

THE PROCESS OF “GOING PUBLIC,”
AND ACCOUNTANT LIABILITY
UNDER THE FEDERAL SECURITIES LAWS

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FEDERAL SECURITIES LAWS:

HOW THEY WORK,

AND

WHAT IT MEANS TO

“GO PUBLIC”

I. THE FEDERAL SECURITIES LAWS: HOW THEY WORK, AND WHAT IT MEANS TO “GO PUBLIC”

A. OVERVIEW OF SECURITIES REGULATION

Securities Act of 1933 (“Securities Act”)

Securities Exchange Act of 1934 (“Exchange Act”)

1. Generally:

- a. The first of the federal securities laws enacted.
- b. They constitute virtually the entire body of general securities regulation.
- c. Passage of the Acts were prompted by the offering abuses of the post war decade:
 - (1) Some \$50 billion of new securities were floated just in the United States.
 - (a) Half of those, \$25 billion, were worthless.
 - (b) There were virtually no regulations on what could be said or done.
 - (2) Market speculation was in a frenzy:
 - (a) 55% of all personal savings were used to purchase securities.
 - (b) A significant amount of investment was on margin with no limit on the amount of credit that could be extended.
 - (3) The total value of all NY Stock Exchange listed securities declined from a high in 1929 of \$89 Billion to \$15 billion in 1932- a drop of over 80%.

2. The Securities Act:

- a. When President Roosevelt recommended the legislation that was to become the Securities Act, he stated that there was an “obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.”
- b. The Securities Act regulates the public offering and sale of securities in interstate commerce and puts the burden of telling the whole truth on the seller.
- c. It was designed to protect investors against fraud through:
 - (1) full and fair disclosure,
 - (2) the imposition of civil liabilities, and
 - (3) the promotion of ethical standards.

- d. The heart of the Securities Act is the mandatory registration process which creates what essentially is a “licensing” requirement for both potential issuers and for the issue itself.
- e. Section 5 of the Securities Act is the provision that requires newly issued securities to be registered with the Securities and Exchange Commission (“SEC” or the “Commission”) before they may be marketed.
- f. Section 5, is divided into three parts which roughly correspond to three important time periods: the pre-filing period, the waiting period, and the post-effective period.
 - (1) The pre-filing period:
 - (a) The time when the issuer contemplates a public offering of its securities, but a registration statement has not yet been filed with the SEC.
 - (b) At this stage, it is unlawful for issuers, underwriters and/or dealers to buy or sell, or offer to buy or sell, the issuer’s securities.
 - i) This prohibition ensures investors are not “pre-sold” on the issuer’s securities by information other than that contained in a registered prospectus.
 - (c) Certain negotiations are permitted:
 - i) Negotiations and agreements between the issuer and underwriters are permitted.
 - ii) This provision allows an issuer to make a firm contract to sell its securities to an underwriter prior to incurring the expense of preparing the registration statement.
 - a) Negotiations are also allowed among underwriters.
 - (d) Some dissemination of information is permitted, as long as it is normal business conduct.
 - (e) However, neither an issuer nor an underwriter can disseminate news releases:
 - i) that discuss the securities to be issued; or
 - ii) give promotional information about the company if the purpose and effect of such release of information is to procure or solicit advance interest in participating in the underwriting and advance purchase orders for the securities to be underwritten.

- g. The waiting period:
- (1) The time when the registration statement has been filed, but the SEC has not declared it to be effective.
 - (2) Generally, actual sales of the securities are still not permitted.
 - (a) However, sales between the issuer and the underwriters or among underwriters are permitted.
 - (3) Underwriters may now arrange with brokers and dealers for their assistance in selling the issue to retail customers.
 - (4) Both underwriters and dealers may solicit offers to purchase so that when the registration statement becomes effective, the securities may be sold rapidly.
 - (5) Regulation of activities:
 - (a) Oral offers during the waiting period are not regulated by the Act.
 - i) However, television and radio advertisements are prohibited.
 - (b) Written offers are regulated.
 - i) Essentially, any written material is prohibited.
 - ii) Tombstone ads and preliminary prospectuses, also known as red herrings, are allowed.
 - (6) During this waiting period, no offers may be accepted.
 - (7) The broker-dealer participating in the offering must take reasonable steps to assure that each sales person who will offer the securities receives copies of the preliminary prospectus and, later, the final prospectus.
- h. The post-effective period:
- (1) The time period after the registration statement becomes effective.
 - (2) Actual sales may now begin.
 - (3) Offers solicited during the waiting period are usually accepted at this time.
 - (4) Use of the preliminary prospectus must be discontinued.
 - (5) A statutory prospectus must be provided.
 - (a) Generally, it must precede or accompany the delivery of securities.
 - (b) Sales literature may be used to supplement the statutory prospectus, as long as the prospectus accompanies or precedes this literature.

- (c) Sales may be accomplished in person or by telephone without furnishing the buyer with a statutory prospectus in advance.
 - i) However, the prospectus must precede or accompany any later written confirmation of the sale or delivery of the security.
- (d) The statutory prospectus must be used as long as the original distribution is taking place
 - i) However, it must be used for at least forty days after selling begins.
 - ii) If it is the issuer's first public offering, it must be used for at least ninety days.
- (e) If the statutory prospectus is utilized for longer than nine months, most likely the prospectus must be updated.
 - i) The information in the prospectus may not be more than sixteen months old.
- (f) The prospectus should be updated any time there is a change or development in new material facts.
 - i) Use of a prospectus which is misleading as to a material fact can result in liability under the Securities Act.
- (6) The effect of Section 5 is to require a prospective issuer of securities to file with the SEC a registration statement, by means of which the issuer must disclose extensive financial information and certain other information about the issuer and its management and business.
- (7) The registration statement is divided into two parts:
 - (a) the prospectus which is required to be delivered to the purchaser of a security before the purchaser may actually take delivery; and
 - (b) the part that contains information required primarily as background material for the more important and specific information contained in the prospectus.

3. The Exchange Act:

- a. It was enacted almost exactly one year after the Securities Act.
- b. Its purposes include:
 - (1) to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions;

- (2) the safeguarding of securities related thereto;
- (3) to impose requirements necessary to make the regulation and control of the systems reasonably complete and effective; and
- (4) to ensure the maintenance of fair and honest markets.
- c. The heart of the Exchange Act is Section 12 which requires that certain kinds of securities be registered with the SEC be publicly traded on an exchange.
- d. Pursuant to Section 12, large public companies are required to register their securities by filing a registration statement with the SEC containing standard issuer information and any additional information as required by the SEC.
- e. Companies whose securities have been registered pursuant to Section 12 are referred to as “reporting” companies.

4. Role of the independent CPA:

- a. The CPA issues a certificate, under its name, which attests to the accuracy, completeness, consistency, and fairness of the financial statements.
 - (1) This certificate is issued only after the CPA has undertaken an independent investigation (an audit) of the financial statements.
- b. By certifying these financial statements, which become public reports that collectively represent the financial status of a corporation, the independent auditor assumes a public responsibility.
 - (1) Ultimately, the CPA’s loyalty is to the corporation’s creditors and stockholders as well as to the investing public.
 - (2) This “public watchdog” function requires the CPA to maintain total independence from the client.
- c. The SEC has consistently emphasized that auditors must be independent of the company being audited.
- d. The test for whether an auditor is independent is whether a reasonable investor, who knows all of the relevant facts and circumstances, would believe that the auditor:
 - (1) had no mutual or conflicting interest with its client; and
 - (2) exercised objective and impartial judgment with regard to all issues brought to the auditor’s attention.

B. PREPARATION OF THE REGISTRATION STATEMENT.

- 1. **The central objective of the Securities Act:** the preparation of a registration statement for securities offered to the public.

2. What must be disclosed:

- a. All material facts:
 - (1) The SEC has discretion over what is material.
 - (2) However, the Supreme Court has defined material information as that which might have been considered important by a reasonable investor.
- b. Financial information:
 - (1) Balance sheets:
 - (a) Generally, the issuer must publicly release a balance sheet dated not more than ninety days before the filing.
 - (b) If the effective date of the registration statement is delayed, the balance sheet must be updated.
 - (2) Profit and loss statement:
 - (a) Generally, the issuer must include a year to date statement of net income and statements of net income for at least the past three years.
- c. Management discussion and analysis:
 - (1) It must be included in the registration statement for certain Exchange Act filings.
 - (2) Management must discuss significant factors that are characteristic of and necessary for an understanding and evaluation of the company.
- d. Other material facts such as:
 - (1) Facts affecting the price or value of the securities.
 - (a) For example: the difference between the book value of the issuer's presently issued shares and the offering price of the new shares.
 - (2) Any substantial disparity between the public offering price and the cost of shares owned by such people as the officers, directors, and promoters.
 - (3) If the issuer is a new company, the factors used to determine the offering price of securities.
 - (4) The use of proceeds from the offering.
 - (5) Any restriction on the use of the issuer's earned surplus that might limit the possibility of future dividends.
 - (6) Facts that may make the securities a high risk. For example:
 - (a) absence of any operating history for the issuer;
 - (b) no earnings history or an erratic pattern of earnings;
 - (c) competitive conditions in the industry; and
 - (d) the issuer's reliance on only one product or a limited product line.

- (7) Facts regarding the status of the issuer. For example:
 - (a) government regulations that could affect the business;
 - (b) pending or threatened litigation of a substantial nature against the issuer; and
 - (c) the intention of the issuer to enter into a new line of business or change its line of business.
- (8) Facts regarding conflicting interest transactions. For example:
 - (a) transactions and proposed transactions aggregating \$60,000 or more must be disclosed if they are between the issuer, or any subsidiary, and any of the following:
 - i) a director or executive officer of the issuer;
 - ii) a nominee for election as a director;
 - iii) any security holder owning or voting more than five percent of any class of voting securities of the issuer if the issuer knows of this ownership or voting power; and
 - iv) any member of the immediate family of any of the above.
- (9) Facts regarding legal proceedings against directors and executives.
- (10) Facts regarding environmental litigation.
- (11) “Soft information” or “forward looking information.”
 - (a) Companies can provide potential investors with information regarding the future of the company. For example:
 - i) financial projections;
 - ii) plans for expansion; and
 - iii) statements made by or on behalf of the issuer by an outside expert reviewer retained by the issuer.
 - (b) The statements should comply with the following requirements:
 - i) A good faith and reasonable basis for the information:
 - a) Experience or past accuracy in making projections may indicate that they were made in good faith with a reasonable basis.

- ii) A duty to update:
 - a) Projections must be updated and assumptions must be restated when new information indicates that the earlier statements are no longer reasonable.
- iii) Compliance with annual reporting requirements:
 - a) Companies that are required to file 10-K annual reports with the SEC under the Exchange Act must file their most recent report to qualify for the safe harbor protection.

3. **Effective date:**

- a. The registration statement becomes effective on the twentieth day after its filing with the SEC.
 - (1) The effective date is automatic unless it is the subject of refusal or stop order.
 - (2) However, almost always, several amendments will be required before the SEC declares the registration statement effective.
 - (a) An amendment starts the twenty day waiting period running anew.
- b. The SEC will normally accelerate the effective date as soon as all the problems with the registration statement have been resolved.

4. **The SEC review procedure:**

- a. Deferred review:
 - (1) An initial review of the registration statement.
- b. Cursory review:
 - (1) Comes after an initial review.
 - (2) If the registration statement appears to be proper, the SEC will indicate to the registrant that only a cursory review has been made, and the statement will be declared effective on the date and time requested.
- c. Summary review:
 - (1) The SEC notifies the issuer that the statement will be declared effective on the receipt of:
 - (a) the same type of information required for a cursory review; and
 - (b) acceptable responses to comments made by the SEC.

- d. Customary review:
 - (1) The SEC conducts a thorough accounting, financial and legal review.
 - (2) Conducted on all first time issuers.

5. Forms:

- a. Prior to 1982, if an issuer wanted to register securities under the Securities Act, it filed a form S-1 registration statement which included full registrant and transaction oriented disclosure.
 - (1) This requirement made sense for first time issuers, but not for issuers who had been through the process and had been continuously updating information in reports filed under the Exchange Act.
 - (2) Therefore, the Commission decided to integrate disclosure and promulgated two new forms: forms S-2 and S-3.
 - (a) These two forms allow a company to incorporate by reference some of the information previously filed with the Commission.
- b. General requirements:
 - (1) Form S-1:
 - (a) The long form available to any issuer.
 - (b) It requires that the prospectus contain complete registrant and transaction information.
 - (c) As a practical matter, it is used by first-time issuers and companies with publicly held securities but only a limited number of shareholders.
 - (2) Form S-2:
 - (a) Requires a lesser degree of detail in disclosure.
 - (b) Registrants must satisfy certain requirements to use this form.
 - i) For example, the issuer must have been filing reports under the Exchange Act for at least three years.
 - (c) Registrants must choose to either:
 - i) deliver a copy of their annual report and a prospectus to security holders or
 - ii) include registrant-oriented information, comparable to that of the annual report, in the prospectus.
 - (d) Certain Exchange Act filings, like the form 10-K, are incorporated by reference.
 - (3) Form S-3:
 - (a) It requires the least detailed level of disclosure.

- (b) It is available to registrants engaging in specified transactions and meeting the same tests required for use of the form S-2.
 - i) For example, in an offering of common stock in exchange for cash, the outstanding voting and non-voting common stock held by nonaffiliates must have a market value of at least \$75 million.
 - (c) The prospectus does not need to contain registrant information, unless there has been a material change in the issuer's affairs which has not been reported.
 - (d) Only the transaction-specific description of the offering needs be specified in the prospectus.
 - (e) Certain Exchange Act filings, like the Form 10-K, are incorporated by reference.
- c. Other forms:
- (1) Form S-8: available to Exchange Act reporting companies that offer securities to employees pursuant to an employee benefit plan.
 - (2) Form S-4: may be used for registration of securities issued in mergers, combinations, consolidations, acquisitions of assets, and recapitalizations.
 - (3) Form SB-2: available to small issuers for an unlimited amount of securities (issuers with revenues less than \$25 million).
 - (4) Form N-1, N-1 A, and N-2 are for registration of securities issued by registered investment companies.
 - (5) Form S-11: available for securities issued by certain real estate investment companies and trusts.
 - (6) Form F-6: available for the registration of American Depository Receipts with respect to depositories holding securities of foreign issuers.

6. Exchange Act filing requirements:

- a. Form 10-K, annual report:
 - (1) Includes extensive descriptions of the company's business, audited financial statements for the fiscal year, and management's discussion and analysis of the position and performance of the company.

- b. Form 10-Q, quarterly reports:
 - (1) The disclosures include unaudited interim financial statements for the company as well as management's analysis of the company's financial operations and conditions.
- c. Form 8-K, reports upon the occurrence of certain materially important events:
 - (1) Must be filed within fifteen days of the occurrence of a material development.
 - (2) For example:
 - (a) changes in who controls the company;
 - (b) changes in the company's auditors;
 - (c) resignation of a director over a dispute over policy; and
 - (d) commencement of insolvency proceedings.
 - (3) Typically short and limited to providing the specific information which triggered the need to use the form.

C. THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995.

1. The purposes of the Reform Act:

- a. One purpose is to lower the cost of raising capital by combating frivolous suits.
 - (1) Recently, there has been an increase in the filing of frivolous "strike" suits whereby lawyers file suit in the hope that defendants will quickly settle to avoid the expense of litigation.
- b. Another purpose is to encourage voluntary disclosure of certain forward-looking information by issuers.
 - (1) With the constant threat of mass shareholder litigation, companies have been increasingly reluctant to volunteer forward-looking information.

2. A side provision of the Reform Act created Section 10A of the Exchange Act.

- a. This provision changed auditor's duties with regard to the auditing of public companies.

3. Changes in auditor's duties:

- a. Prior to the Reform Act:
 - (1) Generally, according to accounting and securities regulations, upon discovery of fraudulent or illegal conduct, auditors were sometimes required to resign and report to the SEC the existence of certain conditions.

- (2) However, nothing in the securities laws specifically required that public company audits be designed to detect illegal conduct or insider transactions.
- b. After the Reform Act:
 - (1) Each audit of a public company by an independent CPA must include procedures that are:
 - (a) in accordance with GAAS,
 - (b) designed to provide reasonable assurance of detecting illegal acts that have a direct and material effect on the figures set forth in the financial statements,
 - (c) designed to identify related party transactions that are material to the financial statements, and
 - (d) designed to identify other transactions required to be disclosed in financial statements.
 - (2) Additionally, auditors must evaluate whether there is substantial doubt about the issuer's ability to continue as a viable entity in the next year.

4. **Auditor's reporting requirements:**

- a. If auditors become aware of an illegal act, they must consider the possible effect of the illegal act on the financial statements.
 - (1) Consideration must be given to any contingent monetary effects, such as fines or penalties, that the company may incur.
- b. Upon detecting an illegal act, auditors may have a first level reporting duty and a second level reporting duty.
 - (1) The first level reporting duty:
 - (a) It is required even if auditors do not perceive the illegal act as having material effect on the company's financial statements.
 - (b) It is not required if the auditors determine that the illegal act is clearly inconsequential.
 - (c) The duty requires auditors to:
 - i) inform the appropriate level of the company's management; and
 - ii) take steps to assure that the company's Audit Committee, or Board of Directors if no such committee exists, is adequately informed of the situation.

- (2) The second level duty:
 - (a) It is required if auditors determine that:
 - i) the illegal act will have a material effect on the financial statements; and
 - ii) senior management has not taken immediate remedial action.
 - (b) The duty requires auditors to:
 - i) issue a qualified audit report; or
 - ii) resign from their engagement, and upon resignation, report their conclusions directly to the Board of Directors.
 - (c) Within one business day after receipt of such an auditors' report, the Board of Directors must notify the SEC and provide a copy of that notice to the auditors.
 - (d) If the auditors do not receive documentation of the company's notice to the SEC, the auditors must resign and furnish a copy of their report directly to the SEC.

5. Penalties for non-compliance.

- a. If an independent auditor willfully violates the Reform Act's requirements:
 - (1) the SEC may impose a civil penalty; and
 - (2) the auditor may be banned from practice before the SEC.

6. Other changes resulting from passage of the Reform Act.

- a. Joint and several liability:
 - (1) If the defendant knowingly violated securities laws, joint and several liability is imposed.
 - (2) If the defendant did not knowingly violate securities laws, the defendant is liable for a proportionate share of the damages.
- b. Aiding and abetting:
 - (1) Prior to 1994, accountants and accounting firms were often sued by private parties on the theory of aiding and abetting.
 - (2) In 1994 the Supreme Court ruled that the federal securities laws did not allow recovery against those who merely aided and abetted in securities fraud.
 - (3) However, the Reform Act contains a provision which permits the SEC to bring suits in reliance on the aiding and abetting theory.

D. SECTION 13(d) OF THE EXCHANGE ACT.

1. Generally:

- a. During the 1960's, securities markets experienced a substantial increase in tender offers used to effect corporate mergers.
- b. The competitive atmosphere and vehemence with which such takeover campaigns were waged became extreme.
- c. This climate led to amendments to the Exchange Act in 1968.
- d. These amendments are called the Williams Act amendments.
- e. Section 13(d) is one of those amendments.
- f. Section 13(d) focuses on the open market and privately negotiated acquisitions of securities that are subject to the Exchange Acts reporting requirements.

2. Filing requirements:

- a. If a person acquires more than five percent of a class of equity securities, a disclosure statement must be filed with the SEC.
- b. The statement must be filed within ten days of reaching the five percent threshold.
- c. Acquisition of the securities may be for direct or indirect beneficial ownership.
- d. If any material change occurs which would result in a change in the information filed, a new disclosure statement must be filed.

3. Standing:

- a. Unresolved.
- b. May be limited to the company and its shareholders.

4. Requirements:

- a. Unresolved.

5. Statute of limitations:

- a. Unresolved.

E. RULE 14a-9 OF THE EXCHANGE ACT.

1. Generally:

- a. Rule 14a-9 is another one of the Williams Act amendments.
- b. The purpose of this Section is to protect the rights of shareholders whose interest in the corporation is likely to be affected by proxy rule violations.
- c. This rule is the general antifraud provision applicable to proxies.

- d. It prohibits the making of any false or misleading statement in connection with any solicitation covered by the rules.
- e. It is immaterial whether the statement is in the proxy or any other written or oral communication.

2. **Examples:**

- a. predictions as to specific future market values; and
- b. material which impugns character, integrity or personal reputation without factual foundation.

3. **Standing:**

- a. Shareholders.

4. **Standard of care:**

- a. Courts are split, but it is probably negligence.

5. **Requirements:**

- a. Material misstatements or omissions.
- b. Reliance: not required in the 9th Circuit.
 - (1) Reliance refers to the shareholder actually relying on the false or misleading information in making a decision.
 - (2) The theory is that if enough other shareholders were misled, and thus approved the challenged transaction, all shareholders are harmed.
- c. Causation: is required.
 - (1) Causation refers to the false or misleading statement causing the harm.
- d. Injury.

F. **SECTION 14(e) OF THE EXCHANGE ACT.**

1. **Generally:**

- a. Section 14(e) is another one of the Williams Act amendments.
- b. It is an antifraud provision that makes it unlawful for any party making a tender offer--or defending against one--to make untrue statements of material fact; or to omit to state material facts; or to engage in any fraudulent, deceptive, or manipulative act.

2. **Private remedies for violation of Section 14(e):**

- a. Private plaintiffs have three possible remedies:
 - (1) damages;
 - (2) a temporary injunction;
 - (3) permanent injunction (sought by the target to prevent the bidder from going forward with the offer).

- b. Reliance:
 - (1) Courts are split as to whether the plaintiffs must show their individual reliance on a misrepresentation or omission.
 - (2) 9th Circuit stated that reliance in a Section 14(e) case may be inferred from a sufficient showing of causation.
- c. Causation.
- d. Standard of culpability:
 - (1) Unresolved.
 - (2) Most courts adopt the analogy to Rule 10b-5, and require a showing of scienter in all Section 14(e) cases.
- e. Damages:
 - (1) The measure of damages is the same as for Rule 10b-5.

G. SECTION 15(c)(4) OF THE EXCHANGE ACT.

1. Generally:

- a. In 1984 Congress gave the Commission additional power to seek civil penalties.
- b. Specifically, Congress significantly expanded the SEC's administrative powers with regard to persons who cause a company to fail to comply with Exchange Act reporting requirements.
- c. Section 15(c)(4) allows the SEC to sanction persons who do not make required filings, or who make filings that are late or incomplete.

2. Persons subject to Section 15(c)(4).

- a. Any person who is subject to Section 12, 13, 14, or 15(d) of the Exchange Act, and who fails to comply with those provisions.
- b. Any person who knowingly is the cause of such a failure to comply.

3. Remedies.

- a. The SEC may:
 - (1) publish its findings; and
 - (2) issue an order requiring such person to comply with rules and regulations.

4. Standard of care remains:

- a. Undetermined.
- b. However, the SEC's Enforcement Division stated that simple negligence was the standard.

H. SECTION 16(b) OF THE EXCHANGE ACT.

1. Generally:

- a. Section 16(b) is designed to prevent corporate insiders from using inside information about their companies to make short-swing profits by buying and then selling or selling and then buying securities of their corporation within a six-month period.
- b. To accomplish this, Section 16(b) requires insiders to file periodic reports of their holdings of the issuer's securities and requires insiders to disgorge any "profits" resulting from the short-swing trading.
 - (1) A short sale is a sale of securities that the seller does not yet own, but plans to purchase just in time to cover the obligations of the sale.

2. Comparison with Rule 10b-5 "insider trading:"

- a. A rule 10b-5 case is based on a misrepresentation or failure to disclose.
- b. Section 16(b), on the other hand, is based on the amount of time elapsed between a purchase and sale of the issuer's securities by an insider.
 - (1) If the amount of time is too short, the insider must give up the "profits," regardless of whether information was misrepresented or withheld.
- c. The presence or absence of fraud is irrelevant to a Section 16(b) case.
- d. Section 16(b) provides that:
 - (1) any officer, director, or 10% owner of any class of an equity security registered under Section 12 who realizes any profit from a purchase and sale or sale and purchase of any nonexempt equity security of the issuer within any period of less than six months shall be liable to the corporation for the profits made from the trading.

3. Standing:

- a. Shareholders.

4. Statute of limitations:

- a. no more than two years after the profit was realized.

1. SEC ENFORCEMENT ACTION.

1. Overview of SEC administrative proceedings:

- a. An SEC administrative proceeding is a quasi-judicial procedure that takes place before an administrative law judge

- b. Most of the formal administrative proceedings conducted by the SEC are disciplinary proceedings to punish alleged violations of the securities laws by persons required to be registered with the SEC and expressly subjected by these laws to such administrative sanctions by the statutes.

2. **SEC injunctive actions:**

- a. When the SEC files a lawsuit, it most often seeks an injunction in federal district court, enjoining those who have allegedly violated or are about to violate the securities laws.
- b. The purpose of an injunction is to prevent future harm and not to punish past misconduct.
- c. The SEC may seek an injunction against any person who is engaged in or is about to engage in acts or practices constituting a violation of the statutes.
- d. Injunctions are usually brought under Rule 10b-5.

3. **Administrative proceedings against professionals pursuant to Rule 2(e):**

- a. Any person compelled to appear before any administrative agency of the United States has the right to be represented by counsel.
- b. In 1970, Rule 2(e) was amended to proscribe conduct that was a willful violation or a willful aiding and abetting of a violation of the securities laws.
- c. Shortly thereafter, the SEC began to assert its present position that, in effect, it may discipline any professional who fails to perform what the SEC deems to be a duty to the SEC.
- d. The SEC may temporarily or permanently deny an accountant the privilege of appearing before it if the accountant:
 - (1) lacks the requisite qualifications;
 - (2) lacks character or integrity;
 - (3) engages in unethical or unprofessional behavior; or
 - (4) willfully violates or aids and abets a violation of the securities laws.
- e. SEC construes “practice before” it to include:
 - (1) appearances before the agency and its staff;
 - (2) filings made with it; and
 - (3) office work by professionals directly related to the federal securities laws.

J. COMMISSIONS RULES OF PRACTICE RULE 102(e).

1. Overview:

- a. In September 1998, the SEC adopted an amendment to Rule 102(e).
- b. Under Rule 102(e) of the Commissions Rules of Practice, the Commission can censure, suspend or bar a professional from appearing or practicing before the Commission.
- c. The amendment clarifies the Commission's standard for determining if an accountant has engaged in "improper professional conduct" and thus is subject to being censured, suspended or barred from appearing or practicing before the Commission.
 - (1) The amendment is intended to encompass violations of professional standards that reveal an accountant's incompetence to practice before the Commission.
 - (2) Ideally, this amendment will encourage professionals to adhere to professional standards and minimum standards of competence.
- d. The amendment was prompted by a recent judicial decision whereby the court found that the Commission failed to clearly articulate the standard for "improper professional conduct."

2. Effective date:

- a. This amendment became effective on November 25, 1998.
- b. It is retroactive; it applies to any past conduct except conduct in litigation.

3. Definition of improper conduct:

- a. The rule sets out categories of conduct that constitute improper professional conduct.
- b. One category encompasses intentional or knowing acts including reckless conduct, resulting in violations of applicable professional standards.
- c. The other category encompasses negligent conduct. There are two alternative forms of negligent conduct that are deemed improper:
 - (1) a single instance of highly unreasonable conduct that violates applicable professional standards where an accountant knows or should know that heightened scrutiny is warranted; and
 - (2) repeated instances of unreasonable conduct, each violating applicable professional standards, that show a lack of competence to practice before the Commission.

4. **Reason for including negligent conduct:**

- a. The SEC contends that an incompetent or negligent auditor can do as much damage as one who acts with an improper motive.

**OVERVIEW OF THE
LIABILITY OF
ACCOUNTANTS
UNDER
FEDERAL SECURITIES
LAWS**

II. OVERVIEW OF THE LIABILITY OF ACCOUNTANT'S UNDER THE FEDERAL SECURITIES LAWS

A. INTRODUCTION.

1. **The Securities Act contains three express liability provisions for private parties.**
 - a. Section 11: liability for misstatements or omissions in a registration statement.
 - b. Section 12(1): liability for offers or sales in violation of Section 5.
 - c. Section 12(2): general civil liability.
2. **These provisions are not available to the SEC:**
 - a. The SEC's Securities Act antifraud enforcement is based on Section 17 which generally prohibits fraud in the offer or sale of securities.
3. **The Exchange Act contains other liability provisions:**
 - a. Rule 10b-5: the general antifraud provision.
 - b. Section 18(a): sets out a private right of action for investors injured due to misleading statements or omissions in documents filed with the Commission.

B. LIABILITY UNDER SECTION 11 OF THE SECURITIES ACT OF 1933 "SECTION 11."

1. **Generally:**
 - a. Section 11 imposes liability on the issuer and others associated with the registration statement for material false or misleading statements or omissions in a registration statement.
 - b. Essentially, the section imposes a due diligence obligation on those involved with the registration statement.
 - c. The purpose of this section is to improve the accuracy of registration statements.
 - d. Improved accuracy in registration statements not only benefits investors, but also aids in the efficient allocation of economic resources.
 - (1) The disclosure of accurate company information allows investors to compare the pros and cons of investing in one company versus another. The result is that capital flows to its most valuable uses.

2. Accountant liability:

- a. Securities Act registration statements must contain certified financial statements.
- b. Auditors that certify the statements are subject to liability under Section 11 as “experts.”
- c. They are subject to liability when a material misrepresentation or omission occurs in a registration statement.
 - (1) However, they are only liable for portions of the registration statement for which they have lent their expertise.
- d. Auditors are not justified in relying upon the client; they must make their own due diligence investigation.
 - (1) Affirmative action must be taken to verify information.
 - (2) Normally, the due diligence requirement merely imposes a duty upon accountants to perform at least up to the standards of their profession.
 - (3) For example, accountants must make an investigation of the facts and state the issuer’s financial results in a manner that conforms to the standards of their profession.

3. Standing:

- a. Anyone who buys stock issued pursuant to a defective registration statement has standing to sue.

4. Requirements:

- a. Lack of knowledge: plaintiff must not have been aware of the truth at the time of purchase.
- b. Reliance: plaintiff must have relied on the registration statement or statutory prospectus.
 - (1) There is a conclusive presumption of reliance for any person purchasing the security prior to the expiration of twelve months.
 - (2) Where the plaintiff has acquired the securities more than twelve months after the effective date of the registration statement, and the issuer distributed an earning statement for that period, then the plaintiff must prove reliance on the misstatement or omission.
- c. Tracing requirement: plaintiff must show that the securities purchased were issued pursuant to the registration statement in question.
- d. Materiality:
 - (1) The statement or omission must have been material.

- (2) Materiality is considered in light of the “bespeaks caution” doctrine whereby cautionary language in the prospectus may preclude misstatements from being actionable.
 - (a) Cautionary language is not always sufficient to prevent a claim.
 - (b) Such language must be sufficient to negate any reasonable reliance on predictions that may appear optimistic.
- e. No requirement of privity, causation, or injury.

5. Statute of limitations:

- a. Suit must be brought within one year after discovery of the falsity or omission that was or should have been made.
- b. Suit may not be brought more than three years after the security was offered to the public.

6. Standard of care:

- a. Accountants are held to a standard of simple negligence, reasonableness.
- b. The standard of reasonableness is that required of a prudent man in the management of his own property.
- c. Considerations in determining whether or not the conduct of an accountant constitutes a reasonable investigation or a reasonable ground for belief:
 - (1) type of issuer;
 - (2) type of security;
 - (3) type of person;
 - (4) office held by the person providing the information, if that person is an officer;
 - (5) presence or absence of another relationship to the issuer, if the person providing the information is a director; and
 - (6) degree of reliance on officers, employees and others whose duties should have given them knowledge of the particular facts.
 - (a) Specifically, with respect to a fact or document incorporated by reference, the person’s level of responsibility for that fact or document at the time of filing.
- d. In other words, courts will look to what kind of investigation would have been conducted by a person in the defendant’s position, with the same responsibilities, skills, and knowledge.

7. Defenses:

- a. Due diligence defense:
 - (1) No liability for misstatements or omissions if:
 - (a) after reasonable investigation, the auditor had reasonable ground to believe and did believe at the time such part of the registration statement became effective that the statements therein were complete and accurate.
 - (2) No liability if the statement in the registration materials:
 - (a) did not fairly represent the auditor's statements as an expert, or
 - (b) was not a fair copy or extract of the auditor's report or evaluation.
 - (3) The burden of due diligence investigation lies solely upon the auditor; others have a qualified right to rely upon the auditor's efforts.
- b. Whistle blowing defense:
 - (1) No liability if, prior to the effective date, the auditor:
 - (a) resigns from the position that connects him with the registration statement, takes all legal steps toward resignation, or ceases to act in that capacity;
 - (b) gives written notice to the issuer and the SEC of such action; and
 - (c) further disclaims all responsibility for the applicable parts of the registration statement.
 - (2) If the registration statement becomes effective without the auditor's knowledge, liability may be avoided by:
 - (a) taking appropriate steps toward resignation;
 - (b) advising the SEC; and
 - (c) giving reasonable public notice that such part of the registration statement had become effective without his knowledge.

8. Damages:

- a. The maximum amount recoverable from all defendants is the aggregate public offering price of the entire issue.
- b. There is a presumption in favor of recessionary measure of damages based upon the difference between the amount paid for the security, so long as that does not exceed the offering price, and
 - (1) its value at the time of the suit;

- (2) the consideration received on resale if the security was sold before the suit; or
- (3) the consideration received if the security was sold after the suit, but before judgment, if that would produce a lesser measure than that stated in H.2.a.

C. SECTION 12(1) OF THE SECURITIES ACT.

1. Generally:

- a. Section 12(1) provides a rescission remedy to purchasers of securities that were required to be registered under Section 5, but were not registered.
- b. The action may be brought only against the “seller” of the securities.
 - (1) “Seller” includes persons:
 - (a) who solicit the purchase of securities; and
 - (b) who actually pass title to the securities.
- c. Section 12(1) imposes liability on any person who offers or sells a security in violation of any provision of Section 5 of the Securities Act.
 - (1) Such violations may include:
 - (a) the sale of unregistered securities;
 - (b) failure to deliver a required prospectus;
 - (c) making an illegal offer during the pre-fling period; and
 - (d) filing a registration statement with false or misleading statements or material omissions.

2. Standing:

- a. Any person who purchased the securities in violation of Section 5.

3. Requirements:

- a. offer or sale of securities;
- b. violation of Section 5 of the Securities Act; and
- c. privity of contract between the plaintiff and the defendant.
- d. There is no requirement of reliance or causation.

4. The standard of care:

- a. Strict liability.
 - (1) This means that the state of mind of the defendant is immaterial.

5. The statute of limitations:

- a. Same as for Section 11.

6. Defenses:

- a. there was no sale of a security;
- b. there was no violation of Section 5;
- c. there was no privity between the parties; or
- d. the statute of limitations has run.

D. SECTION 12(2).

1. Generally:

- a. Section 12(2) provides a rescission remedy to purchasers of securities sold by means of a prospectus or oral communication that contained a materially misleading statement or omission.
- b. The action may be brought only against the “seller” of the securities.
 - (1) According to the 9th Circuit, because the language in Section 12(2) is identical to that of Section 12(1), the term “seller” should have the same meaning.

2. Prohibits fraud in the interstate offer or sale of securities.

- a. It applies whether or not the securities:
 - (1) were registered pursuant to Section 5 of the Securities Act;
 - (2) were offered pursuant to an exemption from such registration; or
 - (3) were offered in writing or orally.

3. Standing:

- a. Any person who purchased the securities in issue.

4. Requirements:

- a. offer or sale of securities;
- b. involved the use of interstate commerce or the mails;
- c. occurred through a prospectus or oral communication;
- d. untrue stat or omission of material fact;
- e. defendant knew the statement was untrue or the omission was material; and
- f. privity of contract between the plaintiff and defendant.
- g. causation may be required.
 - (1) Causation refers to the false or misleading statement causing the harm.

5. There is no requirement of reliance.

- a. Reliance refers to the plaintiff actually relying on the false or misleading information in making a decision.

6. **The standard of care:**
 - a. Probably negligence.

7. **The statute of limitations:**
 - a. The same as for Section 11.

8. **Defenses:**
 - a. defendant lacked knowledge of the misleading statement or omission;
 - b. the exercise of reasonable care would not have revealed the misleading statement or omission;
 - c. plaintiff's knowledge of the true facts;
 - d. there was a lack of privity between the parties; or
 - e. the statement or omission was not material.

E. SECTION 17(a) OF THE SECURITIES ACT.

1. **Generally:**
 - a. This section generally prohibits fraud in connection with any offer of securities.
 - b. It is the general provision under the Securities Act for antifraud enforcement by the SEC.
 - c. The language of Section 17(a) is almost identical to that of Rule 10b-5 of the Exchange Act.
 - (1) They differ in that Section 17(a) applies only to "offers" of securities whereas Rule 10b-5 applies to the "offer and sale" of securities.
 - (2) A defendant can be prosecuted under both provisions.

2. **Standing:**
 - a. Undecided.
 - b. However the judicial trend is not to allow private parties to utilize this section.

3. **Requirements:**
 - a. an offer of securities;
 - b. engaging in fraud;
 - c. causation; and
 - d. reliance.

4. **Standard of care:**
 - a. For injunctive actions, a distinction must be made between subsections of Section 17(a).
 - b. Some subsections require a showing of scienter while others require a showing of mere negligence.

5. **Statute of limitations:**
 - a. The same as for Section 11.

6. **Defenses:**
 - a. no offer or sale of securities;
 - b. no device, scheme or artifice to defraud;
 - c. no untrue statement of material fact or omission of a material fact;
 - d. the standard was not met; or
 - e. no causation or reliance.

F. RULE 10b-5 OF THE EXCHANGE ACT.

1. **Generally:**
 - a. Adopted in 1942 to close a gap in the anti-fraud provisions of the securities laws.
 - (1) Section 17(a) of the Securities Act only covers fraud in the sale of securities.
 - (2) Section 10(b) of the Exchange Act does not specifically cover fraud.
 - (3) Therefore, the Commission combined the language of Section 17(a) with language from Section 10(b) and devised a rule which is sufficiently broad to cover fraud in the purchase and sale of securities.
 - b. It is one of the most frequently utilized actions for fraud available under the Exchange Act.
 - (1) One measure of the frequency of use is the sheer number of cases in which Rule 10b-5 appears.
 - (2) There are over 8,000 federal cases reported that at least mention the rule.

2. **Examples of uses of the rule:**
 - a. Insider trading cases:
 - (1) For example, an officer, director, or other person who has a fiduciary relationship with a corporation buys or sells the company's securities while in the possession of material, non-public information.
 - b. Disclosure cases:
 - (1) For example, a corporation issues misleading information to the public.

- c. Another example is a corporation remains silent when it has a duty to disclose.
- d. Tipping cases:
 - (1) For example, an insider selectively discloses material, non-public information to another party, who then trades securities based on that information.
- e. Manipulation cases:
 - (1) For example, a securities firm or another person manipulates the market for a security traded on the over-the-counter market.

3. Standing:

- a. Investors.

4. Requirements for a private action:

- a. Material misrepresentations or omissions or a deceptive act.
- b. Reliance:
 - (1) The investor relied on the misleading or omitted information.
- c. Causation:
 - (1) The injury was caused by the misleading or omitted information.
- d. Injury:
 - (1) The investor was harmed by the misleading or omitted information.

5. Standard of care is scienter:

- a. Defined as an intent to deceive, manipulate or defraud.
- b. The 9th Circuit has held that recklessness is sufficient to satisfy this standard.
 - (1) Recklessness is more than mere negligence, but less than intent.

6. Damages:

- a. Generally, the measure of damages is the “out-of-pocket” measure:
 - (1) the difference between the price paid or received for securities and their actual value at the time of the purchase or sale.
- b. Another measure of damages is rescission:
 - (1) the plaintiff is entitled to a return of the consideration paid, reduced by:
 - (a) the amount realized when he sold the security; and
 - (b) any income received on the security.

7. Civil penalties:

- a. The amount of the penalty is determined at the discretion of the court. It may be:
 - (1) as high as three times the profit gained or loss avoided as a result of insider trading; or
 - (2) in certain situations, up to \$1.1 million regardless of profit gained or loss avoided.
- b. The Commission can also pay bounties of up to ten percent of the penalty to persons who provide information that leads to the imposition of a penalty.

8. Examples of accountant liability in the 9th Circuit:

- a. An accounting firm is subject to liability under Section 10b-5 when it prepares a fraudulent audit report that it knows its client will include in a form 10-K.
- b. An independent accountant does not violate Rule 10b-5 merely by preparing documents that were never publicly disseminated.
- c. The duty to disclose does not impose liability on accountants for failing to disclose information about improprieties committed by the company, as long as that information was obtained while the accountant was engaged as an independent auditor.
- d. Some type of public statement, or other affirmative act, by the auditor must have occurred in order for there to be a duty to disclose.
- e. An accountant may be liable for violating Rule 10b-5 if:
 - (1) the accountant's participation in the misrepresentation is direct, and the accountant knows, or is reckless in not knowing, that the facts reported in the prospectus misrepresent the condition of the issuer in a material way.
 - (a) The statement or omission need not have been for an audit report, but may instead have been other direct participation in preparing the final documents used to solicit investors.
- f. Scienter is not established by the mere publication of inaccurate accounting figures or a failure to follow GAAP.
 - (1) The plaintiff must prove that the accounting practices were so deficient that the audit amounted to:
 - (a) no audit at all;

- (b) an egregious refusal to see the obvious, or to investigate the doubtful; or
- (c) that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.
- g. An accountant is not a guarantor of reports he prepares.
 - (1) The accountant is only duty bound to act honestly, in good faith and with reasonable care in the discharge of his professional obligations.
- h. Following professional standards, such as GAAP, will not immunize an accountant if that accountant consciously chose not to disclose in a financial statement a known material fact.

G. SECTION 18(a) OF THE EXCHANGE ACT.

1. Generally:

- a. This section sets forth a private right of action for an investor who has been injured due to reliance on materially misleading statements or omissions of material facts in documents required to be filed with the Commission.

2. Liability is imposed upon:

- a. the issuer;
- b. any person who files the document; and
- c. any person who makes or causes to be made any misstatement or omission in any application, report or document filed with the Commission.

3. Standing:

- a. The government or any investor.

4. Requirements:

- a. Actual knowledge:
 - (1) Plaintiff must have read the document fled, or a copy thereof
- b. Reliance:
 - (1) The plaintiff must have actually relied upon statements in the document.
- c. Injury.
 - (1) The plaintiff must have been harmed.

5. Limitations:

- a. It is not sufficient that the plaintiff saw similar information contained in other documents prepared by the issuer.

- b. It only applies to Exchange Act reporting companies.
- c. It does not apply to annual reports which must be sent to shareholders and filed with the SEC, unless the report is incorporated into the proxy statement or other proxy solicitation materials.

6. **Defenses:**

- a. Defendant acted in good faith and had no knowledge that such statement was false or misleading.
 - (1) This defense provides an easier standard than the “due Diligence” defense of Section 11.
- b. The statement was not material.

7. **Statute of limitations:**

- a. One year after discovery.
- b. Not more than three years after the accrual of the cause of action.