

**Securities Regulation  
Final Examination  
December 7, 2002**

General Instructions:

The exam is 180 minutes. I have designated the number of minutes for each question, which also will be the number of points (out of 180) that a correct answer will receive for that question. You may incorporate earlier explanations by reference. The information in the questions is not cumulative, i.e., each question is independent of every other question unless stated otherwise.

When answering "yes" or "no," provide the best answer. If you provide only a "yes" or "no" in your answer but no explanation, and the answer is correct, you will receive partial credit.

**PART 1**

- (1) Answer "yes" or "no" to each of the following questions. Briefly explain each answer.
- (a) Bob buys a row of 48 citrus trees from Howey Company. Although not required to, Bob agrees to have Howey-in-the-Hills (a related company) cultivate, harvest, and market his citrus. Most other purchasers of citrus tree rows enter into the same arrangement with Howey-in-the-Hills, but about 15% of the others have contracted with another company to provide these services. Is Bob's investment a security? **(2 minutes/points)**
  - (b) Bob, Jill and Jean jointly buy a citrus grove as tenants-in-common and hire a local farmer (not the seller of the grove) to cultivate, harvest, and market the citrus. Is their investment a security? **(2 minutes/points)**
  - (c) Would the answer to (b) above be different if the farmer were the seller of the grove? **(2 minutes/points)**
  - (d) Burks is a real estate agent who offers individual condos. He helps buyers arrange with Hotel Corporation (not related to Burks) to collect rent on the condos. Under a rent-pooling agreement, Hotel Corp. pools the rental payments from the condos and the owners share the payments on a pro rata basis. Owners can occupy their condos for only two weeks each year. Burks emphasizes to prospective buyers that the rental payments will cover their principal and interest obligations on the condos. Are the buyers' condo investments securities? **(4 minutes/points)**
  - (e) Burks (see (d) above) also sells "weeks" in condos. Each buyer is offered a single week in a condo which each buyer can use himself or rent to another person through a rental arrangement with Hotel Corp. under which the rent is passed through to the buyer. Burks emphasizes to prospective buyers that the rent will cover their principal and interest obligations on their weeks. Are the buyers' condo "weeks" investments securities? **(4 minutes/points)**
  - (f) Bob and Jill, both sophisticated businesspeople, purchase stock in a corporation. They are the only stockholders. They decide to eliminate the board of directors and co-manage the business, while retaining other typical attributes of the corporate form. Are their investments in the corporation securities? **(3 minutes/points)**
  - (g) Jill obtains financing from a bank to buy a car. Jill gives the bank a promissory note in which she promises to repay her loan in 36 equal payments over 36 months. The note is secured by the car. Is the note a security? **(3 minutes/points)**

- (h) Farmer's Co-Op raises capital for its operations by offering unsecured promissory notes in \$1,000 increments to its 20,000 members. The notes are payable on demand and yield variable rates of interest that are competitive with bank certificates of deposit. Are the notes securities? **(2 minutes/points)**
- (i) Surfboards Unlimited owns a chain of surfing stores in Hawaii and California. It sells all of its Hawaii stores and related inventory and other assets to Hawaii Living Inc. for \$5,000,000. Is Hawaii Living's investment a security? **(4 minutes/points)**
- (j) Bob gives his money to a broker, who manages Bob's money in a discretionary account in which no one else's assets are included. Bob can compensate the broker under three options: (1) a percentage of the account's gains, (2) a flat percentage of the assets in the account, or (3) a \$10,000 annual fee. Might the compensation option selected affect whether Bob's account was considered a security? **(2 minutes/points)**

## **PART 2**

(2) In 1989, 5 senior executives of Universal Burgers, the stock of which is traded on the New York Stock Exchange, left Universal to form Tonic Burger, a privately held company. In January 1990, the owners of Tonic approved a three-part plan whereby: (1) all of Tonic's assets would be sold to Universal in exchange for Universal stock, (2) Tonic would distribute the Universal Stock to its owners pro rata, and (3) Tonic would then dissolve. The plan was implemented in February 1990, after which the previous owners of Sonic rejoined the executive ranks of Universal. Is securities registration required (yes or no)? Briefly explain your answer. **(8 minutes/points)**

## **PART 3**

(3) Oilengas, a company created to drill for oil and gas, seeks investors. Oilengas is not a reporting company. In each of the following situations, does the offering qualify as a nonpublic offering under Section 4(2) and/or Rule 506? Answer "yes" or "no" to each of the questions for Section 4(2) and Rule 506. Briefly explain each answer.

- a) Bob, a multimillionaire expert on the oil and gas business, invested in Oilengas on the basis of his review of drilling logs for properties on which Oilengas holds options. When he visited Oilengas headquarters before making his investment, he asked for more financial information, but was denied the information on the ground that it was proprietary. **(2 minutes/points)**
- b) Assume the same facts as in (a) above except that: (1) while visiting Oilengas, Bob lost much of his personal fortune in the stock market, leaving him with only \$600,000 and no income, (2) he only asked a general few questions, which were answered, and (3) he was not furnished with (nor did he request) any other information. **(4 minutes/points)**
- c) Jill, a multimillionaire who knows nothing about the oil and gas business, invested in Oilengas solely on the basis of advice from a friend. **(2 minutes/points)**
- d) Assume the same facts in (c) above except that Jill invested solely on the basis of an Oilengas ad in a local newspaper. **(2 minutes/points)**

#### **PART 4**

(4) Illustrious Hardware, Inc., a Mississippi corporation with its principal office in Oxford, operates three small hardware stores in Oxford, Tupelo and Batesville. It wants to raise \$2,000,000 to open a new store in Jackson and establish a national mail order business that will be operated at the new store. On January 1, Illustrious raised \$1,690,000 by selling securities to 169 Mississippi residents. On June 15 of the same year, Illustrious raised an additional \$310,000 by selling similar securities on the same terms to a corporation that is 90%-owned by two Mississippi residents and 10%-owned by a Louisiana resident. On December 15 of the same year, 37 of these purchasers sold their securities to Louisiana residents.

- a) Can Illustrious rely on the intrastate offering exemption (yes or no)? Briefly explain your answer. **(6 minutes/points)**
- b) State briefly any advice you would give to Illustrious to make it more likely that it will be able to rely on the exemption. **(4 minutes/points)**

#### **PART 5**

(5) Endrun is a privately-held company that manufactures computer disks. Endrun filed a registration statement (on Form S-3) with the SEC on June 1 that became effective on July 1. Selling began that day. Would there be a section 5 violation in the following circumstances? All events take place during the same year. Answer “yes” or “no” to each question and briefly explain each answer.

##### **Events occurring before June 1:**

- (a) In January, Endrun sends an email to all of its customers that announces, “Endrun expects that it will go public this summer.” **(2 minutes/points)**
- (b) Assume the facts in (a) above. The email also states, “This is not an offer. The offering will be made only by means of a prospectus.” **(2 minutes/points)**
- (c) In January, Bob Scam, the president of Endrun, telephones Sandy Wily, president of New York investment bank Dewey, Cheatem, and Howe, to discuss Endrun’s proposed public offering. One week later, Wily sends Scam a letter that indicates Dewey, Cheatem’s willingness to manage the offering. **(2 minutes/points)**
- (d) In February, Endrun places an ad in the New York Times and the Wall Street Journal announcing a technical workshop on advanced computer disk design. The ad does not appear anywhere else. The ad truthfully states that Endrun “has consistently led the market in bringing new computer disk designs to market.” The ad otherwise includes no information other than details regarding the workshop. **(4 minutes/points)**
- (e) In April, Scam, who never speaks to the press, is cornered by a relentless reporter in a restaurant. The reporter peppers him with questions about Endrun’s plans. Scam refuses to discuss specifically whether Endrun intends to go public, but he does describe in great detail Endrun’s expected profitability during the next year and its plans for expansion and new product lines. The reporter runs the story, including all of Scam’s statements, in the next day’s paper. **(2 minutes/points)**
- (f) In May, Dewey, Cheatem publishes, against the wishes of Scam, a full-page notice in the Wall Street Journal announcing that Endrun proposes to offer 1,000,000 shares of common stock pursuant to a public offering. The notice also describes, *in toto*, the use of the proceeds of the offering, the plans of management, that the price of the stock will be at or near market level when the registration statement becomes effective, and that an offer will only be made by prospectus. **(4 minutes/points)**

- (g) Scam tells his ex-wife, during her visit to Scam's house in March, about the offering. (2 minutes/points)

**Events occurring between June 1 and July 1:**

- (h) On June 5, Endrun runs the same ad described in 1(d) above. (2 minutes/points)
- (i) On June 14, Dewey, Cheatem sends a prospective customer a preliminary prospectus accompanied by a short letter recommending the purchase of Endrun stock pursuant to the public offering. (2 minutes/points)
- (j) On June 21, a dealer in Oxford, MS mails a letter to another dealer in Jackson, MS. The letter offers Endrun stock when it is issued. (2 minutes/points)
- (k) On June 15, Dewey, Cheatem places the following ad in the Wall Street Journal:

This announcement is neither an offer to sell nor a solicitation of an offer to buy any of these securities. The offer is made only by the prospectus, which may be obtained from the undersigned.	
New Issue	June 2, 2002
1,000,000 Shares of Common Stock Endrun Corporation	
-----	
Price Range: \$12.00 to \$18.00	
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Dewey, Cheatem, and Howe Alex. Green & Sons	

(2 minutes/points)

- (l) On June 14, Scam makes a presentation to securities analysts in which he discusses not only Endrun's historical performance, but also its future prospects. (2 minutes/points)
- (m) On June 20, Wily calls a Dewey, Cheatem customer and strongly recommends that the customer purchase stock in the Endrun offering. The customer expresses interest and the same day Wily sends the customer an email with a hyperlink to Endrun's preliminary ("red herring") prospectus and a note in the message line, "This IPO is going to hit the roof!" (4 minutes/points)
- (n) Assume the same facts as in (m) above except that instead of an email, Wily mails the customer a copy of the red herring that encloses a card on which the customer can indicate whether he might be interested in shares of Endrun. The card includes the statement,

No offer to buy the securities can be accepted and no part of the purchase price can be received until the registration statement has become effective, and any such offer may be withdrawn or revoked, without obligation or commitment of any kind, at any time prior to notice of its acceptance given after the effective date. An indication of interest in response to this advertisement will involve no obligation or commitment of any kind.

(4 minutes/points)

**Events occurring after July 1:**

- (o) On July 10, Wily sent a customer a written confirmation accompanied by a final prospectus. Four days later, Wily sends the customer a letter containing truthful, historical, forward-looking information about Endrun that was not included in the prospectus. **(2 minutes/points)**
- (p) A customer who received a preliminary prospectus on June 24 bought shares in the offering on July 3. Wily sends the customer a written confirmation on July 5. **(2 minutes/points)**
- (q) Assume the same facts as in (p) above except that Wily included a term sheet with the confirmation. **(2 minutes/points)**
- (r) On August 25, after Dewey, Cheatem has sold its entire Endrun allotment, one of its traders calls a customer and recommends Endrun. The customer orders 10,000 shares. The trader executes the transaction on an exchange and sends the customer a written confirmation without an accompanying prospectus. **(2 minutes/points)**
- (s) On October 15, a dealer discovers that it never sold 5,000 shares of its allotment. The dealer calls a customer to recommend Endrun and the customers agrees to buy the 5,000 shares. The dealer subsequently sends the customer a written confirmation. **(4 minutes/points)**

**Events occurring before and after July 1:**

- (t) Wily decided to conduct an electronic offering of Endrun shares. Dewey, Cheatem posted the red herring on its web site on June 2. On Tuesday, June 30, Dewey, Cheatem sent an e-mail to customers, who had previously emailed Dewey, Cheatem a conditional offer to buy shares in the offering, requesting that they affirmatively reconfirm the conditional offers. (All of these customers also had previously agreed to review the red herring on Dewey, Cheatem's website.) The same day, all of the customers reconfirmed the conditional offer by email. There was no further communication between the customers and Dewey, Cheatem until Friday, July 1, when Dewey, Cheatem purchased Endrun shares for all of the customers' accounts and sent them confirmations accompanied by a final prospectus.

In addition to stating whether there is a violation of Section 5 and briefly explaining your answer, identify any rules and policies underlying those rules that would support permitting the foregoing actions by Dewey, Cheatem. **(8 minutes/points)**

**PART 6**

- (6) Blue Sox Inc. owns the Blue Sox baseball team and Wayfen Park, the stadium in which the Blue Sox play 81 games each year. The company wishes to raise \$200 million to tear down Wayfen Park and build a new stadium on the same site.
- a) Blue Sox Inc. makes an unregistered public offering that is not exempt from the registration requirements of Section 5. Sheila purchases the securities, which immediately drop 50% in value. The decline in value is caused by an earthquake swallowing up Wayfen Park and the Blue Sox team members during a game the day after Sheila purchased the securities. Will Sheila's Section 12(a)(1) claim against the issuer succeed (regardless of whether she can obtain damages) (yes or no)? Briefly explain your answer. Assuming that Sheila would prevail under Section 12(a)(1), what would the measure of her damages? **(6 minutes/points)**

- b) Blue Sox Inc. registers its securities under Section 5 but omits any reference in the registration statement to an order issued before the filing by the City of Boasting, where Wayfen Park is located, that declares Wayfen Park to be a historic monument and prohibits any modifications to the stadium. Bob, who knows about the City's order, purchased \$10,000 shares in the offering without reading the prospectus. The existence of the order is disclosed at the same moment that an earthquake swallows up Wayfen Park and the Blue Sox team members during a game, and the value of the securities immediately drops 75% in value. Two-thirds of this decline is due to the effect of the earthquake. Will Bob's claims against the issuer under Sections 11, 12(a)(1) and 12(a)(2) claim succeed (regardless of whether he can obtain damages) (yes or no for each)? Briefly explain your answers. **(6 minutes/points)**
- c) Assume the same facts in (b) above. Bob paid \$11/share (the offering price), which were trading at \$16/share just before the 75% decline to their all-time low of \$4/share. Assuming that Bob's claims under Sections 11 and 12(a)(2) would succeed, what would be the dollar amount of his damages under each section? **(6 minutes/points)**
- d) Assume the same facts in (b) above except that Bob did not know about the City's order, and Bill Squawkey, the CEO and a director of Blue Sox Inc., did not have actual knowledge of the City's order. Will Bob prevail in his claims (regardless of whether he can obtain damages) against Squawkey under sections 11 and 12(a)(2) (yes or no for each)? Briefly explain your answer. **(6 minutes/points)**
- e) Assume the same facts in (b) above except that the offering is exempt from registration under Section 3(a)(11). Will Sheila prevail under Section 12(a)(1) and/or Section 12(a)(2) (yes or no for each)? Briefly explain your answer. **(4 minutes/points)**
- f) Blue Sox Inc. registers its securities under Section 5. Golem Stacks Inc. acts as underwriter, and one of its Senior Directors, Barbara, was the lead partner on the offering, although she did not sign the registration statement. The financial statements in the registration statement, which were certified by a public accounting firm, state that the company's annual revenues were \$300 billion and its profits as \$300 million, when the correct figures were actually \$300 million and \$30 million. Will Bob prevail (regardless of whether he can obtain damages) under his Section 11 and 17 private claims against Barbara (yes or no for each)? Briefly explain your answer. **(6 minutes/points)**
- g) Blue Sox Inc., which is a reporting company, registers its securities under Section 5. The prospectus predicts that the Blue Sox will be able to triple their ticket revenues because the new stadium will be three times as large as Wayfen Park and will include 100 expensive sky boxes, but cautions that large construction projects are unpredictable. After the offering, the City rejects the proposed stadium on the ground that building it would require the demolition of Boasting's Museum of Modern Art, a fact that was known, prior to the offering, to Blue Sox Inc. and executive officers of Blue Sox Inc. who approved the statements about the predicted revenues.
- (1) For purposes of Section 11, is the prediction about future revenues material (yes or no)? Briefly explain your answer. **(2 minutes/points)**
  - (2) Are the statements forward-looking statements under Rule 175 and Section 27A (yes or no for each)? Briefly explain your answer. **(2 minutes/points)**
  - (3) Would the issuer be protected against a Section 11 claim by Rule 175 or Section 27A (yes or no for each)? Briefly explain your answer. **(2 minutes/points)**

## PART 7

(7) In each of these factual situations, is the company subject to the reporting requirements of Exchange Act Section 13(a)? Answer “yes” or “no” and briefly explain each answer.

- 1) On the last day of Boble and Narnes Inc.’s fiscal year, it had 700 shareholders and \$7,000,000 in assets. **(2 minutes/points)**
- 2) Boble and Narnes Inc. conducted a public offering of securities registered under the Securities Act. **(2 minutes/points)**
- 3) Boble and Narnes Inc.’s securities are traded on the New York Stock Exchange. **(2 minutes/points)**

## PART 8

(8) Alamo Inc. acquired 80% of the stock of San Antonio Industries, Inc. Alamo wishes to merge San Antonio into Alamo and freeze out San Antonio’s minority shareholders. Alamo commissioned an appraisal of the market value of San Antonio’s assets. The market value of the assets was determined to be \$800 million, or \$800/share. Alamo also commissioned Golem Stacks Inc. to appraise the market value of San Antonio’s stock and provided Golem Stacks with the appraisal of the assets. Golem Stack valued San Antonio’s stock at \$150/share. Although shareholder approval of the merger was not required under state law, San Antonio’s board of directors solicited proxies in which they recommended approval of the merger. Under state law, the minority shareholders were entitled to seek appraisal rights unless they voted for the merger and their vote was not induced by a materially misleading solicitation.

- a) The proxies offered the minority shareholders \$175/share and stated that they could seek appraisal rights in state court. The minority shareholders sued the directors under Rules 14a-9 and 10b-5, claiming that the directors violated their fiduciary duty to the shareholders by not disclosing the information about the asset appraisal.
  - a. Was this information material (yes or no)? Briefly explain your answer. **(2 minutes/points)**
  - b. Will the plaintiffs be able to satisfy the Mills’ “essential link” test under Rule 14a-9 or Rule 10b-5’s “in connection with” requirement (yes or no)? Briefly explain your answer. **(8 minutes/points)**
- b) The minority shareholders also sue Henry, San Antonio’s outside legal counsel, on the ground that he helped prepare the proxy solicitation and knew about the omission of the information about the asset appraisal. Will they prevail against Henry under Rule 10b-5 (yes or no)? Briefly explain your answer. **(2 minutes/points)**

## PART 9

(9) Bioethics Inc. operates a number of laboratories that develop new vaccine. Bioethics’ revenues are generated entirely by the sale of the rights to produce, market and sell the vaccines to large pharmaceutical firms. Bioethic’s Nobel-prize winning director of research and development dies in a car crash, and Bioethics hires John Juryrig as its new director. Its quarterly report states that John Juryrig has a biology PhD from MIT and led the development of numerous, commercially vaccines as the research director for Biovax Inc, Bioethic’s chief competitor. Frank, impressed with Juryrig’s credentials, purchased Bioethics stock immediately after Juryrig was hired. Under Juryrig’s direction, Bioethics is unable to further progress on the development of vaccines and its stock price drops 50% during this period. Juryrig then confesses that his last job was actually as a building custodian and he never graduated from high school. The stock immediately drops another 25%. Frank later sues Bioethics under Rule 10b-5. Will he be able to prove transaction causation and loss causation (yes or no for each)? Briefly explain your answer. **(10 minutes/points)**