

14.3: Cases

What Is a Security?

Reves v. Ernst & Young

494 U.S. 56, 110 S.Ct. 945 (1990)

JUSTICE MARSHALL delivered the opinion of the Court.

This case presents the question whether certain demand notes issued by the Farmer's Cooperative of Arkansas and Oklahoma are "securities" within the meaning of § 3(a)(10) of the Securities and Exchange Act of 1934. We conclude that they are.

The Co-Op is an agricultural cooperative that, at the same time relevant here, had approximately 23,000 members. In order to raise money to support its general business operations, the Co-Op sold promissory notes payable on demand by the holder. Although the notes were uncollateralized and uninsured, they paid a variable rate of interest that was adjusted monthly to keep it higher than the rate paid by local financial institutions. The Co-Op offered the notes to both members and nonmembers, marketing the scheme as an "Investment Program." Advertisements for the notes, which appeared in each Co-Op newsletter, read in part: "YOUR CO-OP has more than \$11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] insured but it is...Safe... Secure...and available when you need it." App. 5 (ellipses in original). Despite these assurances, the Co-Op filed for bankruptcy in 1984. At the time of the filing, over 1,600 people held notes worth a total of \$10 million.

After the Co-Op filed for bankruptcy, petitioners, a class of holders of the notes, filed suit against Arthur Young & Co., the firm that had audited the Co-Op's financial statements (and the predecessor to respondent Ernst & Young). Petitioners alleged, inter alia, that Arthur Young had intentionally failed to follow generally accepted accounting principles in its audit, specifically with respect to the valuation of one of the Co-Op's major assets, a gasohol plant. Petitioners claimed that Arthur Young violated these principles in an effort to inflate the assets and net worth of the Co-Op. Petitioners maintained that, had Arthur Young properly treated the plant in its audits, they would not have purchased demand notes because the Co-Op's insolvency would have been apparent. On the basis of these allegations, petitioners claimed that Arthur Young had violated the antifraud provisions of the 1934 Act as well as Arkansas' securities laws.

Petitioners prevailed at trial on both their federal and state claims, receiving a \$6.1 million judgment. Arthur Young appealed, claiming that the demand notes were not "securities" under either the 1934 Act or Arkansas law, and that the statutes' antifraud provisions therefore did not apply. A panel of the Eighth Circuit, agreeing with Arthur Young on both the state and federal issues, reversed. *Arthur Young & Co. v. Reves*, 856 F.2d 52 (1988). We granted certiorari to address the federal issue, 490 U.S. 1105, 109 S.Ct. 3154, 104 L.Ed.2d 1018 (1989), and now reverse the judgment of the Court of Appeals.

* * *

The fundamental purpose undergirding the Securities Acts is "to eliminate serious abuses in a largely unregulated securities market." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849, 95 S.Ct. 2051, 2059, 44 L.Ed.2d 621 (1975). In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299, 66 S.Ct. 1100, 1103, 90 L.Ed. 1244 (1946), and determined that the best way to achieve its goal of protecting investors was "to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Forman*, supra, 421 U.S., at 847-848, 95 S.Ct., at 2058-2059 (quoting H.R.Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)). Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of "security" sufficiently broad to encompass virtually any instrument that might be sold as an investment.

* * *

[In deciding whether this transaction involves a "security," four factors are important.] First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment." Third, we

examine the reasonable expectations of the investing public: The Court will consider instruments to be “securities” on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not “securities” as used in that transaction. Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

* * *

[We] have little difficulty in concluding that the notes at issue here are “securities.”

Case Questions

1. What are the four factors the court uses to determine whether or not the transaction involves a security?
2. How does the definition of security in this case differ from the definition in *Securities & Exchange Commission v. W. J. Howey*?

Tippee Liability

Dirks v. Securities and Exchange Commission

463 U.S. 646 (1983)

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

* * *

Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. This standard was identified by the SEC itself in *Cady, Roberts*: a purpose of the securities laws was to eliminate “use of inside information for personal advantage.” Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

* * *

Under the inside-trading and tipping rules set forth above, we find that there was no actionable violation by Dirks. It is undisputed that Dirks himself was a stranger to Equity Funding, with no preexisting fiduciary duty to its shareholders. He took no action, directly, or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirks’s sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their *Cady, Roberts* duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty when he passed it on to investors as well as to the Wall Street Journal.

* * *

It is clear that neither Secrist nor the other Equity Funding employees violated their *Cady, Roberts* duty to the corporation’s shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding’s secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. Dirks therefore could not have been “a participant after the fact in [an] insider’s breach of a fiduciary duty.” *Chiarella*, 445 U.S., at 230, n. 12.

* * *

We conclude that Dirks, in the circumstances of this case, had no duty to abstain from the use of the inside information that he obtained. The judgment of the Court of Appeals therefore is reversed.

Case Questions

1. When does a tippee assume a fiduciary duty to shareholders of a corporation?
2. Did Dirks violate any insider trading laws? Why or why not?
3. How does this case refine Rule 10b-5?

Duty to Disclose Material Information

Basic Inc v. Levinson

485 U.S. 224 (1988)

[In December 1978, Basic Incorporated agreed to merge with Consolidated Engineering. Prior to the merger, Basic made three public statements denying it was involved in merger negotiations. Shareholders who sold their stock after the first of these statements and before the merger was announced sued Basic and its directors under Rule 10b-5, claiming that they sold their shares at depressed prices as a result of Basic's misleading statements. The district court decided in favor of Basic on the grounds that Basic's statements were not material and therefore were not misleading. The court of appeals reversed, and the Supreme Court granted certiorari.]

JUSTICE BLACKMUN.

We granted certiorari to resolve the split among the Courts of Appeals as to the standard of materiality applicable to preliminary merger discussions, and to determine whether the courts below properly applied a presumption of reliance in certifying the class, rather than requiring each class member to show direct reliance on Basic's statements.

* * *

The Court previously has addressed various positive and common-law requirements for a violation of § 10(b) or of Rule 10b-5. The Court also explicitly has defined a standard of materiality under the securities laws, see *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), concluding in the proxy-solicitation context that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."...We now expressly adopt the TSC Industries standard of materiality for the § 10(b) and Rule 10b-5 context.

The application of this materiality standard to preliminary merger discussions is not self-evident. Where the impact of the corporate development on the target's fortune is certain and clear, the TSC Industries materiality definition admits straight-forward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category.

* * *

Even before this Court's decision in *TSC Industries*, the Second Circuit had explained the role of the materiality requirement of Rule 10b-5, with respect to contingent or speculative information or events, in a manner that gave that term meaning that is independent of the other provisions of the Rule. Under such circumstances, materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d, at 849.

* * *

Whether merger discussions in any particular case are material therefore depends on the facts. Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transactions at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value. No particular event or factor short of closing the transaction need to be either necessary or sufficient by itself to render merger discussions material.

As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. The fact-specific inquiry we endorse here is consistent with the approach a number of courts have taken in assessing the materiality of merger negotiations. Because the standard of materiality we have adopted differs from that used by both courts below, we remand the case for reconsideration of the question whether a grant of summary judgment is appropriate on this record.

We turn to the question of reliance and the fraud on-the-market theory. Succinctly put:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available information regarding the company and its business....Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements....The causal connection

between the defendants' fraud and the plaintiff's purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations. *Peil v. Speiser*, 806 F.2d 1154, 1160-1161 (CA3 1986).

* * *

We agree that reliance is an element of a Rule 10b-5 cause of action. Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's misrepresentation and a plaintiff's injury. There is, however, more than one way to demonstrate the causal connection.

* * *

Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult. The courts below accepted a presumption, created by the fraud-on-the-market theory and subject to rebuttal by petitioners, that persons who had traded Basic shares had done so in reliance on the integrity of the price set by the market, but because of petitioners' material misrepresentations that price had been fraudulently depressed. Requiring a plaintiff to show a speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made, would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.

Arising out of considerations of fairness, public policy, and probability, as well as judicial economy, presumptions are also useful devices for allocating the burdens of proof between parties. The presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act...

The presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations. It has been noted that "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" *Schlanger v. Four-Phase Systems, Inc.*, 555 F.Supp. 535, 538 (SDNY 1982)...An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

* * *

The judgment of the Court of Appeals is vacated and the case is remanded to that court for further proceedings consistent with this opinion.

Case Questions

1. How does the court determine what is or is not material information? How does this differ from its previous rulings?
2. What is the fraud-on-the-market theory?

This page titled [14.3: Cases](#) is shared under a [CC BY-NC-SA](#) license and was authored, remixed, and/or curated by [Anonymous](#).

- [24.3: Cases](#) by Anonymous is licensed [CC BY-NC-SA 3.0](#). Original source: <https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.