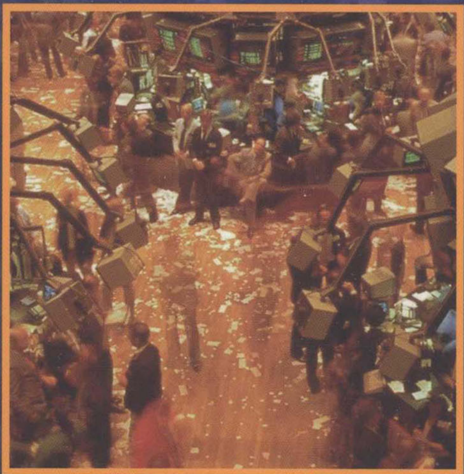
CONCEPTS AND INSIGHTS SERIES

Securities Law

Larry D. Soderquist and Theresa A. Gabaldon



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SECURITIES LAW

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In Memorium
Larry D. Soderquist

For Bob and Will

PREFACE

The aim of this book is to make securities regulation classes fun-or at least not painfully confusing. There is no reason why a student shouldn't enjoy a class on securities law. As described in the Introduction, securities law is a puzzle, and most people can have fun working with a puzzle. The trick is to be properly prepared.

Studying the Securities Act of 1933 or the Securities Exchange Act of 1934 can be miserable if a student is not adequately prepared, because it means trying to put together a puzzle without knowing the rules. Or, picking up on an analogy used in the Introduction, it is like trying to figure out a Houdini illusion without having been shown the mirrors and trap doors.

For some students, reading a casebook and going to class is all the preparation needed. Others find that they get behind, or get lost on some point, and thereafter can't get back on track on their own. And, in the case of securities law, once one is lost, finding one's own way back is extremely difficult. One object of this book is to get a student on track and keep him or her there. Another is to help in reviewing material and preparing for examinations.

What about the student who keeps up-and doesn't have to miss classes for, say, job interviews? Will this book be of much value for that student? Almost certainly. For such a student, this book can be a great aid at exam time because of the quickly understandable synthesis it will provide. In addition, reading about a subject in this book before doing a class assignment likely will make the assignment easier, quicker, and more understandable.

Securities law cases often are filled with material extraneous to the subject being studied, and they often throw a student in over his or her head by discussing material that has not yet been introduced in class. This alone can make a securities regulation class difficult and an assignment tedious. Often, too, cases are not as well written as one would like, making them needlessly hard to understand. No student can protect himself or herself from these problems without help.

In this book, I have followed the example of the founding author, Larry Soderquist, in taking pains to make securities law more accessible to all students. I believe that the material is broken down in easily digestible chunks. In addition, I have tried to be very careful not to get students in over their heads, for example by not using terms or discussing concepts without adequate explanation.

Most important, I have tried hard to make the book easy to read. There is no excuse for turgid prose. Not ever. And certainly not in discussing securities law.

My wish is that you will enjoy your study of securities regulation and find it readily understandable, and I hope that you find this book helpful.

THERESA A. GABALDON

SECURITIES LAW

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INTRODUCTION

Securities law has a reputation for being difficult. And it is—especially the Securities Act of 1933. This act is so difficult, in fact, that a student, or lawyer, cannot learn it on his or her own. *Gustafson v. Alloyd Co., Inc.,*[1] which is discussed in Chapters 4 and 8, provides a good example. In that case, some very bright Supreme Court justices, and their equally intelligent clerks, evidently attempted to figure out the Securities Act on their own—and they failed miserably. From the careful reasoning of the case, it is clear that the problem was not a lack of diligence. The problem, rather, was that the Securities Act is a puzzle that can be put together in many ways that look right, but only one of them is. The justices and their clerks seemed simply to have picked the wrong way to put the puzzle together.

Those attempting to learn securities law should take heart, however. Thankfully, securities law is not conceptually difficult in the way that, say, quantum physics is. Its difficulty is more akin to the difficulty of seeing through one of Houdini's illusions. Although doing that is almost impossible on one's own, it is easy when someone points out the mirrors and trap doors. That is what this book attempts to do—point out the mirrors and trap doors of securities law, or more correctly put, of the most often encountered provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. These are the parts of those acts that students typically study in a securities regulation course and that corporate and securities lawyers generally encounter in their practices.

In doing this, the book covers such other topics as (i) the workings of the Securities and Exchange Commission, (ii) the rules and other pronouncements of the Commission, (iii) many of the more significant securities law cases, (iv) how securities law actually works (which one cannot learn from the statutes, rules, and cases), (v) the business context in which securities law is practiced, (vi) the special position of securities lawyers with respect to professional responsibility, (vii) the Sarbanes–Oxley Act of 2002, and (viii) some of the responses to the panic afflicting the financial markets in 2008–2009. These topics are all part of the mirrors and trap doors of securities law.

1. 513 U.S. 561 (1995).

Chapter 1

WHAT IS A SECURITY

The issue of what is a security is one of the most interesting in securities law. Everyone knows what the most common securities are, such as stocks and bonds. But courts have found that all manner of investment schemes, including some relating to earthworms, chinchillas, and warehouse receipts for Scotch whisky, also involve a security. The student of securities law learns very quickly that the issue of whether a transaction involves a security is based on concepts completely foreign to the uninitiated.

STATUTORY DEFINITION

The substantive provisions of the Securities Act begin with this definition:

> Section 2(a). Definitions.—When used in this title, unless the context otherwise requires—
>
> (1) the term "security" means any note, stock, treasury stock, bond, debenture, security future, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The bulk of section 2(a)(1) is clear, and most questions concerning whether a security exists for purposes of the Securities Act can be answered by reference to that section. Further, since the Securities Act definition is virtually identical to the definition found in Exchange Act section 3(a)(10), most such questions under the Exchange Act may also be answered by references to this same language. One item in the section 2(a)(1) list of securities has caused the majority of the trouble. That item is the "investment contract," and it will be focused on as a paradigm of the Securities Act's inclusiveness. At the other end of the spectrum is the phrase "unless the context otherwise requires," which is found at the beginning of each Act's definitions. That language offers the greatest exclusiveness in terms of defining a security. It will be taken up later in this chapter.

In 2000, as part of the Commodity Futures Modernization Act, Congress added section 2A to the Securities Act to give legal certainty to the status of "swap" agreements. The relevant portion of section 2A provides that neither a security-based swap agreement nor a non-security-based swap agreement (each as defined in the Gramm–Leach–Bliley Act) comes within the Securities Act's definition of a security. The definitions incorporated from the Gramm–Leach–Bliley Act basically provide that swap transactions that do not impose fixed obligations are outside the definition of a "security" if they are individually negotiated by a limited group of eligible persons. Although there may be increased regulation of these transactions in the not too distant future, that regulation most likely will be outside the mainstream of securities law.

INVESTMENT CONTRACT

There long has been confusion about just what constitutes an investment contract. The main reason is that the term has no meaning in a commercial context but is simply a construct of legislators and judges. To understand the federal courts' interpretation of an investment contract, an understanding of *SEC v. W.J. Howey Co.*[2] is necessary. In the 1940s, the W.J. Howey Co. offered sections of an orange grove for sale. At the same time, a sister company offered prospective purchasers ten-year service contracts. Under those contracts, the company offered to take the plots under lease and manage every aspect of growing, harvesting, and selling oranges. The produce harvested by the service company was to be pooled, and any profit allocated to the various owners.

The Commission sought an injunction on the grounds that the Howey companies were offering and selling investment contracts that had not been registered under the Securities Act. The district and circuit courts rejected the Commission's request, but the Supreme Court reversed. As stated by the Court, "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

2. 328 U.S. 293 (1946).

Applying the test, the Court found that the Howey companies were indeed offering investment contracts:

> They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents.... [The offered] tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments.

In the years since *Howey*, litigation has focused on the precise meaning of the *Howey* test. For purposes of discussion, it is helpful to break the test down into four elements:

1. Investment of money
2. Common enterprise
3. Expectation of profits
4. Solely from the efforts of others

The following element-by-element discussion provides a flavor of the interpretive problems inherent in the *Howey* test.

Investment of Money

The meaning of "money" can be disposed of easily. The Securities Act covers all offers and sales of securities, regardless of the form of consideration to be exchanged in the bargain. The consideration does not actually have to be money. Perhaps the Court used "money" as a shorthand for something like "cash or checks (which would cover the *Howey* facts and those of virtually all other cases) and anything else that would constitute consideration."

For an "investment" to exist, one must put out consideration with the hope of a financial return. Perhaps the most important case discussing the meaning of "investment" is *International Brotherhood of Teamsters v. Daniel.*[3] In that case, the Supreme Court had to determine whether an investment contract existed where employers, under a collective bargaining agreement, made contributions to an employees' retirement plan to which the employees themselves did not contribute. The Court found that the employees made no investment, saying that "it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment."

3. 439 U.S. 551 (1979).

Common Enterprise

Two clear and disparate formulations of a "common enterprise" have emerged in the courts of appeals. One is vertical commonality, which focuses on the community of interest of an individual investor and the manager of the enterprise, and the other is horizontal commonality, which concentrates on the interrelated interests of the various investors in a particular scheme.

One formulation of vertical commonality has been nicely stated in *SEC v. Koscot Interplanetary, Inc.*[4] and *SEC v. Glenn W. Turner Enterprises, Inc.*,[5] each of which involved pyramid schemes run by affiliated companies. "A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." Note that, under this formulation, there may be a common enterprise involving only one promoter and one offeree.

In *Milnarik v. M–S Commodities, Inc.*,[6] the Seventh Circuit reached a different conclusion in deciding that a discretionary commodity trading account with a broker did not involve a common enterprise. The court found horizontal commonality to be required in the Seventh Circuit and focused on the fact that the profitability of the plaintiffs' account was not influenced by the success or failure of other accounts managed by the same broker. What existed, the court found, was simply an agency for hire, with the broker's customers being represented by a common agent. In a later case involving a discretionary trading account, *Hirk v. Agri–Research Council, Inc.*,[7] the Seventh Circuit sharpened its horizontal commonality by stating clearly that both multiple investors and a sharing or pooling of funds is required for the common enterprise element to be present.

In thinking about the "common enterprise" element of the *Howey* test, it may be helpful to note that some courts have identified different versions of vertical commonality. One version, called strict vertical commonality, requires that the fortunes of the investor be linked to the *fortunes* of some other party. The other version, called broad vertical commonality, requires only that the fortunes of the investor be linked to the *efforts* of another party. (Note that courts that accept vertical commonality can be expected also to accept horizontal commonality if it happens to exist.)

Expectation of Profits

One of the most important cases on the *Howey* "expectation of profit" element is *International Brotherhood of Teamsters v. Dan-*

4. 497 F.2d 473 (5th Cir.1974).
5. 474 F.2d 476 (9th Cir.1973).
6. 457 F.2d 274 (7th Cir.1972).
7. 561 F.2d 96 (7th Cir.1977).