**The answers that appear here are for substance only. The best exam answers, particularly for the longer ones at the end, follow a basic IRAC/CREAC pattern: Tell me the issue, tell be the rule, apply the rule to the facts. Don’t answer like you are answering a question off the top of your head someone emailed to you.**

**Securities Regulation Review Problems**

Omega Company manufactures fiber-optic switches and is located in Cupertino, California, just south of San Francisco. Omega was formed about seven years ago and now desperately needs to expand its manufacturing capacity as well as pursue certain new product development possibilities. For this, it needs to raise about $50-70 million through a public offering of common shares. Omega contemplates that a registration statement covering the offering will be filed May 1 . For each of the problems that follow, consider whether Section 5 of the Securities Act has been violated. Assume that Omega is a nonreporting issuer unless told otherwise.

1. On February 10 , Bob, Omega’s vice president of marketing, places an advertisement to appear in nine upcoming issues of Business Week. The advertisement previously had run for several months in Byte, a computer trade magazine, and in addition to listing the full range of products manufactured by Omega, it carried a quote from a trade magazine that “Omega is the emerging industry leader in the development and design of fiber-optic

switches.”

Omega can’t make offers before filing a registration statement, so the issue here is whether the ad is an “offer.” The best argument is that the ad falls under a safe harbor rule so it is not considered an offer. The ad is placed on Feb. 10, almost three months before filing. 163A is a good starting point because the ad is over 30 days out and doesn’t mention the offering. However, it looks like the ad will run until The middle of April, so 163A isn’t going to cover every issue. Bob must find a different safe harbor rule. Omega is a nonreporting company, so the best rule would be Rule 169. However, that means the ad must be purely factual, not forward-looking, and similar to ads that Omega has used before. This ad is questionable because it has been moved from a trade magazine to a magazine targeted toward investors and it has the rosy-looking quote.

2. On February 14 , Alice, Omega’s VP of Finance, invites five representatives of San

Francisco investment banking firms to meet with her to explore each firm’s possible

interest in underwriting Omegas offering. As a result of these talks, she asks one of the

firms, Hedley, Hadley Inc. to serve as underwriter. On February 15 , they execute a draft

agreement for a firm commitment underwriting for 4 million Omega shares to be sold for

approximately $15 per share. All discussions were conducted in San Francisco.

Same issues as above, what is an “offer”? No safe harbors would work because Omega is specifically talking about the offering. However, these talks probably fall under the definition of offer in Section 2, which excludes negotiations with the underwriter.

3. From its San Francisco offices, Hedley, Hadley circulates a letter inviting 80 national and regional brokerage houses to participate as underwriters in the upcoming Omega offering.

This is probably not going to be seen as mere negotiations with an underwriter. Omega can’t possibly have 80 underwriters, and does not need to start discussions with that many. This ploy would be seen as trying to condition the market of dealers, not underwriters.

4. On March 15 , Omega’s public relations team prepared a brochure highlighting the

company’s rapid development and innovative products for distribution to the financial

media. Copies will also be distributed to lawyers, accountants, investment advisers, and

other localities where Omega’s name is likely to be recognized. The brochure indicates

that Omega intends to make a public offering in the near future and includes estimates of

its future production capacity as a result of the forthcoming offer.

Though this brochure is being sent out more than 30 days before the offering, it will be seen as conditioning the market. Neither the Rule 135 or 169 safe harbors would apply. The brochure contains a lot more information than 135 allows and has no legend. Rule 169 does not allow for forward-looking information or mentions of the offering.

5. Same facts as #4, but Omega is a reporting company.

Rule 168 allows reporting companies to have forward looking information in its releases of factual information, but the brochure specifically mentions the offering and its audience is investors, not customers. The list is also not a list of QIBs, so the emerging growth company “testing the waters” exemption does not apply, either (Section 5(d)).

6. Same facts as #4, but Hedley, Hadley prepares the brochure in question with the caption “Companies to Watch.”

The underwriter also cannot send this brochure. Because Omega is a nonreporting company and HH is participating in the offering, none of the analyst safe harbors apply (137, 138, 139). However, if Omega is an emerging growth company, then this research report may be exempt from “offer” in Section 2.

7. On April 5 , Omega invites journalists and others to tour its production facilities as a

prelude to its “big expansion plans.” No mention is made of the forthcoming public

offering, but company officials take the occasion to exhibit the first prototypes of some

unusual new products.

Being not quite 30 days out, Omega would have to use Rule 169 and show that the tour is similar to tours given in the past, does not have tour leaders give projections about the future, etc. The journalists should be industry journalists, not financial journalists.

9. In late April, Hedley, Hadley issues on its letterhead an announcement that is carried over the various financial wire services disclosing that Omega will soon undertake a public

offering through a syndicate of underwriters of about 4 million common shares. The

announcement further discloses that the proceeds of the offering will be used to expand

Omega’s production capabilities as well as to broaden its research base. Omega obtains a

copy of the announcement and posts it to its web site.

This almost meets the requirements of Rule 135, but is missing the LEGEND.

10. On April 27 , Omega mails its annual report to shareholders, which it regularly does.

The CEO states that “Omega’s management is optimistic that the company can continue

its growth, especially in light of an expected augmentation of its production facilities and

product lines with the proceeds of the upcoming public offering.” The report is a glossier

rendering of prior reports, with high-quality color photos and new graphics. The report

also includes bouncy bios of its outside directors.

Companies in registration are allowed to talk to current shareholders, however if it looks like “conditioning the market,” it will be seen as an offer of the new securities. Sending current shareholders an annual report is expected, and if it didn’t mention the offering, it could qualify under Rule 169. Here, the annual report mentions the offering, is glossier and fancier and different than other annual reports. Omega’s best bet would be to argue that it’s not “conditioning the market” under the SEC release without a specific safe harbor.

11. On April 28 , Omega places on its website a digital recording of Alice’s recent

presentation to a gathering of investment analysts. The analysts’ invitation to Alice was

made before Omega had begun its discussions with its underwriter. At the meeting, Alice

volunteers that management fully expects that the proceeds of the new offering will make

a substantial contribution to earnings within a year or two.

At the time of Alice’s presentation, Omega probably wouldn’t have been considered “in registration;” however, Omega is definitely in registration now. Because the presentation talks about the offering, there are really no safe harbors.

12. In late April, a broker in St. Louis writes to the underwriter, offering to purchase 1000 shares for his personal account.

This question is here to show that offers to buy are also prohibited under Section 5.

On May 1 , after several weeks of intense work, Omega files a registration statement with the SEC covering 4 million of its common shares.

13. Ethan, a broker with H.T. Gaines, one of the underwriters for the Omega offering,

telephones Gail and strongly recommends that she purchase some of the upcoming

Omega offering. Gail says she is mildly interested, and Ethan sends her a preliminary

prospectus to review.

First, the phone call. Now that Omega has filed its registration statement, “offers” are allowed. Now the rules are interested in “written communications.” Because talking on the phone is not written, the phone call does not violate Section 5. The written communication in this question is in the form of a “preliminary prospectus.” As long as this meets the requirements of a preliminary prospectus, Omega is fine.

14. After several days, Ethan mails Gail a form that asks her to indicate how many shares of the offering she would like to purchase. Ethan attaches his business card to the form, with a note, “This is still a good buy.”

We did not go over this in class, but there is a safe harbor for indications of interest cards. The problematic part of this question is the business card with the note. “This is still a good buy” is an “offer” and it is written. Unfortunately, there is no good safe harbor without a legend and filing with the SEC. This cannot be FWP or any of the tombstones because it does not have necessary info or a legend.

15. Gail sends Ethan a check in the amount of $1,500, penning a note, “Put me down for 100 shares. Thanks, Gail.”

This question just shows that no sales can be made during the Waiting Period. Ethan must send the check back.

16. Florence is a new broker with Hedley, Hadley and has yet to develop a solid clientele. She emails a preliminary prospectus to the entire membership of her health club, a total of 438 addressees. A few days later, she follows up with a phone call to each person to whom she earlier mailed a prospectus.

This seems like it should be a violation, but it’s not. Exemptions under Regulation D can prohibit general solicitation like this, but a registered offering doesn’t have rules against general solicitation, just on the content and form of written solicitations (offers). Because she mailed a conforming prospectus and no other written materials, Florence has not violated Section 5. The telephone conversations, of course, are not prohibited during the Waiting Period.

17. Alice, Omega’s VP of Finance, undergoes a one-hour interview with some of the

underwriters for the forthcoming offering. The interview is digitally recorded and placed

on Hedley, Hadley’s web site where it is password protected. The password is then

discretely distributed among the underwriters, members of the selling group, and select

investors who are told that the recorded interview can also be accessed through the

website.

This question is designed to analyze whether the recording is a “graphic communication.” Because it is recorded, it is a graphic communication. However, it could be a real-time road show, but it does not seem to fit the definition, and there isn’t bona fide real-time road show available

18. In the wake of news reports critical of Omega’s recent performance, Alice sent an email to pep up the company’s 334 employees. The memo spoke optimistically about Omega’s future. Somehow a copy of the email message was posted on an online chat room.

This email is a written communication and may be an offer. It cannot fall into the Rule 169 safe harbor because she specifically talks about the offering. It also would not fall into any other mini-prospectus safe harbor because it has too much information and it doesn’t have a legend. It can’t be FWP because it does not have a legend and was not filed.

19. Hedley, Hadley emails copies of an article from the WSJ to many of tis customers. The article paints a very positive picture of Omega’s performance and discusses the likely

effects of its forthcoming IPO, including several bits of information about Omega that are

not in the documents filed with the SEC (like a quote from its CFO forecasting a 15%

jump in earnings for the next fiscal year). The email contains a hyperlink to the

underwriter’s website where a preliminary prospectus for Omega can be obtained.

The registration statement is declared effective on July 1 at the offering price of $15. Omega’s shares trade on the NASDAQ.

If the email is before the effectiveness date, then HH needs a safe harbor. The WSJ does not need a safe harbor (4(a)(1) – not an issuer, underwriter, or dealer). This would be a good FWP if it had a legend and was filed – it is accompanied by a prospectus. However, it looks like there aren’t any good safe harbors.

**Resales**

1. Sixteen months ago, Beatrice purchased 1,000 unregistered Chromium Mines, Inc. common shares through a private placement. Much to her surprise, Beatrice has just been admitted to the prestigious and expensive Padooka University graduate school. If Beatrice now sells her Chromium shares to pay the tuition deposit demanded by Padooka University, will she violate Section 5?

In the olden days pre-Rule 144, this was a harder question! Without Rule 144, Beatrice would have to show that she had investment intent sixteen months ago, but things had changed with her situation. Now, with Rule 144, she is free to sell because it has been longer than 12 months.

2. A year ago, Burt acquired 1,000 shares of SunTech Inc. in a private placement. SunTech’s annual report, which has just been released, reflects that earnings have quadrupled in the past year. Burt is both ecstatic and in need of cash for a new addition to his house and has approached his neighbor Carol, a broker-dealer, about possibly reselling the shares. Carol offers to contact several of her clients about their purchase of Burt’s shares. Burt agrees. Before Carol actually begins soliciting her clients, she asks your advice. What would you tell Carol?

Again, Burt is ok because it has been over 12 months.

3. Orange Company, Inc. is a highly successful software company, its shares are traded on Nasdaq, and it has a six-member board of directors. Alice, who owns 28.3 percent of the outstanding Orange common shares and is Orange’s largest shareholder, has asked Bob, a broker with Fedder Investments, Inc., to sell in the market approximately one-third of her Orange shares. Bob is aware that three of the six members of Orange’s board of directors are Alice’s nominees. Bob has also been asked by Carl, one of Alice’s nominees, to sell his Orange shares. Advise Alice, Bob and Carl whether they have any Section 5 concerns. Assume the shares held by Alice and Carl were issued four years ago pursuant to a registered public offering.

The only concern for Alice and Bob is whether they are “control persons” or “affiliates.” If so, then they can resell the registered shares, but Rule 144 places volume restrictions on affiliates, even for unrestricted (registered) shares. Alice definitely is an affiliate, and so is Carl.

4. Jeff is the owner of 10,000 unregistered Apex common shares that he purchased in a private offering in July 2020. He now wishes to sell some of these shares. Assume the shares Jeff owns in Problem A were initially issued to Jeff pursuant to the intrastate offering and that he wishes to resale the shares.

Under amended Rule 147 and new Rule 147A, purchasers in intrastate offerings have to hold their shares nine months before reselling them (for offerings after March 15, it will be six months). Jeff needs to hold his shares until April to resell.

5. Frumble Motors Acceptance Corporation (FMAC) needs to quickly raise $70 million by issuing five-year bonds carrying an 8 percent interest rate. FMAC common shares are traded over Nasdaq. With time being of the essence, a registered public offering is not practicable. Marge, FMAC’s Chief Financial Officer, has excellent ties to numerous financial institutions. She seeks your advice on which of the following strategies FMAC should pursue. Under Option I, Marge, by mail and phone, will solicit approximately 200 large financial institutions to buy the unregistered bonds. Option II calls for FMAC first placing all the bonds with an investment banking firm with the understanding that the investment banking firm will dispose of the bonds by selling them to the same 200 large financial institutions targeted in Option I. You are told that each of the financial institutions has an investment portfolio in excess of $100 million. Which of these two options do you recommend?

Option 1 sounds like a Regulation D 506 offering, but the 200 phone calls sounds like general solicitation. Under the amended 506(c), Marge could engage in general solicitation as long as all purchasers are accredited investors. These financial institutions would be accredited investors. Option II sounds like a Rule 144A transaction where the first purchaser sells to QIBs. In either case, the shares are restricted. Now that 506(c) has been amended, these two paths are pretty similar.

6. Assume Bancorp purchased 20 percent of the FMAC bonds sold through the investment banker in Problem #9. Three months after this purchase, Bancorp is in financial distress and simultaneously sells half the FMAC bonds to its cross-town rival, Citizens’ Bank, and the remaining half to seven wealthy, albeit unsophisticated, individual investors. Does FMAC or its investment banker have any exposure under Section 5 because of Bancorp’s resale? What are Bancorp’s problems under Section 5?

Rule 144A can only be used to resell the bonds to QIBs, not accredited individual investors. However, new Section 4(a)(7) allows for resale without a holding period to accredited investors.

**Previously Used Exam Questions:**

1. **(10 points)** In recent years, an alternative to student loan financing has emerged: the Income-Share Agreement (ISA). As an example, if Buzz Lightyear wanted to borrow money to go to Star Ranger Academy, then he might sign an ISA with a lender (maybe the Academy), which would loan him the required $50,000 in tuition. However, instead of Buzz repaying the $50k in standard payments at a standard rate, Buzz will repay the loan after graduation for a fixed term, but pay 17.5% of Buzz’s salary as payment. If the term is ten years, and Buzz makes $25k a year, Buzz will repay only $43,750. However, if Buzz makes $50k a year, Buzz will repay $87,500. **Legislators have consumer protection concerns, but briefly analyze here whether or not the ISA is a “security.”**

This question is a “is this a security” question. A good answer would start by looking at the 2(a)(1) definition. Because ISA is not there, the answer would then analyze the ISA under “investment contract,” including the Howey Test. The kicker here is that Buzz is the “issuer,” so we look at whether the lender’s profit comes from anyone else’s efforts (Buzz’). A good answer would also look at this under the Reves test for notes.

1. **(20 points)** A venture-backed startup company, Infinity Gauntlet, Inc., which owns a chain of novelty stores carrying licensed merchandise from movies, television, video games, and comic books, is planning an IPO. Infinity Gauntlet’s managers are looking toward an August 1, 2019 IP0 filing and attempting to be circumspect about communications that might violate SEC rules. However, Infinity Gauntlet’s CEO, Thanos, loves to post on the company’s Instagram account. Mostly, he posts pictures of new merchandise or items from his own valuable collection of memorabilia. Sometimes, he posts gifs relating to population control, which annoy most of the managers and the general counsel.

On July 4, Thanos posts a picture of fireworks with the caption “Proud to be an American! I’m learning so much about the U.S. capital markets and the NYSE! What a country!”

On July 24, Thanos posts a gif from the video game “Oregon Trail,” with the caption “Love Pioneer Day! Infinity Gauntlet is a pioneer in the novelty industry! We are trekking to new markets every day – 300 new stores by the end of the year!”

On July 31, Infinity Gauntlet sponsors the online live trivia game, HQ, which broadcasts each night at 8:00 CT. Thanos appears with the show’s host, Scott Ragowsky, and talks up Infinity Gauntlet merchandise and stores. The 15 trivia questions that night center on pop culture and each end with a picture of related merchandise from the stores. In between questions, Scott asks Thanos about the future of his stores, given the rise of internet shopping. Thanos responds, “You should ask me that question tomorrow, Scott. Tonight I’m on HQ, but tomorrow we are on EDGAR.” Scott looks really confused.

On August 1, 2019, Infinity Gauntlet files its Form S-1 with the SEC. Investors seem concerned by some of the things in the filing and question whether the business model will survive internet shopping, among other problems.

For example, on August 3, a reporter for Fobes.com writes an article recommending investors pass on another “retail time bomb,” citing the disappointing J. Jill IPO.

Thanos wants to respond to these concerns, so he returns to Instagram. “We are not J. Jill!” – he posts this caption with a gif of a frumpy, middle-aged woman. Minutes later, he posts a picture of Warren Buffet with Thanos’ face. “Infinity Gauntlet stock is a great bet!”

**Discuss whether anyone mentioned here has violated Section 5.**

This question is just a longer form of the hypos above. A good answer would look at every communication, verbal and written in the description.

1. **(10 points)** Luke Skywalker has begun his career as a Jedi Knight. Although not particularly lucrative, the job affords him some disposable income that he would like to use to invest in worthy enterprises. After doing a lot of research, he purchases shares of Millennium Falcon, Inc. on the New York Stock Exchange in its IPO. Millennium Falcon manufactures vehicles with exceptional fuel economy, boasting that its most expensive models can drive 113 miles per gallon of fuel. The Registration Statement on Form S-1 for the company (declared effective March 30, 2019) contains the statement “We are committed to safeguarding this planet for our children, grandchildren, and future generations” and also “Our company is built on integrity.” The Registration Statement repeats the factual information about its vehicles that it lists in their brochures. Luke purchases 100 shares for $50 each on April 15, 2019. On June 3, 2019, a “60 Minutes” episode airs that exposes Millennium Falcon’s bribery of Department of Transportation officials, who certified the “miles per gallon” fuel economy data in the brochures. This bribery involved high-ranking officers of the company and 8 out of 10 vehicle models over 5 years.

On June 4, Millennium Falcon stock opened at $49, down from $60 the day before. By the end of the day, it was at $39. Luke joins a class action lawsuit against Millennium Falcon.

**Discuss the probability of success of Luke’s lawsuit based on statements in the Registration Statement.**

**This is a Section 11/10b-5 question because of a material misstatement in the registration statement. A good answer would start with the fact that because Luke purchased shares in the IPO, he has a cause of action under Section 11. He will have to meet the tracing requirement. If he can’t, he still has a 10b-5 causes of action. In a Section 11 claim, Luke just has to prove materiality. A good answer would talk about materiality v. puffery. A good answer would also discuss the fact that if Luke has to sue under rule 10b-5, he has to prove materiality, reliance, scienter, and loss causation. The bribery probably allows for scienter, but the answer would need to discuss loss causation and the price drop.**