

## Investor Protection and Corporate Governance

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## Securities and Exchange Commission (SEC)

- Independent federal agency created by 1934 Act
- Administers 1933 & 1934 Acts
  - Makes rules
  - Investigates and enforces law
  - Adjudicates offenses with appeal to court

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## Sarbanes-Oxley Act of 2002

- Increases corporate responsibility by
  - Imposing stronger disclosures and penalties
  - Requires CEO to take responsibility for accuracy of FS filed with SEC
  - Creates new private actions
- Created Public Company Accounting Oversight Board to regulate accounting firms

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## Securities Act of 1933

- Designed to prevent fraud and require disclosure of essential information so investors can make informed decisions
- *SEC v. Howey* (1946)
  - US Supreme Court held that a security exists in transaction in which person
    1. invests money
    2. in a common enterprise,
    3. reasonably expecting profits, and
    4. derived primarily from others' managerial or entrepreneurial efforts

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## Registration Statement

- Security must be registered with SEC and state before public offering
  - unless qualifies for exemption under Section 5 of Securities Act of 1933
- Corporation must file registration statement and prospectus with SEC
  - Contain significant provisions of offering, how registrants intends to use proceeds, description of registrants property and business
  - Prospectus later distributed to investors

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## Violations of 1933 Act

- Intentionally or negligently defrauding investors by misrepresenting or omitting material facts in registration statement and/or prospectus
- Penalties
  - Criminal: up to 5 years in prison and \$10,000 fine
  - Civil: damages, refund of investment, injunction
- Defenses
  - Omission was not material; plaintiff knew of fraud and purchased stock; registrant believed statements were true

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## Securities Exchange Act of 1934

- Requires registration of securities exchanges, brokers, dealers, and national securities exchanges and associations
- Requires continuous disclosure system for corporations with securities sold on national exchanges or assets in excess of \$5 million and 500 or more shareholders (Section 12 or 1934 companies)

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## 1934 Act (2)

- Rule 14(a) proxy regulations
- Market surveillance by SEC
- Rule 10(b) prohibits fraud with insider trading and disclosure regulations
- Rule 16 (b) insider reporting and trading
- Rule 12 regulates tender offer

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## Insider Trading

- Section 10(b) prohibits use of any manipulative or deceptive device or contrivance in contravention of rules and regulations of SEC
- Rule 10b(5) prohibits commission of fraud in connection with purchase or sale of any security

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## Insider Trading (2)

- Section 10b(5) “Insiders”
- Rule 10b-5 “Outsiders”
  - Tipper/Tipee theory
    - insider’s fiduciary duty must be breached
  - Misappropriation theory
    - person wrongfully obtains inside info and trades on it
      - Courts still require fiduciary duty be breached, e.g. to employer

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## Violations of 1934 Act

- *Scienter* or intent required to prove civil or criminal penalties under 10(b) and Rule 10b-5
  - Violator must have had intent to defraud
    - false statements or wrongfully failed to disclose material facts

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## Violations of 1934 Act: Penalties

- Criminal Penalties
  - 10(b) and Rule 10b-5: \$5 million and 20 years in prison (person), \$25 million (partnership or corporation)
  - Sarbanes-Oxley: 25 years in prison
- Civil Sanctions
  - Both SEC and private parties can bring actions against violators under Insider Trading and Securities Fraud Enforcement Act
  - Private actions for violations of 10(b) and Rule 10b-5

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## Regulation of Investment Companies

- Act on behalf of many smaller investors by pooling funds to buy securities and manage portfolio professionally (mutual fund)
- To safeguard company assets, all securities must be held by a bank or stock exchange member
- No dividends paid except from undistributed net income

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## State Securities Law

- Called “Blue Sky” laws
- Issuer must comply with federal and state securities laws and states do not allow same exemptions as federal government
- States could require registration or qualification
- Uniform Securities Act has been adopted in many parts of country

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## Online Securities Offering and Disclosures

- Springstreet Brewing Co.
  - first online IPO (1996)
- Regulations governing online securities offerings:
  - Timely and adequate notice of delivery of information
  - On-line communication system must be easily accessible
  - Some evidence of delivery required

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### Potential Liability Created by Online Offering Materials

- Should exercise caution in hyperlinking to external documents
- Concern if info on website viewed by anyone
  - Many offering are restricted to limited number of “unaccredited” investors

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### Online Securities Fraud

- SEC aggressively prosecutes internet fraud using traditional laws
- Investment scams
- Using chat rooms to manipulate security prices
  - Pumping and dumping

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