I. Introduction

Rampant speculation led to the stock market crash of 1929. The crash precipitated the Great Depression, a time of enormous suffering in this county. In reaction, Congress passed the 1933 and 1934 securities acts. Prior to that time, securities were regulated only by state law.

The 1933 Securities Act regulates the issuance of new securities. The 1934 Securities Exchange Act created the Securities Exchange Commission. It also regulates secondary trading. The SEC serves as the federal agency that oversees securities issuance and trading. It provides guidance where the law is unclear, and also has civil enforcement powers. Criminal prosecutions are brought by the Department of Justice.

In order for an investment to be regulated under the 1933 or 1934 acts, it must be a “security”. The definition of that term provided by statute is so broad as to be nearly useless. As a result, the courts have defined a security as any transaction in which the buyer invests money in a common enterprise and expects to earn a profit predominately from the efforts of others. In one case, orange trees were held to be securities. This was because the trees, planted in a Florida grove, were being sold to many buyers who were hoping to make money but who did not expect to be involved in the farming process.

II. Securities Act of 1933

A. Introduction. The 1933 Act requires that, before offering or selling securities, the issuer must register the investment instruments with the SEC, unless an exemption applies. An issuer is the company whose stocks or bonds are being sold. When an issuer registers securities, the SEC does not investigate the quality of the offering. Instead, it simply checks to insure that all required information has been disclosed.

B. Exemptions. Because compliance with the 1933 Act is expensive and time-consuming, companies looking to raise capital by selling stocks and bonds will try to qualify for an exemption. Exemptions include those based on the nature of the transaction or the identity of the issuer. The latter would include insurance contracts and bonds sold by a city, for example, to raise money for some project. Some securities are exempt because of the nature of the transaction. For example, small offerings may be exempt if certain requirements are met, including restrictions on advertising and who can invest. To prevent abuse of these exemptions, the resale of some securities may be subject to restrictions.

C. Public Offerings – If no exemption applies, a company looking to raise capital by selling securities must register, meaning comply with the disclosure requirements of the 1933 Act. A company selling stock usually starts by hiring an investment bank to serve as
the underwriter. The underwriter performs various functions, including advising the firm on the price at which to sell the securities and also helping to sell the shares once SEC approval has been received.

A registration statement is required for a company preparing to sell securities. Its purpose is to notify the SEC that a sale is pending, and to disclose information to purchasers. The registration statement includes detailed information about the issuer, its business, the securities to be sold, the proposed use of the proceeds and also audited financial statements.

A prospectus is a portion of the registration statement which must be given to prospective purchasers. (The registration statement includes some information generally relevant to only the SEC.) The company’s sales effort is restricted before the registration statement becomes effective. During the waiting period, which is after the registration statement is filed, but before the SEC approves it, the issuer can publish simple ads and distribute preliminary copies of the prospectus. The SEC may require changes to the registration statement before allowing the securities to be sold. The changes are outlined in the comment letter.

D. Liability - If after it is filed by the SEC, a final registration statement contains a material misstatement or omission, the purchaser of the security can recover from the issuer, and its directors, chief officers, auditors, attorneys, and underwriters. Experts, like the audit firm, are liable only for the portion of registration statement they prepared and the underwriter is only liable for the amount of the offering it underwrote. All others have joint and several liability.

Damages apply where the plaintiff can show a material misstatement or omission existed and the plaintiff lost money. It is not necessary to show the plaintiff relied on the inaccurate document when deciding to purchase the security. Material means the information is important enough to affect the investor’s decision. Recovery under this provision is equal to difference between what the investor paid for the securities and their value on date of lawsuit. Defendants other than the issuer may be able to avoid liability by proving due diligence. This means defendant acted as prudent person would in management of his or her own property.


Among other requirements, under the Securities Exchange Act publicly traded companies and certain large corporations must disclose certain information on a regular basis. Mandatory disclosures include:

- An initial, detailed information statement when the company first registers.
- Annual reports on Form 10-K, including audited financials, a detailed analysis of the company’s performance, and information about officers and directors.
- Quarterly reports on Form 10-Q. These are less detailed than 10-Ks and include unaudited financials.
- Form 8-Ks, reporting significant developments or changes. These must be filed
within days of the event occurring. Triggering events include a change in audit firms, a change in control of the firm, etc.

Sarbanes-Oxley amended the securities laws to require CEOs and CFOs to certify that the information in the annual and quarterly reports is true and that the company has effective internal controls. Internal controls are procedures put in place by a company to try to prevent fraud or misuse of funds. In addition, the officers must inform the company’s audit committee and its external auditors of any concerns they may have with the corporation’s internal control structure.

The 1934 Act prohibits short-swing trading. This section limits insiders from profiting on purchases and later sales or sales and later purchases of company stock within a six-month period. The provision applies to officers, directors and 10% shareholders. The law requires them to report their trades within two business days. This is a strict liability provision. It applies whether or not inside information actually was used in the transaction.

IV. Liability under the 1934 Act

A. One of the more significant liability provisions of the 1934 Act is Section 10(b), which prohibits fraud in the purchase and sale of any security. To show a violation of this section, a plaintiff must prove a misstatement or omission of material fact and reliance.

Material means important enough to influence an investor’s decision. Courts generally assume reliance. *Scienter*, meaning that the defendant acted knowingly, willfully or recklessly, also must be proven. In other words, the defendant knew or was reckless in not knowing the statement was inaccurate and intended for the plaintiff to rely. Carelessness is not enough. To recover, a plaintiff must show economic loss that was caused by the misstatement or omission. A plaintiff cannot collect damages under this provision for loss caused by other factors, like an economic downturn.

Either purchasers or sellers can sue; persons who failed to buy because of a material misstatement or omission cannot. Section 10(b) and an SEC regulation interpreting this provision, Rule 10b-5, are frequently used in insider trading cases, as discussed below.

B. Forward-Looking Statements – Companies frequently release public statements that include projections or statements about future plans. Congress felt that these statements should not be the basis of a fraud suit and so amended the securities laws in 1995 to discourage this litigation. Under the Private Securities Litigation Reform Act, a company can be liable for forward-looking statements only if it failed to include a warning that the statements might not come true AND the shareholders can show that company executives knew the predictions were false. This means that even if a company failed to include the required warning, it would be liable for fraud only if the executives knew the prediction was false when they made it.
C. Insider Trading- Trading on nonpublic information is illegal for many reasons. These include fairness and making sure investors have confidence in the market. Someone who trades on inside information is liable only if he has a fiduciary duty to the company whose stock he has traded or to the source of the information. In other words, a person who finds a piece of trash on the street containing non public information and trades on it has no liability. A fiduciary violates Rule 10b-5 if she trades in stock of her company while in possession of nonpublic material information. These means an employee who knows non public information and buys stock because of it has engaged in insider trading. This rule also applies to constructive, or temporary, insiders. Constructive insiders could include persons with an indirect employment relationship, like employees of the company’s audit or law firms.

Insiders who don’t trade themselves but pass on non-public, material information (tippers) are liable if they know the information is confidential and they expect some personal gain. (Personal gain includes favors for a friend.) Even though not a fiduciary, recipients of tips (tippees) also can be responsible if (1) they knew the information was confidential, (2) they knew it came from an insider who was violating a fiduciary duty, and (3) they knew the insider had passed the tip on expecting some sort of personal gain. In other words, if an employee of a drug company learns of non public information and passes it along to his housemate, instead of paying rent, the employee has engaged in insider trading as a tipper. The housemate also can be prosecuted as a tippee, if the requirements above are satisfied.

More recently, the Supreme Court has recognized a misappropriation theory in insider trading cases. Under this theory, a person with material non-public information is liable if he reveals or trades on it in breach of a fiduciary duty to the source of the information. Misappropriation was used to convict a litigator who traded on information he found in the trash cans of his partners who did securities work, in violation of the duty owed by the litigator to the law firm where he worked. Note the difference between tippee and tipper liability, discussed above, and misappropriation theory. Tippees and tippers are liable only where the breached fiduciary duty is owed to the company whose stock is being traded. By comparison, misappropriation theory supports a conviction where fiduciary duty owed to the source of the information is breached, even though the source is not the company whose stock is being traded.

V. State Securities Laws

Many states have securities legislation. These are known as “Blue Sky laws”. Although Congress has limited the scope of some state regulation, corporations must comply with both federal and state securities laws.