*Chapter 21*

**Investor Protection, Insider Trading, and Corporate Governance**

Answers to Learning Objectives/

Learning Objectives Check Questions

at the Beginning and the End of the Chapter

**Note that your students can find the answers to the even-numbered *Learning Objectives Check* questions in Appendix E at the end of the text. We repeat these answers here as a convenience to you.**

**1A.** ***What is meant by the term* securities*?*** *Securities* are generally defined as any documents evidencing corporate owner­ship (stock) or debts (bonds).

**2A.** ***What are the two major statutes regulating the securities industry?*** The major statutes regulating the securities industry are the Securities Act of 1933 and the Securities Exchange Act of 1934, which created the Securities and Exchange Commission.

**3A.** ***What is insider trading? Why is it prohibited?*** *Insider trading* is the purchase or sale of securities on the basis of information that has not been made available to the public. It is prohibited to remove the ad­vantage that corporate directors, officers, and other corporate insiders have, be­cause of their positions, to obtain advance inside information and affect the fu­ture market value of corporate stock through manipulative practices.

**4A.** ***What are some of the features of state securities laws?*** Typically, state laws have disclosure requirements and antifraud provisions patterned after Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. State laws provide for the registration or qualification of securities offered or issued for sale within the state with the appropriate state official***.*** Also, most state securities laws regulate securities brokers and dealers.

**5A.** ***What certification requirements does the Sarbanes-Oxley Act impose on corporate executives?*** The Sarbanes-Oxley requires chief executive officers and chief financial officers to certify that corporate financial statements “fairly present, in all material respects, the financial condition and results of operation of the issuer.” This requirement makes officers directly accountable for the accuracy of the financial reporting.

Answer to Critical Thinking Question

**in the Feature**

# Beyond Our Borders—Critical Thinking

***Why does the presence of a capitalist system affect a nation’s perspective on corporate governance?*** Private property and the protection of its ownership are valued in capitalist theory.This may affect the priority given to a firm’s owners in determining corporate governance principles.

Answers to Critical Thinking Questions

**in the Cases**

**Case 21.1—Critical Thinking—Legal Consideration**

***Would a reasonable investor have cause to complain if an issuer, without having consulted a lawyer, states, “We believe our conduct is lawful”? Explain.*** Yes, a reasonable investor might have cause to complain if an issuer, without having consulted a lawyer, states, “We believe our conduct is lawful.” This statement could be misleadingly incomplete. In the context of the securities market—indeed, in almost any context—an individual, including an investor, is aware that a lawyer’s opinion can turn out to be wrong in the end. But in the context described in the *Omnicare* case—the formality of a registration statement, its text, and the customs and practices of a particular industry—an investor likely expects such a statement to be based on an actual inquiry, not on intuition or an uninformed surmise.

**Case 21.3—Critical Thinking—Ethical Consideration**

***What is the difference between a sales commission or a transaction fee and a kickback? Why is a kickback unethical? Discuss.*** A sales commission or a transaction fee is a fee paid to an agent or employee for a particular transaction, usually a percentage of the money received in the transaction. A kickback is a payment or payoff for special favors or services. More specifically, a kickback is the return of a portion of a sum received as part of a secret agreement. What can make a kickback unethical is the secrecy of the agreement, the intent or reason for its payment, and the result.

In the *Newton* case, the kickbacks were intended to be payments for the services of the federal agents in arranging for the purchase of the defendants’ stock at artificially inflated prices. What made the kickbacks unethical here were the same factors that made them illegal—the deception of the public, the intent to defraud the public, and the artificial inflation of the stock price as a result.

Answers to Questions in the Reviewing Feature

at the End of the Chapter

**1A.** ***Registration***

No, because the securities were not newly issued or offered to the public. In this scenario, Dakota Gasworks was the target company in a successful takeover, it did not issue new securities to raise capital or offer any securities to the public. Therefore, it would not have been required to register with the SEC.

**2A.** ***Securities laws***

No, because he did *not* fail to disclose a material fact in connection with the purchase and sale of securities, nor did he intend to defraud or have knowledge of his misconduct. Emerson did not fail to disclose a material fact in connection with the purchase or sale of securities. What he did do was use bad judgment and breach a fiduciary duty by mentioning the planned takeover to his uncle, who then took the information and used it to his advantage. There is no indication in the facts that Emerson intended to do anything wrong or knew that his uncle would use this information to trade on the information (that he should not have disclosed).

**3A.** ***Insider trading theory***

Because Wallace acquired inside information as a result of Emerson’s breach of his fiduciary duty, Wallace could be held liable for insider trading under the tipper/tippee theory. Wallace would have to have known that the information came from a breach of the fiduciary duty.

**4A.** ***Certification***

Under the Sarbanes-Oxley Act, the chief executive officers and the chief financial officers are required to certify the financial statements.

Answer to Debate This Question in the Reviewing Feature

at the End of the Chapter

***Inside trading should be legalized.*** The more quickly information about publicly held companies gets into the hands of the public, the more efficient the stock market becomes.  Therefore, insider trading should be made legal because both good and bad company information will be made completely public more quickly.  Those in publicly held companies who profit from having access to such inside information will end up with lower salaries because of competition in the labor market, even for managers.

Laws against insider trading were put in place to prevent insiders—usually highly paid upper-level managers—from undeservedly benefiting from their positions in the publicly head companies.  If insider trading were no longer illegal, insiders would stand to make fortunes from buying the companies’ stock before good news is released.  If the inside news is bad, insiders can make fortunes selling short the companies’ stocks.

Answers to Issue Spotters

at the End of the Chapter

**1A.** ***When a corporation wishes to issue certain securities, it must provide sufficient information for an unsophisticated investor to evaluate the financial risk involved. Specifically, the law imposes liability for making a false statement or omission that is “material.” What sort of information would an investor consider material?*** The average investor is not con­cerned with mi­nor inaccuracies but with facts that if disclosed would tend to deter him or her from buying the se­curities. This would include facts that have an important bearing on the con­dition of the issuer and its busi­ness—li­abilities, loans to officers and directors, cus­tomer delinquencies, and pending lawsuits.

**2A.** ***Lee is an officer of Magma Oil, Inc. Lee knows that a Magma geologist has just discovered a new deposit of oil. Can Lee take advantage of this information to buy and sell Magma stock? Why or why not?*** No. The Securities Exchange Act of 1934 ex­tends liability to officers and di­rectors in their per­sonal transactions for taking advantage of inside informa­tion when they know it is unavail­able to the persons with whom they are dealing.

Answers to Questions and Case Problems

**at the End of the Chapter**

**Business Scenarios and Case Problems**

**21–1A . *Registration requirements***

Joseph is right. Under Regulation A, securities issued by an issuer that has offered less than $5 million in securities in any twelve-month period are exempt from registration. With respect to the amount of the offering in this problem, the issue would also fall under Rule 504 of Regulation D, which exempts noninvestment company offerings up to $1 million in any twelve-month period. It may also qualify as exempt under Regulation D’s Rule 505, depending on to whom the issue is offered to and how it is advertised. Rule 505 exempts offerings of up to $5 million in any twelve-month period made to investors that include fewer than thirty-five unaccredited investors, as long as there is no general advertising or solicitation.

If this were a private offering, it could be exempt under Rule 506, regardless of the amount, provided each unaccredited investor was sufficiently knowledgeable or experienced. Also, under Section 3(a)(11) of the Securities Act of 1933, stock offer­ings that are restricted to residents of the state in which the issuing company is organized and doing business are exempt from registration requirements. The issue will, however, be subject to state securities legislation. Unless it qualifies for exemption from state registration requirements, the stock offering will have to be registered with the appropriate state official.

**21–2A. *Insider trading***

There is likely enough evidence in the facts of this problem to find that David violated the law because there was a clear pattern—every time David called his brother or fa­ther, Mark or Jordan bought more RS stock. Establishing liability under Section 10(b) and SEC Rule 10b-5 requires proof of an intent to defraud or knowledge of misconduct with respect, in this case, to a failure to disclose material facts used at the time of a trade. People generally buy when they be­lieve the price of a stock is going up and sell when they believe it is going down. Insider trading can be established when it can be inferred that the most likely source of that belief was an insider. For example, a stock purchase or sale’s proximity in time to a phone conversation between a trader and one with inside information provides a reasonable basis for inferring an exchange of that infor­mation. Thus, in this problem, on this basis, a court could hold David liable for insider trading.

**21–3A . Business Case Problem with Sample Answer—*Violations of the 1934 act***

An omission or misrepresentation of a material fact in connection with the purchase or sale of a security may violate Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The key question is whether the omitted or misrepresented information is material. A fact, by itself, is not automatically material. A fact will be regarded as material only if it is significant enough that it would likely affect an investor’s decision as to whether to buy or sell the company’s securities. For example, a company’s potential liability in a product liability suit and the financial consequences to the firm are material facts that must be disclosed because they are significant enough to affect an investor’s decision as to whether to buy stock in the company.

In this case, the plaintiffs’ claim should not be dismissed. To prevail on their claim that the defendants made material omissions in violation of Section 10(b) and SEC Rule 10-5, the plaintiffs must prove that the omission was material. Their complaint alleged the omission of information linking Zicam and anosmia (a loss of the sense of smell) and plausibly suggested that reasonable investors would have viewed this information as material. Zicam products account for 70 percent of Matrixx’s sales. Matrixx received reports of consumers who suffered anosmia after using Zicam Cold Remedy.

In public statements discussing revenues and product safety, Matrixx did not disclose this information. But the information was significant enough to likely affect a consumer’s decision to use the product, and this would affect revenue and ultimately the commercial viability of the product. The information was therefore significant enough to likely affect an investor’s decision whether to buy or sell Matrixx’s stock, and this would affect the stock price. Thus, the plaintiffs’ allegations were sufficient. Contrary to the defendants’ assertion, statistical sampling is not required to show materiality—reasonable investors could view reports of adverse events as material even if the reports did not provide statistically significant evidence.

**21–4A. *Disclosure under SEC Rule 10b-5***

Even if Goldman did not affirmatively misrepresent any facts about the CDOs, Dodona can recover if Goldman failed to disclose material facts. An omission is regarded as material if it is significant enough that it would have affected an investor’s decision concerning the securities. Here, Dodona might recover by showing that Goldman did not fully disclose the risks of investing in the CDOs. Goldman may have misled Dodona by providing only boilerplate statements about investments that it knew were particularly risky.

**21–5A . *Violations of the 1933 Act***

Yes, World Trade violated the Securities Act of 1933. It is a violation of this act to sell securities without registration unless they qualify for an exemption. It is also a violation of the act to sell securities without registration under an exemption for which they do not qualify. Most securities can be resold without registration. Resales of restricted securities, however, trigger the registration requirements unless the securities fall under the “safe harbor” exceptions of Rule 144 or Rule 144A.

In this problem, the facts state that the securities were restricted. There is no indication that they fell under any of the “safe harbor” exceptions of Rule 144 or Rule 144A. Thus, they could not be resold without registration unless they otherwise qualified for an exemption. And there is nothing expressed in the facts to show that these securities qualified for an exemption. In fact, it is pointed out that the securities’ certificates included a statement disqualifying them for resale without registration. The statement had been wrongly removed. But there are a number of publicly available facts noted in the problem that should have triggered World Trade’s inquiry into the status of the company and its stock—its lack of an operating history or earnings, its net losses, and the thin trading of its shares. The broker’s failure to make this inquiry is likely a violation of an important duty. And of course, World Trade’s sale of the stock without registration was a violation of the Securities Act of 1933.

In the actual case on which this problem is based, the Financial Industry Regulatory Authority imposed fines and other sanctions on World Trade for its sales of the iStorage stock, and these penalties were upheld on appeal by the Securities and Exchange Commission and the U.S. Court of Appeals for the Ninth Circuit.

**21–6A . *The Securities Act of 1933***

Yes, liability under the Securities Act of 1933 can be imposed on a seller for a false statement that was made by someone else. It is a violation of the Securities Act to intentionally defraud investors by misrepresenting or omitting facts in a connection with the purchase or sale of securities. Liability is also imposed on those who are negligent for not discovering the fraud.

In this problem, CyberKey falsely informed Big Apple that CyberKey had been awarded a $25 million contract with the Department of Homeland Security (DHS). Big Apple, a public relations firm, aggressively promoted CyberKey’s stock and was compensated for these efforts in the form of CyberKey shares. When the Securities and Exchange Commission (SEC) began to investigate the assertions, Big Apple sold the stock for $7.8 million. In these circumstances, Big Apple may have known that CyberKey’s representation about the DHS contract was false, in which case Big Apple might be liable for fraud. Or Big Apple may have been reckless in failing to exercise due diligence and thereby discover CyberKey’s fraud, in which situation Big Apple could be liable for negligence.

In the actual case on which this problem is based, the SEC alleged that Big Apple “knew, or [was] severely reckless in not knowing” that CyberKey did not have a contract with DHS. The court issued a summary judgment in favor of the SEC’ and against Big Apple. The U.S. Court of Appeals for the Eleventh Circuit affirmed.

**21–7A. A Question of Ethics—*Violations of the 1934 act***

**1.** The court issued a summary judgment against the defendants and ordered injunctive relief. The defendants were given time to respond to the injunction order, after which “the court will determine .  .  . the appropriateness and amount of any order of disgorgement with .  .  . interest as well as with respect to the assessment and amount of any other civil penalties.”

Under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, it must be shown that the “Defendants made misrepresentations or omissions of material fact in connection with the offer or sale of a security. .  .  . A fact is considered material if there is a substantial likelihood that a reasonable investor would consider the fact important, and the fact, if disclosed, would have significantly altered the total mix of information made available to the reasonable investor.”

The court found that Montana, Lyttle and Knight “misrepresented the use, safety and control of the investor funds. Each represented to the investors that their funds would be placed in a program that would generate extraordinary rates of return with no risk to the principal. The evidence makes clear that neither promise was ever intended nor did it ever materialize. In fact, no Trading Program even existed.” The “Defendants' representations and assurances made in connection with the offers for sale of securities, in particular with regard to the use, safety, rates of return and control of the funds they were investing, were important in terms of the investors' decisions to invest.”

Proof of *scienter* is also required. “Persons who act with an intent to deceive or with reckless regard for the truth are deemed to possess the necessary *scienter*.” In this case, “it is clear that Montana .  .  . acted recklessly in relying on Lyttle's representations concerning the Trading Program without performing any due diligence to confirm what Lyttle had told him and the investors. Montana failed to verify the details of the Trading Program, never mind its existence, including whether the promised rates of return could actually be achieved or whether the investor funds were, in fact, safe.” There is no “evidence or argument indicating anything other than Montana's apparent, complete willingness to serve as a shill for .  .  . Lyttle's fictitious Trading Program.”

It was also clear that Lyttle acted with *scienter* “insofar as he had to have known that his statements about the Trading Program were false.” And Lyttle “continued to sign people up .  .  . long after he well knew that the investor funds were being used in a manner contrary to his representations to these investors and even after using some of the investors' funds for his own personal purposes.”

As for Knight, he too “clearly knew that no legitimate trading program actually existed that would or could deliver on the promised financial returns without invading the investors' principal. And Knight also used the funds in a manner totally inconsistent with the representations he had made .  .  . [to] individual investors before and after the investments were made.”

**2.** The court described the documents that Montana, Lyttle, and Knight supplied to the investors as including “many sections which contained provisions clearly designed to appear substantive and official, which actually carried no legitimate significance with regard to the types of trades supposedly to be conducted. In fact, .  .  . many of the representations in these agreements have no significance in the financial world and amount to little more than gibberish.” The court also referred to the investors as “unsophisticated.”

There is an adage that if something sounds too good to be true, it probably is. That would seem to apply to the promises of Montana, Lyttle, and Knight in this case. Their clients may have been fueled—and fooled—by their own greed as much as by the outlandish claims of these con artists. Eager to increase their wealth quickly and easily, the investors may have declined to conduct their own due diligence so as not to discourage themselves. For that reason, there may be less sympathy for the losses suffered by the investors.

Of course, the investors may have been honestly unsophisticated and truly defrauded by Montana, Lyttle, and Knight’s representations as to the safety of the principal. The investors’ only ethical transgression may have been to trust too readily in their advisors’ veracity. In that circumstance, it would seem less fair, or at least less supportable, that they should suffer a loss.

**Critical Thinking and Writing Assignments**

**21–8A. Business Law Critical Thinking Group Assignment**

**1.** Svoboda and Robles committed fraud when they traded securities using the nonpublic information that Svoboda had access to. Criminal charges could be filed against them under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission (SEC) Rule 10b-5, which generally prohibit fraud in connection with the purchase or sale of securities. Penalties could include extended incarceration and significant fines.

A person commits fraud under Section 10(b) and Rule 10b-5 when he or she misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. If this person tips another individual, the tippee also is liable for trading on the information if the tipper's breach of his or her duty is established and the tippee was aware of the breach. The tipper must act with *scienter*—an intent to deceive, manipulate, or defraud, or at least knowing misconduct. The information must be material, which occurs if there is a substantial likelihood that a reasonable investor would view it as significantly altering the total mix of information. It must also be nonpublic, which means generally that persons trading in the stock must not have known it.

In this problem, Svoboda breached fiduciary duties owed to Rogue Bank and its clients by passing along confidential information to Robles for trading purposes and by personally trading on the information. Robles is liable as a tippee because of Robles' awareness of Svoboda’s breaches of duty, as shown by Robles' agreement to execute all of the trades. These parties acted with *scienter*. Their scheme involved repeated acts of fraud and steps to conceal the illegal activity. And the information on which they based their trades was material and nonpublic.

**2.** Svoboda and Robles are also subject to civil liability for their actions. The SEC could file a civil suit in a federal district court against them for their insider-trading violations. Possible sanctions include permanent injunctions against violating the securities laws, hefty civil fines, and disgorgement of their profit, plus interest. Svoboda might be assessed with joint and several liability for Robles’s portion.

**3.** Svoboda’s might defend against the civil charges by arguing that he had been “punished enough”—he had been caught, indicted on criminal charges, convicted, fined, and sentenced to incarceration. This defense is not likely to succeed.