14.2: Liability Under the Securities Act

As explained in the previous section, many companies were initially irritated by the creation of the Securities Exchange Act of 1934, as it created a myriad of legal responsibilities and potential liabilities that impacted their business models. Companies came to recognize that they needed legal counsel and internal systems in place to ensure that they were in compliance. The liabilities for not complying with the Securities and Exchange Act of 1934 include not only monetary fines, but also **civil** penalties, and in some cases, **criminal** proceedings. Insider trading is one violation that can result in criminal charges.

Insider Trading

While laws vary from country to country, **insider trading** can be understood by what the SEC defines as the “buying or selling a security, in breach of a **fiduciary** duty or other relationship of trust and confidence, on the basis of material, nonpublic information about the security.” The word fiduciary comes from the Latin word for trust and refers to someone who is charged with the responsibility to act in the best interest of the other party. In the case of businesses, fiduciaries are expected to act in the best interests of their investors. However, they are often aware of information that the public is not. This knowledge has important implications as addressed by Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, which prohibits the purchase or sale of securities on the basis of "**material nonpublic information**,"; meaning information of any kind that would impact the market price of securities that has not been disclosed to the public, i.e., insider information. The directors, large shareholders, and officers of companies frequently have access to nonpublic information that could affect the future value of a security. While an individual, as opposed to an entire company, is often charged as an insider trader, such charges can affect the entire company’s reputation, putting it in a negative light and eroding investor trust.

One instance of insider trading that received widespread media attention involved Martha Stewart, who in 2003 became the subject of legal scrutiny after selling her shares in the pharmaceutical company ImClone. Following the advice of her broker, David Bacanovic, Stewart sold all of her shares of ImClone before it lost 16 percent of its value. Bacanovic represented ImClone CEO Sam Waksal, who was selling $\$5$ million of his ImClone shares. While Bacanovic claimed he did not know why, he shared this information with Stewart. As it turned out, the FDA had not approved ImClone’s primary pharmaceutical product, Erbitux, which was a setback that only insiders were privy to. Stewart avoided a $\$45,673$ loss by selling her shares before the public announcement. Even though Stewart may not have known exactly why ImClone would go down in value, the court decided that her decision to act upon her broker’s suggestion constituted a wrongdoing. Stewart’s role as a public figure was also relevant to this decision, as explained by SEC’s Director of Enforcement Stephen M. Cutler, who said, “It is fundamentally unfair for someone to have an edge on the market just because she has a stockbroker who is willing to break the rules and give her an illegal tip. It’s worse still when the individual engaging in the insider trading is the Chairman and CEO of a public company.”

Figure 14.2.1: Insider trading can result in criminal conviction and possibly jail time. (Credit: Suzy Hazelwood/ pexels/ License: CC0)

Insider trading is not always illegal. In certain instances, individuals in possession of insider knowledge can disclose their trading activity to the SEC. However, disclosure alone is not enough to make trading on the basis of insider information legally acceptable.

Another instance in which the officers of publicly held companies can legally transact securities involves **pre-arranged trading plans**. For example, SEC Rule 10b5-1 permits executives at public companies to transact securities so long as it is arranged in good faith beforehand to take place on certain predetermined future dates and involves pre-set amounts. So long as these criteria are followed, they are granted safe harbor. **Safe harbor**, in this context, refers to exemption from insider trading charges for compliant pre-arranged equity trades.

Schedule 13D

In 1968, the Williams Act amended the Securities Exchange Act of 1934 so that investors could have advance warning of possible corporate takeovers. If someone (individual/corporation) becomes the **beneficial owner** of more than 5% of a company's stock, that entity must file a Schedule 13D with the SEC within 10 days of purchase. A beneficial owner is anyone with "voting and investment power over their shares." There are a few exceptions that apply, such as qualified **institutional investors**—large investors who are deemed to have sophisticated knowledge of securities such that they do not need the same level of protection as general investors. Insurance companies, state employee benefits plans, and investment companies are examples of qualified institutional investors who are allowed to report their holdings at the end of the calendar year.

Insider Transactions

Corporate insiders are those officers, directors, and beneficial owners who own more than 10% of a class of securities, registered under Section 12 of the Securities Exchange Act of 1934. Corporate insiders must file a statement of ownership with the SEC to be in compliance, and as of August 27, 2002, the SEC implemented new rules that shortened the time period to report insider transactions. It is important for a company to have internal controls and a system to ensure their corporate insiders are reporting their trades in a timely fashion. Companies that do not implement and enforce compliance procedures can become liable for the actions of their employees who fail to follow the law.

Reporting Requirements

Publicly owned companies that meet certain size requirements are called **reporting companies**, and per Section 13(a) of the Securities Exchange Act of 1934, they must file periodic disclosures. The purpose of these disclosures is to help investors make educated decisions regarding how to invest their money. These reports include information about a company's line of business, corporate officers and directors, and financial statements.

- **Form 10-K**. Form 10-K, also known as the annual report, contains **audited** financial statements. Audited financial statements have been reviewed by one or more CPAs who are not affiliated with the company and who provide an objective opinion about whether or not the financial statements, such as the balance sheet, income statement, statement of changes to retained earnings, and cash flow statement, conform with accounting standards known as the Generally Accepted Accounting Principles (GAAP). When the Securities Exchange Act of 1934 was first passed, most companies' annual reports contained only the bare minimum amount of information. However, over time, companies came to view their annual reports as a way to not only comply with SEC requirements, but also to attract new investors and impress securities analysts, or financial professionals who study various industries to make recommendations on whether a security should be bought, held, or sold. Today, many annual reports contain not only the required facts, but also compelling narratives that detail the company's mission and strategic goals. The annual reports of certain companies—for example, Berkshire Hathaway, written by Warren Buffett and Charlie Munger—provide not only their opinions on their own operations, known as the **management discussion**, but also their thoughts on the economy overall. The Form 10-K is a large responsibility for a company because it must disclose the company's analysis of its financial conditions, potential market risks, internal controls, legal proceedings, defaults, and other information that is deemed important for investors to make sound investment decisions.
- **Form 10-Q**. Form 10-Qs are quarterly unaudited financial statements that contain financial information. Since they are unaudited, they are less expensive and time-consuming for the company to prepare; however, investors do not have the additional assurance that they have been analyzed by a neutral CPA.
- **Form 8-K**. Certain events require the company to file a Form 8-K, such as a change in the company's officers, mergers, or declarations of bankruptcy. These are required to be filed within four business days with the SEC.
- **Proxy Statements**. Proxy statements are documents that the SEC requires that shareholders of companies with securities registered under Section 12 of the Securities Exchange Act of 1934 receive to allow them to vote on issues that will be decided at a stockholder meeting. This process is commonly applied when voting for directors or deciding corporate actions. Even shareholders who own just one share of a company receive proxy statements; thus, the process of sending out these statements

is a large undertaking for companies. While some companies still use the mail to deliver proxy statements, others send a "Notice of Internet Availability of Proxy Materials" to shareholders a minimum of 40 days before the shareholders' meeting.

Ongoing Responsibilities

Businesses must stay current with changes in securities laws that impact their liabilities and responsibilities. The Exchange Act allows the SEC to make new laws, like it did in 2000 with Regulation FD, which stands for "fair disclosure". In 2013, the SEC started to allow the use of social media channels, in certain circumstances, as a means of distributing information to shareholders.

Summary

These two sections have provided an overview of some of the most important points of the Securities Exchange Act of 1934. Considering the sheer number of exceptions and complexities, coupled with today's rapidly changing technological and political climates, a successful company needs competent legal counsel to help it navigate the compliance requirements of the SEC. While certain illegal actions can be due to malicious intent, such as insider trading, this situation is not always the case; a corporate insider can fail to comply simply because he or she is not aware of the nuances of the law.

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