) that in the aggregate owns and invests on a discretionary basis $100 million or more in securities of companies unaffiliated with the QIB, Rule 144A(a)(1). Insurance companies, investment companies, corporations, and partnerships, among others, are included. The $100 million threshold represents a presumption on the part of the SEC that institutions with such a large portfolio will have extensive financial sophistication and experience. Pursuant to the JOBS Act of 2012, Congress directed the SEC to modify Rule 144A to allow offers to all investors, including non-QIBs. Although the seller must reasonably believe that purchasers are QIBs, the JOBS Act allows sellers to engage in general solicitation and general advertising broadly in an effort to contact QIBs. The SEC implemented this directive by deleting all references to "offer" and "offeree" in Rule 144A(d)(1). Resales under Rule 144A can now be done through general solicitation, as long as the purchasers are limited to QIBs.