
The Securities Act of 1933

Prohibits fraud and stabilizes the securities industry by requiring disclosure of all essential information relating to the issuance of stocks to the investing public.

1. **Registration** requirements—Securities, unless exempt, must be registered with the SEC before being offered to the public through the mails or any facility of interstate commerce (including securities exchanges). The **registration statement** must include detailed financial information about the issuing corporation; the intended use of the proceeds of the securities being issued; and certain disclosures, such as interests of directors or officers and pending lawsuits.

2. Prospectus—A **prospectus** must be provided to investors, describing the security being sold, the issuing corporation, and the risk attaching to the security.

3. **Exemptions**—The SEC has exempted certain offerings from the requirements of the Securities Act of 1933. Exemptions may be determined on the basis of the size of the issue, whether the offering is private or public, and whether advertising is involved. Exemptions are summarized in Exhibit 17-5.

The Securities Exchange Act of 1934

Provides for the regulation and registration of securities exchanges, brokers, dealers, and national securities associations (such as the NASD). Maintains a continuous disclosure system for all corporations with securities on the securities exchanges and for those companies that have assets in excess of $5 million and five hundred or more shareholders (Section 12 companies).

1. **SEC Rule 1 Ob-5** [under Section 10(b) of the 1934 act]—
   a. Applies to insider trading by corporate officers, directors, majority shareholders, and any persons receiving information not available to the public who base their trading on this information.
   b. Liability for violation can be civil or criminal.
   c. May be violated by failing to disclose "material facts" that must be disclosed under this rule
   d. Applies in virtually all cases concerning the trading of securities—a firm does not have to have its securities registered under the 1934 act for the 1934 act to apply.
   e. Liability may be based on the tipper-tippee or misappropriation theory.
   f. Applies only when the requisites of federal jurisdiction (such as use of the mails, stock exchange facilities, or any facility of interstate commerce) are present.

2. **Insider trading** [under Section 16(b) of the 1934 act]—To prevent corporate officers and directors from taking advantage of inside information (information not available to the investing public), the 1934 act requires officers, directors, and shareholders owning 10 percent or more of the issued stock of a corporation to turn over to the corporation all short-term profits (called short-swing profits) realized from the purchase and sale or sale and purchase of corporate stock within any six-month period.

3. **Proxies** [under Section 14(a) of the 1934 act]—The SEC regulates the content of proxy statements sent to shareholders by corporate managers of Section 12 companies who are requesting authority to vote on behalf of the shareholders in a particular election on specified issues. Section 14(a) is essentially a disclosure law, with provisions similar to the antifraud provisions of SEC Rule 10b-5.

State Securities Laws

All states have corporate securities laws (*blue sky* laws) that regulate the offer and sale of securities within state borders; designed to prevent "speculative schemes which have no more basis than so many feet of 'blue sky.'" States regulate securities concurrently with the federal government.
• Exemptions under the 1933 Securities Act

- Bank securities sold before July 27, 1933
- Commercial paper with a maturity date of less than nine months
- Securities of charitable organizations
- Certain securities from corporate reorganizations
- Securities exchanged with the issuer's existing security holders
- Securities issued to finance railroad equipment purchases
- Annuities and other issues of insurance companies
- Government-issued securities
- Securities issued by banks and other institutions subject to government supervision
- Issues of up to $5 million in any twelve-month period under Regulation A

All Securities Offerings

Exempt Securities

- Regulation D—
  - Rule 504: Noninvestment company offerings up to $1 million in any twelve-month period
  - Rule 504a: Offerings up to $500,000 in any one year by "blank check" companies
  - Rule 505: Private, noninvestment company offerings up to $5 million in any twelve-month period
  - Rule 506: Private, noninvestment company offerings in unlimited amounts that are not generally advertised or solicited

Nonexempt Transactions

Unregistered Unrestricted Securities

Unregistered Restricted Securities

Nonexempt Securities

Section 4(6)—Offerings up to $5 million made solely to accredited investors in any twelve-month period (not advertised or solicited)
### Comparison of Coverage, Application, and Liabilities under SEC Rule 10b-5 and Section 16(b)

<table>
<thead>
<tr>
<th>AREAS OF COMPARISON</th>
<th>SEC RULE 10b-5</th>
<th>SECTION 16(b)</th>
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<tbody>
<tr>
<td><strong>What is the subject matter of the transaction?</strong></td>
<td>Any security (does not have to be registered).</td>
<td>Any security (does not have to be registered).</td>
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<tr>
<td><strong>What transactions are covered?</strong></td>
<td>Purchase or sale.</td>
<td>Short-swings purchase and sale or short-swings sale and purchase.</td>
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<tr>
<td><strong>Who is subject to liability?</strong></td>
<td>Virtually anyone with inside information under a duty to disclose-including officers, directors, controlling stockholders, and tippees.</td>
<td>Officers, directors, and certain 10 percent stockholders.</td>
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<td><strong>Is omission or misrepresentation necessary for liability?</strong></td>
<td>Yes.</td>
<td>NO.</td>
</tr>
<tr>
<td><strong>Are there any exempt transactions?</strong></td>
<td>NO.</td>
<td>Yes, there are a variety of exemptions.</td>
</tr>
<tr>
<td><strong>Is direct dealing with the party necessary?</strong></td>
<td>NO.</td>
<td>NO.</td>
</tr>
<tr>
<td><strong>Who may bring an action?</strong></td>
<td>4 person transacting with an insider, the SEC, or a purchaser or seller damaged by a wrongful act.</td>
<td>A corporation or a shareholder by derivative action.</td>
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R Foster Winans, a reporter for the *Wall Street Journal*, co-authored an influential daily financial column called “Heard on the Street.” The column discussed selected stocks, and after its publication, there was often a noticeable change in the market price of the company stock that was the subject of the column. Winans entered into a scheme with Kenneth Felis and another stockbroker at Kidder Peabody to give the brokers advance information as to the timing and contents of the “Heard on the Street” column. The brokers would then buy or sell stock based on the probable impact of the column on the market and share the resulting profits. David Carpenter, a news clerk at the *Journal*, also participated in the scheme, acting primarily as a messenger between the conspirators. Over a four-month period, the net profits resulting from this trading activity were about $690,000. Correlations between the “Heard on the Street” articles and trading in the Clark account were noted at Kidder Peabody, and inquiries began. Later, the SEC began an investigation. Eventually, Winans and Carpenter revealed the entire scheme to the SEC. Winans and Felis were convicted for participating in an insider trading-scheme based on information misappropriated from the *Journal*, as well as for mail and wire fraud. Carpenter was convicted of aiding and abetting in the commission of securities fraud and mail and wire fraud. On appeal, Winans and the others (the appellants) contended that they could not be held liable under Rule 10b-5 because they were not corporate insiders and did not misappropriate material nonpublic information from corporate insiders.

In *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), the United States Court of Appeals for the Second Circuit upheld the convictions of the defendants, ruling that the defendants had violated insider-trading laws by trading to their profit on the basis of information obtained by Winans in violation of his duty to his employer to keep the information confidential. The court brushed aside the defendant’s argument that the misappropriation theory may be applied only when corporate insiders who owe the corporation and its shareholders a fiduciary duty are involved, stating that the misappropriation theory proscribes the conversion by insiders or others of material nonpublic information in connection with the purchase or sale of securities. The court found that the theft of nonpublic material information breached an imposed duty of confidentiality for which the defendants were liable.