37th Annual Northwest Securities Institute

Cosponsored by the Oregon State Bar Securities Regulation Section and the Washington State Bar Business Law Section, in cooperation with WSBA CLE

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Oregon: 5.25 General CLE credits and 1 Ethics credit

Washington: 5.25 Law and Legal credits and 1 Ethics credit
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7:30  Registration and Breakfast

8:30  SEC Enforcement Update and Hot Topics Panel
Judith Anderson, Assistant Regional Director, San Francisco Regional Office, U.S. Securities and Exchange Commission, San Francisco, CA
David Angeli, Angeli Law Group LLC, Portland, OR
Jina Choi, Regional Director, San Francisco Regional Office, U.S. Securities and Exchange Commission, San Francisco, CA
Jane Norberg, Chief, Office of the Whistleblower, Division of Enforcement, U.S. Securities and Exchange Commission, Washington, DC

9:45  SEC Division of Corporation Finance Update
David Fredrickson, Chief Counsel and Associate Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, Washington, DC

10:45 Break

11:00 State and Provincial Regulatory Update
Moderator: Mike Liles, Jr., Karr Tuttle Campbell, Seattle, WA
William Beatty, Securities Administrator, Division of Securities, Washington State Department of Financial Institutions, Olympia, WA
Jim Burns, Securities Bureau Chief, Idaho Department of Finance, Boise, ID
Douglas Muir, Director of Enforcement, British Columbia Securities Commission, Vancouver, BC
Kristy Naylor, Enforcement and Securities Chief, Alaska Division of Banking and Securities, Anchorage, AK
David Tatman, Chief of Enforcement, Oregon Division of Financial Regulation, Salem, OR

12:00 Lunch: Changing Media Coverage in the Digital Age
Professor Damian Radcliffe, School of Journalism and Communication, University of Oregon, Eugene, OR
Kateri Walsh, Oregon State Bar, Tigard, OR

1:30 Breakout A—Hot Topics in Federal Transactional Law
♦ SEC revised Rule 504, and revised/new Rules 147/147A
♦ Evolving practices under Rule 506(c)
♦ Reg A+ and Reg CF developments and the (relatively) new resale exemption under 4(a)7
Professor Daniel Morrissey, Gonzaga University School of Law, Spokane, WA
Jonathan Norling, Emerge Law Group, Portland, OR
Paul Swegle, Newyu, Inc., Seattle, WA

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♦ SEC administrative law judge authority
Brad Daniels, Stoel Rives LLP, Portland, OR
Douglas Greene, Lane Powell PC, Seattle, WA
Roger Mellem, Ryan Swanson & Cleveland PLLC, Seattle, WA
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Steven Boender, Stoel Rives LLP, Portland, OR
Joseph Wallin, Carney Badley Spellman PS, Seattle, WA

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♦ Secondary liability under Oregon securities law
♦ Trulia and disclosure-only settlements
John Casey, Stoel Rives LLP, Portland, OR
Keith Ketterling, Stoll Stoll Berne Lokting & Shlachter PC, Portland, OR
Douglas Siddoway, Randall | Danskin PS, Spokane, WA

3:30 Break

3:45 Where’s Your Data? Data Privacy and Your Ethical Obligations
Calon Russell, Holland & Knight LLP, Portland, OR
Dayna Underhill, Holland & Knight LLP, Portland, OR

4:45 Adjourn
FACULTY

**Judith Anderson**, Assistant Regional Director, San Francisco Regional Office, U.S. Securities and Exchange Commission, San Francisco, CA. Ms. Anderson is Assistant Regional Director for Investor Services and Special Projects in the SEC’s San Francisco Regional Office, where she supervises review and intake of complaints and investor inquiries and outreach to community groups, other regulators, and members of law enforcement and is responsible for other enforcement matters, including investigations and litigation. She is a coleader of the Division of Enforcement’s Pyramid Scheme Task Force. Prior to joining the commission staff in 2001, Ms. Anderson was a litigation associate in Los Angeles and San Francisco.

**David Angeli**, Angeli Law Group LLC, Portland, OR. Mr. Angeli represents corporations and individuals in complex criminal, regulatory, and commercial cases. Mr. Angeli is vice chair of the National Association of Criminal Defense Lawyers White Collar Crime Committee and serves as an Adjunct Professor of Law at Lewis & Clark Law School, where he teaches a federal white-collar crime seminar. He is a frequent speaker at local and national CLE events.

**William Beatty**, Securities Administrator, Division of Securities, Washington State Department of Financial Institutions, Olympia, WA. Mr. Beatty was appointed Securities Administrator of the Washington Securities Division in July 2010. His career at the division began in 1986, and he has served stints as a staff attorney, general counsel, and program manager. He is past president of the North American Securities Administrators Association (NASAA) and has participated on various NASAA project groups, task forces, and committees since 1990.

**Jim Burns**, Securities Bureau Chief, Idaho Department of Finance, Boise, ID. Mr. Burns has been associated with the financial services industry for more than three decades, serving in both industry and regulatory capacities. Prior to his appointment as Bureau Chief, he served as the Securities Bureau Investigations Chief and Money Transmitter Program Manager for the department. Mr. Burns is a Certified Fraud Examiner, a Certified Anti-Money Laundering Specialist, and a Certified Regulatory and Compliance Professional.

**Steven Boender**, Stoel Rives LLP, Portland, OR. Mr. Boender is a partner in Stoel Rives’s Corporate Group and focuses his practice on corporate transactional matters, including mergers and acquisitions, financings, and other corporate and securities issues. He has represented corporate clients and financial advisors on a variety of transactions, including acquisitions, joint ventures, restructurings, and commercial contracts. He has assisted startup and emerging growth companies with formation, fundraising, and structuring issues, as well as several joint development arrangements in the area of technology. He has represented issuers and underwriters in public offerings and private placements of debt, equity, and convertible securities. Mr. Boender has also counseled a number of public company clients on securities compliance matters, including periodic reporting, current reporting, proxy statements, shelf registration statements, and employee benefit plan matters. He is admitted to practice in Oregon and Illinois.

**John Casey**, Stoel Rives LLP, Portland, OR. Mr. Casey focuses his practice on complex commercial disputes, including securities litigation, insurance coverage disputes, intellectual property litigation, class action defense, products liability, concussion-related litigation, complex contract disputes, bankruptcy litigation, and employment matters. He has represented a broad range of clients, including accounting firms, law firms, national banks, investment banks, hedge funds, private equity firms, public utilities, consumer goods companies, technology companies (from start-ups to public companies), media conglomerates, and a wide range of manufacturing companies. He is admitted to practice in Oregon and Illinois.
Jina Choi, Regional Director, San Francisco Regional Office, U.S. Securities and Exchange Commission, San Francisco, CA. Ms. Choi is the Regional Director of the U.S. Securities and Exchange Commission’s San Francisco Regional Office. The Regional Office has a staff of over 125 people and is responsible for the SEC’s enforcement and examination programs in Northern California, Washington, Oregon, Montana, Idaho, and Alaska with over 1,000 investment advisers (and $5 trillion in assets under management), more than 50 mutual fund complexes, and over 250 broker-dealers located in the region. The public and pre-IPO companies located in the region are among the most dynamic and closely followed issuers and companies in the country, including those in Silicon Valley, San Francisco, Seattle, and Portland. Prior to her appointment as Director of the Regional Office, Ms. Choi served as an Assistant Regional Director and in the Division of Enforcement’s Market Abuse Unit. She has conducted and supervised investigations into financial reporting fraud, insider trading, misconduct by investment advisers and brokers, FCPA, and other securities law violations.

Brad Daniels, Stoel Rives LLP, Portland, OR. Mr. Daniels is a partner in the Litigation practice group and is also active in the Property Tax section. His practice focuses on securities litigation, complex business litigation (including class actions, shareholder disputes, unlawful trade practices, and derivative cases), appellate litigation, and property tax issues. He has represented individual and corporate clients in state and federal courts and in Financial Industry Regulatory Authority and other arbitrations. Mr. Daniels is treasurer of the Oregon State Bar Securities Regulation Section and a member of the Owen M. Panner American Inn of Court Executive Committee, the Oregon State Bar Litigation Section, the Federal Bar Association, and the Multnomah Bar Association. He is admitted to practice in Oregon and Washington.

David Fredrickson, Chief Counsel and Associate Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, Washington, DC. Mr. Fredrickson is Associate Director and Chief Counsel of the U.S. Securities and Exchange Commission’s Division of Corporation Finance. Previously, Mr. Fredrickson was Assistant General Counsel in the SEC’s Office of General Counsel, where he provided legal and policy advice on, among other matters, implementation of the Sarbanes-Oxley Act, the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the Jumpstart Our Business Startups (JOBS) Act.

Douglas Greene, Lane Powell PC, Seattle, WA. Mr. Greene chairs the firm’s Securities Litigation Practice Group and focuses his practice exclusively on securities and corporate governance litigation. He defends public companies and their directors and officers in securities class actions, litigation concerning mergers and acquisitions, shareholder derivative actions, and U.S. Securities and Exchange Commission investigations and enforcement proceedings. He also conducts internal corporate investigations. Mr. Greene is an Advisory Board Member of the National Association of Corporate Directors Northwest Chapter and the Securities Reform Act Litigation Reporter. He is also a member of the Washington State Bar Association Securities Committee. He is a frequent public speaker and author and is the founder of and principal contributor to Lane Powell’s blog D&O Discourse, which is devoted to providing opinion from a defense perspective on shareholder litigation matters.

Keith Ketterling, Stoll Stoll Berne Lokting & Shlachter PC, Portland, OR. Mr. Ketterling, one of the firm’s managing shareholders, is a trial lawyer who represents institutional and individual investors in securities and financial fraud litigation. He also handles matters involving real estate litigation, securities class actions, trade secret and noncompetition litigation, and other complex business litigation. He is a past board member of the Oregon Trial Lawyers Association and past chair of the association’s Business Litigation Section.
Mike Liles, Jr., Karr Tuttle Campbell, Seattle, WA. Mr. Liles is a member of the Corporate Finance Practice Group of Karr Tuttle Campbell’s Business and Finance Department. He has been the primary legal adviser in over 30 major public offerings, the majority of them initial public offerings, and an equal number of major mergers and acquisitions. Mr. Liles is also active in the resolution of administrative actions by securities regulators. He is a principal drafter of SCOR, the Small Company Offering Registration, a simplified public offering procedure developed for use in Washington State, which was later adopted by most other states and by the SEC. For the American Bar Association, Mr. Liles chairs the State Regulation of Securities Committee Regulation A+ Working Group and the Subcommittee on NSMIA and Limited Offering Exemptions and is a member of the Private Placement Broker-Dealer Task Force, the Federal Regulation of Securities Committee, and the Corporate Governance Committee. He is also a member of the Washington State Bar Association Business Law Section Securities Law Committee and the King County Bar Association.

Roger Mellem, Ryan Swanson & Cleveland PLLC, Seattle, WA. Mr. Mellem chairs his firm’s Registered Investment Advisor practice group and focuses his practice on securities litigation and regulatory defense. He defends and resolves governmental investigations and disciplinary or enforcement actions, as well as customer complaints, for registered investment advisors, investment advisor representatives, hedge funds, hedge fund managers, investment bankers, broker-dealers, and registered representatives. Mr. Mellem’s significant securities litigation experience also includes class actions, stock option disputes, shareholder derivative actions, directors’ and officers’ liability issues, insider trading, corporate governance and internal investigations, proxy contests, and mortgage-backed securities. He is a member of the Washington State Bar Association Business Law Section Securities Law Committee.

Professor Daniel Morrissey, Gonzaga University School of Law, Spokane, WA. Professor Morrissey is a professor and former dean at Gonzaga University Law School. He previously served as a tenured law professor at the University of Tulsa, visiting professor at Pepperdine University Law School, the University of Denver, Seton Hall University, DePaul University, and New York University Law School, adjunct professor at Loyola Law School, and dean of St. Thomas University Law School. He has published a number of articles in the areas of corporate/securities law and jurisprudence. He is the coauthor of the casebook Securities Litigation: Law, Policy, and Practice (Carolina Academic Press, 2016). Professor Morrissey has also served as a consultant and expert witness in a number of cases involving issues of corporate and securities law.

Douglas Muir, Director of Enforcement, British Columbia Securities Commission, Vancouver, BC. Mr. Muir is the Director of Enforcement at the British Columbia Securities Commission, the independent government agency that administers the British Columbia Securities Act. He previously served as Associate General Counsel in the commission’s Office of the Chair, where he provided expert legal advice to the executive on a variety of matters including administrative law procedures and freedom of information. Before that, he was Litigation Counsel in the Commission’s Enforcement Division Litigation Group, where he prosecuted a wide range of cases before the commission tribunal.

Kristy Naylor, Enforcement and Securities Chief, Alaska Division of Banking and Securities, Anchorage, AK. Ms. Naylor is the Enforcement and Securities Chief with the Alaska Department of Commerce, Community, and Economic Development Division of Banking and Securities (DBS). She oversees all aspects of the Securities Section at DBS as well as all enforcement for the 12 major program areas that the division administers. Ms. Naylor joined DBS as a Securities Examiner in 2012 and has held her current position since 2014. She previously worked for the State of Oregon as an administrative law judge and as a staff attorney with the Oregon Law Commission. Ms. Naylor is an inactive member of the Oregon State Bar.
Jane Norberg, Chief, Office of the Whistleblower, Division of Enforcement, U.S. Securities and Exchange Commission, Washington, DC. Ms. Norberg was promoted to chief of the SEC Office of the Whistleblower in September 2016. She joined the SEC in 2012 as the first deputy chief of the Office of the Whistleblower and helped establish the office, which intakes and reviews whistleblower tips received by the agency, evaluates whistleblower award claims, and makes recommendations on whether claimants have satisfied eligibility requirements to receive an award. She had served as acting chief since the departure of the office’s inaugural chief. Before joining the SEC, Ms. Norberg was in private law practice and prior to that served as a special agent for the U.S. Secret Service, where her duties included providing protection to the President, Vice President, and visiting foreign dignitaries as well as conducting criminal investigations into federal crimes.

Jonathan Norling, Emerge Law Group, Portland, OR. Mr. Norling is a renewable energy and corporate attorney representing developers, investors, and lenders on matters related to the development and financing of renewable energy projects. He has represented developers on almost every type of agreement in the development process and has conducted legal due diligence on behalf of lenders and investors on all types of renewable energy projects. He has managed acquisitions and financing of solar, wind, biomass, and biofuel project companies, as well as cleantech venture companies. Mr. Norling has substantial in-house counsel experience and is adept at managing outside counsel. He is a nationally recognized speaker on energy law issues. Mr. Norling is admitted to practice in California and Oregon.

Professor Damian Radcliffe, School of Journalism and Communication, University of Oregon, Eugene, OR. Professor Radcliffe is the Carolyn S. Chambers Professor in Journalism at the University of Oregon, a fellow of the Tow Center for Digital Journalism at Columbia University, an honorary research fellow at Cardiff University’s School of Journalism, Media and Culture Studies, and a fellow of the Royal Society for the Encouragement of Arts, Manufactures and Commerce. He is a regular contributor to the BBC Academy, CBS Interactive (ZDNet), Huffington Post, MediaShift, and TheMediaBriefing, where he writes about digital trends, social media, technology, the business of media, and the evolution of journalism. His experience encompasses roles at the BBC, the NGO Volunteering Matters, Ofcom (the UK communications regulator), and Qatar’s Ministry of Information and Communications Technology. He works across all media sectors (commercial, public, government, regulatory, academic, and nonprofit/civil society) and platforms, from print and digital to TV and radio broadcasting. Professor Radcliffe has written, spoken to, or provided consulting services for a wide range of industry and academic organizations. His research focuses on the usage of social media and wider trends in local media, technology, the business of media, and journalism innovation.

Calon Russell, Holland & Knight LLP, Portland, OR. Mr. Russell advises lawyers, law firms, and government and corporate legal departments on legal ethics and professional responsibility matters. His practice involves assisting clients at the organizational level with law firm formation and operations, dissolution, and lateral lawyer moves. He also counsels on regulatory compliance issues such as the unauthorized practice of law, litigation financing, fee splitting, conflicts of interest, and state bar admissions. As part of his practice, Mr. Russell also focuses on civil litigation, primarily at the appellate level, and has a background in constitutional law, labor and employment matters, construction defect litigation, foreclosure proceedings, premises liability, and the representation of public officials. He is a member of the Multnomah Bar Association.

Douglas Siddoway, Randall | Danskin PS, Spokane, WA. Mr. Siddoway is a business, transactional, and securities lawyer. He is a member of the Washington, New York, and Idaho bar associations.
Paul Swegle, Newyu, Inc., Seattle, WA. Mr. Swegle is of counsel to Kinsel Law in Seattle and serves as acting general counsel to several startups. He provides guidance, assistance, and representation in many areas, including regulatory compliance, corporate governance, finance, commercial agreements, employment law, intellectual property, and litigation. Prior to entering private practice, he served as a senior attorney advisor in the SEC’s Division of Corporate Finance. Mr. Swegle is chair of the Washington State Bar Association Corporate Counsel Section. He was named Corporate Counsel of the Year in 2012 by the Puget Sound Business Journal.

David Tatman, Chief of Enforcement, Oregon Division of Financial Regulation, Salem, OR. Mr. Tatman serves as the Chief of Enforcement for the Division of Financial Regulation within the Oregon Department of Business and Consumer Services (DCBS) and was appointed to that role at its creation in January 2016. The new division oversees the regulation of all financial services in Oregon, including banking, mortgage lending, insurance, and securities. Mr. Tatman oversees a team of eight lawyers and six investigators. The team is responsible for investigating complaints and alleged violations concerning the various financial programs in the division. Prior to his current position, Mr. Tatman served as the Administrator of the Oregon Division of Finance and Corporate Securities.

Dayna Underhill, Holland & Knight LLP, Portland, OR. Ms. Underhill focuses her practice on complex commercial litigation, as well as legal ethics and risk management for law firms, lawyers, and corporate in-house counsel. She advises lawyers on all aspects of the law governing lawyers, including the defense of bar disciplinary complaints, lawyer mobility, lateral hiring, client engagement, conflicts of interest, attorney-client privilege, and law firm data privacy, breach, and response. Ms. Underhill also maintains an active state and federal court employment and complex commercial litigation practice. She is a member of the Oregon State Bar House of Delegates, Oregon Women Lawyers, the Washington State Bar Association Disciplinary Advisory Roundtable, the Association of Professional Responsibility Lawyers, and the American Bar Association Labor and Employment Section and Center on Professional Responsibility. She is a frequent speaker on all aspects of the law governing lawyers. As an adjunct professor at Lewis & Clark Law School, Ms. Underhill taught trial practice and coached the law school mock trial team at the American College of Trial Lawyers National Competition for two consecutive years.

Joseph Wallin, Carney Badley Spellman PS, Seattle, WA. Mr. Wallin focuses his practice on emerging, high-growth, and startup companies. He frequently represents companies in angel and venture financings, mergers and acquisitions, and other significant business transactions. He also represents investors in and acquirers of businesses and provides general counsel services for companies from startup to post-public. Mr. Wallin advocated on behalf of and provided an initial draft for the new Washington State crowdfunding bill signed into law in March 2014. He is the cofounder and editor of The Law of Startups blog. In addition, he invites guest speakers to chat on his weekly podcasts on a variety of issues for startups. He is a regular author and speaker, and he has served as an Adjunct Professor of Taxation at the Seattle University School of Law.

Kateri Walsh, Oregon State Bar, Tigard, OR. Ms. Walsh is the Director of Media Relations for the Oregon State Bar, taking a lead role in public education and outreach about the law, the courts, and the legal profession in Oregon. She also serves as the primary spokesperson on issues related to OSB policy and on the organization’s regulatory role. In addition, Ms. Walsh oversees the OSB New Lawyer Mentoring Program, a mandatory one-year program for all new lawyers in Oregon.
Chapter 1

SEC Enforcement Update and Hot Topics

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Division of Enforcement
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Chapter 1—SEC Enforcement Update and Hot Topics

103 S.Ct. 3255
Supreme Court of the United States
Raymond L. DIRKS, Petitioner
v.
SECURITIES AND EXCHANGE COMMISSION.
No. 82–276.
Argued March 21, 1983.
Decided July 1, 1983.

Syllabus

While serving as an officer of a broker-dealer, petitioner, who specialized in providing investment analysis of insurance company securities to institutional investors, received information from a former officer of an insurance company that its assets were vastly overstated as the result of fraudulent corporate practices and that various regulatory agencies had failed to act on similar charges made by company employees. Upon petitioner’s investigation of the allegations, certain company employees corroborated the fraud charges, but senior management denied any wrongdoing. Neither petitioner nor his firm owned or traded any of the company’s stock, but throughout his investigation he openly discussed the information he had obtained with a number of clients and investors, some of whom sold their holdings in the company. The Wall Street Journal declined to publish a story on the fraud allegations, as urged by petitioner. After the price of the insurance company’s stock fell during petitioner’s investigation, the New York Stock Exchange halted trading in the stock. State insurance authorities then impounded the company’s records and uncovered evidence of fraud. Only then did the Securities and Exchange Commission (SEC) file a complaint against the company, and only then did the Wall Street Journal publish a story based largely on information assembled by petitioner. After a hearing concerning petitioner’s role in the exposure of the fraud, the SEC found that he had aided and abetted violations of the antifraud provisions of the federal securities laws, including § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b–5, by repeating the allegations of fraud to members of the investment community who later sold their stock in the insurance company. Because of petitioner’s role in bringing the fraud to light, however, the SEC only censured him. On review, the Court of Appeals entered judgment against petitioner.

Held:

1. Two elements for establishing a violation of § 10(b) and Rule 10b–5 by corporate insiders are the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure. A duty to disclose or abstain does not arise from the mere possession of nonpublic market information. Such a duty arises rather from the existence of a fiduciary relationship. Chiarella v. United States, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348. There must also be “manipulation or deception” to bring a breach of fiduciary duty in connection with a securities transaction within the ambit of Rule 10b–5. Thus, an insider is liable under the Rule for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes secret profits. Pp. 3260 – 3261.

2. Unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships. There must be a breach of the insider’s fiduciary duty before the tippee inherits the duty to disclose or abstain. Pp. 3261 – 3266.

(a) The SEC’s position that a tippee who knowingly receives nonpublic material information from an insider invariably has a fiduciary duty to disclose before trading rests on the erroneous theory that the antifraud provisions require equal information among all traders. A duty to disclose arises from the relationship between parties and not merely from one’s ability to acquire information because of his position in the market. Pp. 3261 – 3263.

(b) A tippee, however, is not always free to trade on inside information. His duty to disclose or abstain is derivative from that of the insider’s duty. Tippees must assume an insider’s duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly. Thus, 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. Pp. 3263 – 3264.

(c) In determining whether a tippee is under an obligation to disclose or abstain, it is necessary to determine whether the insider’s “tip” constituted a breach of the insider’s fiduciary duty. Whether disclosure is a breach of duty depends in large part on the personal benefit the insider receives as a result of the disclosure. Absent an improper purpose, there is no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach. Pp. 3265 – 3266.
3. Under the inside-trading and tipping rules set forth above, petitioner had no duty to abstain from use of the inside information that he obtained, and thus there was no actionable violation by him. He had no pre-existing fiduciary duty to the insurance company’s shareholders. Moreover, the insurance company’s employees, as insiders, did not violate their duty to the company’s shareholders by providing information to petitioner. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by petitioner. Pp. 3266 – 3268.


**Attorneys and Law Firms**

David Bonderman argued the cause for petitioner. With him on the briefs were Lawrence A. Schneider and Eric Summergrad.

Paul Gonson argued the cause for respondent. With him on the brief were Daniel L. Goelzer, Jacob H. Stillman, and Whitney Adams.*

* Solicitor General Lee, Assistant Attorney General Jensen, Stephen M. Shapiro, Deputy Assistant Attorney General Olsen, David A. Strauss, and Geoffrey S. Stewart filed a brief for the United States as amicus curiae urging reversal.


**Opinion**

Justice POWELL delivered the opinion of the Court.

Petitioner Raymond Dirks received material nonpublic information from “insiders” of a corporation with which he had no connection. He disclosed this information to investors who relied on it in trading in the shares of the corporation. The question is whether Dirks violated the antifraud provisions of the federal securities laws by this disclosure.

I

In 1973, Dirks was an officer of a New York broker-dealer firm who specialized in providing investment analysis of insurance company securities to institutional investors. On March 6, Dirks received information from Ronald Secrist, a former officer of Equity Funding of America. Secrist alleged that the assets of Equity Funding, a diversified corporation primarily engaged in selling life insurance and mutual funds, were vastly overstated as the result of fraudulent corporate practices. Secrist also stated that various regulatory agencies had failed to act on similar charges made by Equity Funding employees. He urged Dirks to verify the fraud and disclose it publicly.

Dirks decided to investigate the allegations. He visited Equity Funding’s headquarters in Los Angeles and interviewed several officers and employees of the corporation. The senior management denied any wrongdoing, but certain corporation employees corroborated the charges of fraud. Neither Dirks nor his firm owned or traded any Equity Funding stock, but throughout his investigation he openly discussed the information he had obtained with a number of clients and investors. Some of these persons sold their holdings of Equity Funding securities, including five investment advisers who liquidated holdings of more than $16 million.

While Dirks was in Los Angeles, he was in touch regularly with William Blundell, the Wall Street Journal’s Los Angeles bureau chief. Dirks urged Blundell to write a story on the fraud allegations. Blundell did not believe, however, that such a massive fraud could go undetected and declined to write the story. He feared that publishing such damaging hearsay might be libelous.

During the two-week period in which Dirks pursued his investigation and spread word of Secrist’s charges, the price of Equity Funding stock fell from $26 per share to less than $15 per share. This led the New York Stock Exchange to halt trading on March 27. Shortly thereafter California insurance authorities impounded Equity Funding’s records and uncovered evidence of the fraud. Only then did the Securities and Exchange Commission (SEC) file a complaint against Equity Funding. and only then, on April 2, did the Wall Street Journal publish a front-page story based largely on information assembled by Dirks. Equity Funding immediately went into receivership.

The SEC began an investigation into Dirks’ role in the exposure of the fraud. After a hearing by an administrative law judge, the SEC found that Dirks had aided and abetted violations of § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b–5, 17 CFR § 240.10b–5 (1982), by repeating the allegations of fraud to members of the investment community who later sold their Equity Funding stock. The SEC concluded: “Where ‘tippees’—regardless of their motivation or occupation—come into possession of material ‘information that they know is confidential and know or should know came from a corporate insider,’ they must either publicly disclose that information or refrain from trading.” 21 S.E.C. Docket 1401, 1407 (1981) (footnote omitted) (quoting Chiarella v. United States, 445 U.S. 222, 230 n. 12, 100 S.Ct. 1108, 1115 n. 12, 63 L.Ed.2d 348 (1980)). Recognizing,
However, that Dirks “played an important role in bringing [Equity Funding’s] massive fraud to light,” 21 S.E.C. Docket, at 1412, the SEC only censured him.\footnote{37th Annual Northwest Securities Institute} Dirks sought review in the Court of Appeals for the District of Columbia Circuit. The court entered judgment against Dirks “for the reasons stated by the Commission in its opinion.” App. to Pet. for Cert. C–2. Judge Wright, a member of the panel, subsequently issued an opinion. Judge Robb concurred in the result and Judge Tamm dissented; neither filed a separate opinion. Judge Wright believed that “the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large.” 220 U.S.App.D.C. 309, 324, 681 F.2d 824, 839 (1982). Alternatively, Judge Wright concluded that, as an employee of a broker-dealer, Dirks had violated “obligations to the SEC and to the public completely independent of any obligations he acquired” as a result of receiving the information. Id., at 325, 681 F.2d, at 840.

In view of the importance to the SEC and to the securities industry of the question presented by this case, we granted a writ of certiorari. 459 U.S. 1014, 103 S.Ct. 371, 74 L.Ed.2d 506 (1982). We now reverse.

II

In the seminal case of In re Cady, Roberts & Co., 40 S.E.C. 907 (1961), the SEC recognized that the common law in some jurisdictions imposes on “corporate ‘insiders,’ particularly officers, directors, or controlling stockholders” an “affirmative duty of disclosure ... when dealing in securities.” Id., at 911, and n. 13.\footnote{37th Annual Northwest Securities Institute} The SEC found that not only did breach of this common-law duty also establish the elements of a Rule 10b–5 violation,\footnote{37th Annual Northwest Securities Institute} but that individuals other than corporate insiders could be obligated either to disclose material nonpublic information\footnote{37th Annual Northwest Securities Institute} before trading or to abstain from trading altogether. Id., at 912. In Chiarella, we accepted the two elements set out in Cady Roberts for establishing a Rule 10b–5 violation: “(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.” 445 U.S., at 227, 100 S.Ct., at 1114. In examining whether Chiarella had an obligation to disclose or abstain, the Court found that there is no general duty to disclose before trading on material nonpublic information,\footnote{37th Annual Northwest Securities Institute} and held that “a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.” Id., at 235, 100 S.Ct., at 1118. Such a duty arises rather from the existence of a fiduciary relationship. See id., at 227–235, 100 S.Ct., at 1114–18.

Not “all breaches of fiduciary duty in connection with a securities transaction,” however, come within the ambit of Rule 10b–5. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 472, 97 S.Ct. 1292, 1300, 51 L.Ed.2d 480 (1977). There must also be “manipulation or deception.” Id., at 473, 97 S.Ct., at 1300. In an inside-trading case this fraud derives from the “inherent unfairness involved where one takes advantage”\footnote{37th Annual Northwest Securities Institute} of “information intended to be available only for a corporate purpose and not for the personal benefit of anyone.” In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968). Thus, an insider will be liable under Rule 10b–5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes “secret profits.” Cady, Roberts, 40 S.E.C., at 916, n. 31.

III

We were explicit in Chiarella in saying that there can be no duty to disclose where the person who has traded on inside information “was not [the corporation’s] agent, ... was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.” 445 U.S., at 232, 100 S.Ct., at 1116. Not to require such a fiduciary relationship, we recognized, would “depart[ ] radically from the established doctrine that duty arises from a specific relationship between two parties” and would amount to “recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.” Id., at 232, 233, 100 S.Ct., at 1116, 1117. This requirement of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and courts in policing tippees who trade on inside information. Unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships.\footnote{37th Annual Northwest Securities Institute} In view of this absence, it has been unclear how a tippee acquires the Cady, Roberts duty to refrain from trading on inside information.

A

The SEC’s position, as stated in its opinion in this case, is that a tippee “inherits” the Cady, Roberts obligation to shareholders whenever he receives inside information from an insider:

“In tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from [Equity Funding] insiders. Tippees such as Dirks who receive non-public material information from insiders become ‘subject to the same duty as [the] insiders.’ Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. [495 F.2d 228, 237 (CA2 1974) (quoting Ross v. Licht, 263 F.Supp. 395, 410 (SDNY 1967))]. Such a tippee breaches the fiduciary duty which he assumes from the insider when the tippee knowingly transmits the information to someone who will probably trade on the basis thereof.... Presumably, Dirks’ informants were entitled to disclose the [Equity Funding] fraud in order to bring it to light and its perpetrators to justice. However, Dirks—standing in their shoes—committed a breach of the fiduciary...
duty which he had assumed in dealing with them, when he passed the information on to traders.” 21 S.E.C. Docket, at 1410, n. 42.

This view differs little from the view that we rejected as inconsistent with congressional intent in *Chiarella*. In that case, the Court of Appeals agreed with the SEC and affirmed Chiarella’s conviction, holding that “[a] nyone — corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose.” 9 United States v. Chiarella, 588 F.2d 1358, 1365 (CA2 1978) (emphasis in original). Here, the SEC maintains that anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading.15

In effect, the SEC’s theory of tippee liability in both cases appears rooted in the idea that the antifraud provisions require equal information among all traders. This conflicts with the principle set forth in *Chiarella* that only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information.16 Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading: “[T]he ‘information’ theory is rejected. Because the disclose-or-refrain duty is extraordinary, it attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws.” 220 U.S.App.D.C., at 322, 681 F.2d, at 837. See *Chiarella*, 445 U.S., at 235, n. 20, 100 S.Ct., at 1118, n. 20. We reaffirm today that “[a] duty [to disclose] arises from the relationship between parties ... and not merely from one’s ability to acquire information because of his position in the market.” 445 U.S., at 232–233, n. 14, 100 S.Ct., at 1116–17, n. 14.

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is “would open up opportunities for devious dealings in the name of the others that the trustee could not conduct in his own.”

The conclusion that recipients of inside information do not invariably acquire a duty to disclose or abstain does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. See 15 U.S.C. § 78t(b) (making it unlawful to do indirectly “by means of any other person” any act made unlawful by the federal securities laws). Similarly, the transactions of those who knowingly participate with the fiduciary in such a breach are “as forbidden” as transactions “on behalf of the trustee himself.” *Mosser v. Darrow*, 341 U.S. 267, 272, 71 S.Ct. 680, 682, 95 L.Ed. 927 (1951). See *Jackson v. Smith*, 254 U.S. 586, 589, 41 S.Ct. 200, 201, 65 L.Ed. 418 (1921); *Jackson v. Ludeling*, 88 U.S. (21 Wall) 616, 631–632, 22 L.Ed. 492 (1874). As the Court explained in *Mosser*, a contrary rule “would open up opportunities for devising dealings in the name of the others that the trustee could not conduct in his own.” 341 U.S., at 271, 71 S.Ct., at 682. See *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (CA2), cert. denied, 404 U.S. 1005, 92 S.Ct. 561, 30 L.Ed.2d 558 (1971). Thus, the tippee’s duty to disclose or abstain is derivative from that of the insider’s duty. See Tr. of Oral Arg. 38. Cf. *Chiarella*, 445 U.S., at 246, n. 1, 100 S.Ct., at 1123, n. 1 (BLACKMUN, J., dissenting). As we noted in *Chiarella*, “[t]he tippee’s obligation has been viewed as arising from his role as a participant after the fact in the insider’s breach of a fiduciary duty.” 445 U.S., at 230, n. 12, 100 S.Ct., at 1115, n. 12.

Thus, some tippees must assume an insider’s duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*.19 And for Rule 10b–5 purposes, the insider’s disclosure is improper only where it would violate his *Cady, Roberts* duty. Thus, 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.20 As Commissioner Smith perceptively observed in *Investors Management Co.*: “[T]he responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information....” 44 S.E.C., at 651 (concurring in the result). Tipping thus properly is viewed only as a means of indirectly violating the *Cady, Roberts* disclose-or-abstain rule.21

In determining whether a tippee is under an obligation to disclose or abstain, it is thus necessary to determine whether the insider’s “tip” constituted a breach of the insider’s fiduciary duty. All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders. In contrast to the extraordinary facts of this case, the more typical situation in which there will be a question whether disclosure violates the insider’s *Cady, Roberts* duty is when insiders

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15. *Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading: “[T]he ‘information’ theory is rejected. Because the disclose-or-refrain duty is extraordinary, it attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws.”

16. *220 U.S.App.D.C., at 322, 681 F.2d, at 837. See *Chiarella*, 445 U.S., at 235, n. 20, 100 S.Ct., at 1118, n. 20. We reaffirm today that “[a] duty [to disclose] arises from the relationship between parties ... and not merely from one’s ability to acquire information because of his position in the market.”

19. *The conclusion that recipients of inside information do not invariably acquire a duty to disclose or abstain does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. See 15 U.S.C. § 78t(b) (making it unlawful to do indirectly “by means of any other person” any act made unlawful by the federal securities laws). Similarly, the transactions of those who knowingly participate with the fiduciary in such a breach are “as forbidden” as transactions “on behalf of the trustee himself.”

20. *As Commissioner Smith perceptively observed in *Investors Management Co.*: “[T]he responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information....”

21. *In determining whether a tippee is under an obligation to disclose or abstain, it is thus necessary to determine whether the insider’s “tip” constituted a breach of the insider’s fiduciary duty. All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders. In contrast to the extraordinary facts of this case, the more typical situation in which there will be a question whether disclosure violates the insider’s *Cady, Roberts* duty is when insiders*
disclose information to analysts. See n. 16, supra. In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market. For example, it may not be clear—either to the corporate insider or to the recipient analyst—whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market. 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.” 40 S.E.C., at 912, n. 15. See n. 10, supra. 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. As Commissioner Smith stated in Investors Management Co.: “It is important in this type of case to focus on policing insiders and what they do ... rather than on policing information per se and its possession...” 44 S.E.C., at 648 (concurring in the result).

The SEC argues that, if inside-trading liability does not exist when the information is transmitted for a proper purpose but is used for trading, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information. We think the SEC is unduly concerned. In determining whether the insider’s purpose in making a particular disclosure is fraudulent, the SEC and the courts are not required to read the parties’ minds. Scienter in some cases is relevant in determining whether the tipper has violated his Cady, Roberts duty. But to determine whether the disclosure itself “deceive[s], manipulate[s], or defraud[s]” shareholders, Aaron v. SEC, 446 U.S. 680, 686, 100 S.Ct. 1945, 1950, 64 L.Ed.2d 611 (1980), the initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings. Cf. 40 S.E.C., at 912, n. 15; Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv.L.Rev. 324, 348 (1979) (“The theory ... is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself....”). There are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.

Determining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts. But it is essential, we think, to have a guiding principle for those whose daily activities must be limited and instructed by the SEC’s inside-trading rules, and we believe that there must be a breach of the insider’s fiduciary duty before the tippee inherits the duty to disclose or abstain. In contrast, the rule adopted by the SEC in this case would have no limiting principle.

IV

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 pre-existing 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 Dirk’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. See supra, at 3258. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. See n. 20, supra. 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, 100 S.Ct., at 1115, n. 12.

V

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

Reversed.
Justice BLACKMUN, with whom Justice BRENNAN and Justice MARSHALL join, dissenting.

The Court today takes still another step to limit the protections provided investors by § 10(b) of the Securities Exchange Act of 1934.1 See Chiarella v. United States, 445 U.S. 222, 246, 100 S.Ct. 1108, 1123, 63 L.Ed.2d 348 (1980) (dissenting opinion). The device employed in this case engrafts a special motivational requirement on the fiduciary duty doctrine. This innovation excuses a knowing and intentional violation of an insider’s duty to shareholders if the insider does not act from a motive of personal gain. Even on the extraordinary facts of this case, such an innovation is not justified.

I

As the Court recognizes, ante, at 3263, n. 17, the facts here are unusual. After a meeting with Ronald Secrist, a former Equity Funding employee, on March 7, 1973, App. 226, petitioner Raymond Dirks found himself in possession of material nonpublic information of massive fraud within the company.2 In the Court’s words, “[h]e uncovered ... startling information that required no analysis or exercise of judgment as to its market relevance.” Ante, at 3263, n. 17. In disclosing that information to Dirks, Secrist intended that Dirks would disseminate the information to his clients, those clients would unload their Equity Funding securities on the market, and the price would fall precipitously, thereby triggering a reaction from the authorities. App. 16, 25, 27.

Dirks complied with his informant’s wishes. Instead of reporting that information to the Securities and Exchange Commission (SEC or Commission) or to other regulatory agencies, Dirks began to disseminate the information to his clients and undertook his own investigation.3 One of his first steps was to direct his associates at Delafield Childs to draw up a list of Delafield clients holding Equity Funding securities. On March 12, eight days before Dirks flew to Los Angeles to investigate Secrist’s story, he reported the full allegations to Boston Company Institutional Investors, Inc., which on March 15 and 16 sold approximately $1.2 million of Equity securities.4 See id., at 199. As he gathered more information, he selectively disclosed it to his clients. To those holding Equity Funding securities he gave the “hard” story—all the allegations; others received the “soft” story—a recitation of vague factors that might reflect adversely on Equity Funding’s management. See id., at 211, n. 24.

Dirks’ attempts to disseminate the information to nonclients were feeble, at best. On March 12, he left a message for Herbert Lawson, the San Francisco bureau chief of The Wall Street Journal. Not until March 19 and 20 did he call Lawson again, and outline the situation. William Blundell, a Journal investigative reporter based in Los Angeles, got in touch with Dirks about his March 20 telephone call. On March 21, Dirks met with Blundell in Los Angeles. Blundell began his own investigation, relying in part on Dirks’ contacts, and on March 23 telephoned Stanley Sporkin, the SEC’s Deputy Director of Enforcement. On March 26, the next business day, Sporkin and his staff interviewed Blundell and asked to see Dirks the following morning. Trading was halted by the New York Stock Exchange at about the same time Dirks was talking to Los Angeles SEC personnel. The next day, March 28, the SEC suspended trading in Equity Funding securities. By that time, Dirks’ clients had unloaded close to $15 million of Equity Funding stock and the price had plummeted from $26 to $15. The effect of Dirks’ selective dissemination of Secrist’s information was that Dirks’ clients were able to shift the losses that were inevitable due to the Equity Funding fraud from themselves to uninformed market participants.

II

A

No one questions that Secrist himself could not trade on his inside information to the disadvantage of uninformed shareholders and purchasers of Equity Funding securities. See Brief for United States as Amicus Curiae 19, n. 12. Unlike the printer in Chiarella, Secrist stood in a fiduciary relationship with these shareholders. As the Court states, ante, at 3260, corporate insiders have an affirmative duty of disclosure when trading with shareholders of the corporation. See Chiarella, 445 U.S., at 227, 100 S.Ct., at 1114. This duty extends as well to purchasers of the corporation’s securities. Id., at 227, n. 8, 100 S.Ct., at 1114, n. 8, citing Gratz v. Claughton, 187 F.2d 46, 49 (CA2), cert. denied, 341 U.S. 920, 71 S.Ct. 741, 95 L.Ed. 1353 (1951).

The Court also acknowledges that Secrist could not do by proxy what he was prohibited from doing personally. Ante, at 3263; Mosser v. Darrow, 341 U.S. 267, 71 S.Ct. 680, 682, 95 L.Ed. 927 (1951). But this is precisely what Secrist did. Secrist used Dirks to disseminate information to Dirks’ clients, who in turn dumped stock on unknowing purchasers. Secrist thus intended Dirks to injure the purchasers of Equity Funding securities to whom Secrist had a duty to disclose. Accepting the Court’s view of tippee liability,5 it appears that Dirks’ knowledge of this breach makes him liable as a participant in the breach after the fact. Ante, at 3263, 3267; Chiarella, 445 U.S., at 230, n. 12, 100 S.Ct., at 1115, n. 12.

B

The Court holds, however, that Dirks is not liable because Secrist did not violate his duty; according to the Court, this is so because Secrist did not have the improper purpose of personal gain. Ante, at 3265 – 3266, 3266 – 3267. In so doing, the Court
imposes a new, subjective limitation on the scope of the duty owed by insiders to shareholders. The novelty of this limitation is reflected in the Court’s lack of support for it.6

The insider’s duty is owed directly to the corporation’s shareholders.7 See Langevoort, Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement, 70 Calif.L.Rev. 1, 5 (1982); 3A W. Fletcher, Private Corporations § 1168.2, pp. 288–289 (1975). As Chiarella recognized, it is based on the relationship of trust and confidence between the insider and the shareholder. 445 U.S., at 228, 100 S.Ct., at 1114. That relationship assures the shareholder that the insider may not take actions that will harm him unfairly.8 The affirmative duty of disclosure protects against this injury. See Pepper v. Litton, 308 U.S. 295, 307, n. 15, 60 S.Ct. 238, 245, n. 15, 84 L.Ed. 281 (1939); Strong v. Rapide, 213 U.S. 419, 431–434, 29 S.Ct. 521, 525–26, 53 L.Ed. 853 (1909); see also Chiarella, 445 U.S., at 228, n. 10, 100 S.Ct., at 1114, n. 10; cf. Pepper, 308 U.S., at 307, 60 S.Ct., at 245 (fiduciary obligation to corporation exists for corporation’s protection).

C

The fact that the insider himself does not benefit from the breach does not eradicate the shareholder’s injury.9 Cf. Restatement (Second) of Trusts § 205, Comments c and d (1959) (trustee liable for acts causing diminution of value of trust); 3A Scott on Trusts § 205, p. 1665 (1967) (trustee liable for any losses to trust caused by his breach). It makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider’s misuse of nonpublic information. The duty is addressed not to the insider’s motives,10 but to his actions and their consequences on the shareholder. Personal gain is not an element of the breach of this duty.11

This conclusion is borne out by the Court’s decision in Mosser v. Darrow, 341 U.S. 267, 71 S.Ct. 680, 95 L.Ed. 927 (1951). There, the Court faced an analogous situation: a reorganization trustee engaged two employee-promoters of subsidiaries of the companies being reorganized to provide services that the trustee considered to be essential to the successful operation of the trust. In order to secure their services, the trustee expressly agreed with the employees that they could continue to trade in the securities of the subsidiaries. The employees then turned their inside position into substantial profits at the expense both of the trust and of other holders of the companies’ securities.

The Court acknowledged that the trustee neither intended to nor did in actual fact benefit from this arrangement; his motives were completely selfless and devoted to the companies. 341 U.S., at 275, 71 S.Ct., at 684. The Court, nevertheless, found the trustee liable to the estate for the activities of the employees he authorized.12 The Court described the trustee’s defalcation as “a willful and deliberate setting up of an interest in employees adverse to that of the trust.” Id., at 272, 71 S.Ct., at 682. The breach did not depend on the trustee’s personal gain, and his motives in violating his duty were irrelevant; like Secrist, the trustee intended that others would abuse the inside information for their personal gain. Cf. Dodge v. Ford Motor Co., 204 Mich. 459, 506–509, 170 N.W. 668, 684–685 (1919) (Henry Ford’s philanthropic motives did not permit him to set Ford Motor Company dividend policies to benefit public at expense of shareholders).

As Mosser demonstrates, the breach consists in taking action disadvantageous to the person to whom one owes a duty. In this case, Secrist owed a duty to purchasers of Equity Funding shares. The Court’s addition of the bad purpose element to a breach of fiduciary duty claim is flatly inconsistent with the principle of Mosser. I do not join this limitation of the scope of an insider’s fiduciary duty to shareholders.13

III

The improper purpose requirement not only has no basis in law, but it rests implicitly on a policy that I cannot accept. The Court justifies Secrist’s and Dirks’ action because the general benefit derived from the violation of Secrist’s duty to shareholders outweighed the harm caused to those shareholders, see Heller, Chiarella, SEC Rule 14e–3 and Dirks : “Fairness” versus Economic Theory, 37 Bus. Lawyer 517, 550 (1982); Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 S.Ct.Rev. 309, 338—in other words, because the end justified the means. Under this view, the benefit conferred on society by Secrist’s or Dirks’ activities may be paid for with the losses caused to shareholders trading with Dirks’ clients.14

Although Secrist’s general motive to expose the Equity Funding fraud was laudable, the means he chose were not. Moreover, even assuming that Dirks played a substantial role in exposing the fraud,15 he and his clients should not profit from the information they obtained from Secrist. Misprison of a felony long has been against public policy. Branzburg v. Hayes, 408 U.S. 665, 696–697, 92 S.Ct. 2646, 2664, 33 L.Ed.2d 626 (1972); see 18 U.S.C. § 4. A person cannot condition his transmission of information of a crime on a financial award. As a citizen, Dirks had at least an ethical obligation to report the information to the proper authorities. See ante, at 3264, n. 20. The Court’s holding is deficient in policy terms not because it fails to create a legal norm out of that ethical norm, see ibid., but because it actually rewards Dirks for his aiding and abetting.

Dirks and Secrist were under a duty to disclose the information or to refrain from trading on it.16 I agree that disclosure in this case would have been difficult. Ante, at 3264, n. 20. I also recognize that the SEC seemingly has been less than helpful in its view of the nature of disclosure necessary to satisfy the disclose-or-refrain duty. The Commission tells persons with inside
information that they cannot trade on that information unless they disclose; it refuses, however, to tell them how to disclose. See In re Faberge, Inc., 45 S.E.C. 249, 256 (1973) (disclosure requires public release through public media designed to reach investing public generally). This seems to be a less than sensible policy, which it is incumbent on the Commission to correct. The Court, however, has no authority to remedy the problem by opening a hole in the congressionally mandated prohibition on insider trading, thus rewarding such trading.

IV

In my view, Secrist violated his duty to Equity Funding shareholders by transmitting material nonpublic information to Dirks with the intention that Dirks would cause his clients to trade on that information. Dirks, therefore, was under a duty to make the information publicly available or to refrain from actions that he knew would lead to trading. Because Dirks caused his clients to trade, he violated § 10(b) and Rule 10b–5. Any other result is a disservice to this country’s attempt to provide fair and efficient capital markets. I dissent.

Footnotes


2 Dirks received from his firm a salary plus a commission for securities transactions above a certain amount that his clients directed through his firm. See 21 S.E.C. Docket, at 1402, n. 3. But “[i]t is not clear how many of those with whom Dirks spoke promised to direct some brokerage business through [Dirks’ firm] to compensate Dirks, or how many actually did so.” 220 U.S.App.D.C., at 316, 681 F.2d, at 831. The Boston Company Institutional Investors, Inc., promised Dirks about $25,000 in commissions, but it is unclear whether Boston actually generated any brokerage business for his firm. See App. 199, 204–205; 21 S.E.C. Docket, at 1404, n. 10; 220 U.S.App.D.C., at 316, n. 5, 681 F.2d, at 831, n. 5.

3 As early as 1971, the SEC had received allegations of fraudulent accounting practices at Equity Funding. Moreover, on March 9, 1973, an official of the California Insurance Department informed the SEC’s regional office in Los Angeles of Secrist’s charges of fraud. Dirks himself voluntarily presented his information at the SEC’s regional office beginning on March 27.

4 A federal grand jury in Los Angeles subsequently returned a 105-count indictment against 22 persons, including many of Equity Funding’s officers and directors. All defendants were found guilty of one or more counts, either by a plea of guilty or a conviction after trial. See Brief for Petitioner 15; App. 149–153.

5 Section 17(a) provides:
   “It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
   “(1) to employ any device, scheme, or artifice to defraud, or
   “(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   “(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”

6 Section 10(b) provides:
   “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
   “(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”
“(a) To employ any device, scheme, or artifice to defraud,

“(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

“(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”


The duty that insiders owe to the corporation’s shareholders not to trade on inside information differs from the common-law duty that officers and directors also have to the corporation itself not to mismanage corporate assets, of which confidential information is one. See 3 Fletcher Cyclopedia of the Laws of Private Corporations §§ 848, 900 (1975 ed. and Supp.1982); 3A Fletcher §§ 1168.1, 1168.2. In holding that breaches of this duty to shareholders violated the Securities Exchange Act, the Cady, Roberts Commission recognized, and we agree, that “[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.” See 37th Annual Northwest Securities Institute 40 S.E.C., at 912, n. 15.

Rule 10b–5 is generally the most inclusive of the three provisions on which the SEC rested its decision in this case, and we will refer to it when we note the statutory basis for the SEC’s inside-trading rules.

The SEC views the disclosure duty as requiring more than disclosure to purchasers or sellers: “Proper and adequate disclosure of significant corporate developments can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group.” In re Faberge, Inc., 45 S.E.C. 249, 256 (1973).

See 445 U.S., at 233, 100 S.Ct., at 1117; id., at 237, 100 S.Ct., at 1119 (STEVENS, J., concurring); id., at 238–239, 100 S.Ct., at 1119–20 (BRENNAN, J., concurring in the judgment); id., at 239–240, 100 S.Ct., at 1120 (BURGER, C.J., dissenting). Cf. id., at 252, n. 2, 100 S.Ct., at 1126, n. 2 (BLACKMUN, J., dissenting) (recognizing that there is no obligation to disclose material nonpublic information obtained through the exercise of “diligence or acumen” and “honest means,” as opposed to “stealth”).

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. See SEC v. Monarch Fund, 608 F.2d 938, 942 (CA2 1979); In re Investors Management Co., 44 S.E.C. 633, 645 (1971); In re Van Alstyne, Noel & Co., 43 S.E.C. 1080, 1084–1085 (1969); In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 937 (1968); Cady, Roberts, 40 S.E.C., at 912. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (CA2 1974) (investment banker had access to material information when working on a proposed public offering for the corporation). For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

Apparently, the SEC believes this case differs from Chiarella in that Dirks’ receipt of inside information from Secrist, an insider, carried Secrist’s duties with it, while Chiarella received the information without the direct involvement of an insider and thus inherited no duty to disclose or abstain. The SEC fails to explain, however, why the receipt of nonpublic information from an insider automatically carries with it the fiduciary duty of the insider. As we emphasized in Chiarella, mere possession of nonpublic information does not give rise to a duty to disclose or abstain; only a specific relationship does that.
And we do not believe that the mere receipt of information from an insider creates such a special relationship between the tippee and the corporation’s shareholders. 

Applying the weakness of its argument in light of <i>Chiarella</i>, the SEC attempts to distinguish that case factually as involving not “inside” information, but rather “market” information, i.e., “information generated within the company relating to its assets or earnings.” Brief for Respondent 23. This Court drew no such distinction in <i>Chiarella</i> and, as THE CHIEF JUSTICE noted, “[i]t is clear that § 10(b) and Rule 10b–5 by their terms and by their history make no such distinction.” 445 U.S., at 241, n. 1, 100 S.Ct., at 1121, n. 1 (dissenting opinion). See ALI Fed.Sec.Code § 1603, Comment (2)(j) (Proposed Official Draft 1978).

In <i>Chiarella</i>, we noted that formulation of an absolute equal information rule “should not be undertaken absent some explicit evidence of congressional intent.” 445 U.S., at 233, 100 S.Ct., at 1117. Rather than adopting such a radical view of securities trading, Congress has expressly exempted many market professionals from the general statutory prohibition set forth in § 11(a)(1) of the Securities Exchange Act, 15 U.S.C. § 78k(a)(1), against members of a national securities exchange trading for their own account. See id., at 233, n. 16, 100 S.Ct., at 1117, n. 16. We observed in <i>Chiarella</i> that “[t]he exception is based upon Congress’ recognition that [market professionals] contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of [nonpublic information].” Ibid.

The SEC expressly recognized that “[t]he value to the entire market of [analysts’] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst’s work redounds to the benefit of all investors.” 21 S.E.C., at 1406. The SEC asserts that analysts remain free to obtain from management corporate information for purposes of “filling in the ‘interstices in analysis’...” Brief for Respondent 42 (quoting <i>Investors Management Co.</i>, 44 S.E.C., at 646). But this rule is inherently imprecise, and imprecision prevents parties from ordering their actions in accord with legal requirements. Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed. Cf. <i>Adler v. Klawans</i>, 267 F.2d 840, 845 (CA2 1959) (Burger, J., sitting by designation).

On its facts, this case is the unusual one. Dirks is an analyst in a broker-dealer firm, and he did interview management in the course of his investigation. He uncovered, however, startling information that required no analysis or exercise of judgment as to its market relevance. Nonetheless, the principle at issue here extends beyond these facts. The SEC’s rule—applicable without regard to any breach by an insider—could have serious ramifications on reporting by analysts of investment views.

Despite the unusualness of Dirks’ “find,” the central role that he played in uncovering the fraud at Equity Funding, and that analysts in general can play in revealing information that corporations may have reason to withhold from the public, is an important one. Dirks’ careful investigation brought to light a massive fraud at the corporation. And until the Equity Funding fraud was exposed, the information in the trading market was grossly inaccurate. But for Dirks’ efforts, the fraud might well have gone undetected longer. See n. 8, supra.

The SEC itself has recognized that tippee liability properly is imposed only in circumstances where the tippee knows, or has reason to know, that the insider has disclosed improperly inside corporate information. In <i>Investors Management Co.</i>, supra, the SEC stated that one element of tippee liability is that the tippee knew or had reason to know “that [the information] was non-public and had been obtained improperly by selective revelation or otherwise.” 44 S.E.C., at 641 (emphasis added). Commissioner Smith read this test to mean that a tippee can be held liable only if he received information in breach of an insider’s duty not to disclose it. Id., at 650 (concurring in the result).

Professor Loss has linked tippee liability to the concept in the law of restitution that “... [w]here a fiduciary in violation of his duty to the beneficiary communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information.” 3 L. Loss, Securities Regulation 1451 (2d ed. 1961) (quoting Restatement of Restitution § 201(2) (1937)). Other authorities likewise have expressed the view that tippee liability exists only where there has been a breach of trust by an insider of which the tippee had knowledge. See, e.g., <i>Ross v. Licht</i>, 263 F.Supp. 395, 410 (SDNY 1967); A. Jacobs, The Impact of Rule 10b–5, § 167, at 7–4 (1975) (“[T]he better view is that a tipper must know or have reason to know the information is nonpublic and was improperly obtained.”); Fleischer, Mundheim & Murphy, An Initial Inquiry Into the Responsibility to Disclose Market Information, 121 U.Pa.L.Rev. 798, 818, n. 76 (1973) (“The extension of rule 10b–5 restrictions to tippees of corporate insiders can best be justified on the theory that they are participating in the insider’s breach of his fiduciary duty.”). Cf. Restatement (Second) of Agency § 312, comment c (1958) (“A person who, with notice that an agent is thereby violating his duty to his principal, receives confidential information from the agent, may be [deemed] ... a constructive trustee.”).

We do not suggest that knowingly trading on inside information is ever “socially desirable or even that it is devoid of moral considerations.” Dooley, Enforcement of Insider Trading Restrictions, 66 Va.L.Rev. 1, 55 (1980). Nor do we imply an absence of responsibility to disclose promptly indications of illegal actions by a corporation to the proper authorities—typically the SEC and exchange authorities in cases involving securities. Depending on the circumstances, and
even where permitted by law, one’s trading on material nonpublic information is behavior that may fall below ethical standards of conduct. But in a statutory area of the law such as securities regulation, where legal principles of general application must be applied, there may be “significant distinctions between actual legal obligations and ethical ideals.” SEC, Report of the Special Study of Securities Markets, H.R.Doc. No. 95, 88th Cong., 1st Sess., pt. 1, pp. 237–238 (1963). The SEC recognizes this. At oral argument, the following exchange took place:

“QUESTION: So, it would not have satisfied his obligation under the law to go to the SEC first?

“[SEC’s counsel]: That is correct. That an insider has to observe what has come to be known as the abstain or disclosure rule. Either the information has to be disclosed to the market if it is inside information ... or the insider must abstain.” Tr. of Oral Arg. 27.

Thus, it is clear that Rule 10b–5 does not impose any obligation simply to tell the SEC about the fraud before trading.

An example of a case turning on the court’s determination that the disclosure did not impose any fiduciary duties on the recipient of the inside information is Walton v. Morgan Stanley & Co., 623 F.2d 796 (CA2 1980). There, the defendant investment banking firm, representing one of its own corporate clients, investigated another corporation that was a possible target of a takeover bid by its client. In the course of negotiations the investment banking firm was given, on a confidential basis, unpublished material information. Subsequently, after the proposed takeover was abandoned, the firm was charged with relying on the information when it traded in the target corporation’s stock. For purposes of the decision, it was assumed that the firm knew the information was confidential, but that it had been received in arm’s-length negotiations. See id., at 798. In the absence of any fiduciary relationship, the Court of Appeals found no basis for imposing tippee liability on the investment firm. See id., at 799.

“A mental state embracing intent to deceive, manipulate, or defraud,” Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, n. 12, 96 S.Ct. 1375, 1381, n. 12, 47 L.Ed.2d 668 (1976)—is an independent element of a Rule 10b–5 violation. See Aaron v. SEC, 446 U.S. 680, 695, 100 S.Ct. 1945, 1955, 64 L.Ed.2d 611 (1980). Contrary to the dissent’s suggestion, see post, at p. 3271, n. 10, motivation is not irrelevant to the issue of scienter. It is not enough that an insider’s conduct results in harm to investors; rather, a violation may be found only where there is “intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.” Ernst & Ernst v. Hochfelder, supra, 425 U.S., at 199, 96 S.Ct., at 1383. The issue in this case, however, is not whether Secrist or Dirks acted with scienter, but rather whether there was any deceptive or fraudulent conduct at all, i.e., whether Secrist’s disclosure constituted a breach of his fiduciary duty and thereby caused injury to shareholders. See n. 27, infra. Only if there was such a breach did Dirks, a tippee, acquire a fiduciary duty to disclose or abstain.

Without legal limitations, market participants are forced to rely on the reasonableness of the SEC’s litigation strategy, but that can be hazardous, as the facts of this case make plain. Following the SEC’s filing of the Texas Gulf Sulphur action, Commissioner (and later Chairman) Budge spoke of the various implications of applying Rule 10b–5 in inside-trading cases:

“Turning to the realm of possible defendants in the present and potential civil actions, the Commission certainly does not contemplate suing every person who may have come across inside information. In the Texas Gulf action neither tippees nor persons in the vast rank and file of employees have been named as defendants. In my view, the Commission in future cases normally should not join rank and file employees or persons outside the company such as an analyst or reporter who learns of inside information.” Speech of Hamer Budge to the New York Regional Group of the American Society of Corporate Secretaries, Inc. (Nov. 18, 1965) (emphasis added), reprinted in Budge, The Texas Gulf Sulphur Case—What It Is and What It Isn’t, Corp. Secretary No. 127, at 6 (Dec. 17, 1965).

Dirks contends that he was not a “tippee” because the information he received constituted unverified allegations of fraud that were denied by management and were not “material facts” under the securities laws that required disclosure before trading. He also argues that the information he received was not truly “inside” information, i.e., intended for a confidential corporate purpose, but was merely evidence of a crime. The Solicitor General agrees. See Brief for United States as Amicus Curiae 22. We need not decide, however, whether the information constituted “material facts,” or whether information concerning corporate crime is properly characterized as “inside information.” For purposes of deciding this case, we assume the correctness of the SEC’s findings, accepted by the Court of Appeals, that petitioner was a tippee of material inside information.

Judge Wright found that Dirks acquired a fiduciary duty by virtue of his position as an employee of a broker-dealer. See 220 U.S.App.D.C., at 325–327, 681 F.2d, at 840–842. The SEC, however, did not consider Judge Wright’s novel theory in its decision, nor did it present that theory to the Court of Appeals. The SEC also has not argued Judge Wright’s theory in this Court. See Brief for Respondent 21, n. 27. The merits of such a duty are therefore not before the Court. See SEC v. Chenery Corp., 332 U.S. 194, 196–197, 67 S.Ct. 1575, 1577, 91 L.Ed. 1995 (1947).

In this Court, the SEC appears to contend that an insider invariably violates a fiduciary duty to the corporation’s shareholders by transmitting nonpublic corporate information to an outsider when he has reason to believe that the outsider...
may use it to the disadvantage of the shareholders. “Thus, regardless of any ultimate motive to bring to public attention the
derelictions at Equity Funding, Secrist breached his duty to Equity Funding shareholders.” Brief for Respondent 31. This
perceived “duty” differed markedly from the one that the SEC identified in Cady, Roberts and that has been the basis for
federal tippee-trading rules to date. In fact, the SEC did not charge Secrist with any wrongdoing, and we do not understand
the SEC to have relied on any theory of a breach of duty by Secrist in finding that Dirks breached his duty to Equity
Funding’s shareholders. See App. 250 (decision of administrative law judge) (“One who knows himself to be a beneficiary of
non-public, selectively disclosed inside information must fully disclose or refrain from trading.”); SEC’s Reply to Notice of
Supplemental Authority before the SEC 4 (“If Secrist was acting properly, Dirks inherited a duty to [Equity Funding]’s
shareholders to refrain from improper private use of the information.”); Brief on behalf of the SEC in the Court of Appeals, at
47–50; id., at 51 (“[K]nowing possession of inside information by any person imposes a duty to abstain or disclose.”); id., at
52–54; id., at 55 (“[T]his obligation arises not from the manner in which such information is acquired...”). 220

The dissent argues that “Secrist violated his duty to Equity Funding shareholders by transmitting material nonpublic
information to Dirks with the intention that Dirks would cause his clients to trade on that information.” Post, at 3274. By
perceiving a breach of fiduciary duty whenever inside information is intentionally disclosed to securities traders, the
dissenting opinion effectively would achieve the same result as the SEC’s theory below, i.e., mere possession of inside
information while trading would be viewed as a Rule 10b–5 violation. But Chiarella made it explicitly clear there is no
general duty to forgo market transactions “based on material, nonpublic information.” 445 U.S., at 233, 100 S.Ct., at 1117.
Such a duty would “depar[t] radically from the established doctrine that duty arises from a specific relationship between two
parties.” Ibid. See p. 3261, supra.

Moreover, to constitute a violation of Rule 10b–5, there must be fraud. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199,
96 S.Ct. 1375, 1383, 47 L.Ed.2d 668 (1976) (statutory words “manipulative,” “device,” and “contrivance... connot[e] intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of
securities”) (emphasis added). There is no evidence that Secrist’s disclosure was intended to or did in fact “deceive or defraud” anyone. Secrist certainly intended to convey relevant information that management was unlawfully concealing,
and—as so far as the record shows—he believed that persuading Dirks to investigate was the best way to disclose the fraud.
Other efforts had proved fruitless. Under any objective standard, Secrist received no direct or indirect personal benefit from the
disclosure.

The dissenting opinion focuses on shareholder “losses,” “injury,” and “damages,” but in many cases there may be no clear
causal connection between inside trading and outsiders’ losses. In one sense, as market values fluctuate and investors act on
inevitably incomplete or incorrect information, there always are winners and losers; but those who have “lost” have not
necessarily been defrauded. On the other hand, inside trading for personal gain is fraudulent, and is a violation of the federal
securities laws. See Dooley, supra, at 39 – 41, 70. Thus, there is little legal significance to the dissent’s argument that Secrist
and Dirks created new “victims” by disclosing the information to persons who traded. In fact, they prevented the fraud from
continuing and victimizing many more investors.

1See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975); Ernst & Ernst v.
926, 51 L.Ed.2d 124 (1977); Chiarella v. United States, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980); Aaron v. SEC,
446 U.S. 680, 100 S.Ct. 1945, 64 L.Ed.2d 611 (1980). This trend frustrates the congressional intent that the securities laws be
interpreted flexibly to protect investors, see Affiliated Ute Citizens v. United States, 406 U.S. 128, 151, 92 S.Ct. 1456, 1471,
31 L.Ed.2d 741 (1972); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186, 84 S.Ct. 275, 279, 11 L.Ed.2d 237
(1963), and to regulate deceptive practices “detrimental to the interests of the investor,” S.Rep. No. 792, 73d Cong., 2d Sess.,
18 (1934); see H.R.Rep. No. 1383, 73d Cong., 2d Sess., 10 (1934). Moreover, the Court continues to refuse to accord to SEC
administrative decisions the deference it normally gives to an agency’s interpretation of its own statute. See, e.g., Blum v.
Bacon, 457 U.S. 132, 102 S.Ct. 2355, 72 L.Ed.2d 728 (1982).

2Unknown to Dirks, Secrist also told his story to New York insurance regulators the same day. App. 23. They immediately
assured themselves that Equity Funding’s New York subsidiary had sufficient assets to cover its outstanding policies and then
passed on the information to California regulators who in turn informed Illinois regulators. Illinois investigators, later
joined by California officials, conducted a surprise audit of Equity Funding’s Illinois subsidiary, id., at 87–88, to find $22
million of the subsidiary’s assets missing. On March 30, these authorities seized control of the Illinois subsidiary. Id., at 271.

3In the same administrative proceeding at issue here, the Administrative Law Judge (ALJ) found that Dirks’ clients—five
institutional investment advisors—violated § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), § 10(b) of the Securities
Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b–5, 17 CFR § 240.10b–5, by trading on Dirks’ tips. App. 297. All the
clients were censured, except Dreyfus Corporation. The ALJ found that Dreyfus had made significant efforts to disclose the
information to Goldman, Sachs, the purchaser of its securities. App. 299, 301. None of Dirks’ clients appealed these
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4The Court’s implicit suggestion that Dirks did not gain by this selective dissemination of advice, ante, at 3258, n. 2, is inaccurate. The ALJ found that because of Dirks’ information, Boston Company Institutional Investors, Inc., directed business to Delafield Childs that generated approximately $25,000 in commissions. App. 199, 204–205. While it is true that the exact economic benefit gained by Delafield Childs due to Dirks’ activities is unknowable because of the structure of compensation in the securities market, there can be no doubt that Delafield and Dirks gained both monetary rewards and enhanced reputations for “looking after” their clients.

5I interpret the Court’s opinion to impose liability on tippees like Dirks when the tippee knows or has reason to know that the information is material and nonpublic and was obtained through a breach of duty by selective revelation or otherwise. See In re Investors Management Co., 44 S.E.C. 633, 641 (1971).

6The Court cites only a footnote in an SEC decision and Professor Brudney to support its rule. Ante, at 3266. The footnote, however, merely identifies one result the securities laws are intended to prevent. It does not define the nature of the duty itself. See n. 9, infra. Professor Brudney’s quoted statement appears in the context of his assertion that the duty of insiders to disclose prior to trading with shareholders is in large part a mechanism to correct the information available to noninsiders. Professor Brudney simply recognizes that the most common motive for breaching this duty is personal gain; he does not state, however, that the duty prevents only personal aggrandizement. Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv.L.Rev. 322, 345–348 (1979). Surely, the Court does not now adopt Professor Brudney’s access-to-information theory, a close cousin to the equality-of-information theory it accuses the SEC of harboring. See ante, at 3261 – 3263.

7The Court correctly distinguishes this duty from the duty of an insider to the corporation not to mismanage corporate affairs or to misappropriate corporate assets. Ante, at 3260, n. 9. That duty also can be breached when the insider trades in corporate securities on the basis of inside information. Although a shareholder suing in the name of the corporation can recover for the corporation damages for any injury the insider causes by the breach of this distinct duty, Diamond v. Oreamuno, 24 N.Y.2d 494, 498, 301 N.Y.S.2d 78, 80, 248 N.E.2d 910, 912 (1969); see Thomas v. Robin Industries, Inc., 520 F.2d 1393, 1397 (CA3 1975), insider trading generally does not injure the corporation itself. See Langevoort, Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement, 70 Calif.L.Rev. 1, 2, n. 5, 28, n. 111 (1982).


“Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.” In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (footnote omitted).

The first element—on which Chiarella’s holding rests—establishes the type of relationship that must exist between the parties before a duty to disclose is present. The second—not addressed by Chiarella—identifies the harm that the duty protects against: the inherent unfairness to the shareholder caused when an insider trades with him on the basis of undisclosed inside information.

9Without doubt, breaches of the insider’s duty occur most often when an insider seeks personal aggrandizement at the expense of shareholders. Because of this, descriptions of the duty to disclose are often coupled with statements that the duty prevents unjust enrichment. See, e.g., In re Cady, Roberts & Co., 40 S.E.C. 907, 912, n. 15 (1961); Langevoort, 70 Calif.L.Rev., at 19. Private gain is certainly a strong motivation for breaching the duty.

It is, however, not an element of the breach of this duty. The reference to personal gain in Cady, Roberts for example, is appended to the first element underlying the duty which requires that an insider have a special relationship to corporate information that he cannot appropriate for his own benefit. See n. 8, supra. It does not limit the second element which addresses the injury to the shareholder and is at issue here. See ibid. In fact, Cady, Roberts describes the duty more precisely in a later footnote: “In the circumstances, [the insider’s] relationship to his customers was such that he would have a duty not to take a position adverse to them, not to take secret profits at their expense, not to misrepresent facts to them, and in general to place their interests ahead of his own.” 40 S.E.C., at 916, n. 31. This statement makes clear that enrichment of the insider himself is simply one of the results the duty attempts to prevent.

10Of course, an insider is not liable in a Rule 10b–5 administrative action unless he has the requisite scienter. Aaron v. SEC, 446 U.S. 680, 691, 100 S.Ct. 1945, 1952, 64 L.Ed.2d 611 (1980). He must know or intend that his conduct violate his duty. Secrist obviously knew and intended that Dirks would cause trading on the inside information and that Equity Funding shareholders would be harmed. The scienter requirement addresses the intent necessary to support liability; it does not address the motives behind the intent.
Should the adviser receiving the information use it to trade, it may breach a separate contractual or other duty to the corporation not to misuse the information. Absent such an arrangement, however, the adviser is not barred by Rule 10b–5 from trading on that information if it believes that the insider has not breached any duty to his shareholders. See Walton v. Morgan Stanley & Co., 623 F.2d 796, 798–799 (CA2 1980).

The situation here, of course, is radically different. Ante, at 3263, n. 17 (Dirks received information requiring no analysis “as to its market relevance”). Secrist divulged the information for the precise purpose of causing Dirks’ clients to trade on it. I fail to understand how imposing liability on Dirks will affect legitimate insider-analyst contacts.

12The duty involved in Mosser was the duty to the corporation in trust not to misappropriate its assets. This duty, of course, differs from the duty to shareholders involved in this case. See n. 7, supra. Trustees are also subject to a higher standard of care than scienter. 3 A. Scott on Trusts § 201, p. 1650 (1967). In addition, strict trustees are bound not to trade in securities at all. See Langevoort, 70 Calif.L.Rev., at 2, n. 5. These differences, however, are irrelevant to the principle of Mosser that the motive of personal gain is not essential to a trustee’s liability. In Mosser, as here, personal gain accrued to the tippees. See 341 U.S., at 273, 71 S.Ct., at 683.

13Although I disagree in principle with the Court’s requirement of an improper motive, I also note that the requirement adds to the administrative and judicial burden in Rule 10b–5 cases. Assuming the validity of the requirement, the SEC’s approach—a violation occurs when the insider knows that the tippee will trade with the information, Brief for SEC 31—can be seen as a presumption that the insider gains from the tipping. The Court now requires a case-by-case determination, thus prohibiting such a presumption.

The Court acknowledges the burdens and difficulties of this approach, but asserts that a principle is needed to guide market participants. Ante, at 3265. I fail to see how the Court’s rule has any practical advantage over the SEC’s presumption. The Court’s approach is particularly difficult to administer when the insider is not directly enriched monetarily by the trading he induces. For example, the Court does not explain why the benefit Secrist obtained—the good feeling of exposing a fraud and his enhanced reputation—is any different from the benefit to an insider who gives the information as a gift to a friend or relative. Under the Court’s somewhat cynical view, gifts involve personal gain. See ibid. Secrist surely gave Dirks a gift of the commissions Dirks made on the deal in order to induce him to disseminate the information. The distinction between pure altruism and self-interest has puzzled philosophers for centuries; there is no reason to believe that courts and administrative law judges will have an easier time with it.

14This position seems little different from the theory that insider trading should be permitted because it brings relevant information to the market. See H. Manne, Insider Trading and the Stock Market 59–76, 111–146 (1966); Manne, Insider Trading and the Law Professors, 23 Vand.L.Rev. 547, 565–576 (1970). The Court also seems to embrace a variant of that extreme theory, which postulates that insider trading causes no harm at all to those who purchase from the insider. Ante, at 3267, n. 27. Both the theory and its variant sit at the opposite end of the theoretical spectrum from the much maligned equality-of-information theory, and never have been adopted by Congress or ratified by this Court. See Langevoort, 70 Calif.L.Rev., at 1 and n. 1. The theory rejects the existence of any enforceable principle of fairness between market participants.

15The Court uncritically accepts Dirks’ own view of his role in uncovering the Equity Funding fraud. See ante, at 3263, n. 17. It ignores the fact that Secrist gave the same information at the same time to state insurance regulators, who proceeded to expose massive fraud in a major Equity Funding subsidiary. The fraud surfaced before Dirks ever spoke to the SEC.

16Secrist did pass on his information to regulatory authorities. His good but misguided motive may be the reason the SEC did not join him in the administrative proceedings against Dirks and his clients. The fact that the SEC, in an exercise of prosecutorial discretion, did not charge Secrist under Rule 10b–5 says nothing about the applicable law. Cf. ante, at 3266, n. 25 (suggesting otherwise). Nor does the fact that the SEC took an unsupportable legal position in proceedings below indicate that neither Secrist nor Dirks is liable under any theory. Cf. ibid. (same).
17 At oral argument, the SEC’s view was that Dirks’ obligation to disclose would not be satisfied by reporting the information to the SEC. Tr. of Oral Arg. 27, quoted ante, at 3264, n. 20. This position is in apparent conflict with the statement in its brief that speaks favorably of a safe harbor rule under which an investor satisfies his obligation to disclose by reporting the information to the Commission and then waiting a set period before trading. Brief for SEC 43–44. The SEC, however, has neither proposed nor adopted a rule to this effect, and thus persons such as Dirks have no real option other than to refrain from trading.
Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission’s Rule 10b–5 prohibit undisclosed trading on inside corporate information by persons bound by a duty of trust and confidence not to exploit that information for their personal advantage. These persons are also forbidden from tipping inside information to others for trading. A tippee who receives such information with the knowledge that its disclosure breached the tipper’s duty acquires that duty and may be liable for securities fraud for any undisclosed trading on the information. In Dirks v. SEC, 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911, this Court explained that tippee liability hinges on whether the tipper’s disclosure breaches a fiduciary duty, which occurs when the tipper discloses the information for a personal benefit. The Court also held that a personal benefit may be inferred where the tipper receives something of value in exchange for the tip or “makes a gift of confidential information to a trading relative or friend.” Id., at 664, 103 S.Ct. 3255.

Petitioner Salman was indicted for federal securities-fraud crimes for trading on inside information he received from a friend and relative-by-marriage, Michael Kara, who, in turn, received the information from his brother, Maher Kara, a former investment banker at Citigroup. Maher testified at Salman’s trial that he shared inside information with his brother Michael to benefit him and expected him to trade on it, and Michael testified to sharing that information with Salman, who knew that it was from Maher. Salman was convicted.

While Salman’s appeal to the Ninth Circuit was pending, the Second Circuit decided that Dirks does not permit a factfinder to infer a personal benefit to the tipper from a gift of confidential information to a trading relative or friend, unless there is “proof of a meaningfully close personal relationship” between tipper and tippee “that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature,” United States v. Newman, 773 F.3d 438, 452, cert. denied, 577 U.S. ———, 136 S.Ct. 242, 193 L.Ed.2d 133. The Ninth Circuit declined to follow Newman so far, holding that Dirks allowed Salman’s jury to infer that the tipper breached a duty because he made “ ‘a gift of confidential information to a trading relative.’ ” 792 F.3d 1087, 1092 (quoting Dirks, 463 U.S., at 664, 103 S.Ct. 3255).

Held:

The Ninth Circuit properly applied Dirks to affirm Salman’s conviction. Under Dirks, the jury could infer that the tipper here personally benefited from making a gift of confidential information to a trading relative. Pp. 425 – 429.

(a) Salman contends that a gift of confidential information to a friend or family member alone is insufficient to establish the personal benefit required for tippee liability, claiming that a tipper does not personally benefit unless the tipper’s goal in disclosing information is to obtain money, property, or something of tangible value. The Government counters that a gift of confidential information to anyone, not just a “trading relative or friend,” is enough to prove securities fraud because a tipper personally benefits through any disclosure of confidential trading information for a personal (non-corporate) purpose. The Government argues that any concerns raised by permitting such an inference are significantly alleviated by other statutory elements prosecutors must satisfy. Pp. 425 – 427.

(b) This Court adheres to the holding in Dirks, which easily resolves the case at hand: “when an insider makes a gift of confidential information to a trading relative or friend ... [t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient,” 463 U.S., at 664, 103 S.Ct. 3255. In these situations, the tipper personally benefits because giving a gift of trading information to a trading relative is the same thing as trading by the tipper followed by a gift of the proceeds. Here, by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, Maher breached his duty of trust and confidence to Citigroup and its clients—a duty acquired and breached by Salman when he traded on the information with full knowledge that it had been improperly disclosed. To the extent that the Second Circuit in Newman held that the tipper must also receive something of a “pecuniary or similarly valuable nature” in exchange for a gift to a trading relative, that rule is inconsistent with Dirks. Pp. 427 – 428.

(c) Salman’s arguments to the contrary are rejected. Salman has cited nothing in this Court’s precedents that undermines the gift-giving principle this Court announced in Dirks. Nor has he demonstrated that either § 10(b) itself or Dirks’s gift-giving
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standard “leav[e] grave uncertainty about how to estimate the risk posed by a crime” or are plagued by “hopeless indeterminacy.” Johnson v. United States, 576 U.S. —–, —–, —–, 135 S.Ct. 2551, 2557, 2558, 192 L.Ed.2d 569. Salman also has shown “no grievous ambiguity or uncertainty that would trigger” the rule of lenity. Barber v. Thomas, 560 U.S. 474, 492, 130 S.Ct. 2499, 177 L.Ed.2d 1 (internal quotation marks omitted). To the contrary, his conduct is in the heartland of Dirks’s rule concerning gifts of confidential information to trading relatives. Pp. 428–429.

792 F.3d 1087, affirmed.

ALITO, J., delivered the opinion for a unanimous Court.

Attorneys and Law Firms

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Opinion

Justice ALITO delivered the opinion of the Court.

Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission’s Rule 10b–5 prohibit undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage. 48 Stat. 891, as amended, 15 U.S.C. § 78j(b) (prohibiting the use, “in connection with the purchase or sale of any security,” of “any manipulative or deceptive device or contrivance in contravention of such rules as the [Securities and Exchange Commission] may prescribe”); 17 C.F.R. § 240.10b–5 (2016) (forbidding the use, “in connection with the sale or purchase of any security,” of “any device, scheme or artifice to defraud,” or any “act, practice, or course of business which operates ... as a fraud or deceit”); see United States v. O’Hagan, 521 U.S. 642, 650–652, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997). Individuals under this duty may face criminal and civil liability for trading on inside information (unless they make appropriate disclosures ahead of time).

These persons also may not tip inside information to others for trading. The tippee acquires the tipper’s duty to disclose or abstain from trading if the tippee knows the information was disclosed in breach of the tipper’s duty, and the tippee may commit securities fraud by trading in disregard of that knowledge. In Dirks v. SEC, 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983), this Court explained that a tippee’s liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information. A tipper breaches such a fiduciary duty, we held, when the tipper discloses the inside information for a personal benefit. And, we went on to say, a jury can infer a personal benefit—and thus a breach of the tipper’s duty—where the tipper receives something of value in exchange for the tip or “makes a gift of confidential information to a trading relative or friend.” Id., at 664, 103 S.Ct. 3255.

Petitioner Bassam Salman challenges his convictions for conspiracy and insider trading. Salman received lucrative trading tips from an extended family member, who had received the information from Salman’s brother-in-law. Salman then traded on the information. He argues that he cannot be held liable as a tippee because the tipper (his brother-in-law) did not personally receive money or property in exchange for the tips and thus did not personally benefit from them. The Court of Appeals disagreed, holding that Dirks allowed the jury to infer that the tipper here breached a duty because he made a “‘gift of confidential information to a trading relative.’ ” 792 F.3d 1087, 1092 (C.A.9 2015) (quoting Dirks, supra, at 664, 103 S.Ct. 3255). Because the Court of Appeals properly applied Dirks, we affirm the judgment below.

I

Maher Kara was an investment banker in Citigroup’s healthcare investment banking group. He dealt with highly confidential information about mergers involving Citigroup’s clients. Maher enjoyed a close relationship with his older brother, Mounir Kara (known as Michael). After Maher started at Citigroup, he began discussing aspects of his job with Michael. At first he relied on Michael’s chemistry background to help him grasp scientific concepts relevant to his new job. Then, while their father was battles cancer, the brothers discussed companies that dealt with innovative cancer treatment and
pain management techniques. Michael began to trade on the information Maher shared with him. At first, Maher was unaware of his brother’s trading activity, but eventually he began to suspect that it was taking place.

Ultimately, Maher began to assist Michael’s trading by sharing inside information with his brother about pending mergers and acquisitions. Maher sometimes used code words to communicate corporate information to his brother. Other times, he shared inside information about deals he was not working on in order to avoid detection. See, e.g., App. 118, 124–125. Without his younger brother’s knowledge, Michael used the information to others—including Salman, Michael’s friend and Maher’s brother-in-law. By the time the authorities caught on, Salman had made over $1.5 million in profits that he split with another relative who executed trades via a brokerage account on Salman’s behalf.

Salman was indicted on one count of conspiracy to commit securities fraud, see 18 U.S.C. § 371, and four counts of securities fraud, see 15 U.S.C. §§ 78j(b), 78ff; 18 U.S.C. § 2; 17 C.F.R. § 240.10b–5. Facing charges of their own, both Maher and Michael pleaded guilty and testified at Salman’s trial.

The evidence at trial established that Maher and Michael enjoyed a “very close relationship.” App. 215. Maher “love[d] [his] brother very much.” Michael was like “a second father to Maher,” and Michael was the best man at Maher’s wedding to Salman’s sister. Id., at 158, 195, 104–107. Maher testified that he shared inside information with his brother to benefit him and with the expectation that his brother would trade on it. While Maher explained that he disclosed the information in large part to appease Michael (who pestered him incessantly for it), he also testified that he tipped his brother to “help him” and to “fulfill[ ] whatever needs he had.” Id., at 118, 82. For instance, Michael once called Maher and told him that “he needed a favor.” Id., at 124. Maher offered his brother money but Michael asked for information instead. Maher then disclosed an upcoming acquisition. Ibid. Although he instantly regretted the tip and called his brother back to implore him not to trade, Maher expected his brother to do so anyway. Id., at 125.

For his part, Michael told the jury that his brother’s tips gave him “timely information that the average person does not have access to” and “access to stocks, options, and what have you, that I can capitalize on, that the average person would never have or dream of.” Id., at 251. Michael testified that he became friends with Salman when Maher was courting Salman’s sister and later began sharing Maher’s tips with Salman. As he explained at trial, “any time a major deal came in, [Salman] was the first on my phone list.” Id., at 258. Michael also testified that he told Salman that the information was coming from Maher. See, e.g., id., at 286 (“‘Maher is the source of all this information’”).

After a jury trial in the Northern District of California, Salman was convicted on all counts. He was sentenced to 36 months of imprisonment, three years of supervised release, and over $730,000 in restitution. After his motion for a new trial was denied, Salman appealed to the Ninth Circuit. While his appeal was pending, the Second Circuit issued its opinion in United States v. Newman, 773 F.3d 438 (2014), cert. denied, 577 U.S. ——, 136 S.Ct. 242, 193 L.Ed.2d 133 (2015). There, the Second Circuit reversed the convictions of two portfolio managers who traded on inside information. The Newman defendants were “several steps removed from the corporate insiders” and the court found that “there was no evidence that either was aware of the source of the inside information.” 773 F.3d, at 443. The court acknowledged that Dirks and Second Circuit case law allow a factfinder to infer a personal benefit to the tipper from a gift of confidential information to a trading relative or friend. 773 F.3d, at 452. But the court concluded that, “[t]o the extent” Dirks permits “such an inference,” the inference “is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.” 773 F.3d, at 452.

Pointing to Newman, Salman argued that his conviction should be reversed. While the evidence established that Maher made a gift of trading information to Michael and that Salman knew it, there was no evidence that Maher received anything of “a pecuniary or similarly valuable nature” in exchange—or that Salman knew of any such benefit. The Ninth Circuit disagreed and affirmed Salman’s conviction. 792 F.3d 1087. The court reasoned that the case was governed by Dirks’s holding that a tipper benefits personally by making a gift of confidential information to a trading relative or friend. Indeed, Maher’s disclosures to Michael were “precisely the gift of confidential information to a trading relative that Dirks envisioned.” 792 F.3d, at 1092 (internal quotation marks omitted). To the extent Newman went further and required additional gain to the tipper in cases involving gifts of confidential information to family and friends, the Ninth Circuit “decline[d] to follow it.” 792 F.3d, at 1093.

We granted certiorari to resolve the tension between the Second Circuit’s Newman decision and the Ninth Circuit’s decision in this case. 577 U.S. ——, 136 S.Ct. 899, 193 L.Ed.2d 788 (2016).

II

A

In this case, Salman contends that an insider’s “gift of confidential information to a trading relative or friend,” Dirks, 463 U.S., at 664, 103 S.Ct. 3255 is not enough to establish securities fraud. Instead, Salman argues, a tipper does not personally benefit unless the tipper’s goal in disclosing inside information is to obtain money, property, or something of tangible value.
He claims that our insider-trading precedents, and the cases those precedents cite, involve situations in which the insider exploited confidential information for the insider’s own “tangible monetary profit.” Brief for Petitioner 31. He suggests that his position is reinforced by our criminal-fraud precedents outside of the insider-trading context, because those cases confirm that a fraudster must personally obtain money or property. Id., at 33–34. More broadly, Salman urges that defining a gift as a personal benefit renders the insider-trading offense indeterminate and overbroad: indeterminate, because liability may turn on facts such as the closeness of the relationship between tipper and tippee and the tipper’s purpose for disclosure; and overbroad, because the Government may avoid having to prove a concrete personal benefit by simply arguing that the tipper meant to give a gift to the tippee. He also argues that we should interpret Dirks’s standard narrowly so as to avoid constitutional concerns. Brief for Petitioner 36–37. Finally, Salman contends that gift situations create especially troubling problems for remote tippees—that is, tippees who receive inside information from another tippee, rather than the tipper—who may have no knowledge of the relationship between the original tipper and tippee and thus may not know why the tipper made the disclosure. Id., at 43, 48, 50.

The Government disagrees and argues that a gift of confidential information to anyone, not just a “trading relative or friend,” is enough to prove securities fraud. See Brief for United States 27 (“Dirks’s personal-benefit test encompasses a gift to any person with the expectation that the information will be used for trading, not just to a trading relative or friend” ) (quoting 463 U.S., at 664, 103 S.Ct. 3255; emphasis in original). Under the Government’s view, a tipper personally benefits whenever the tipper discloses confidential trading information for a noncorporate purpose. Accordingly, a gift to a friend, a family member, or anyone else would support the inference that the tipper exploited the trading value of inside information for personal purposes and thus personally benefited from the disclosure. The Government claims to find support for this reading in Dirks and the precedents on which Dirks relied. See, e.g., id., at 654, 103 S.Ct. 3255 (“fraud” in an insider-trading case “derives from the inherent unfairness involved where one takes advantage of ‘information intended to be available only for a corporate purpose and not for the personal benefit of anyone’” ) (quoting In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968))).

The Government also argues that Salman’s concerns about unlimited and indeterminate liability for remote tippees are significantly alleviated by other statutory elements that prosecutors must satisfy to convict a tippee for insider trading. The Government observes that, in order to establish a defendant’s criminal liability as a tippee, it must prove beyond a reasonable doubt that the tipper expected that the information being disclosed would be used in securities trading. Brief for United States 23–24; Tr. of Oral Arg. 38. The Government also notes that, to establish a defendant’s criminal liability as a tippee, it must prove that the tippee knew that the tipper breached a duty—in other words, that the tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue. Brief for United States 43; Tr. of Oral Arg. 36–37, 39.

We adhere to Dirks, which easily resolves the narrow issue presented here.

In Dirks, we explained that a tippee is exposed to liability for trading on inside information only if the tippee participates in a breach of the tipper’s fiduciary duty. Whether the tipper breached that duty depends “in large part on the purpose of the disclosure” to the tippee. 463 U.S., at 662, 103 S.Ct. 3255. “[T]he test,” we explained, “is whether the insider personally will benefit, directly or indirectly, from his disclosure.” Ibid. Thus, the disclosure of confidential information without personal benefit is not enough. In determining whether a tipper derived a personal benefit, we instructed courts to “focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputation benefit that will translate into future earnings.” Id., at 663, 103 S.Ct. 3255. This personal benefit can “often” be inferred “from objective facts and circumstances,” we explained, such as “a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient.” Ibid., at 664, 103 S.Ct. 3255. In particular, we held that “[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend.” Ibid. (emphasis added). In such cases, “[t]he tip and trade resemble trading by the insider followed by a gift of the profits to the recipient.” Ibid. We then applied this gift-giving principle to resolve Dirks itself, finding it dispositive that the tippers “received no monetary or personal benefit” from their tips to Dirks, “nor was their purpose to make a gift of valuable information to Dirks.” Id., at 667, 103 S.Ct. 3255 (emphasis added).

Our discussion of gift giving resolves this case. Maher, the tipper, provided inside information to a close relative, his brother Michael. Dirks makes clear that a tipper breaches a fiduciary duty by making a gift of confidential information to “a trading relative,” and that rule is sufficient to resolve the case at hand. As Salman’s counsel acknowledged at oral argument, Maher would have breached his duty had he personally traded on the information he himself then given the proceeds as a gift to his brother. Tr. of Oral Arg. 3–4. It is obvious that Maher would personally benefit in that situation. But Maher effectively achieved the same result by disclosing the information to Michael, and allowing him to trade on it. Dirks appropriately prohibits that approach, as well. Cf. 463 U.S., at 659, 103 S.Ct. 3255 (holding that “insiders are forbidden” both “from personally using undisclosed corporate information to their advantage” and from “giving” such information to an outsider for
the same improper purpose of exploiting the information for their personal gain”). *Dirks* specifies that when a tipper gives inside information to “a trading relative or friend,” the jury can infer that the tipper meant to provide the equivalent of a cash gift. In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds. Here, by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, Maher breached his duty of trust and confidence to Citigroup and its clients—a duty Salman acquired, and breached himself, by trading on the information with full knowledge that it had been improperly disclosed.

To the extent the Second Circuit held that the tipper must also receive something of a “pecuniary or similarly valuable nature” in exchange for a gift to family or friends, *Newman*, 773 F.3d, at 452, we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*.

**C**

Salman points out that many insider-trading cases—including several that *Dirks* cited—involved insiders who personally profited through the misuse of trading information. But this observation does not undermine the test *Dirks* articulated and applied. Salman also cites a sampling of our criminal-fraud decisions construing other federal fraud statutes, suggesting that they stand for the proposition that fraud is not consummated unless the defendant obtains money or property. *Sekhar v. United States*, 570 U.S. ——, 133 S.Ct. 2720, 186 L.Ed.2d 794 (2013) (Hobbs Act); *Skilling v. United States*, 561 U.S. 358, 130 S.Ct. 2896, 177 L.Ed.2d 619 (2010) (honest-services mail and wire fraud); *Cleveland v. United States*, 531 U.S. 12, 121 S.Ct. 365, 148 L.Ed.2d 221 (2000) (wire fraud); *McNally v. United States*, 483 U.S. 350, 107 S.Ct. 2875, 97 L.Ed.2d 292 (1987) (mail fraud). Assuming that these cases are relevant to our construction of § 10(b) (a proposition the Government forcefully disputes), nothing in them undermines the commonsense point we made in *Dirks*. Making a gift of inside information to a relative like Michael is little different from trading on the information, obtaining the profits, and doling them out to the trading relative. The tipper benefits either way. The facts of this case illustrate the point: In one of their tipper-tippee interactions, Michael asked Maher for a favor, declined Maher’s offer of money, and instead requested and received lucrative trading information.

We reject Salman’s argument that *Dirks*’s gift-giving standard is unconstitutionally vague as applied to this case. *Dirks* created a simple and clear “guiding principle” for determining tippee liability, 463 U.S., at 664, 103 S.Ct. 3255 and Salman has not demonstrated that either § 10(b) itself or the *Dirks* gift-giving standard “leave[e] grave uncertainty about how to estimate the risk posed by a crime” or are plagued by “hopeless indeterminacy,” *Johnson v. United States*, 576 U.S. ——, ——, 135 S.Ct. 2551, 2557, 2558, 192 L.Ed.2d 569 (2015). At most, Salman shows that in some factual circumstances assessing liability for gift-giving will be difficult. That alone cannot render “shapeless” a federal criminal prohibition, for even clear rules “produce close cases.” *Id.*, at ——, ——, 135 S.Ct., at 2560. We also reject Salman’s appeal to the rule of leniency, as he has shown “no grievous ambiguity or uncertainty that would trigger the rule’s application.” *Barber v. Thomas*, 560 U.S. 474, 492, 130 S.Ct. 2499, 177 L.Ed.2d 1 (2010) (internal quotation marks omitted). To the contrary, Salman’s conduct is in the heartland of *Dirks*’s rule concerning gifts. It remains the case that “[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts.” 463 U.S., at 664, 103 S.Ct. 3255. But there is no need for us to address those difficult cases today, because this case involves “precisely the ‘gift of confidential information to a trading relative’ that *Dirks* envisioned.” 792 F.3d, at 1092 (quoting 463 U.S., at 664, 103 S.Ct. 3255).

**III**

Salman’s jury was properly instructed that a personal benefit includes “the benefit one would obtain from simply making a gift of confidential information to a trading relative.” App. 398–399. As the Court of Appeals noted, “the Government presented direct evidence that the disclosure was intended as a gift of market-sensitive information.” 792 F.3d, at 1094. And, as Salman conceded below, this evidence is sufficient to sustain his conviction under our reading of *Dirks*. Appellant’s Supplemental Brief in No. 14–10204(CA9), p. 6 (“Maher made a gift of confidential information to a trading relative [Michael] ... and, if [Michael’s] testimony is accepted as true (as it must be for purposes of sufficiency review), Salman knew that Maher had made such a gift” (internal quotation marks, brackets, and citation omitted)). Accordingly, the Ninth Circuit’s judgment is affirmed.

*It is so ordered.*

Footnotes

1The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

3The Second Circuit also reversed the *Newman* defendants’ convictions because the Government introduced no evidence that the defendants knew the information they traded on came from insiders or that the insiders received a personal benefit in exchange for the tips. 773 F.3d, at 453–454. This case does not implicate those issues.
Dirks v. SEC, 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983), established the personal-benefit framework in a case brought under the classical theory of insider-trading liability, which applies “when a corporate insider” or his tippee “trades in the securities of [the tipper’s] corporation on the basis of material, nonpublic information.” United States v. O’Hagan, 521 U.S. 642, 651–652, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997). In such a case, the defendant breaches a duty to, and takes advantage of, the shareholders of his corporation. By contrast, the misappropriation theory holds that a person commits securities fraud “when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information” such as an employer or client. Id., at 652, 117 S.Ct. 2199. In such a case, the defendant breaches a duty to, and defrauds, the source of the information, as opposed to the shareholders of his corporation. The Court of Appeals observed that this is a misappropriation case, 792 F.3d, 1087, 1092, n. 4 (C.A.9 2015), while the Government represents that both theories apply on the facts of this case, Brief for United States 15, n. 1. We need not resolve the question. The parties do not dispute that Dirks’s personal-benefit analysis applies in both classical and misappropriation cases, so we will proceed on the assumption that it does.
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UNITED STATES Court of Appeals, Second Circuit.
UNITED STATES of America, Appellee,
v.
Todd NEWMAN, Anthony Chiasson, Defendants–Appellants,
Jon Horvath, Danny Kuo, Hyung G. Lim, Michael Steinberg, Defendants.¹
Nos. 13–1837–cr (L), 13–1917–cr (con).
Argued: April 22, 2014.

Attorneys and Law Firms
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Opinion
BARRINGTON D. PARKER, Circuit Judge:


The Government alleged that a cohort of analysts at various hedge funds and investment firms obtained material, nonpublic information from employees of publicly traded technology companies, shared it amongst each other, and subsequently passed this information to the portfolio managers at their respective companies. The Government charged Newman, a portfolio manager at Diamondback Capital Management, LLC (“Diamondback”), and Chiasson, a portfolio manager at Level Global Investors, L.P. (“Level Global”), with willfully participating in this insider trading scheme by trading in securities based on the inside information illicitly obtained by this group of analysts. On appeal, Newman and Chiasson challenge the sufficiency of the evidence as to several elements of the offense, and further argue that the district court erred in failing to instruct the jury that it must find that a tippee knew that the insider disclosed confidential information in exchange for a personal benefit.

We agree that the jury instruction was erroneous because we conclude that, in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit. Moreover, we hold that the evidence was insufficient to sustain a guilty verdict against Newman and Chiasson for two reasons. First, the Government’s evidence of any personal benefit received by the alleged insiders was insufficient to establish the tipper liability from which defendants’ purported tippee liability would derive. Second, even assuming that the scant evidence offered on the issue of personal benefit was sufficient, which we conclude it was not, the Government presented no evidence that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders’ fiduciary duties.

Accordingly, we reverse the convictions of Newman and Chiasson on all counts and remand with instructions to dismiss the indictment as it pertains to them with prejudice.

BACKGROUND

This case arises from the Government’s ongoing investigation into suspected insider trading activity at hedge funds. On January 18, 2012, the Government unsealed charges against Newman, Chiasson, and several other investment professionals.
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At trial, the Government presented evidence that a group of financial analysts exchanged information they obtained from company insiders, both directly and more often indirectly. Specifically, the Government alleged that these analysts received information from insiders at Dell and NVIDIA disclosing those companies’ earnings numbers before they were publicly released in Dell’s May 2008 and August 2008 earnings announcements and NVIDIA’s May 2008 earnings announcement. These analysts then passed the inside information to their portfolio managers, including Newman and Chiasson, who, in turn, executed trades in Dell and NVIDIA stock, earning approximately $4 million and $68 million, respectively, in profits for their respective funds.

Newman and Chiasson were several steps removed from the corporate insiders and there was no evidence that either was aware of the source of the inside information. With respect to the Dell tipping chain, the evidence established that Rob Ray of Dell’s investor relations department tipped information regarding Dell’s consolidated earnings numbers to Sandy Goyal, an analyst at Neuberger Berman. Goyal in turn gave the information to Diamondback analyst Jesse Tortora. Tortora in turn relayed the information to his manager Newman as well as to other analysts including Level Global analyst Spyridon “Sam” Adondakis. Adondakis then passed along the Dell information to Chiasson, making Newman and Chiasson three and four levels removed from the inside tipper, respectively.

With respect to the NVIDIA tipping chain, the evidence established that Chris Choi of NVIDIA’s finance unit tipped inside information to Hyung Lim, a former executive at technology companies Broadcom Corp. and Altera Corp., whom Choi knew from church. Lim passed the information to co-defendant Danny Kuo, an analyst at Whittier Trust. Kuo circulated the information to the group of analyst friends, including Tortora and Adondakis, who in turn gave the information to Newman and Chiasson, making Newman and Chiasson four levels removed from the inside tipper.

Although Ray has yet to be charged administratively, civilly, or criminally, and Choi has yet to be charged criminally, for insider trading or any other wrongdoing, the Government charged that Newman and Chiasson were criminally liable for insider trading because, as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose.

At the close of evidence, Newman and Chiasson moved for a judgment of acquittal pursuant to Federal Rule of Criminal Procedure 29. They argued that there was no evidence that the corporate insiders provided inside information in exchange for a personal benefit which is required to establish tipper liability under Dirks v. S.E.C., 463 U.S. 646, 103 S.Ct. 3255, 77 L.Ed.2d 911 (1983). Because a tippee’s liability derives from the liability of the tipper, Newman and Chiasson argued that they could not be found guilty of insider trading. Newman and Chiasson also argued that, even if the corporate insiders had received a personal benefit in exchange for the inside information, there was no evidence that they knew about any such benefit. Absent such knowledge, appellants argued, they were not aware of, or participants in, the tippers’ fraudulent breaches of fiduciary duties to Dell or NVIDIA, and could not be convicted of insider trading under Dirks. In the alternative, appellants requested that the court instruct the jury that it must find that Newman and Chiasson knew that the corporate insiders had disclosed confidential information for personal benefit in order to find them guilty.

The district court reserved decision on the Rule 29 motions. With respect to the appellants’ requested jury charge, while the district court acknowledged that their position was “supportable certainly by the language of Dirks,” Tr. 3595:10–12, it ultimately found that it was constrained by this Court’s decision in S.E.C. v. Obus, 693 F.3d 276 (2d Cir.2012), which listed the elements of tippee liability without enumerating knowledge of a personal benefit received by the insider as a separate element. Tr. 3604:3–3605:5. Accordingly, the district court did not give Newman and Chiasson’s proposed jury instruction. Instead, the district court gave the following instructions on the tippers’ intent and the personal benefit requirement:

Now, if you find that Mr. Ray and/or Mr. Choi had a fiduciary or other relationship of trust and confidence with their employers, then you must next consider whether the [G]overnment has proven beyond a reasonable doubt that they intentionally breached that duty of trust and confidence by disclosing material[,] nonpublic information for their own benefit.

Tr. 4030.

On the issue of the appellants’ knowledge, the district court instructed the jury:

To meet its burden, the [G]overnment must also prove beyond a reasonable doubt that the defendant you are considering knew that the material, nonpublic information had been disclosed by the insider in breach of a duty of trust and confidence. The mere receipt of material, nonpublic information by a defendant, and
even trading on that information, is not sufficient; he must have known that it was originally disclosed by the insider in violation of a duty of confidentiality.

Tr. 4033:14–22.

On December 17, 2012, the jury returned a verdict of guilty on all counts. The district court subsequently denied the appellants’ Rule 29 motions.

On May 2, 2013, the district court sentenced Newman to an aggregate term of 54 months’ imprisonment, to be followed by one year of supervised release, imposed a $500 mandatory special assessment, and ordered Newman to pay a $1 million fine and to forfeit $737,724. On May 13, 2013, the district court sentenced Chiasson to an aggregate term of 78 months’ imprisonment, to be followed by one year of supervised release, imposed a $600 mandatory special assessment, and ordered him to pay a $5 million fine and forfeiture in an amount not to exceed $2 million. This appeal followed.

DISCUSSION

Newman and Chiasson raise a number of arguments on appeal. Because we conclude that the jury instructions were erroneous and that there was insufficient evidence to support the convictions, we address only the arguments relevant to these issues. We review jury instructions de novo with regard to whether the jury was misled or inadequately informed about the applicable law. See United States v. Moran–Toala, 726 F.3d 334, 344 (2d Cir.2013).

I. The Law of Insider Trading

Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), prohibits the use “in connection with the purchase or sale of any security ... [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe....” Although Section 10(b) was designed as a catch-all clause to prevent fraudulent practices, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202–06, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), neither the statute nor the regulations issued pursuant to it, including Rule 10b–5, expressly prohibit insider trading. Rather, the unlawfulness of insider trading is predicated on the notion that insider trading is a type of securities fraud proscribed by Section 10(b) and Rule 10b–5. See Chiarella v. United States, 445 U.S. 222, 226–30, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980).

A. The “Classical” and “Misappropriation” Theories of Insider Trading

The classical theory holds that a corporate insider (such as an officer or director) violates Section 10(b) and Rule 10b–5 by trading in the corporation’s securities on the basis of material, nonpublic information about the corporation. Id. at 230, 100 S.Ct. 1108. Under this theory, there is a special “relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position within that corporation.” Id. at 228, 100 S.Ct. 1108. As a result of this relationship, corporate insiders that possess material, nonpublic information have “a duty to disclose [or to abstain from trading] because of the ‘necessity of preventing a corporate insider from ... tak[ing] unfair advantage of ... uninformed ... stockholders.’ ” Id. at 228–29, 100 S.Ct. 1108 (citation omitted).

In accepting this theory of insider trading, the Supreme Court explicitly rejected the notion of “a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.” Id. at 233, 100 S.Ct. 1108. Instead, the Court limited the scope of insider trading liability to situations where the insider had “a duty to disclose arising from a relationship of trust and confidence between parties to a transaction,” such as that between corporate officers and shareholders. Id. at 230, 100 S.Ct. 1108.

An alternative, but overlapping, theory of insider trading liability, commonly called the “misappropriation” theory, expands the scope of insider trading liability to certain other “outsiders,” who do not have any fiduciary or other relationship to a corporation or its shareholders. Liability may attach where an “outsider” possesses material non-public information about a corporation and another person uses that information to trade in breach of a duty owed to the owner. United States v. O’Hagan, 521 U.S. 642, 652–53, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997); United States v. Libera, 989 F.2d 596, 599–600 (2d Cir.1993). In other words, such conduct violates Section 10(b) because the misappropriator engages in deception by pretending “loyalty to the principal while secretly converting the principal’s information for personal gain.” Obus, 693 F.3d at 285 (citations omitted).

B. Tipping Liability

The insider trading case law, however, is not confined to insiders or misappropriators who trade for their own accounts. Id. at 285. Courts have expanded insider trading liability to reach situations where the insider or misappropriator in possession of material nonpublic information (the “tipper”) does not himself trade but discloses the information to an outsider (a “tippee”) who then trades on the basis of the information before it is publicly disclosed. See Dirks, 463 U.S. at 659, 103 S.Ct. 3255. The elements of tipping liability are the same, regardless of whether the tipper’s duty arises under the “classical” or the “misappropriation” theory. Obus, 693 F.3d at 285–86.
In \textit{Dirks}, the Supreme Court addressed the liability of a tippee analyst who received material, nonpublic information about possible fraud at an insurance company from one of the insurance company’s former officers. \textit{Dirks}, 463 U.S. at 648–49, 103 S.Ct. 3255. The analyst relayed the information to some of his clients who were investors in the insurance company, and some of them, in turn, sold their shares based on the analyst’s tip. \textit{Id.} The SEC charged the analyst Dirks with aiding and abetting securities fraud by relaying confidential and material inside information to people who traded the stock.

In reviewing the appeal, the Court articulated the general principle of tipping liability: “Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.” \textit{Id.} at 659, 103 S.Ct. 3255 (citation omitted). The test for determining whether the corporate insider has breached his fiduciary duty “is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, \textit{there has been no breach of duty...}” \textit{Id.} at 662, 103 S.Ct. 3255 (emphasis added).

The Supreme Court rejected the SEC’s theory that a recipient of confidential information (i.e. the “tippee”) must refrain from trading “whenever he receives inside information from an insider.” \textit{Id.} at 655, 103 S.Ct. 3255. Instead, the Court held that “[t]he tippee’s duty to disclose or abstain is derivative from that of the insider’s duty.” \textit{Id.} at 659, 103 S.Ct. 3255. Because the tipper’s breach of fiduciary duty requires that he “personally will benefit, directly or indirectly, from his disclosure,” \textit{id.} at 662, 103 S.Ct. 3255, a tippee may not be held liable in the absence of such benefit. Moreover, the Supreme Court held that a tippee may be found liable “only when the insider has breached his fiduciary duty \ldots and the tippee knows or should know that there has been a breach.” \textit{Id.} at 660, 103 S.Ct. 3255 (emphasis added). In \textit{Dirks}, the corporate insider provided the confidential information in order to expose a fraud in the company and not for any personal benefit, and thus, the Court found that the insider had not breached his duty to the company’s shareholders and that Dirks could not be held liable as tippee.

\textbf{E. Mens Rea}

Liability for securities fraud also requires proof that the defendant acted with scienter, which is defined as “a mental state embracing intent to deceive, manipulate or defraud.” \textit{Hochfelder}, 425 U.S. at 193 n. 12, 96 S.Ct. 1375. In order to establish a criminal violation of the securities laws, the Government must show that the defendant acted “willfully.” 15 U.S.C. § 78ff(a). We have defined willfulness in this context “as a realization on the defendant’s part that he was doing a wrongful act under the securities laws.” \textit{United States v. Cassese}, 428 F.3d 92, 98 (2d Cir.2005) (internal quotation marks and citations omitted); \textit{see also United States v. Dixon}, 536 F.2d 1388, 1395 (2d Cir.1976) (holding that to establish willfulness, the Government must “establish a realization on the defendant’s part that he was doing a wrongful act \ldots under the securities laws” and that such an act “involve[d] a significant risk of effecting the violation that occurred.”) (quotation omitted).

\textbf{II. The Requirements of Tippee Liability}

The Government concedes that tippee liability requires proof of a personal benefit to the insider. Gov’t Br. 56. However, the Government argues that it was not required to prove that Newman and Chiasson knew that the insiders at Dell and NVIDIA received a personal benefit in order to be found guilty of insider trading. Instead, the Government contends, consistent with the district court’s instruction, that it merely needed to prove that the “defendants traded on material, nonpublic information they knew insiders had disclosed in breach of a duty of confidentiality...” Gov’t Br. 58.

In support of this position, the Government cites \textit{Dirks} for the proposition that the Supreme Court only required that the “tippee know that the tipper disclosed information in breach of a duty.” \textit{Id.} at 40 (citing \textit{Dirks}, 463 U.S. at 660, 103 S.Ct. 3255) (emphasis added). In addition, the Government relies on dicta in a number of our decisions post-\textit{Dirks}, in which we have described the elements of tippee liability without specifically stating that the Government must prove that the tippee knew that the corporate insider who disclosed confidential information did so for his own personal benefit. \textit{Id.} at 41–44 (citing, \textit{inter alia}, \textit{United States v. Jiau}, 734 F.3d 147, 152–53 (2d Cir.2013); \textit{Obus}, 693 F.3d at 289; \textit{S.E.C. v. Warde}, 151 F.3d 42, 48–49 (2d Cir.1998)). By selectively parsing this dictum, the Government seeks to revive the absolute bar on tippee trading that the Supreme Court explicitly rejected in \textit{Dirks}.

Although this Court has been accused of being “somewhat Delphic” in our discussion of what is required to demonstrate tippee liability, \textit{United States v. Whitman}, 904 F.Supp.2d 363, 371 n. 6 (S.D.N.Y.2012), the Supreme Court was quite clear in \textit{Dirks}. \textit{First}, the tippee’s liability derives \textit{only} from the tipper’s breach of a fiduciary duty, \textit{not} from trading on material, non-public information. \textit{See Chiarella}, 445 U.S. at 233, 100 S.Ct. 1108 (noting that there is no “general duty between all participants in market transactions to forgo actions based on material, nonpublic information”). \textit{Second}, the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure. \textit{Third}, even in the presence of a tipper’s breach, a tippee is liable only if he knows or should have known of the breach.

While we have not yet been presented with the question of whether the tippee’s knowledge of a tipper’s breach requires knowledge of the tipper’s personal benefit, the answer follows naturally from \textit{Dirks}. \textit{Dirks} counsels us that the exchange of confidential information for personal benefit is not separate from an insider’s fiduciary breach; it is the fiduciary breach that triggers liability for securities fraud under Rule 10b–5. For purposes of insider trading liability, the insider’s disclosure of
confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach.

The Government’s overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders. By contrast, our prior cases generally involved tippees who directly participated in the tipper’s breach (and therefore had knowledge of the tipper’s disclosure for personal benefit) or tippees who were explicitly apprised of the tipper’s gain by an intermediary tippee. See, e.g., Jiau, 734 F.3d at 150 (“To provide an incentive, Jiau promised the tippers insider information for their own private trading.”); United States v. Falcone, 257 F.3d 226, 235 (2d Cir.2001) (affirming conviction of remote tipper where intermediary tippee paid the inside tipper and had told remote tippee “the details of the scheme”); Warde, 151 F.3d at 49 (tipper and tippee engaged in parallel trading of the inside information and “discussed not only the inside information, but also the best way to profit from it”); United States v. Mylett, 97 F.3d 663 (2d Cir.1996) (tippee acquired inside information directly from his insider friend). We note that the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading.

Jiau illustrates the importance of this distinction quite clearly. In Jiau, the panel was presented with the question of whether the evidence at trial was sufficient to prove that the tippers personally benefitted from their disclosure of insider information. In that context, we summarized the elements of criminal liability as follows:

1. the insider-tippers ... were entrust the duty to protect confidential information, which (2) they breached by disclosing [the information] to their tippee ... who (3) knew of [the tippers’] duty and (4) still used the information to trade a security or further tip the information for [the tippee’s] benefit, and finally
2. the insider-tippers benefited in some way from their disclosure.

Jiau, 734 F.3d at 152–53 (citing Dirks, 463 U.S. at 659–64, 103 S.Ct. 3255; Obus, 693 F.3d at 289). The Government relies on this language to argue that Jiau is merely the most recent in a string of cases in which this Court has found that a tippee, in order to be criminally liable for insider trading, need know only that an insider-tipper disclosed information in breach of a duty of confidentiality. Gov’t Br. 43. However, we reject the Government’s position that our cursory recitation of the elements in Jiau suggests that criminal liability may be imposed on a defendant based only on knowledge of a breach of a duty of confidentiality. In Jiau, the defendant knew about the benefit because she provided it. For that reason, we had no need to reach the question of whether knowledge of a breach requires that a tippee know that a personal benefit was provided to the tipper.

In light of Dirks, we find no support for the Government’s contention that knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability. Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation’s securities markets. The Supreme Court explicitly repudiated this premise not only in Dirks, but in a predecessor case, Chiarella v. United States. In Chiarella, the Supreme Court rejected this Circuit’s conclusion that “the federal securities laws have created a system providing equal access to information necessary for reasoned and intelligent investment decisions... because [material non-public] information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.” 445 U.S. at 232, 100 S.Ct. 1108. The Supreme Court emphasized that “[t]his reasoning suffers from [a] defect... [because] not every instance of financial unfairness constitutes fraudulent activity under § 10(b).” Id. See also United States v. Chestman, 947 F.2d 551, 578 (2d Cir.1991) (Winter, J., concurring) (“The policy rationale [for prohibiting insider trading] stops well short of prohibiting all trading on material nonpublic information. Efficient capital markets depend on the protection of property rights in information. However, they also require that persons who acquire and act on information about companies be able to profit from the information they generate....” ). Thus, in both Chiarella and Dirks, the Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries. This is a critical limitation on insider trading liability that protects a corporation’s interests in confidentiality while promoting efficiency in the nation’s securities markets.

As noted above, Dirks clearly defines a breach of fiduciary duty as a breach of the duty of confidentiality in exchange for a personal benefit. See Dirks, 463 U.S. at 662, 103 S.Ct. 3255. Accordingly, we conclude that a tippee’s knowledge of the insider’s breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit.

Our conclusion also comports with well-settled principles of substantive criminal law. As the Supreme Court explained in *Staples v. United States*, 511 U.S. 600, 605, 114 S.Ct. 1793, 128 L.Ed.2d 608 (1994), under the common law, *mens rea*, which requires that the defendant know the facts that make his conduct illegal, is a necessary element in every crime. Such a requirement is particularly appropriate in insider trading cases where we have acknowledged “it is easy to imagine a ... trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful.” *United States v. Kaiser*, 609 F.3d 556, 569 (2d Cir.2010). This is also a statutory requirement, because only “willful” violations are subject to criminal provision. See *United States v. Temple*, 447 F.3d 130, 137 (2d Cir.2006) (“ ‘Willful’ repeatedly has been defined in the criminal context as intentional, purposeful, and voluntary, as distinguished from accidental or negligent”).

In sum, we hold that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper’s breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit. See *Jiau*, 734 F.3d at 152–53; *Dirks*, 463 U.S. at 659–64, 103 S.Ct. 3255.

In view of this conclusion, we find, reviewing the charge as a whole, *United States v. Mitchell*, 328 F.3d 77, 82 (2d Cir.2003), that the district court’s instruction failed to accurately advise the jury of the law. The district court charged the jury that the Government had to prove: (1) that the insiders had a “fiduciary or other relationship of trust and confidence” with their corporations; (2) that they “breached that duty of trust and confidence by disclosing material, nonpublic information”; (3) that they “personally benefited in some way” from the disclosure; (4) “that the defendant ... knew the information he obtained had been disclosed in breach of a duty”; and (5) that the defendant used the information to purchase a security. Under these instructions, a reasonable juror might have concluded that a defendant could be criminally liable for insider trading merely if such defendant knew that an insider had divulged information that was required to be kept confidential. But a breach of the duty of confidentiality is not fraudulent unless the tipper acts for personal benefit, that is to say, there is no breach unless the tipper “is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself...” *Dirks*, 463 U.S. at 664, 103 S.Ct. 3255 (quotation omitted). Thus, the district court was required to instruct the jury that the Government had to prove beyond a reasonable doubt that Newman and Chiasson knew that the tippers received a personal benefit for their disclosure.

The Government argues that any possible instructional error was harmless because the jury could have found that Newman and Chiasson inferred from the circumstances that some benefit was provided to (or anticipated by) the insiders. Gov’t Br. 60. We disagree.

An instructional error is harmless only if the Government demonstrates that it is “clear beyond a reasonable doubt that a rational jury would have found the defendant guilty absent the error[.]” *Neder v. United States*, 527 U.S. 1, 17–18, 119 S.Ct. 1827, 144 L.Ed.2d 35 (1999); *acord Moran–Toala*, 726 F.3d at 345; *United States v. Quattrone*, 441 F.3d 153, 180 (2d Cir.2006). The harmless error inquiry requires us to view whether the evidence introduced was “uncontested and supported by overwhelming evidence” such that it is “clear beyond a reasonable doubt that a rational jury would have found the defendant guilty absent the error.” *Neder*, 527 U.S. at 18, 119 S.Ct. 1827. Here both Chiasson and Newman contested their knowledge of any benefit received by the tippers and, in fact, elicited evidence sufficient to support a contrary finding. Moreover, we conclude that the Government’s evidence of any personal benefit received by the insiders was insufficient to establish tipper liability from which Chiasson and Newman’s purported tippee liability would derive.

### III. Insufficiency of the Evidence

As a general matter, a defendant challenging the sufficiency of the evidence bears a heavy burden, as the standard of review is exceedingly deferential. *United States v. Coplan*, 703 F.3d 46, 62 (2d Cir.2012). Specifically, we “must view the evidence in the light most favorable to the Government, crediting every inference that could have been drawn in the Government’s favor, and deferring to the jury’s assessment of witness credibility and its assessment of the weight of the evidence.” *Id.* (citing *United States v. Chavez*, 549 F.3d 119, 124 (2d Cir.2008)). Although sufficiency review is *de novo*, we will uphold the judgments of conviction if “any rational trier of fact could have found the essential elements of the crime beyond a reasonable doubt.” *Id.* (citing *United States v. Vannotti*, 541 F.3d 112, 120 (2d Cir.2008) (emphasis omitted); *Jackson v. Virginia*, 443 U.S. 307, 319, 99 S.Ct. 2781, 61 L.Ed.2d 560 (1979)). This standard of review draws no distinction between direct and circumstantial evidence. The Government is entitled to prove its case solely through circumstantial evidence, provided, of course, that the Government still demonstrates each element of the charged offense beyond a reasonable doubt. *United States v. Lorenzo*, 534 F.3d 153, 159 (2d Cir.2008).

However, if the evidence “is nonexistent or so meager,” *United States v. Guadagna*, 183 F.3d 122, 130 (2d Cir.1999), such that it “gives equal or nearly equal circumstantial support to a theory of guilt and a theory of innocence, then a reasonable jury must necessarily entertain a reasonable doubt,” *Cassese*, 428 F.3d at 99. Because few events in the life of an individual are more important than a criminal conviction, we continue to consider the “beyond a reasonable doubt” requirement with
utmost seriousness. Cassese, 428 F.3d at 102. Here, we find that the Government’s evidence failed to reach that threshold, even when viewed in the light most favorable to it.

The circumstantial evidence in this case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips. As to the Dell tips, the Government established that Goyal and Ray were not “close” friends, but had known each other for years, having both attended business school and worked at Dell together. Further, Ray, who wanted to become a Wall Street analyst like Goyal, sought career advice and assistance from Goyal. The evidence further showed that Goyal advised Ray on a range of topics, from discussing the qualifying examination in order to become a financial analyst to editing Ray’s résumé and sending it to a Wall Street recruiter, and that some of this assistance began before Ray began to provide tips about Dell’s earnings. The evidence also established that Lim and Choi were “family friends” that had met through church and occasionally socialized together. The Government argues that these facts were sufficient to prove that the tippers derived some benefit from the tip. We disagree. If this was a “benefit,” practically anything would qualify.

We have observed that “[p]ersonal benefit is broadly defined to include not only pecuniary gain, but also, inter alia, any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.” Jiau, 734 F.3d at 153 (internal citations, alterations, and quotation marks deleted). This standard, although permissive, does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature. If that were true, and the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity. To the extent Dirks suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee’s trades “resemble trading by the insider himself followed by a gift of the profits to the recipient,” see 463 U.S. at 664, 103 S.Ct. 3255, we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. In other words, as Judge Walker noted in Jiau, this requires evidence of “a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].” Jiau, 734 F.3d at 153.

While our case law at times emphasizes language from Dirks indicating that the tipper’s gain need not be immediately pecuniary, it does not erode the fundamental insight that, in order to form the basis for a fraudulent breach, the personal benefit received in exchange for confidential information must be of some consequence. For example, in Jiau, we noted that at least one of the corporate insiders received something more than the ephemeral benefit of the “value[ ] of [Jiau’s] friendship” because he also obtained access to an investment club where stock tips and insight were routinely discussed. Id. Thus, by joining the investment club, the tipper entered into a relationship of quid pro quo with Jiau, and therefore had the opportunity to access information that could yield future pecuniary gain. Id.; see also SEC v. Yun, 327 F.3d 1263, 1280 (11th Cir.2003) (finding evidence of personal benefit where tipper and tippee worked closely together in real estate deals and commonly split commissions on various real estate transactions); SEC v. Sargent, 229 F.3d 68, 77 (1st Cir.2000) (finding evidence of personal benefit when the tipper passed information to a friend who referred others to the tipper for dental work).

Here the “career advice” that Goyal gave Ray, the Dell tipper, was little more than the encouragement one would generally expect of a fellow alumus or casual acquaintance. See, e.g., J.A.2080 (offering “minor suggestions” on a resume), J.A.2082 (offering advice prior to an informational interview). Crucially, Goyal testified that he would have given Ray advice without receiving information because he routinely did so for industry colleagues. Although the Government argues that the jury could have reasonably inferred from the evidence that Ray and Goyal swapped career advice for inside information, Ray himself disavowed that any such quid pro quo existed. Further, the evidence showed Goyal began giving Ray “career advice” over a year before Ray began providing any insider information. Tr. 1514. Thus, it would not be possible under the circumstances for a jury in a criminal trial to find beyond a reasonable doubt that Ray received a personal benefit in exchange for the disclosure of confidential information. See, e.g., United States v. D’Amato, 39 F.3d 1249, 1256 (2d Cir.1994) (evidence must be sufficient to “reasonably infer” guilt).

The evidence of personal benefit was even more scant in the NVIDIA chain. Choi and Lim were merely casual acquaintances. The evidence did not establish a history of loans or personal favors between the two. During cross examination, Lim testified that he did not provide anything of value to Choi in exchange for the information. Tr. 3067–68. Lim further testified that Choi did not know that Lim was trading NVIDIA stock (and in fact for the relevant period Lim did not trade stock), thus undermining any inference that Choi intended to make a “gift” of the profits earned on any transaction based on confidential information.

Even assuming that the scant evidence described above was sufficient to permit the inference of a personal benefit, which we conclude it was not, the Government presented absolutely no testimony or any other evidence that Newman and Chiasson knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures, or even that Newman and Chiasson consciously avoided learning of these facts. As discussed above, the
Government is required to prove beyond a reasonable doubt that Newman and Chiasson knew that the insiders received a personal benefit in exchange for disclosing confidential information.

It is largely uncontested that Chiasson and Newman, and even their analysts, who testified as cooperating witnesses for the Government, knew next to nothing about the insiders and nothing about what, if any, personal benefit had been provided to them. Adondakis said that he did not know what the relationship between the insider and the first-level tippee was, nor was he aware of any personal benefits exchanged for the information, nor did he communicate any such information to Chiasson. Adondakis testified that he merely told Chiasson that Goyal “was talking to someone within Dell,” and that a friend of a friend of Tortora’s would be getting NVIDIA information. Tr. 1708, 1878. Adondakis further testified that he did not specifically tell Chiasson that the source of the NVIDIA information worked at NVIDIA. Similarly, Tortora testified that, while he was aware Goyal received information from someone at Dell who had access to “overall” financial numbers, he was not aware of the insider’s name, or position, or the circumstances of how Goyal obtained the information. Tortora further testified that he did not know whether Choi received a personal benefit for disclosing inside information regarding NVIDIA.

The Government now invites us to conclude that the jury could have found that the appellants knew the insiders disclosed the information “for some personal reason rather than for no reason at all.” Gov’t Br. 65. But the Supreme Court affirmatively rejected the premise that a tipper who discloses confidential information necessarily does so to receive a personal benefit. See Dirks, 463 U.S. at 661–62, 103 S.Ct. 3255 (“All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders”). Moreover, it is inconceivable that a jury could conclude, beyond a reasonable doubt, that Newman and Chiasson were aware of a personal benefit, when Adondakis and Tortora, who were more intimately involved in the insider trading scheme as part of the “corrupt” analyst group, disavowed any such knowledge.

Alternatively, the Government contends that the specificity, timing, and frequency of the updates provided to Newman and Chiasson about Dell and NVIDIA were so “overwhelmingly suspicious” that they warranted various material inferences that could support a guilty verdict. Gov’t Br. 65. Newman and Chiasson received four updates on Dell’s earnings numbers in the weeks leading up to its August 2008 earnings announcement. Similarly, Newman and Chiasson received multiple updates on NVIDIA’s earnings numbers between the close of the quarter and the company’s earnings announcement. The Government argues that given the detailed nature and accuracy of these updates, Newman and Chiasson must have known, or deliberately avoided knowing, that the information originated with corporate insiders, and that those insiders disclosed the information in exchange for a personal benefit. We disagree.

Even viewed in the light most favorable to the Government, the evidence presented at trial undermined the inference of knowledge in several ways. The evidence established that analysts at hedge funds routinely estimate metrics such as revenue, gross margin, operating margin, and earnings per share through legitimate financial modeling using publicly available information and educated assumptions about industry and company trends. For example, on cross-examination, cooperating witness Goyal testified that under his financial model on Dell, when he ran the model in January 2008 without any inside information, he calculated May 2008 quarter results of $16.071 billion revenue, 18.5% gross margin, and $0.38 earnings per share. Tr. 1566. These estimates came very close to Dell’s reported earnings of $16.077 billion revenue; 18.4% gross margin, and $0.38 earnings per share. Appellants also elicited testimony from the cooperating witnesses and investor relations associates that analysts routinely solicited information from companies in order to check assumptions in their models in advance of earnings announcements. Goyal testified that he frequently spoke to internal relations departments to run his model by them and ask whether his assumptions were “too high or too low” or in the “ball park,” which suggests analysts routinely updated numbers in advance of the earnings announcements. Tr. 1511. Ray’s supervisor confirmed that investor relations personnel routinely assisted analysts with developing their models.

Moreover, the evidence established that NVIDIA and Dell’s investor relations personnel routinely “leaked” earnings data in advance of quarterly earnings. Appellants introduced examples in which Dell insiders, including the head of Investor Relations, Lynn Tyson, selectively disclosed confidential quarterly financial information arguably similar to the inside information disclosed by Ray and Choi to establish relationships with financial firms who might be in a position to buy Dell’s stock. For example, appellants introduced an email Tortora sent Newman summarizing a conversation he had with Tyson in which she suggested “low 12% opex [was] reasonable” for Dell’s upcoming quarter and that she was “fairly confident on [operating margin] and [gross margin].” Tr. 568:18–581:23.

No reasonable jury could have found beyond a reasonable doubt that Newman and Chiasson knew, or deliberately avoided knowing, that the information originated with corporate insiders. In general, information about a firm’s finances could certainly be sufficiently detailed and proprietary to permit the inference that the tippee knew that the information came from an inside source. But in this case, where the financial information is of a nature regularly and accurately predicted by analyst modeling, and the tippees are several levels removed from the source, the inference that defendants knew, or should have known, that the information originated with a corporate insider is unwarranted.

Moreover, even if detail and specificity could support an inference as to the nature of the source, it cannot, without more, permit an inference as to that source’s improper motive for disclosure. That is especially true here, where the evidence
showed that corporate insiders at Dell and NVIDIA regularly engaged with analysts and routinely selectively disclosed the same type of information. Thus, in light of the testimony (much of which was adduced from the Government’s own witnesses) about the accuracy of the analysts’ estimates and the selective disclosures by the companies themselves, no rational jury would find that the tips were so overwhelmingly suspicious that Newman and Chiasson either knew or consciously avoided knowing that the information came from corporate insiders or that those insiders received any personal benefit in exchange for the disclosure.

In short, the bare facts in support of the Government’s theory of the case are as consistent with an inference of innocence as one of guilt. Where the evidence viewed in the light most favorable to the prosecution gives equal or nearly equal circumstantial support to a theory of innocence as a theory of guilt, that evidence necessarily fails to establish guilt beyond a reasonable doubt. See United States v. Glenn, 312 F.3d 58, 70 (2d Cir.2002). Because the Government failed to demonstrate that Newman and Chiasson had the intent to commit insider trading, it cannot sustain the convictions on either the substantive insider trading counts or the conspiracy count. United States v. Gaviria, 740 F.2d 174, 183 (2d Cir.1984) (“[W]here the crime charged is conspiracy, a conviction cannot be sustained unless the Government establishes beyond a reasonable doubt that the defendant had the specific intent to violate the substantive statute.”) (internal quotation marks omitted). Consequently, we reverse Newman and Chiasson’s convictions and remand with instructions to dismiss the indictment as it pertains to them.

CONCLUSION

For the foregoing reasons, we vacate the convictions and remand for the district court to dismiss the indictment with prejudice as it pertains to Newman and Chiasson.

Footnotes

1The Clerk of Court is directed to amend the caption as set forth above.

2The district court subsequently set the forfeiture amount at $1,382,217.

3Although the Government argues that district court decisions in S.E.C. v. Thrasher, 152 F.Supp.2d 291 (S.D.N.Y.2001) and S.E.C. v. Musella, 678 F.Supp. 1060 (S.D.N.Y.1988) support their position, these cases merely stand for the unremarkable proposition that a tippee does not need to know the details of the insider’s disclosure of information. The district courts determined that the tippee did not have to know for certain how information was disclosed, Thrasher, 152 F.Supp.2d at 304–05, nor the identity of the insiders, Musella, 678 F.Supp. at 1062–63. This is not inconsistent with a requirement that a defendant tippee understands that some benefit is being provided in return for the information.

4See also United States v. Santoro, 647 F.Supp. 153, 170–71 (E.D.N.Y.1986) (“An allegation that the tippee knew of the tipper’s breach necessarily charges that the tippee knew that the tipper was acting for personal gain.”) rev’d on other grounds sub nom., United States v. Davidoff, 845 F.2d 1151 (2d Cir.1988); Hernandez v. United States, 450 F.Supp.2d 1112, 1118 (C.D.Cal.2006) (“[U]nder the standard set forth in Dirks a tippee can be liable under Section 10(b) and Rule 10(b)–5 “if the tippee had knowledge of the insider-tipper’s personal gain.”).

5We note that Judge Sullivan had an opportunity to address the issue in Steinberg only because the Government chose to charge Matthew Steinberg in the same criminal case as Newman and Chiasson by filing a superseding indictment. Notably, the Government superseded to add Steinberg on March 29, 2013, after the conclusion of the Newman trial, after Judge Sullivan refused to give the defendants’ requested charge on scienter now at issue on this appeal, and at a time when there was no possibility of a joint trial with the Newman defendants.
Chapter 1—SEC Enforcement Update and Hot Topics

2016 ANNUAL REPORT TO CONGRESS ON THE

Dodd-Frank
Whistleblower Program

U.S. SECURITIES AND EXCHANGE COMMISSION

37th Annual Northwest Securities Institute
Chapter 1—SEC Enforcement Update and Hot Topics

DISCLAIMER
This is a report of the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.
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Report available on the Web at: https://www.sec.gov/whistleblower
MESSAGE FROM THE CHIEF OF THE OFFICE OF THE WHISTLEBLOWER

Fiscal Year (FY) 2016 was historic for the SEC’s whistleblower program. In August 2016, the SEC announced that its awards to whistleblowers since the beginning of the program have surpassed the $100 million mark. In the program’s short term of existence, the SEC already has awarded more than $111 million to 34 whistleblowers whose information and cooperation assisted the agency in bringing multiple successful Commission enforcement actions and related actions.¹ The total award amount demonstrates the invaluable information and assistance whistleblowers have provided to the agency and underscores the program’s extraordinary impact on the agency’s enforcement initiatives.

In FY 2016 alone, the agency issued awards totaling over $57 million—higher than all award amounts issued in previous years combined. The ten highest awards issued by the SEC to whistleblowers have each totaled more than $1 million, with the largest exceeding more than $30 million. Six of the ten highest whistleblower awards were made in FY 2016.

The transformative effect the SEC’s whistleblower program has had on the agency’s enforcement program is further demonstrated by the hundreds of millions of dollars that have been returned to investors. The information and assistance provided by the 34 whistleblowers who received awards under the program led to successful SEC enforcement actions in which over $584 million in financial sanctions was ordered, including more than $346 million in disgorgement of ill-gotten gains and interest. Not only has the whistleblower program provided whistleblowers with protections and financial rewards, but it has also bolstered the agency’s enforcement efforts and aided harmed investors.

We believe that awareness of the program has grown tremendously over the years, as we have continued to experience a consistent increase in the number of whistleblower tips received. In FY 2016, we received over 4,200 tips, which is a more than 40 percent increase in whistleblower tips since FY 2012, the first year for which we have full-year data. We believe that the continued payment of significant awards, like those made this past year, will continue to incentivize company insiders, market participants, and others with knowledge of potential securities law violations to come forward and report their information to the agency.

FY 2016 witnessed significant and ground-breaking enforcement activity on the whistleblower protection front, with the agency bringing charges against a company

¹ Unless specifically stated otherwise in this report, the statistics contained herein are current through September 30, 2016, the end of Fiscal Year 2016.
for retaliating against an employee for reporting a possible securities law violation and charges against multiple companies for impeding their employees’ ability to report to the SEC through severance agreements and other practices.

The Commission brought a first-of-its-kind enforcement action in September 2016, when it brought a stand-alone whistleblower retaliation case against casino-gaming company, International Game Technology (IGT). The company agreed to pay a half-million dollar penalty for firing an employee with several years of positive performance reviews because the employee had reported to senior management and the SEC that the company’s financial statements might be distorted. As this case demonstrates, strong enforcement of the anti-retaliation protections is a critical component of the SEC’s whistleblower program.

In September 2016, the Commission filed an action against Anheuser-Busch InBev SA/NV, in which the company agreed to settle charges that it violated Exchange Act Rule 21F-17(a), among other violations, by entering into a separation agreement that stopped an employee from continuing to voluntarily communicate with the SEC due to a substantial financial penalty that would be imposed for violating strict non-disclosure terms. As this case demonstrates, companies simply cannot impede their employees’ ability to report wrongdoing to the agency through threats of financial punishment.

In August 2016, the SEC also instituted proceedings against two companies for stand-alone violations of Rule 21F-17(a). An Atlanta-based buildings product distributor, BlueLinx Holdings, Inc., settled charges that it violated the securities laws by using severance agreements that required outgoing employees to waive their rights to monetary recovery in the event they filed a charge or complaint with the SEC or other federal agencies. The company agreed to pay a $265,000 penalty. In another case, California-based health insurance provider, Health Net, Inc., agreed to pay a $340,000 penalty for illegally using severance agreements that required outgoing employees to waive their ability to obtain monetary awards from the SEC’s whistleblower program. As these cases demonstrate, companies cannot end-run the SEC’s whistleblower program by requiring employees to forego potential whistleblower awards as a condition to receiving their severance payments.

Finally, in June 2016, Merrill Lynch agreed to pay $415 million and admit wrongdoing to settle charges that the firm violated the customer protection rule. Additionally, Merrill Lynch settled charges for violating Rule 21F-17(a) by using language in severance agreements that operated to impede employees from voluntarily providing information to the SEC.

Assessing confidentiality, severance, and other kinds of agreements that may stifle a would-be whistleblower from reporting his or her information to the agency and that strip away the very incentives Congress intended for the program will continue to be a
We anticipate that the whistleblower program will continue to positively impact SEC enforcement of the federal securities laws...”

JANE NORBERG
Chief, Office of the Whistleblower
November 15, 2016
HISTORY AND PURPOSE

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act or Dodd-Frank) amended the Securities Exchange Act of 1934 (Exchange Act) by, among other things, adopting Section 21F entitled “Securities Whistleblower Incentives and Protection.” Section 21F directs the Commission to make monetary awards to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions resulting in monetary sanctions over $1 million and successful related actions.

Awards are required to be made in an amount equal to 10 percent to 30 percent of the monetary sanctions collected. To ensure that whistleblower payments would not diminish the amount of recovery for victims of securities law violations, Congress established a separate fund, called the Investor Protection Fund (Fund), out of which eligible whistleblowers are paid.

The Commission established OWB, a separate office within the SEC’s Division of Enforcement (Enforcement), to administer and effectuate the whistleblower program. It is OWB’s mission to administer a vigorous whistleblower program that will help the Commission identify and halt frauds early and quickly to minimize investor losses.

In addition to establishing an awards program to encourage the submission of high-quality information, the Dodd-Frank Act and the Commission’s implementing regulations (Whistleblower Rules) prohibit retaliation against whistleblowers who report possible wrongdoing based on a reasonable belief that a possible securities violation has occurred, is in progress, or is about to occur.

In adopting its Whistleblower Rules, the Commission recognized that whistleblower reporting through internal compliance procedures can enhance the Commission’s enforcement efforts in appropriate circumstances. For this reason, the Commission adopted strong incentives and protections for employees who choose to work within their company’s own compliance structure because they believe that the employer’s internal compliance function is an effective mechanism to address any potential wrongdoing.

Dodd-Frank Section 924(d) requires OWB to report annually to Congress on OWB’s activities, whistleblower complaints received, and the response of the Commission to such complaints. In addition, Section 21F(g)(5) of the Exchange Act requires the Commission to submit an annual report to Congress that addresses the following subjects:

4 Id. § 78u-6.
5 “Related actions” is defined at 17 C.F.R. §§ 240.21F-3.
6 17 C.F.R. §§ 240.21F-1 through 21F-17.
7 15 U.S.C. § 78u-6(b)(1); 17 C.F.R. § 240.21F-2(b).
9 See id. §§ 21F-4(b)(7), (a)(4), (b)(5).
• The whistleblower award program, including a description of the number of awards granted and the types of cases in which awards were granted during the preceding fiscal year;

• The balance of the Fund at the beginning of the preceding fiscal year;

• The amounts deposited into or credited to the Fund during the preceding fiscal year;

• The amount of earnings on investments made under Section 21F(g)(4) during the preceding fiscal year;

• The amount paid from the Fund during the preceding fiscal year to whistleblowers pursuant to Section 21F(b);

• The balance of the Fund at the end of the preceding fiscal year; and

• A complete set of audited financial statements, including a balance sheet, income statement, and cash flow analysis.

This report has been prepared by OWB to satisfy the reporting obligations of Section 924(d) of the Dodd-Frank Act and Section 21F(g)(5) of the Exchange Act. The sections in this report addressing the activities of OWB, the whistleblower tips received during FY 2016, and the processing of those whistleblower tips primarily address the requirements of Section 924(d) of the Dodd-Frank Act. The sections in this report addressing the Fund and whistleblower incentive awards made during FY 2016 primarily address the requirements of Section 21F(g)(5) of the Exchange Act.
ACTIVITIES OF THE OFFICE OF THE WHISTLEBLOWER

Section 924(d) of the Dodd-Frank Act directed the Commission to establish a separate office within the Commission to administer and to enforce the provisions of Section 21F of the Exchange Act. Jane Norberg, the Office’s first Deputy Chief, was named Chief of OWB in September 2016. Ms. Norberg’s appointment followed the departure of Sean X. McKessy, who left the Commission in July 2016 after presiding over the Office for the past five years. In the past fiscal year, OWB also was staffed by eleven attorneys, five paralegals, and an administrative assistant. Below is an overview of OWB’s primary responsibilities and activities over the past fiscal year.

Assessment of Award Applications
The whistleblower program was designed, in part, to provide a monetary incentive to corporate insiders and others with relevant information concerning potential securities violations to report their information to the Commission. As such, much of OWB’s work relates to the assessment of claims for whistleblower awards.

OWB posts a Notice of Covered Action (NoCA) on its website for every Commission enforcement action that results in monetary sanctions of over $1 million. Anyone who believes that they are entitled to a whistleblower award may submit an application in response to a posted NoCA. Before submitting an application, however, a whistleblower should check to make sure that there is a nexus between the whistleblower tip he or she provided to the Commission and what was ultimately charged in the enforcement matter.

OWB staff tracks investigations where a whistleblower has provided information or assistance to Enforcement. This case-tracking initiative is intended to help OWB know which cases may involve a potential award payout. Although it is ultimately a whistleblower’s responsibility to make a timely application for an award, OWB may contact whistleblowers who have been actively working with Enforcement staff to confirm they are aware of the NoCA posting and applicable deadline for submitting a claim for award.

After receiving an application for an award, OWB attorneys assess the application and the eligibility of the claimant and confer with relevant Enforcement or Office of Compliance, Inspections, and Exams staff to understand in more detail the contribution of the claimant, if any. OWB then makes recommendations to the Claims Review Staff, currently comprised of five senior members of Enforcement, as to award eligibility. For a fuller explanation of how applications for awards are processed at the Commission, as well as what awards were made during FY 2016, please refer to pages 10-16 of this report.
**Reviewing Restrictive Agreements**

During FY 2016, one area of focus for OWB was addressing whether employers were using confidentiality, severance, and other kinds of agreements, or engaging in other practices, to interfere with individuals’ ability to report potential wrongdoing to the SEC. Exchange Act Rule 21F-17(a) provides that “[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications.”10 In FY 2016, the Commission brought charges against multiple companies for violating Rule 21F-17(a). OWB continues to work closely with investigative staff to identify and investigate practices in the use of confidentiality and other kinds of agreements, or other actions, that may violate Rule 21F-17(a). For more information about these activities, please see pages 19-20.

**Advancing Anti-Retaliation Protections**

OWB identifies and monitors whistleblower complaints alleging retaliation by employers or former employers in response to the employee’s reporting of possible securities law violations internally or to the Commission. The Commission has authority to enforce all the provisions of the Exchange Act, including the anti-retaliation provisions of the Dodd-Frank Act. In FY 2016, the Commission brought its first stand-alone whistleblower retaliation case since the Dodd-Frank Act authorized the agency to bring such charges. Bringing retaliation cases illustrates the high priority placed on ensuring a safe environment for whistleblowers. OWB continues to work with Enforcement staff on identifying cases where companies take reprisals for whistleblowing efforts and which may be appropriate for enforcement action.

OWB also monitors federal court cases involving the anti-retaliation provisions of the Dodd-Frank Act and the Sarbanes-Oxley Act.11 Finally, OWB works with the SEC’s Office of General Counsel, which has filed *amicus* briefs and appeared in federal courts around the country in support of the Commission’s position that the anti-retaliation provisions of the Dodd-Frank Act protect individuals who report internally to their companies as well as those who report directly to the Commission.12 For more information about these activities, please see pages 21-22.

10 17 C.F.R. § 240.21F-17(a).
11 18 U.S.C. § 1514A.
12 The SEC’s interpretive guidance regarding internal reporting may be found on OWB’s webpage, http://www.sec.gov/about/offices/owb/owb-resources.shtml, and also has been published in the Federal Register at 80 Fed. Reg. 47,829 (Aug. 10, 2015).
Chapter 1—SEC Enforcement Update and Hot Topics

Intake of Whistleblower Tips

The Commission created an internal database called the Tips, Complaints, and Referrals Intake and Resolution System (TCR System) to serve as a central repository for all tips and complaints received by the Commission, as well as referrals from self-regulatory organizations and other government agencies. Exchange Act Rule 21F-9 provides whistleblowers the option to submit tips either electronically through an online portal that feeds directly into the TCR System or by mailing or faxing a hard-copy Form TCR directed to OWB. This flexibility supports whistleblowers who may not have ready access to a computer or who, for other reasons, may prefer to submit their information in hard copy. In cases where whistleblowers elect to submit a hard-copy Form TCR, OWB manually enters the tip into the TCR System so that it can be appropriately reviewed, assigned, and tracked in the same manner as tips received through the online portal. For more information on the number and types of tips received, please refer to pages 23-26.

Communications with Whistleblowers

OWB serves as the primary liaison between the Commission and individuals who have submitted information or are considering whether to submit information to the agency concerning a possible securities violation. OWB created a whistleblower hotline, in operation since May 2011, to respond to questions from the public about the whistleblower program. Individuals leave messages on the hotline, which are returned by OWB attorneys within 24 business hours. To protect the identity of whistleblowers, OWB will not leave return messages unless the caller’s name is clearly and fully identified on the caller’s voicemail message. If OWB is unable to leave a message because the individual’s name is not identified or if it appears to be a shared voicemail system, OWB attorneys make two additional attempts to contact the individual.

During FY 2016, the Office returned over 3,121 phone calls from members of the public. Many of the calls OWB receives relate to how the caller should submit a tip to be eligible for an award, how the Commission will maintain the confidentiality of a whistleblower’s identity, requests for information on the investigative process or tracking an individual’s complaint status, and whether the SEC is the appropriate agency to handle the caller’s tip.

In addition to communicating with whistleblowers through the hotline, the Office regularly communicates with whistleblowers who have submitted tips, additional information, claims for awards, and other correspondence to OWB.
Public Outreach and Education

One of the Office's primary goals is to increase public awareness of the Commission’s whistleblower program. As part of that outreach effort, OWB has actively participated in numerous webinars, media interviews, presentations, press releases, and other public communications. By raising awareness of the program, we hope to receive an even greater number of high-quality tips that can assist the Commission in more quickly discovering and stopping fraudulent schemes and other securities laws violations. As more individuals have become aware of the program, we have received more tips, as well as award claims.

In FY 2016, OWB staff participated in many public engagements aimed at promoting and educating the public concerning the Commission’s whistleblower program. The Office’s target audience generally includes potential whistleblowers, whistleblower counsel, and corporate compliance counsel and professionals. In an effort to increase the visibility of the Commission’s whistleblower program, the Office has participated in legal panels and other forums with other federal agencies that have similar whistleblower programs, including a recent panel with staff from the Commodity Futures Trading Commission and the Internal Revenue Service.

We also aim to promote and educate the public about our program through OWB’s website (www.sec.gov/whistleblower). The website contains detailed information about the program, copies of the forms required to submit a tip or claim an award, a listing of enforcement actions for which a claim for award may be made, links to helpful resources, and answers to frequently asked questions.
CLAIMS FOR AWARDS

Whistleblower Awards Made in FY 2016
In FY 2016, the Commission awarded more than $57 million to 13 whistleblowers, each of whom provided new information of which the agency was previously unaware that either led to the opening of the investigation or significantly contributed to the successful enforcement action. In total, the SEC has issued more than $111 million in awards to 34 whistleblowers since the program’s establishment in August 2011.

Below are the top ten highest awards made under the SEC’s whistleblower program, each exceeding $1 million.

TOP 10 SEC WHISTLEBLOWER AWARDS
Since the program’s inception, the SEC has awarded $111 million to 34 whistleblowers.

As reflected in the graph, six of the ten largest whistleblower awards were made by the Commission during FY 2016. The more than $30 million award issued by the Commission in September 2014 remains the highest award made to date under the program.13

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The following is an overview of SEC whistleblower awards during FY 2016.

**Second-Highest Award of Over $22 Million**

On August 30, 2016, the Commission authorized an award of more than $22 million to a company insider who provided information about a well-hidden securities violation that would have been unlikely to have been detected but for the whistleblower’s information.\(^\text{14}\) This was the second-highest award made under the SEC’s whistleblower program.

**Third-Highest Award of More Than $17 Million**

On June 9, 2016, the Commission issued an award of more than $17 million to a former company employee whose detailed tip substantially advanced the agency’s investigation and ultimate enforcement action.\(^\text{15}\) The information and assistance provided by the whistleblower enabled the investigative staff to conserve time and resources and gather strong evidence supporting the Commission’s case. This was the Commission’s third-highest whistleblower award.

**More Than $5 Million Award for Tip that Uncovered Difficult-to-Detect Securities Violations**

On May 17, 2016, the Commission issued an award that is expected to yield a total payout between $5-6 million to a former company insider whose detailed tip led the agency to uncover securities violations that would have been nearly impossible for it to detect but for the whistleblower’s information.\(^\text{16}\)

**More Than $4 Million Award**

On September 20, 2016, the Commission announced an award of more than $4 million to a whistleblower whose original information alerted the agency to a fraud.\(^\text{17}\) With this award, the SEC’s whistleblower awards in FY 2016 totaled more than $57 million—exceeding the amount of all awards made in prior fiscal years combined.

**More Than $3.5 Million Award for Bolstering Ongoing Investigation**

On May 13, 2016, the Commission announced an award of more than $3.5 million to a company employee whose tip bolstered an ongoing investigation with additional evidence of wrongdoing that strengthened the SEC’s case.\(^\text{18}\) Whistleblowers can receive an award not only when their tip initiates an investigation, but also when they provide new information or documentation that significantly contributes to an existing investigation. This particular whistleblower’s tip substantially strengthened the agency’s ongoing case and increased the SEC’s leverage during settlement negotiations with the company.

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Nearly $2 Million Award to Three Whistleblowers
On March 8, 2016, the SEC awarded nearly $2 million to three whistleblowers.¹⁹ The largest of the three awards went to a whistleblower who voluntarily provided original information that prompted the agency to open the investigation. That whistleblower, who received approximately $1.8 million, continued to provide valuable information throughout the investigation. The other two whistleblowers jointly received payment of over $130,000 for providing information after the investigation started. In determining the appropriate award percentages, the SEC considered the relative contribution of each of the claimants to the successful enforcement action.

Industry Expert Received More Than $700,000 for Detailed Analysis
On January 15, 2016, the SEC announced an award of more than $700,000 to a company outsider who conducted a detailed analysis that led to a successful SEC enforcement action.²⁰ This award reflected the fact that the voluntary submission of high-quality analysis by industry experts can be just as valuable as first-hand knowledge of wrongdoing by company insiders.

Two Whistleblowers Jointly Awarded More Than $450,000
On May 20, 2016, the SEC issued a joint award of more than $450,000 to two individuals for a tip that led the agency to open a corporate accounting investigation and for their assistance once the investigation was underway.²¹ These whistleblowers not only provided valuable tips that helped open the investigation, but they also provided valuable assistance as the investigation proceeded. The SEC's whistleblower program rewards those who continue to provide helpful and meaningful assistance throughout the process of bringing an enforcement action.

SEC Whistleblower Award of More Than $325,000
On November 4, 2015, the Commission awarded a former employee of an investment firm $325,000 for providing specific and detailed information that caused staff to open the investigation.²² The whistleblower provided a detailed description of the misconduct and specifically identified individuals responsible for the wrongdoing. The whistleblower, however, waited until after leaving the company to report the information to the SEC.

Unreasonable reporting delay is a negative factor that may decrease an award percentage. The Commission found that the whistleblower’s delay, while limited in duration, was unreasonable in light of the incentives and protections now afforded to whistleblowers under the Commission’s whistleblower program. Also of significance, the great majority of the total disgorgement ordered in the underlying enforcement matter was attributable to the misconduct that occurred after the whistleblower learned about the misconduct and before reporting the information to the Commission, with a

resulting increase in the monetary sanctions upon which the whistleblower’s award was based. Delayed reporting is particularly problematic where the securities violations are ongoing and the ill-gotten gains of the wrongdoing increase after the whistleblower has learned of the misconduct and yet delays reporting the activity internally, to another regulator, or to the Commission. Further, delayed reporting can potentially result in wrongdoers squandering ill-gotten gains that belong to investors or other innocent third parties and may negatively impact the Commission’s ability to prosecute an enforcement action.

**Whistleblower’s Tip Leads to Successful Commission and Related Criminal Actions**
On April 5, 2016, the Commission awarded a whistleblower more than $275,000 in connection with a detailed tip that helped lead to the successful enforcement of a Commission action as well as a related criminal action. The amount of the award, however, was offset by monetary obligations unpaid from a final judgment entered against the whistleblower in another unrelated matter.

**Overview of Award Process**
Before a whistleblower receives payment of an award, there are a number of pre-conditions that must be met before an award may be issued or payment made. The diagram below provides a snapshot of the overall process, from the filing of the whistleblower tip to payment of the whistleblower award. As reflected, the time between the submission of a whistleblower tip and when an individual may receive an award payment can be several years, particularly where the underlying investigation is especially complex, where there are multiple, competing award claims, or where there are claims for related actions.

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Chapter 1—SEC Enforcement Update and Hot Topics

The following discussion focuses on the award claims process, from the posting of the NoCA to the issuance of a Final Order by the Commission.

**NoCA Posted**
The Office posts on its website a NoCA for each Commission enforcement action where a final judgment or order, by itself or together with other prior judgments or orders in the same action issued after July 21, 2010, results in monetary sanctions exceeding $1 million.24 During FY 2016, OWB posted 178 NoCAs.

OWB announces on Twitter each time a new group of NoCAs is posted to its website, and sends email alerts to GovDelivery when the NoCA listing is updated.25 In addition, whistleblowers and other members of the public may sign up to receive an update via email every time the list of NoCAs on OWB’s website is updated. OWB typically posts new NoCAs on its website at the end of each month.

**Award Claim Submitted**
Once a NoCA is posted, individuals have 90 calendar days to apply for an award by submitting a completed Form WB-APP to OWB.26 Although OWB may make courtesy calls to those whistleblowers or their counsel whom we know have been actively working with Enforcement staff to inform them of the NoCA posting, it is the whistleblower’s responsibility to make a timely application for award. As such, we encourage whistleblowers and their counsel to regularly review the monthly NoCA postings or to sign up to receive emails to alert them as to when new NoCAs are posted.

**Award Claim Reviewed**
OWB attorneys evaluate each application for a whistleblower award, often tracking prior correspondence between the claimant and the Commission and analyzing intra-agency databases to understand the origin of the case and what tips or other correspondence the claimant may have submitted to the Commission. OWB works closely with investigative staff responsible for the relevant action, as well as other Commission staff who may have interacted with the claimant, to understand the contribution or involvement the applicant may have had in the matter.

Utilizing the information and materials provided by the claimant in support of the application, as well as other relevant materials, OWB prepares a written recommendation to the Claims Review Staff as to whether the applicant should receive an award, and if so, the percentage of the award.

**Preliminary Determination Issued**
The Claims Review Staff, designated by the Director of Enforcement, considers OWB’s recommendation on the award application in accordance with the criteria set forth in the Dodd-Frank Act and the Whistleblower Rules. The Claims Review Staff currently is composed of five senior officers in Enforcement, including the Director of Enforcement.

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24 OWB posts a NoCA for every enforcement action that results in monetary sanctions exceeding $1 million. By posting a NoCA for a particular case, the Commission is not making a determination either that a whistleblower tip, complaint or referral led to the Commission opening an investigation or filing an action with respect to the case or that an award to a whistleblower will be paid in connection with the case.

25 GovDelivery is a vendor that provides communications for public-sector clients.

26 17 C.F.R. §§ 240.21F-10(a), (b).
The Claims Review Staff then issues a Preliminary Determination setting forth its assessment of whether the claim should be allowed or denied and, if allowed, setting forth the proposed award percentage amount.27

Award percentages are based on the particular facts and circumstances of each case, and are not based on any hard-set mathematical formula. However, the Whistleblower Rules outline a number of positive and negative factors that the Commission and Claims Review Staff may consider in assessing an individual’s award percentage. Factors that may increase an award percentage include the significance of the information provided by the whistleblower, the level of assistance provided by the whistleblower, the law enforcement interests at stake, and whether the whistleblower reported the violation internally through his or her firm’s internal reporting channels or mechanisms. Factors that may decrease an award percentage include whether the whistleblower was culpable or involved in the underlying misconduct, interfered with internal compliance systems, or unreasonably delayed in reporting the violation to the Commission.

Record and Reconsideration Requested
An applicant can submit a written request within 30 calendar days of the date of the Preliminary Determination asking for a copy of the record that formed the basis of the Claims Review Staff’s decision as to the applicant’s claim for award. As a precondition to receiving a copy of the record, OWB requires claimants and their counsel, if represented, to execute a confidentiality agreement limiting the use of such materials to the claims review process.28 A claimant also has 30 calendar days to request a meeting with OWB, which OWB may grant at its discretion.

Claimants can seek reconsideration of the Preliminary Determination by submitting a written response to OWB within 60 calendar days of the later of (i) the date of the Preliminary Determination, or (ii) if the record was requested, the date when OWB made the record available for a claimant’s review.29 If a claim is denied and the applicant does not object within the time period prescribed under the Whistleblower Rules, then the Preliminary Determination of the Claims Review Staff becomes the Final Order of the Commission.

Final Order Issued
After considering any requests for reconsideration, the Claims Review Staff issues a Proposed Final Determination, and the matter is submitted to the Commission for its decision.30

All Preliminary Determinations of the Claims Review Staff that involve an award of money are submitted to the Commission for consideration as Proposed Final Determinations irrespective of whether the applicant objected to the Preliminary Determination.31

“Award percentages are based on the particular facts and circumstances of each case, and are not based on any hard-set mathematical formula.”
Within 30 days of receiving notice of the Proposed Final Determination, any Commissioner may request that the Proposed Final Determination be reviewed by the Commission. If no Commissioner requests such a review within the 30-day period, then the Proposed Final Determination becomes the Final Order of the Commission. Claimants who are issued a denial have a right to appeal the Commission’s Final Order within 30 days of issuance to the United States Court of Appeals for the District of Columbia Circuit, or to the circuit where the aggrieved person resides or has his or her principal place of business.32

Final Orders of the Commission are made publicly-available on the Commission’s and OWB’s website. The public Final Orders are redacted to protect the confidentiality of the award applicant.

There are a number of factors that may affect the length of time it takes for OWB to review an award claim and for the Commission to issue a Final Order. Our Office works closely with Enforcement investigative staff, staff of the Commission’s Office of General Counsel, and other Commission divisions and offices, as appropriate, to conduct a thorough analysis of each claim for award that the Commission receives. These efforts are designed to provide each claimant with a fair review and to promote Commission award determinations that are sound both factually and legally. Therefore, the number of claimants applying for an award in connection with a covered action affects the time it takes to process a claim. In connection with one NoCA, for example, OWB received sixteen claims for award. The presence of novel issues, or the need to supplement the record with additional information from the claimant, may also lengthen the time it takes to process a claim. There may also be a delay when there is a related action, requiring OWB to coordinate with or receive assistance from another regulator to understand what contribution the whistleblower may have made in the related action.

32 Id. § 21F-10(h). A whistleblower’s rights of appeal from a Commission Final Order are set forth in Section 21F(f) of the Exchange Act, 15 U.S.C. § 78u-6(f), and Rule 21F-13(a) of the Whistleblower Rules, 17 C.F.R. § 240.21F-13(a).
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PROFILES OF AWARD RECIPIENTS

The Dodd-Frank Act prohibits the Commission and its staff from disclosing any information that reasonably could be expected to reveal the identity of a whistleblower, subject to certain exceptions. Protecting whistleblower confidentiality is an integral component of the whistleblower program. For this reason, information that may tend to reveal a whistleblower’s identity is redacted from Commission orders granting or denying awards before they are issued publicly. This may include redacting the name of the enforcement action upon which the award is based.

Consistent with our practice of maintaining whistleblower confidentiality as provided for by the Dodd-Frank Act—but in an effort to provide more transparency—this section provides certain information on an aggregate basis regarding whistleblowers who have received awards under the program, while still protecting the identity of any particular individual.

Since the beginning of the whistleblower program, the Commission has issued awards to 34 individuals in connection with 26 covered actions, as well as in connection with several related actions. There are commonalities among many of the tips or complaints that were submitted by these successful whistleblowers. The information provided by each award recipient was specific, in that the whistleblower identified particular individuals involved in the fraud, or provided specific documents that substantiated their allegations or explained where such documents could be located. In some instances, the whistleblower identified specific financial transactions that evidenced the fraud, or provided detailed assessment of the wrongdoing. The misconduct was relatively recent or ongoing at the time it was reported to the Commission.

An individual may be eligible to receive an award where his or her information leads to a successful enforcement action, meaning generally that the original information either caused an examination or investigation to open or the original information significantly contributed to a successful enforcement action where the matter was already under examination or investigation. Almost 60 percent of the whistleblowers who have received awards under the program provided original information that caused Enforcement staff to open an investigation, while the remaining 40 percent received awards because their original information significantly contributed to an existing investigation. In assessing whether information significantly contributed to an enforcement action, the Commission will consider such factors as whether the information allowed the agency to bring the action in significantly less time or with fewer resources, and whether it supported additional successful charges, or successful claims against additional individuals or entities.33

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There is no requirement under the Whistleblower Rules that an individual be an employee or other insider to be eligible for an award. However, to date, almost 65 percent of the award recipients were insiders of the entity on which they reported information of wrongdoing to the SEC. This percentage has grown. Last year, we reported that approximately half of the award winners were insiders. Of the award recipients who were current or former employees of the entity, approximately 80 percent raised their concerns internally to their supervisors or compliance personnel, or understood that their supervisor or relevant compliance personnel knew of the violations, before reporting their information of wrongdoing to the Commission.

Individuals may obtain information of possible wrongdoing through other channels. The remaining award recipients obtained their information because they were either investors who had been victims of the fraud, professionals working in the same or related industry, or individuals who had a personal relationship with the wrongdoer.

Whistleblowers are not required to be represented by counsel unless they choose to file their tips with the Commission anonymously. Approximately half of the award recipients were represented by counsel when they initially submitted their tips to the agency. Certain of the individuals who were not represented by counsel at the time they submitted their tip subsequently retained counsel during the course of the investigation or during the whistleblower award application process (although retaining counsel is not required to file for a whistleblower award). Almost one quarter of the award recipients submitted their information anonymously to the Commission through counsel.

Several of the cases in which a whistleblower received an award concerned firms involved in the financial services industry, with some involving broker-dealers or investment advisers. A number of the award recipients reported information to the Commission concerning suspected Ponzi-like schemes. Other award recipients provided tips to the Commission relating to false or misleading statements in a company’s offering memoranda or marketing materials, false pricing information, accounting irregularities, and internal controls violations, among other types of misconduct.

Under the Whistleblower Rules, individuals are permitted to jointly submit a tip to the Commission. Five of the cases in which an award payment was made involved two or more whistleblowers jointly submitting information and materials to the Commission.

Individuals who provide information that leads to successful SEC actions resulting in monetary sanctions over $1 million also may be eligible to receive an award if the same information led to a related action, such as a parallel criminal prosecution. Six of the award recipients have received payments based, in part, on collections made in related criminal actions.

The award recipients hail from several different parts of the United States and eight of the award recipients were foreign nationals at the time they submitted their tips to the Commission, including the recipient of the program’s highest award to date.
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PRESERVING EMPLOYEES’ RIGHTS TO REPORT TO THE COMMISSION AND SHIELDING EMPLOYEES FROM RETALIATION

As noted above, protecting whistleblowers’ rights to report possible securities law violations to the Commission, and protecting whistleblowers from retaliation, was a focus for OWB in FY 2016 and will continue to be a priority in the coming fiscal year.

Restrictive Agreements
Exchange Act Rule 21F-17(a) provides that “[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications.”

In the previous fiscal year, the Commission brought its first enforcement action against a company for its use of confidentiality agreements that impeded whistleblowers in violation of Rule 21F-17(a). In FY 2016, the Commission advanced its enforcement efforts in this area, bringing additional significant actions aimed at protecting the rights of whistleblowers to report freely to the agency.

On June 23, 2016, in connection with the SEC’s administrative settlement with Merrill Lynch for violations of the customer protection rule, the Commission also charged Merrill Lynch with violating Rule 21F-17(a) by using language in severance agreements that operated to impede employees from voluntarily providing information to the SEC. For example, after the adoption of Rule 21F-17, the company used language in a severance agreement with departing employees based on a standard template that prohibited them from disclosing any aspect of the company’s confidential information or trade secrets to any outside person or entity except pursuant to formal legal processes or unless the former employee first obtained the written approval of an authorized company representative. Further, in 2014, the company added a clause to its form severance agreement advising departing employees that the severance agreement did not prohibit initiating communications directly with the Commission or other authorities, but limiting the types of information that could be conveyed to information relating to the severance agreement itself or “its underlying facts and circumstances.” In accepting the settlement, the Commission considered Merrill Lynch’s remedial acts, including revising the language in its form severance agreements so that information beyond the underlying facts and circumstances of those agreements can be conveyed to the Commission and other regulatory authorities. The updated language states that, subject to applicable privileges, nothing in the agreements prohibits employees from voluntarily communicating with the SEC regarding suspected violations of law. Merrill Lynch also now provides employees with notice of their whistleblower rights as part of mandatory annual training.

34 17 C.F.R. § 240.21F-17(a).
On August 10, 2016, the Commission instituted proceedings against BlueLinx Holdings, Inc. for violating Rule 21F-17(a). BlueLinx, an Atlanta-based building products distributor, used severance agreements that required outgoing employees to waive their rights to monetary recovery should they file a complaint with the SEC or other federal agency. BlueLinx added the monetary recovery prohibition to all of its severance agreements in mid-2013, nearly two years after the SEC’s adoption of Rule 21F-17(a). BlueLinx agreed to pay a $265,000 civil penalty and to amend its severance agreements to make clear that employees may report possible securities violations to the SEC without the company’s prior approval and without having to forfeit any resulting whistleblower award. BlueLinx also agreed to make reasonable efforts to contact former employees who had executed severance agreements after August 12, 2011, to notify them that BlueLinx does not prohibit former employees from providing information to the SEC or from accepting SEC whistleblower awards.

On August 16, 2016, the Commission instituted another stand-alone action for violating Rule 21F-17(a). Health Net, Inc., a California-based health insurance provider, unlawfully used severance agreements that required outgoing employees to waive their ability to obtain monetary awards from the SEC’s whistleblower program as a condition of receiving severance payments and other consideration from the company. Health Net added the provision in August 2011 after the SEC adopted Rule 21F-17(a). Health Net removed the SEC-specific language from its severance agreements in June 2013, but nonetheless retained restrictive language that required an employee to waive any right to individual monetary recovery in any proceeding brought based on any communication by the employee with any federal, state or local government agency or department. Health Net amended the agreements to strike all such restrictive language in 2015. Health Net agreed to pay a $340,000 civil penalty and to contact former employees who had signed the severance agreements to inform them that they are not prohibited from seeking and obtaining a whistleblower award from the Commission.

Finally, on September 28, 2016, the Commission instituted proceedings against Anheuser-Busch InBev SA/NV (ABI InBev) for violations of Rule 21F-17(a), as well as violations of the books and records and internal controls provisions of the Foreign Corrupt Practices Act. The company entered into a separation agreement, including strict confidentiality provisions, with an employee who had reported internally concerns about improper payments to government officials. After signing the agreement, the employee, who had also been communicating with the Commission, stopped doing so because he believed the separation agreement prohibited such communications and that he could risk being liable to the company under the agreement for liquidated damages. Prior to the Commission’s Order, AB InBev amended its separation agreements for departing employees of its United States entities to make clear that they do not prohibit the employees from reporting possible violations of law to governmental agencies. Further, as part of the settlement, ABI InBev agreed to make reasonable efforts to contact former employees of AB InBev’s United States entities previously identified by the Commission staff, and provide them with a copy of the Commission’s Order and a statement that ABI InBev does not prohibit former employees from contacting the Commission regarding possible violations of federal law or regulation.

39 In the Matter of Anheuser-Busch InBev SA/NV, Rel. No. 78957, File No. 3-17586 (Sept. 28, 2016).
Anti-Retaliation Enforcement

Section 21F(h)(1) of the Exchange Act, promulgated by Section 922 of the Dodd-Frank Act, prohibits employers from retaliating against whistleblowers in the terms and conditions of their employment because of their whistleblowing activities. Individuals who have experienced such retaliation may pursue a private cause of action in the federal courts. In addition, Rule 21F-2(b)(2) under the Exchange Act states that Section 21F(h)(1) is enforceable in an action or proceeding brought by the Commission. This rule reflects the fact that the Commission has general enforcement authority over any violation of the Exchange Act.

On September 29, 2016, the Commission brought its first stand-alone retaliation case under Section 21F(h)(1) of the Exchange Act. The whistleblower, a director of a division of casino gaming company International Game Technology (IGT), had received positive performance evaluations throughout his tenure with the company, including his mid-year review in 2014. Shortly after the whistleblower received a favorable 2014 mid-year review, the whistleblower raised concerns to senior managers, to the company’s internal complaint hotline, and to the SEC, that IGT’s publicly-reported financials may have been distorted. The whistleblower became concerned that the company’s cost accounting model could result in inaccuracies in IGT’s financial statements, and reported these concerns to management and the SEC. Within weeks of raising the concerns, the whistleblower was slated for termination and removed from significant work assignments. The company conducted an internal investigation into the whistleblower’s allegations and determined that its reported financial statements were not inaccurate. Shortly thereafter, IGT fired the whistleblower. The Commission found that IGT’s conduct violated Section 21F(h), and IGT agreed to pay a $500,000 civil penalty to settle the charges.

The SEC previously brought another retaliation enforcement action in June 2014, charging hedge fund advisory firm Paradigm Capital Management, Inc. with retaliating against its head trader for reporting prohibited principal transactions to the SEC. The Commission ordered the firm to pay $2.2 million to settle the retaliation and other charges.

Protection for Internal Reporting

When the Commission issued the Whistleblower Rules in 2011, it clarified that the Dodd-Frank employment retaliation protections apply not only when individuals report potential securities law violations directly to the SEC but also when they, among other things, report internally within public companies. In August 2015, the Commission released interpretive guidance clarifying the interaction of the anti-retaliation provisions and the award provisions of the Whistleblower Rules with respect to the protection of internal reporting under Dodd-Frank. As explained in the interpretive guidance,

40 240 C.F.R. § 21F-2(b)(2).
41 In the Matter of International Game Technology, Rel. No. 78991, File No. 3-17596 (Sept. 29, 2016).
42 In the Matter of Paradigm Capital Management, Inc. and Candace King Weir, Rel. No. 72393, File No. 3-15930 (June 16, 2014).
43 17 C.F.R. § 240.21F-2(b)(1). The anti-retaliation protections apply whether or not the individual satisfies the requirements to qualify for an award. Id. § 240.21F-2(b)(1)(ii).
individuals can report possible securities law violations internally, through their companies’ respective reporting structures, and still be protected if they then suffer adverse employment consequences—even if they have not reported such information to the SEC in the manner required to qualify for an award under the Whistleblower Rules.44

There is a divide among the federal Courts of Appeals on whether the Dodd-Frank anti-retaliation provisions extend to individuals who report potential violations of the securities laws internally without also reporting directly to the Commission. In *Asadi v. G.E. Energy (USA), LLC*, the U.S. Court of Appeals for the Fifth Circuit interpreted Dodd-Frank as limiting employment retaliation protection only to those individuals who report securities law violations directly to the Commission.45 By contrast, in *Berman v. Neo@Ogilvy LLC*, the U.S. Court of Appeals for the Second Circuit held that the pertinent provisions of the Dodd-Frank Act were sufficiently ambiguous to warrant the court’s deference to the SEC’s rule that the statute’s retaliation protections apply to employees who report securities law violations to their employers, regardless of whether they also report to the Commission.46 The Second Circuit acknowledged that its decision created a circuit split because of the Fifth Circuit’s contrary decision in *Asadi*. The Second Circuit also noted the significant existing disagreement among a large number of district courts on the issue, the majority of which have deferred to the SEC’s rule.

During FY 2016, as in the prior fiscal year, the Commission filed several *amicus curiae* briefs in private retaliation lawsuits to urge district courts and appellate courts to defer to the SEC’s rule and hold that individuals are entitled to employment retaliation protection if they report information of a possible securities violation internally at a publicly-traded company, regardless of whether they have separately reported the information to the SEC.47 As the SEC has explained in these *amicus* filings, ensuring that employees are protected from employment retaliation whenever they report possible securities law violations, whether internally or to the SEC, is critical to the SEC’s enforcement efforts. Put simply, if individuals are not assured that they will be protected from retaliation when they report internally, they will be less likely to report internally, which could undermine the important role that internal compliance programs play in helping the Commission prevent, detect, and stop securities law violations.

44 The SEC’s interpretive guidance may be found on OWB’s webpage, http://www.sec.gov/about/offices/owb/owb-resources.shtml, and also has been published in the Federal Register at 80 Fed. Reg. 47,829 (Aug. 10, 2015).
45 720 F.3d 620 (5th Cir. 2013).
46 801 F.3d 145 (2d Cir. 2015).
**WHISTLEBLOWER TIPS RECEIVED**

The Whistleblower Rules specify that individuals who would like to be part of the whistleblower program must submit their tip via the Commission’s online portal or by mailing or faxing their tip on Form TCR to OWB. Whistleblowers who use the online portal to submit a complaint receive a computer-generated confirmation of receipt with a TCR submission number. For those who submit a hard-copy Form TCR by mail or fax, OWB sends an acknowledgement letter, which includes a TCR submission number, or a deficiency letter explaining that the TCR was not properly submitted under the Whistleblower Rules. All whistleblower tips related to potential securities law violations received by the Commission are entered into the TCR System and are evaluated by the Commission’s Office of Market Intelligence within the Division of Enforcement.

**Increase in Whistleblower Tips**

For each fiscal year that the whistleblower program has been in operation, the Commission has received an increasing number of whistleblower tips. Since August 2011, the Commission has received a total of 18,334 whistleblower tips, and in FY 2016 alone, received more than 4,200 tips. The table below shows the number of whistleblower tips received by the Commission on a yearly basis since the inception of the whistleblower program:

<table>
<thead>
<tr>
<th>FY</th>
<th>Whistleblower Tips</th>
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<tbody>
<tr>
<td>FY2011</td>
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</tr>
<tr>
<td>FY2016</td>
<td>4,218</td>
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</tbody>
</table>

As reflected in the table, from FY 2012, the first year for which we have full-year data, to FY 2016, the number of whistleblower tips received by the Commission has grown more than 40 percent.

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48 17 C.F.R. § 240.21F-9(a).
49 The Commission also receives TCRs from individuals who do not wish, or are not eligible, to be considered for an award under the whistleblower program. The data in this report is limited to those TCRs that include the required whistleblower declaration and does not reflect all TCRs received by the Commission during the fiscal year.
50 Because the Whistleblower Rules became effective August 12, 2011, only 7 weeks of whistleblower data is available for FY 2011.
51 During FY 2016, the Commission received an unusually high number of whistleblower tips from the same individual. This number excludes tips received from this individual.
Whistleblower Allegation Type

Whether submitting their tips on Form TCR or through the online portal, whistleblowers are asked to identify the nature of their complaint allegations. For FY 2016, the most common complaint categories reported by whistleblowers were Corporate Disclosures and Financials (22 percent), Offering Fraud (15 percent), and Manipulation (11 percent).52

The following graph reflects the number of whistleblower tips received in FY 2016 by allegation type:53

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52 This breakdown reflects the categories selected by whistleblowers and, thus, the data represents the whistleblower’s own characterization of the violation type.

53 The category of “Other” indicates that the submitter identified the whistleblower TCR as not fitting into any allegation category that is listed on the questionnaire.
The type of securities violations reported by whistleblowers has remained generally consistent over the last five years. Since the beginning of the program, Corporate Disclosures and Financials, Offering Fraud, and Manipulation have consistently ranked as the three highest allegation types reported by whistleblowers. Appendix A to this report provides a comparison among the number of whistleblower tips by allegation type that the Commission received during Fiscal Years 2013 through 2016.

**Geographic Origin of Whistleblower Tips**
Through OWB’s extensive outreach efforts to publicize and promote the Commission’s whistleblower program, the Commission continues to receive whistleblower submissions from individuals throughout the United States, as well as internationally.

During FY 2016, California, New York, Florida, Ohio, and Texas yielded the highest number of whistleblower tips.
Since the beginning of the whistleblower program, the Commission has received whistleblower tips from individuals in 103 countries outside the United States. In FY 2016 alone, the Commission received whistleblower submissions from individuals in 67 foreign countries. After the United States, OWB received the highest number of whistleblower tips in FY 2016 from individuals in Canada, the United Kingdom, and Australia. The map below reflects all countries in which whistleblower tips originated during FY 2016.

Appendices B and C to this report provide detailed information concerning the sources of domestic and foreign whistleblower tips that the Commission received during FY 2016.
PROCESSING OF WHISTLEBLOWER TIPS

The Office of Market Intelligence (OMI), within the Commission’s Division of Enforcement, evaluates incoming whistleblower TCRs and assigns specific, credible, and timely TCRs to members of the Commission staff for further investigation or analysis.

TCR Evaluation
OMI reviews every TCR submitted by a whistleblower to the Commission. During the evaluation process, OMI staff examines each tip to identify those with high-quality information that warrant the additional allocation of Commission resources. When OMI determines that a complaint warrants deeper investigation, OMI staff assigns the complaint to one of the Commission's eleven regional offices, a specialty unit, or to an Enforcement group in the Home Office. Complaints that relate to an existing investigation are forwarded to the staff working on the matter. Generally, when the evaluation of a tip could benefit from the specific expertise of another Division or Office within the SEC, the tip is forwarded to staff in that Division or Office for further analysis.

The Commission may use information from whistleblower tips and complaints in several different ways. For example, the Commission may initiate an enforcement investigation based on the whistleblower’s tip. Even if the tip does not cause an investigation to be opened, it may still help lead to a successful enforcement action if the whistleblower provides additional information that significantly contributes to an ongoing or active investigation. Tips also may prompt the Commission to commence an examination of a regulated entity, which may lead to an enforcement action.

As noted previously, OWB actively tracks whistleblower tips that are referred to Enforcement staff for investigation or follow-up. OWB currently is tracking over 800 matters in which a whistleblower’s tip has caused a Matter Under Inquiry or investigation to be opened or which have been forwarded to Enforcement staff for review and consideration in connection with an ongoing investigation. However, not all of these matters will result in an enforcement action, or an enforcement action where the required threshold of over $1 million in monetary sanctions will be ordered.

In general, the more specific, credible, and timely a whistleblower tip, the more likely it is that the tip will be forwarded to investigative staff for further follow-up or investigation. For instance, if the tip identifies individuals involved in the scheme, provides examples of particular fraudulent transactions, or points to non-public materials evidencing the fraud, the tip is more likely to be assigned to Enforcement staff for investigation. Tips that make blanket assertions or general inferences based on market events, or which do not relate to the federal securities laws are less likely to be sent to or pursued by Enforcement staff.

In certain instances, OMI may determine it is more appropriate that a whistleblower’s tip be investigated by another regulatory or law enforcement agency. When this occurs, OMI refers the tip to the other agency in accordance with the Exchange Act’s whistleblower confidentiality requirements.
Tips that relate to the financial affairs of an individual investor or a discrete investor group usually are forwarded to the Commission’s Office of Investor Education and Advocacy (OIEA) for resolution. Comments or questions about agency practice or the federal securities laws also are forwarded to OIEA.

**Assistance by OWB**

OWB supports the tip allocation and investigative processes in several ways. When whistleblowers submit tips on a Form TCR in hard-copy by mail or fax, OWB enters the information into the TCR System so it can be evaluated by OMI. During the evaluation process, OWB may assist by contacting the whistleblower to obtain additional information to help in the triage process.

After submitting an initial tip, a whistleblower is free to, and often does, submit additional information or materials to buttress the allegations. Additional information should be sent to OWB in hard-copy by mail or fax and should include the original TCR submission number. OWB then uploads the additional information into the TCR System and sends an acknowledgement letter to the whistleblower confirming receipt of the information or materials.

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54 Tips submitted by whistleblowers through the Commission’s online portal are automatically forwarded to OMI for evaluation.
Section 922 of the Dodd-Frank Act established the Fund to provide funding for the Commission’s whistleblower award program, including the payment of awards in related actions.\footnote{Section 21F(g)(2)(A) of the Exchange Act, 15 U.S.C. § 78u-6(g)(2)(A).} Also, the Fund is used to finance the operations of the suggestion program of the SEC’s Office of Inspector General.\footnote{Section 21F(g)(2)(B) of the Exchange Act, 15 U.S.C. § 78u-6(g)(2)(B), provides that the Fund shall be available to the Commission for “funding the activities of the Inspector General of the Commission under section 4(i).” The Commission’s Office of General Counsel has interpreted this section to refer to Exchange Act Section 4D, which established the Inspector General’s suggestion program. That section provides that the “activities of the Inspector General under this subsection shall be funded by the Securities and Exchange Commission Investor Protection Fund established under Section 21F.” \textit{Id.} § 78d-4(e).} The suggestion program is intended for the receipt of suggestions from Commission employees for improvements in work efficiency, effectiveness, productivity, and the use of resources at the Commission, as well as allegations by Commission employees of waste, abuse, misconduct, or mismanagement within the Commission, and is operated outside of OWB.\footnote{Section 4D(a) of the Exchange Act, \textit{id.} § 78d-4(a).}

Section 21F(g)(5) of the Exchange Act requires certain Fund information to be reported to Congress on an annual basis. Below is a chart containing Fund-related information for FY 2016.

<table>
<thead>
<tr>
<th>FY 2016</th>
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<tbody>
<tr>
<td>Balance of Fund at beginning of fiscal year</td>
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<tr>
<td>Amounts deposited into or credited to Fund during fiscal year</td>
</tr>
<tr>
<td>Amount of earnings on investments during fiscal year</td>
</tr>
<tr>
<td>Amount paid from Fund during fiscal year to whistleblowers</td>
</tr>
<tr>
<td>Amount disbursed to Office of the Inspector General during fiscal year</td>
</tr>
<tr>
<td>Balance of Fund at end of the fiscal year</td>
</tr>
</tbody>
</table>

In addition, Section 21F(g)(5) of the Exchange Act requires a complete set of audited financial statements for the Fund, including a balance sheet, income sheet, income statement, and cash flow analysis. That information will be included in the Commission’s Agency Financial Report, which will be separately submitted to Congress.
APPENDIX A
WHISTLEBLOWER TIPS BY ALLEGATION TYPE
COMPARISON OF FISCAL YEARS 2013–2016

* "Other" indicates that the submitter has identified their WB TCR as not fitting into any allegation category that is listed on the questionnaire.
**APPENDIX B**

**WHISTLEBLOWER TIPS RECEIVED BY GEOGRAPHIC LOCATION**

**UNITED STATES AND ITS TERRITORIES**

**FY 2016**

*Multiple individuals may jointly submit a TCR under the Commission’s whistleblower program. Appendix B reflects the number of individuals submitting WB TCRs to the Commission within the United States or one of its territories, and not the total number of domestic WB TCRs received by the Commission during FY 2016. For example, a WB TCR that is jointly submitted by two individuals in New York and New Jersey would be reflected on Appendix B as a submission from both New York and New Jersey. The total number of persons submitting WB TCRs in the United States or one of its territories during FY 2016 was 3,087, which constitutes approximately 70 percent of the individuals participating in the Commission’s whistleblower program for this period. Additionally, 902 individuals constituting approximately 20 percent of the total number of persons participating in the Commission’s whistleblower program for FY 2016 submitted WB TCRs without any foreign or domestic geographical categorization or submitted them anonymously through counsel.*
APPENDIX C
WHISTLEBLOWER TIPS RECEIVED BY GEOGRAPHIC LOCATION INTERNATIONAL FY 2016*

*As with domestic WB TCRs, multiple individuals from abroad may jointly submit a TCR under the Commission’s whistleblower program. Appendix C reflects the number of individuals submitting WB TCRs to the Commission from abroad, and not the total number of foreign WB TCRs received by the Commission during FY 2016. The total number of persons submitting WB TCRs from abroad during FY 2016 was 464, which constitutes approximately 10 percent of the individuals participating in the Commission’s whistleblower program.
SEC Division of Corporation Finance 2017 Update

David Fredrickson

“The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This [article, outline, speech, chapter] expresses the author’s views and does not necessarily reflect those of the Commission, the [other] Commissioners, or [other] members of the staff.”

Working with OCC

• Online form
  https://www.sec.gov/forms/corp_fin_interpretive

• Telephone
  (202) 551-3500

• How formal should my request be?
Compliance Disclosure and Interpretations ("CDIs")

- Transparent
- Accessible
- Current
- Consistent

Recent Positions

- 506(b) -> 506(c) Offerings
- Employee compensation
  - Form S-8 fees
  - 401k/directed brokerage
  - Rule 701
Intrastate and Limited Offerings

- Exemptions to Facilitate Intrastate and Regional Securities Offering, Rel. No. 33-10238 (October 26, 2016)

- Securities Act Rules 147 and 147A
  - Key differences
    - Place of incorporation
    - Offers to anyone

- Regulation D/Rules 504 and 505

Non-GAAP

- Regulation G

- Item 10(e) of Regulation S-K

- Staff Qs&As (last updated May 17, 2016)
  https://www.sec.gov/divisions/corpfin/guidance/non_gaap_interp.htm
Disclosure Effectiveness

- Report on Modernization and Simplification of Regulation S-K (Nov. 23, 2016)

Shareholder Proposals

- Proxy Access
  - “directly conflicts”
  - “substantially implemented”

- Graphics
  - Exchange Act Rule 14a-8(d): “The proposal, including any accompanying supporting statement, may not exceed 500 words.”
Rule 701

• What is an “employee” or “consultant or advisor”?  

• Is an RSU a derivative security?  

• What does “delivery” mean?  

• Further guidance, regulatory or legislative changes?
Chapter 3A
Washington Securities Developments

WILLIAM BEATTY
Securities Administrator
Division of Securities
Washington State Department of Financial Institutions
Olympia, Washington

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1The Department of Financial Institutions, as a matter of policy, disclaims responsibility for the private publications of its staff. The views herein are those of the authors and are not necessarily those of the department or its staff.
I. SELECTED RECENT SECURITIES ENFORCEMENT CASES

The following represent some of the larger, more significant or representative enforcement cases brought by or involving the Securities Division in 2016 and early 2017. PDF versions of these and other enforcement actions are available at: http://dfi.wa.gov/securities-enforcement-actions/securities2016 and http://dfi.wa.gov/securities-enforcement-actions/securities2017.

A. Life Partners Enforcement Actions

In March 2016, the Securities Division entered a Statement of Charges and Notice of Intent to Enter Order to Cease and Desist, Impose Fines, and to Charge Costs against Life Partners, Inc.; Life Partners Holdings, Inc.; Brian Pardo, R. Scott Peden; David Barr; James Billington; Kim Butler; Gary Cassill; Michael Chapman; Tomas Delos Santos; Neal Inscoe; John Ley; William Meyer; Steven Minnich; Tim Watters; Don Wells; Alliance of Professionals for Business, Inc.; NW Retirement Solutions LLC; NW Safe Retirement LLC; Partners Portfolio Solutions, Inc.; and Strategic Insurance Services, LLC. The Statement of Charges related to the offer and sale of approximately $17 million of Life Partners, Inc. life settlements to Washington residents from 2009 to 2014. It named the firm, an affiliate, principals, and sales agents. The Securities Division has since entered into settlements with most of the respondents named in the Statement of Charges.

Brian Pardo – S-14-1603-16-FO01 – Final Order

On April 26, 2016, the Securities Division entered a Final Order to Cease and Desist, Impose Fines, and Recover Costs as to Brian Pardo (“Pardo”). In the Final Order, the Securities Division found that Pardo, as CEO of Life Partners, Inc. and Life Partners Holdings, Inc., offered and sold unregistered securities in violation of RCW 21.20.140. The Securities Division further found that Pardo violated RCW 21.20.010 by misrepresenting or failing to disclose material information in connection with the offer and sale of life settlements to Washington residents. The Securities Division ordered Pardo to cease and desist from violating the Securities Act of Washington, to pay a fine of $100,000, and to pay investigative costs of $5,000. Pardo has a right to request judicial review of this matter.

Tomas Delos Santos – S-14-1603-16-FO02 – Final Order

On May 27, 2016 the Securities Division entered a Final Order to Cease and Desist, Impose Fines, and Recover Costs as to Tomas Delos Santos (“Delos Santos”). In the Final Order, the Securities Division found that Delos Santos offered and sold unregistered securities, in violation of RCW 21.20.140. The Securities Division further found that Delos Santos offered and sold securities while unregistered as a securities salesperson, in violation of RCW 21.20.040. The Securities Division further found that Delos Santos violated RCW 21.20.010 by misrepresenting or failing to disclose material
information in connection with the offer and sale of life settlements to Washington residents. The Securities Division ordered Delos Santos to cease and desist from violating the Securities Act of Washington, to pay a fine of $460, and to pay investigative costs of $500. Delos Santos has a right to request judicial review of this matter.

**James Billington – S-14-1603-16-CO08 – Consent Order**

On May 27, 2016, the Securities Division entered into a Consent Order with Respondent James Billington (“Billington”). In the Statement of Charges, the Securities Division alleged that Billington violated the securities registration, securities salesperson, and antifraud provisions of the Securities Act of Washington in the offer and sale of Life Partners, Inc. life settlements. Without admitting or denying the Securities Division’s allegations, Billington agreed to cease and desist from violating the Securities Act of Washington, to pay a fine of $10,000, and to pay investigative costs of $1,000. Billington waived his right to a hearing and judicial review of this matter.

**Michael Chapman – S-14-1603-16-CO06 – Consent Order**

On June 2, 2016, the Securities Division entered into a Consent Order with Respondent Michael Chapman (“Chapman”). In the Statement of Charges, the Securities Division alleged that Chapman violated the securities registration, securities salesperson, and antifraud provisions of the Securities Act of Washington in the offer and sale of Life Partners, Inc. life settlements. Without admitting or denying the Securities Division’s allegations, Chapman agreed to cease and desist from violating the Securities Act of Washington. Chapman waived his right to a hearing and judicial review of this matter.

**Neal Inscoe; Alliance of Professionals for Business, Inc. – S-14-1603-16-CO01 – Consent Order**

On June 3, 2016 the Securities Division entered into a Consent Order with Respondents Neal Inscoe (“Inscoe”) and Alliance of Professionals for Business, Inc. (“APB”). In the Statement of Charges, the Securities Division alleged that Inscoe and APB violated the securities registration, securities salesperson, and antifraud provisions of the Securities Act of Washington in the offer and sale of Life Partners, Inc. life settlements. Without admitting or denying the Securities Division’s allegations, Inscoe and APB agreed to cease and desist from violating the Securities Act of Washington, to pay a fine of $1,750, and to pay investigative costs of $250. Inscoe and APB waived their right to a hearing and judicial review of this matter.

**Kim Butler; Partners Portfolio Solutions, Inc. – S-14-1603-16-CO11 – Consent Order**

On June 27, 2016 the Securities Division entered into a Consent Order with Respondents Kim Butler (“Butler”) and Partners Portfolio Solutions, Inc. (“PPS”). In the Statement of Charges, the Securities Division alleged that Butler and PPS violated the securities registration, securities salesperson, and antifraud provisions of the Securities Act of
Washington in the offer and sale of Life Partners, Inc. life settlements. Without admitting or denying the Securities Division’s allegations, Butler and PPS agreed to cease and desist from violating the Securities Act of Washington, to pay a fine of $1,950, and to pay investigative costs of $250. Butler and PPS waived their right to a hearing and judicial review of this matter.

**Life Partners, Inc. & Life Partners Holdings, Inc. – S-14-1603-16-CO04 – Consent Order**

On July 18, 2016, the Securities Division entered into a Consent Order with Respondents Life Partners, Inc. and Life Partners Holdings, Inc. (“LPI” and “LPHI” respectively). In the Statement of Charges, the Securities Division alleged that LPI and LPHI violated the securities registration and antifraud provisions of the Securities Act of Washington in the offer and sale of life settlements. Without admitting or denying the Securities Division’s allegations, LPI and LPHI agreed to cease and desist from violating the Securities Act of Washington. LPI and LPHI waived their right to a hearing and judicial review of this matter.

**Tim Watters – S-14-1603-16-CO12 – Consent Order**

On July 18, 2016, the Securities Division entered into a Consent Order with Respondent Tim Watters (“Watters”). In the Statement of Charges, the Securities Division alleged that Watters violated the securities registration, securities salesperson, and antifraud provisions of the Securities Act of Washington in the offer and sale of Life Partners, Inc. life settlements. Without admitting or denying the Securities Division’s allegations, Watters agreed to cease and desist from violating the Securities Act of Washington, to pay a fine of $3,600, and to pay investigative costs of $250. Watters waived his right to a hearing and judicial review of this matter.

**Donald Wells – S-14-1603-16-CO03 – Consent Order**

On August 2, 2016, the Securities Division entered into a Consent Order with Respondent Donald Wells. In the Statement of Charges, the Securities Division alleged that Wells violated the securities registration, securities salesperson, and antifraud provisions of the Securities Act of Washington in the offer and sale of Life Partners, Inc. life settlements. Without admitting or denying the Securities Division’s allegations, Wells agreed to cease and desist from violating the Securities Act of Washington, to pay a fine of $2,450, and to pay investigative costs of $250. Wells waived his right to a hearing and judicial review of this matter.

**R. Scott Peden – S-14-1603-16-CO05 – Consent Order**

On February 8, 2017, the Securities Division entered into a Consent Order with Respondent R. Scott Peden (“Peden”). In the Statement of Charges, the Securities Division alleged that Peden violated the securities registration and antifraud provisions of the Securities Act of Washington in the offer and sale of Life Partners, Inc. life
settlements. Without admitting or denying the Securities Division’s allegations, Peden agreed to cease and desist from violating the Securities Act of Washington, to pay a fine of $6,250, and to pay investigative costs of $3,750. Peden waived his right to a hearing and judicial review of this matter.

Gary Cassill – S-14-1603-16-CO07 – Consent Order

On February 27, 2017, the Securities Division entered into a Consent Order with Respondent Gary Cassill. In the Statement of Charges, the Securities Division alleged that Cassill violated the securities registration, securities salesperson, and antifraud provisions of the Securities Act of Washington in the offer and sale of Life Partners, Inc. life settlements. Without admitting or denying the Securities Division's allegations, Cassill agreed to cease and desist from violating the Securities Act of Washington, to pay a fine of $500, and to pay investigative costs of $500. Cassill waived his right to a hearing and judicial review of this matter.

David Barr – S-14-1603-16-CO09 – Consent Order

On March 2, 2017, the Securities Division entered into a Consent Order with Respondent David Barr. In the Statement of Charges, the Securities Division alleged that Barr violated the securities registration, securities salesperson, and antifraud provisions of the Securities Act of Washington in the offer and sale of Life Partners, Inc. life settlements. Without admitting or denying the Securities Division’s allegations, Barr agreed to cease and desist from violating the Securities Act of Washington, to pay a fine of $2,500, and to pay investigative costs of $500. Barr waived his right to a hearing and judicial review of this matter.

B. Actions Involving Registered Firms or Persons

Ameriprise Financial Services, Inc. – S-15-1575-16-CO02 – Consent Order

On May 18, 2016, the Securities Division entered into a Consent Order with Ameriprise Financial Services, Inc. (“Ameriprise”). The Securities Division previously entered a Statement of Charges against Ameriprise on February 23, 2016. The Statement of Charges alleged that Ameriprise and offered and sold non-traded real estate investment trusts (“REITs”) to customers, including many senior citizens, through unsuitable recommendations and failed to disclose complete information regarding the fees, commissions, and illiquidity of these products. The Securities Division further alleged that Ameriprise failed to adequately supervise Lori Cousineau Weaver, who was formerly a securities salesperson at the firm.

In settling the matter, Ameriprise neither admitted nor denied the allegations, but agreed to cease and desist from violating the Securities Act. The Respondent further agreed to pay a fine of $40,000 and reimburse the Securities Division $15,000 for its costs of investigation. Ameriprise waived its right to a hearing and to judicial review of the matter.
Lori Cousineau Weaver., S-14-1575-16-CO01– Consent Order

On August 9, 2016, the Securities Division entered into a Consent Order with Lori Cousineau Weaver (“Cousineau Weaver”). The Securities Division previously entered a Statement of Charges against Cousineau Weaver on February 23, 2016. The Statement of Charges alleged Cousineau Weaver offered and sold non-traded real estate investment trusts (“REITs”) to customers, including many senior citizens, through unsuitable recommendations and failed to disclose complete information regarding the fees, commissions, and illiquidity of these products.

In settling the matter, Cousineau Weaver neither admitted nor denied the allegations, but agreed to cease and desist from violating the Securities Act. Cousineau Weaver further agreed to pay a fine of $100,000 and to reimburse the Securities Division $10,000 for its costs of investigation. Cousineau Weaver agreed to a 30 day suspension from registration as a securities salesperson. Cousineau Weaver waived her right to a hearing and to judicial review of the matter.

UCI Wealth Advisors, LLC; Travis Higgins – S-16-2049-16-CO01 – Consent Order

On March 3, 2017 the Securities Division entered into Consent Order S-16-2046-16-CO01 with UCI Wealth Advisors, LLC (CRD # 0154884) (UCI) and Travis Higgins (CRD # 04460566) wherein Respondent UCI’s investment adviser registration was revoked. The Securities Division alleged that Higgins failed to disclose conflicts of interest to clients and that he borrowed money from clients. Respondent Higgins withdrew his registration as an investment adviser representative in lieu of revocation and agreed to not apply for registration as an investment adviser representative or securities salesperson for 2 years. Higgins also agreed to not apply for registration as an investment adviser or broker-dealer for 5 years. Respondents paid costs of $750 and waived their right to request a hearing in the matter.

C. Enforcement Actions Relating to Iversen Genetics Diagnostics, Inc.

The Securities Division entered a Statement of Charges against Iversen Genetics Diagnostics, Inc. (“Iverson”) and other Respondents on April 26, 2016. The Statement of Charges alleged that Iverson, a genetic testing company, raised over $19 million through the sale of unregistered common stock and convertible debt. The Securities Division further alleged that Iverson used an unregistered salesperson to solicit such investments and made material misrepresentations or omissions in the offer and sale of the securities. The Securities Division subsequently entered final orders and consent orders against the respondents named in the statement of charges.

James Lisowsky – S-14-1415-16-FO01 – Final Order

On May 31, 2016, the Securities Division entered a Final Order against James Lisowsky. The Securities Division previously entered a Statement of Charges against Lisowsky and
other Respondents on April 26, 2016. The Final Order orders Lisowsky to cease and desist from violating the Securities Act of Washington, to pay a fine of $20,000, and to pay investigative costs of $1,000. Lisowsky has the right to request judicial review of the Final Order.

Iverson Genetic Diagnostics, Inc. – S-14-1415-15-FO04 - Final Order

On June 28, 2016, the Securities Division entered a Final Order against Iverson Genetic Diagnostics, Inc. (“Iverson”). The Final Order orders Iverson to cease and desist from violating the Securities Act of Washington. The Final Order orders Iverson to pay a fine of $60,000 and to pay investigative costs of $10,000. Iverson has the right to request judicial review of the Final Order.

D. Other Selected Enforcement Actions

Frederick J. Birks, Gryphon Asset Management LLC, Gregory Groeller – S-14-1415-16-FO02- Final Order

On June 1, 2016, the Securities Division entered a Final Order against Frederick J. Birks (“Birks”), Gryphon Asset Management LLC (“Gryphon”), and Gregory Groeller (“Groeller”). The Final Order orders Birks, Gryphon, and Groeller to cease and desist from violating the Securities Act of Washington. The Final Order orders Birks to pay a fine of $40,000 and Groeller to pay a fine of $10,000. The Final Order orders Birks to pay investigative costs of $1,000 and Groeller to pay investigative costs of $500. Birks, Gryphon, and Groeller have the right to request judicial review of the Final Order.

Dean A. Esposito; Joseph DeVito; Viper Asset Management, LLC; DJC Consulting LLC – S-14-1415-15-FO03-Final Order

On June 17, 2016, the Securities Division entered a Final Order against Dean A. Esposito (“Esposito”); Joseph DeVito (“DeVito”); Viper Asset Management, LLC (“Viper”); and DJC Consulting LLC (“DJC”). The Final Order orders Esposito, DeVito, Viper, and DJC to cease and desist from violating the Securities Act of Washington. The Final Order orders Esposito to pay a fine of $30,000 and DeVito to pay a fine of $30,000. The Final Order orders Esposito to pay investigative costs of $1,000 and DeVito to pay investigative costs of $1,000. Esposito, DeVito, Viper, and DJC have the right to request judicial review of the Final Order.

Couch Oil & Gas, Inc., Charles O. Couch – S-14-1417-16-FO01 – Final Order

On May 13, 2016, the Department of Financial Institutions entered a Final Decision & Order Affirming Initial Order on Summary Judgment Motion as to Couch Oil & Gas, Inc. and Charles O. Couch (“Final Order”). The Securities Division had previously entered a Statement of Charges against, among others, Respondents Couch Oil & Gas, Inc. and Charles O. Couch on May 23, 2014. The Statement of Charges alleged that Respondents violated RCW 21.20.010, RCW 21.20.140, and RCW 21.20.040 when they offered and
sold $629,375 of unregistered oil and gas investments to Washington residents while failing to disclose material information. On January 13, 2016, Administrative Law Judge Lisa N.W. Dublin issued an Initial Order on Summary Judgment Motion, finding that Respondents Couch Oil & Gas, Inc. and Charles O. Couch violated the Securities Act of Washington as set out in the Statement of Charges. The Final Order affirmed the Initial Order of Summary Judgment Motion, and it ordered Respondents Couch Oil & Gas, Inc. and Charles O. Couch to cease and desist from violating the Securities Act of Washington, ordered Couch Oil & Gas, Inc. to pay a fine of $20,000 and investigative costs of $1,500, and ordered Charles O. Couch to pay a fine of $20,000 and investigative costs of $1,500. Respondents Couch Oil & Gas, Inc. and Charles O. Couch have a right to petition for reconsideration and judicial review of this Final Order.

**Scott B. Wilkerson and WebRotator, Inc. – S-15-1702-16-CO01 – Consent Order**

On August 5, 2016, the Securities Division entered into a Consent Order with Scott B. Wilkerson and WebRotator, Inc (“Respondents”). The Securities Division alleged that Respondents each violated RCW 21.20.140 by offering and selling more than $2.5 million worth of unregistered stock to more than 100 investors and that Scott B. Wilkerson violated RCW 21.20.040 by offering and selling stock while not being registered as a securities broker-dealer or salesperson. The Securities Division also alleged that Respondents each violated RCW 21.20.010, the anti-fraud section of the Securities Act of Washington, by making materially misleading statements or by failing to disclose material information. Without admitting or denying the Securities Division’s allegations, the Respondents each agreed to cease and desist from any violation of RCW 21.20.010 and RCW 21.20.140 and Scott B. Wilkerson agreed to cease and desist from any violation of RCW 21.20.040, to pay a fine of $25,000, and to pay costs of $5,000. The Respondents each waived their right to a hearing and judicial review of this matter.

**James Lisowsky – S-15-1672-16-FO01 – Final Order**

On August 29, 2016 the Securities Division entered a Final Order against James Lisowsky (“Lisowsky”). The Securities Division previously entered a Statement of Charges against Lisowsky and other Respondents on August 1, 2016. The Statement of Charges alleged that Lisowsky took part in raising over $600,000 for SoloMatrix, Inc., a cell phone accessory company, through the sale of various unregistered debt instruments and common stock. The Securities Division further alleged that Lisowsky was not registered to solicit such investments and made material misrepresentations or omissions in the offer and sale of the securities. The Final Order orders Lisowsky to cease and desist from violating the Securities Act of Washington, to pay a fine of $7,500, and to pay investigative costs of $1,000. Lisowsky has the right to request judicial review of the Final Order.
Jeanne Christensen and Doing Business, Inc. – S-13-1218-16-FO01 – Final Decision and Order

On October 28, 2016, the Securities Division entered a Final Decision and Order against Jeanne Christensen and Doing Business, Inc.

Previously, on June 12, 2014, the Securities Division issued a Statement of Charges against Jeanne Christensen and Doing Business, Inc. The Statement of Charges alleged that Jeanne Christensen and Doing Business, Inc. violated the registration and the anti-fraud provisions of the Securities Act of Washington in connection with their operation of a fraudulent high-yield investment program.

The Office of Administrative Hearings (OAH), on June 23, 2016, issued an Initial Order on Respondents’ Motion to Dismiss and Department’s Summary Judgment Motion (Initial Order). In the Initial Order, OAH affirmed the conclusions of law and the listed penalties in the Statement of Charges.

After reviewing Jeanne Christensen’s and Doing Business, Inc.’s Petition for Review of the Initial Order, in its Final Decision and Order, the Securities Division affirmed findings of fact, conclusions of law, and listed penalties in the Initial Order. Both Jeanne Christensen and Doing Business, Inc. each have a right to seek judicial review of the Final Decision and Order.

E. Criminal Cases

Boyd sentencing

On June 9, 2016, Sean Michael Borzage Boyd, a/k/a “Sean Michael” was sentenced by U.S. District Court Chief Judge Thomas O. Rice in Spokane, Washington to 3 years imprisonment and ordered to pay restitution in the amount of $2,872,300. In December 2015, Boyd pleaded guilty Conspiracy to Commit Mail Fraud and Wire Fraud in connection with the sale of investments in BlueStar Digital Technologies, Inc. ("BlueStar") in Spokane, Washington, of which Boyd was the former Senior Executive Vice President. BlueStar was in the business of replicating Blu-Ray discs. Between October 2010 and January 2014, BlueStar raised approximately $2.8 million through the sale of investments to over 40 investors. The case was prosecuted by the United States Attorney's Office in Spokane, and was investigated by the Securities Division and the Federal Bureau of Investigation (FBI).

Young resentencing

On March 1, 2017, Clarence Young was resentenced by King County Superior Court Judge Laura Inveen to 51 months imprisonment. On July 10, 2015, Young had been sentenced to 6 months work release and 6 months of home detention. King County appealed the sentence. On July 11, 2016, Division I of the Washington Court of Appeals reversed the trial court and remanded the case for resentencing. Young had pled guilty to
ten courts of securities fraud on April 29, 2015. In 2006, Young, a former CPA, solicited residents of multiple Washington counties to invest in a feeder fund he called Safeguard that invested in a hedge fund named Gemstar. Young made various misrepresentations to investors regarding the rate of return and the risks of investing. Between 2006 and 2008, Gemstar paid more than $5 million to Safeguard. Young did not inform investors about these distributions, and diverted more than $4 million to his vineyard business, Amigo Vino, to pay off a line of credit and other debts.
II. RECENT RULE-MAKING INITIATIVES

Recent rule-making activity by the Securities Division is summarized below. Rule-making documents may be found on our website at: http://dfi.wa.gov/securities/rulemaking.

Rulemaking in Progress

A. Preproposal Statement of Inquiry Concerning the Limited Offering Exemption and Crowdfunding

On December 10, 2015, the Securities Division filed a Preproposal Statement of Inquiry (Form CR-101), stating that it is considering amending the limited offering exemption in WAC 460-44A-504, as well as the crowdfunding rules contained in chapter 460-99C WAC, in the event the Securities and Exchange Commission (“SEC”) adopted amendments that were proposed to related federal rules. See Wash. St. Reg. 16-01-048.

On October 26, 2016, the SEC adopted final rules to amend Securities Act Rule 147 to modernize the safe harbor under Section 3(a)(11) of the Securities Act, to make it easier for issuers to use state crowdfunding exemptions that are conditioned upon compliance with both Section 3(a)(11) and Rule 147. The final rules also establish a new intrastate offering exemption, Securities Act Rule 147A, that further accommodates offers accessible to out-of-state residents and companies that are incorporated or organized out-of-state. Furthermore, the final rules amend Rule 504 of Regulation D under the Securities Act to increase the aggregate amount of securities that may be offered and sold from $1 million to $5 million. In light of the changes to Rule 504, the final rules repeal Rule 505 of Regulation D. The Securities Division plans to amend its own rules in light of these changes to promote capital formation and will seek public comment on draft proposed rules once published.

B. Adoption of Rules to Implement the Washington Small Business Retirement Marketplace


The Washington Small Business Retirement Marketplace was signed into law by Governor Inslee on May 18, 2015. The Washington Small Business Retirement Marketplace will be an online marketplace operated by the Washington Department of Commerce to promote low-cost retirement savings vehicles to small businesses. The Department of Commerce will approve financial services firms and retirement plans for
inclusion on the marketplace provided that either the Department of Financial Institutions or the Washington Office of the Insurance Commissioner has verified that the retirement plan and the financial services firm offering it meet the requirements set forth in RCW 43.330.732(7) and RCW 43.330.735. The adopted rules specify the application filing requirements for financial services firms that are seeking verification from DFI to be able to participate in the online marketplace.

C. Adoption of Rule to Require Notice Filings in Connection with Federal Crowdfunding Rules

On June 15, 2016, the Securities Division filed a Rule-Making Order (Form CR-103) adopting rules to require notice filings of crowdfunding offerings made under new federal rules. See Wash. St. Reg. 16-13-085.

Title III of the Jumpstart Our Business Startups (JOBS) Act amended Section 4 of the Securities Act of 1933 to create a new federal exemption for offerings of securities in crowdfunding offerings. On October 30, 2015, the Securities and Exchange Commission adopted final rules that will implement this new exemption. See Regulation Crowdfunding, Release Nos. 33-9974; 34-76324, available at: http://www.sec.gov/rules/final/2015/33-9974.pdf. Under the JOBS Act, states retain the authority to require notice filings of crowdfunding offerings if a state is the principal place of business of the issuer or if a state is home to purchasers of 50% or more of the offering.

Washington adopted rules, codified at WAC 460-18A-210, that require companies raising capital under Regulation CF to submit a notice filing, a consent to service of process, and a notice filing fee if Washington is the principal place of business of the issuer or if Washington is home to purchasers of 50% or more of the aggregate value of the securities offered in the crowdfunding campaign.

D. Repeal of WAC 460-44A-505

On April 12, 2017, the Securities Division filed a Rule-Making Order (Form CR-103) adopting the repeal of WAC 460-44A-505, the “Uniform offering exemption for limited offers and sales of securities not exceeding $5,000,000,” in light of the recent repeal of the corresponding federal exemption from securities registration. See Wash. St. Reg. 17-09-033.

On October 26, 2016, the Securities and Exchange Commission adopted final rules amending exemptions to facilitate intrastate and regional securities offerings. See SEC Rulemaking Release No. 33-10238, titled “Exemptions to Facilitate Intrastate and Regional Securities Offerings,” available at: https://www.sec.gov/rules/final/2016/33-10238.pdf. Included in these amendments is a repeal of federal Rule 505 in its entirety. The repeal of federal Rule 505 will be effective on May 22, 2017. Once the repeal of federal Rule 505 becomes effective, businesses will be unable to rely on the corresponding exemption from state registration requirements in WAC 460-44A-505.
E. Adoption of Technical Updates to the Manual Exemption and Updating References to Securities Manuals

On February 1, 2017, the Securities Division filed a Rule-Making Order (Form CR-103) amending the Manual Exemption in WAC 460-44A-100 to more closely align the exemption with Section 202(2) of the Uniform Securities Act of 2002; amending the definition of “Nationally Recognized Securities Manual” in WAC 460-10A-160 to accommodate certain online investor services that provide similar information to preexisting securities manuals; and amending WAC 460-10A-160, 42A-030, and 42A-082 to account for changes in the securities manual and securities ratings industries. See Wash. St. Reg. 17-05-002.
III. RECENT LEGISLATIVE INITIATIVES

The following legislation from the 2016 and 2017 legislative sessions impact the work of the Securities Division:

A. Changes to Washington State Crowdfunding (House Bill 1593)

House Bill 1593 makes changes to the registration exemption available for certain small securities offerings (intrastate crowdfunding) under the Securities Act of Washington. The bill:

- Allows the exemption to be used in connection with any applicable exemption from registration under federal law.
- Permits offerings of any type of equity or convertible debt security under the crowdfunding exemption.
- Removes confusing and ineffective language referring to portals.
- Removes the requirement that issuers be organized under Washington law.
- Reduces the burden of providing periodic reports by instead mandating that reports must be provided to investors on an annual basis and by eliminating the requirement that the reports be made “publicly accessible, free of charge, at the issuer’s internet web site address.”
- Removes the investment amount cap with respect to sales to “accredited investors.”

This bill was delivered to Governor Inslee on April 18, 2017 and is awaiting his signature as of April 21, 2017.

B. Changes to the Washington Small Business Retirement Marketplace (Substitute Senate Bill 5675)

Substitute Senate Bill 5675 makes changes to the Washington Small Business Retirement Marketplace, which was created in 2015 to provide Washington self-employed individuals and small business employers the opportunity to participate in retirement plans. The bill:

- Permits financial services firms to charge enrollees a de minimis fee for new and low balance accounts in amounts negotiated and agreed upon by the Department of Commerce.
- Eliminates the requirement that there must be at least two financial services firms offering approved plans. The bill requires two approved plans for the Washington Small Business Retirement Marketplace to operate.
- Changes the plan verification process to allow the Office of the Insurance Commissioner to request the Department of Financial Institutions to conduct the plan review if the plan includes either life insurance or annuity products.

The bill was signed into law by Governor Inslee on April 19, 2017.
C. Technical Corrections to the Securities Act of Washington

At the request of the Department of Financial Institutions, Senate Bill 6283 was introduced in the 2016 Regular Session of the Washington State Legislature. A companion bill was introduced in the House. The bill makes certain technical corrections to the Securities Act of Washington. The Senate bill was substituted, and Substitute Senate Bill 6283 was passed in both houses of the Legislature and signed into law on March 29, 2016. The bill:

- Corrected cross-references to federal and state law.
- Clarified that offerings made in reliance on the crowdfunding exemption in RCW 21.20.880 are lawful under RCW 21.20.140.
- Clarified that the Director or Securities Administrator may enter an order to deny, revoke, or condition the crowdfunding exemption in RCW 21.20.880, consistent with the authority to do so with respect to other exemptions under the Securities Act pursuant to RCW 21.20.325.
- Amended the notice periods in administrative actions to extend the 15 day notice periods contained in the Securities Act to 20 day notice periods consistent with requirements under the Washington Administrative Procedures Act, chapter 34.05 RCW.
- Revised the renewal deadline for investment advisers, broker-dealers, and their representatives from December 31st to the deadline set by the Financial Industry Regulatory Authority, which operates the national databases through which these licenses are renewed.
- Eliminated the second duplicative version of RCW 21.20.400 (criminal penalties) that resulted from two versions of this code section being enacted in 2003 without reference to each other.
- Made other spelling and grammatical corrections.
IV. SIGNIFICANT SECURITIES CASES OF 2016

The following 2016 cases arose under or reference the Securities Act of Washington, chapter 21.20 RCW:

A. Norton v. Graham & Dunn, P.C.

In Norton v. Graham & Dunn, P.C., 193 Wn. App. 1023, review denied, 186 Wn.2d 1021, 383 P.3d 1018 (2016) (unpublished opinion) Division I of the Court of Appeals considered whether claims against a law firm were barred by the three-year statute of limitations for violations of the Securities Act of Washington.

In 2006, Jose Luis Nino de Guzman, Jr., a Peruvian national, established NDG Investment Group, LLC (“NDG”) to engage in real estate development in Peru. In 2007, de Guzman and NDG retained the law firm of Graham & Dunn, P.C. to form LLCs for real estate projects in Peru. In 2008, Norton, both individually and through his investment company, invested in NDG and purchased membership interests in several LLCs that planned to develop commercial and residential properties in Peru.

In January 2009, Norton met with de Guzman in Peru to discuss the status of the investments. During this meeting, de Guzman admitted that he had sold a property and used the funds to buy other properties without consulting Norton.

After returning to the U.S., Norton reviewed information about the LLCs and their investments and “continued to discover…the inappropriate nature” of de Guzman’s business dealings. On March 11, 2009, Norton’s business partner sent him an e-mail stating that de Guzman admitted to an employee that he was “running a financial house of cards” and that “[de Guzman] has proven himself to be a very accomplished liar and con man.”

After investors became aware of NDG’s fraud, a group of investors formed a “Steering Committee” to recover funds. Norton agreed to join the Steering Committee. On June 11, 2009, Norton sent an e-mail to his attorney expressing concerns about the Steering Committee’s proposed allocation for the recovery assets. In that e-mail, Norton identified a potential claim against Graham & Dunn as a possible recovery opportunity.


On July 23, 2012, more than 80 NDG investors, many of whom were members of the Steering Committee, filed a lawsuit against Graham & Dunn (Angela Aggen, et al. v. Graham & Dunn). The Aggen complaint alleged that Graham & Dunn violated the Securities Act of Washington and aided and abetted NDG in committing fraud. This

1 Prepared by Nathan Quigley, Esq., Registration & Regulator Affairs Unit, Securities Division.
lawsuit alleged that the Private Placement Memorandum provided to NDG investors stated that, on advice of counsel, NDG planned to rely on the Rule 506 exemption from registration. The complaint alleged that Graham & Dunn knew that NDG’s offerings were not in compliance with Regulation D, but that Graham & Dunn continued to form new LLCs for NDG despite the firm’s knowledge that NDG was in violation of securities laws. Norton did not participate in this lawsuit.

On April 11, 2013, Norton filed a lawsuit against Graham & Dunn. The lawsuit asserted the same claims as the Aggen complaint. On October 9, 2014, Graham & Dunn filed a motion for summary judgment of Norton’s lawsuit, arguing it was barred by the three-year statute of limitation in RCW 21.20.430(4)(b). Graham & Dunn argued that evidence established that Norton knew in 2009 that de Guzman was engaged in a Ponzi scheme and had identified a potential claim against Graham & Dunn in June 2009. However, Norton but did not file suit until April 2013. In response to the motion for summary judgment, Norton argued that the fraud and violations of the Securities Act of Washington did not accrue until the Aggen complaint was filed in 2012. The trial court ruled Norton’s claims against Graham & Dunn were barred by the statute of limitation. The trial court concluded that Norton had identified Graham & Dunn “as a possible source of recovery” and did not act with diligence to pursue his claims against the firm. The trial court noted that Norton had “ample evidence” to base a claim against Graham & Dunn but opted to pursue other avenues of recovery.

On appeal, the court affirmed the summary judgment dismissal of the lawsuit. The court was not persuaded by Norton’s argument that the discovery rule tolled the statute of limitation because he had not seen documents produced to the Steering Committee that supported a claim against Graham & Dunn. The court opined that the discovery rule requires due diligence to discover the basis for a cause of action, and that the record indicated that Norton had identified a potential claim against Graham & Dunn but opted to pursue other avenues of recovery.

B. Burdick v. Rosenthal Collins Grp., LLC


From 1996 to 2009, Enrique Villalba perpetrated a Ponzi scheme. After receiving investor funds, Villalba paid himself large management fees, funded his lavish lifestyle, and made $3 million in Ponzi-type payments to other investors. Investors were unaware as Villalba lied to his clients and provided false account statements which reflected steady gains.

Rosenthal Collins Group (“RCG”) opened a nondiscretionary commodity futures trading account for Villalba in 1998, which was just 18 months after Villalba accepted his
first investment. Villalba retained complete control over the futures account and had full responsibility and liability for all trading decisions. Shortly after Villalba’s fraud was uncovered, the Commodities Futures Trading Commission (CFTC) investigated RCG’s role in Villalba’s fraud. The CFTC found that RCG ignored many “red flags” regarding Villalba’s account and that it should have acted in light of “the lack of regard for trading losses, commissions, and fees in [Villalba’s] account.” RCG neither admitted or denied these findings in the CFTC’s consent order.

Burdick alleged that RCG was secondarily liable as a “seller” or “broker-dealer” under RCW 21.20.430(1) and (3). Burdick argued that RCG’s involvement was that of a “seller” in Villalba’s scheme because RCG’s actions were “a substantial contributive factor.” Burdick also argued that RCG could be held liable because RCG “materially aid[ed]” Villalba as a broker-dealer.

On appeal, the court noted that the Washington Supreme Court has held that service providers, such as RCG, can be held liable as a “seller” under RCW 21.20.430(1) if they are a “substantial contributive factor” in a securities offering. The court noted, however, that the service provider must have some level of “active participation” in the sales transaction itself, citing Hines v. Data Line Systems, Inc., 114Wn.2d 127 (1990). In addition, the court noted that no Washington appellate court has opined in any significant way on the “materially aids” standard for holding a broker-dealer liable under RCW 21.20.430(3). However, after reviewing case law from other jurisdictions, the court determined that, at a minimum, the material aid must be given “in the course of the sales transaction” to establish secondary liability of a broker-dealer.

The court determined that RCG could not be liable under the Securities Act of Washington because RCG did not participate “at all” in Villalba’s sale of securities to investors. The court noted that investors admitted that RCG did not factor into their decision to invest with Villalba. As a result, the court affirmed the order granting summary judgment of Burdick’s claim under the Securities Act of Washington.

C. State v. Young

In State v. Young, 194 Wn. App. 1054 (2016), review denied, 187 Wn.2d 1004, 386 P.3d 1095 (2017) (unpublished), Division I of the Court of Appeals considered whether the trial court erred when it imposed an exceptional sentence below the standard range for an individual who plead guilty to 10 counts of securities fraud.

In 2006, Young solicited investment from 16 people for a feeder fund, Safeguard Capital, LLC (“Safeguard”). Young told clients that their investment would earn “a guaranteed return of between 18 and 24 percent with no risk.” Young invested $1.6 million of the $2.2 million he raised for Safeguard in a hedge fund, Gemstar Capital Croup, Inc. (“Gemstar”). He used the remaining $600,000 to repay a line of credit for his other business, Amigo Vino, which supplied wine grapes to hobbyists and small wineries. Over the next two years, Gemstar paid over $5 million in distributions to Safeguard, a
profit of $3.4 million. Instead of distributing the profit to Safeguard investors, Young directed the money to Amigo Vino.

The SEC investigated and sued Gemstar for operating a Ponzi scheme. During the investigation into the Gemstar’s fraud, Young testified that he was the sole investor in Safeguard. Young continued to tell his investors that Safeguard was successful and failed to tell them about the SEC action against Gemstar.

In 2011, the Washington State Department of Financial Institutions received a complaint regarding Young and the Securities Division launched an investigation. In January 2013, DFI entered charges against Young for selling unregistered securities, acting as an unregistered salesperson, acting as an unregistered investment advisor, and for anti-fraud violations. In May 2013, DFI entered into a consent order with Young which required him to cease and desist in engaging in investments on behalf of others.

In June 2014, Young was charged with multiple counts of securities fraud. Young pleaded guilty to 10 counts of securities fraud. The standard sentence range was 51 to 60 months of incarceration. However, the trial court determined that multiple factors were sufficient to merit a departure from the sentencing guidelines and impose an exceptional sentence downward. As a result, the trial court sentenced Young to six months of work release and six months home detention. The trial court based its decision to depart from the sentencing guidelines on Young’s age, his medical condition, his lack of criminal history, the cost of incarnation, and the fact that it was more likely he could continue to make restitution payments if he was not incarcerated.

The State appealed Young’s sentence. The court noted that one of the statutory mitigating factors established by the Sentencing Reform Act states that “before detection, the defendant compensated, or made a good effort to compensate the victim of criminal conduct for any damage or injury sustained.” However, after reviewing the record, the court determined that the trial court failed to conclude that the elements of this mitigating factor were established. Rather, the trial court concluded that Young made restitution payments prior to entering his plea, not that Young made restitution payments before his fraud was detected. In addition, the trial court never made a finding as to when Young’s criminal conduct was detected. Finally, the court noted that there was no evidence in the record that Young communicated to his investors that the funds he repaid them were being made to compensate them for wrongdoing. As a result the court concluded that the trial court failed to make the required findings and conclusions to satisfy the statutory mitigating factor.

In addition, the court noted that many of the other mitigating factors cited by the trial court were personal in nature, and that Washington courts have held that the Sentencing Reform Act prohibits exceptional sentences based on factors personal in nature to a particular defendant. As a result, the court found that the trial court erred in imposing an exceptional sentence and remanded the case for resentencing within the standard range.
D. Bastida v. Nat’l Holdings Corp.

In *Bastida v. Nat’l Holdings Corp.*, No. C16-388RSL, 2016 WL 4250135 (W.D. Wash. Aug. 4, 2016) (unpublished), the U.S. District Court for the Western District of Washington considered a motion to dismiss for failure to state a claim in an action alleging the defendant was liable as a control person under RCW 21.20.430, among other claims.

In the mid-1990s, Bastida and others became customers of William Gillis, a securities broker. In 2008, Gillis began working at National Securities Corporation (“NSC”). In 2016, Bastida filed a lawsuit alleging that Gillis and NSC violated the Washington Securities Act by recommending large investments in high-risk companies that were unsuitable considering the financial needs of retired persons. In the complaint, Bastida alleged that National Holding Corporation was the complete owner of NSC and had “control” over the actions of NSC and Gillis.

National Holding Corporation argued that Bastida’s complaint failed to adequately plead that the National Holding Corporation was liable as a “control person” under RCW 21.20.430. The court noted that the Washington Supreme Court has applied a two-part federal test for control liability, “requiring that the plaintiff show that the defendant exercised control over the operations of the corporation allegedly in violation of the law, and that the defendant had actual power to control the relevant transactions,” citing *Hines v. Data Lines Sys.*, 114 Wn.2d 127 (1990). While the defendant had argued that “complete ownership is not sufficient to establish that a corporate parent has control of over a subsidiary within the meaning of RCW 21.20.430,” the court concluded that ownership of shares is a “relevant indicia of control.” Accepting Bastida’s allegation that National Holding Corporation owned all shares in NSC as true, the court concluded that National Holding Corporation owned a sufficient percentage of voting securities to have achieved the required level of control to support a theory of control person liability. As a result, the court denied National Holding Corporation’s motion of dismiss with respect to this claim.
V. WASHINGTON SECURITIES DIVISION STATISTICS

A. Jurisdictional Areas and Regulated Entities as of 12/31/2016

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<tr>
<th>Act (RCW)</th>
<th>Securities Permits, Notifications And Exemption Letters</th>
<th>Registered Securities Broker-Dealers</th>
<th>Registered Investment Advisers</th>
<th>Investment Adviser Notice Filed</th>
<th>Registered Securities Salespersons</th>
<th>Exempt Reporting Advisers – Active Organizations</th>
<th>Registered Investment Adviser Representatives</th>
<th>Branch Offices Of Broker-Dealers</th>
<th>Complaints</th>
<th>Active Enforcement Cases</th>
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### B. Registration and Licensing Filing Activity Totals for Calendar Year 2016*

#### Registrations, Exemptions & Notifications

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<td>Other Coordination Filings</td>
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#### Firms & Entities

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#### Representatives & Salespersons

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<td><strong>176,989</strong></td>
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</tr>
</tbody>
</table>

*This workload data does not include information on registrations or licenses that terminate or fail to renew during the year.*
Chapter 3B
State Regulatory Update—Idaho

Jim Burns
Securities Bureau Chief
Idaho Department of Finance
Boise, Idaho

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## IDAHO Fiscal Year Statistical Footprint

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<th>FY-16</th>
<th>15-16 Change</th>
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<td>8,148</td>
<td>8,556</td>
<td>8,226</td>
<td>8,292</td>
<td>8,557</td>
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<td>9,613</td>
<td>9,792</td>
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<td>1,646</td>
<td>1,604</td>
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<td>1,530</td>
<td>1,513</td>
<td>1,495</td>
<td>1,498</td>
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<td>Idaho Registered Agents (BD, IA, Issuer)</td>
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<td>75,844</td>
<td>80,358</td>
<td>77,823</td>
<td>82,841</td>
<td>92,517</td>
<td>95,343</td>
<td>96,802</td>
<td>101,955</td>
<td>107,282</td>
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<td>Federal IA Notice Filers</td>
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<td>782</td>
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<td>839</td>
<td>853</td>
<td>860</td>
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<td>Money Transmitters</td>
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<td>38</td>
<td>40</td>
<td>44</td>
<td>51</td>
<td>62</td>
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<td>Endowed Care Cemeteries</td>
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<td><strong>Securities</strong></td>
<td>79,078</td>
<td>86,469</td>
<td>91,463</td>
<td>88,548</td>
<td>93,629</td>
<td>103,575</td>
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<td>113,601</td>
<td>119,479</td>
<td>124,596</td>
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IDAHO DEPARTMENT OF FINANCE SANCTIONS REPORT

ADMINISTRATIVE SANCTIONS & ORDERS ISSUED UNDER THE IDAHO UNIFORM SECURITIES ACT / IDAHO ESCROW ACT / IDAHO MONEY TRANSMITTERS ACT

July 13, 2015

CITIGROUP GLOBAL MARKETS INC, New York, NY – Administrative Consent Order – In resolving multi-state investigations, Citigroup Global Markets Inc (CGMI) entered into a settlement agreement in Idaho wherein the firm 1) neither admitted nor denied the findings of fact or conclusions of law contained in the order, 2) agreed to pay a penalty of $35,000 and 3) agreed to establish and maintain policies, procedures and systems that reasonably supervise the trade process so that a sales associate (SA) can only accept client orders that originate from jurisdictions where the SA accepting the order is appropriately registered.

The multi-state investigation was focused on registered sales associates (RSAs) who accepted client orders while not being registered in the appropriate jurisdiction as required, and CGMI's supervision of state registrations for RSAs during the period from January 1, 2007 through September 30, 2014.

December 15, 2015

SMART PAYMENT PLAN LLC, Naples, FL – Agreement and Order – In connection with a review of their business activities and in connection with their application for a money transmitter license in Idaho, The Department alleged that unlicensed money transmission activity had occurred in Idaho prior to the submission of the application. In resolution of the Department’s allegations, Smart Payment Plan LLC (SPP) executed a settlement order where SPP 1) neither admitted nor denied the state’s findings of violations, 2) brought its money transmission activities into compliance with the Idaho Money Transmitters Act and 3) agreed to pay a fine of $8,000.

December 21, 2015

LPL FINANCIAL, Boston, MA – Consent Order – To resolve coordinated multi-state investigations, LPL Financial (LPL) entered into a settlement agreement in Idaho in which the firm 1) agreed to comply with all state and federal securities laws, 2) neither admitted
nor denied the findings of fact or conclusions of law contained in the order, 3) agreed to offer to remediate losses for all non-traded REITs that were sold in amounts which exceeded state concentration limits and LPL’s own guidelines for products sold between January 1, 2008 through December 31, 2013 and 4) agreed to pay a civil penalty to the Department in the amount of $17,738.18.

The multi-state investigations related to sales transactions of non-traded REITs that were sold in excess of the prospectus standards, state concentration limits, and/or LPL’s own guidelines. By engaging in such activities, LPL allegedly failed to diligently supervise its agents and to establish, maintain or enforce adequate written supervisory procedures reasonably designed to achieve compliance with state law in connection with LPL's sale of nontraded REITs.

December 21, 2015

CONSOLIDATED WEALTH HOLDINGS, INC., JOHN SPALDING, DEANNA OSBORNE, and SCOTT OSBORNE, Kansas City, MO – Agreement and Order – The Department alleged that Respondents engaged in omissions of material facts in connection with the offer, sale or purchase of life settlement securities. In resolution of the state investigation, the Respondents agree to 1) use their best efforts to pay the death benefits and premiums relating to the life insurance policies that affected Idaho investors had ownership interests in, 2) notify the Department when Idaho investors receive final payment from the identified life settlements, and 3) comply with all provisions of state and federal laws and regulations applicable to its business activities in Idaho at all times in the future.

March 22, 2016

RULON LEE TOLMAN, Meridian, ID – Agreement and Order – The Department alleged that Tolman violated the registration and anti-fraud provisions of the Idaho Uniform Securities Act in connection with his offer and sale of life settlement securities and related promissory notes. In resolution of the State’s investigation, Tolman 1) admitted to the allegations and conclusions of law contained in the order, 2) agreed to pay a civil penalty of $10,000 and 3) agreed to permanently refrain from selling or offering nonexempt securities aside from life, health or disability insurance unless Respondent and such security are duly registered.

ORDERS ISSUED UNDER THE IDAHO FINANCIAL FRAUD PREVENTION ACT

October 16, 2015 TRACY ANN WIDNER, Boise, ID – Consent Order with Tracy Ann
Widner for violating the Idaho Financial Fraud Prevention Act. Widner was employed by an Idaho state-chartered credit union; her position provided her with access to the credit union members’ loan and share accounts. Widner embezzled over $6,000 via unauthorized advances on members’ loans, unauthorized share account withdrawals, and creation of unauthorized accounts beginning in September 2014. Widner was charged with grand theft, to which she pleaded guilty. The Consent Order states that Widner’s activity violated the Act, and requires her to pay restitution to the credit union for any unreimbursed amounts. In addition, the Order bars Widner from employment by any Idaho financial institution, except with the prior written consent of the Director.

**June 1, 2016**

**JACQUELINE KAY MANNING, Boise, ID.** Consent Order with Jacqueline Kay Manning for violating the Idaho Financial Fraud Prevention Act. While employed by a federal credit union in Boise, Manning created and concealed unreconciled balances in the credit union’s accounts by entering false entries to the ACH accounting records of the credit union. Manning was charged with felony grand theft, to which she pleaded guilty. The Consent Order states that Manning’s activity violated the Act, and requires her to pay restitution to the credit union of $213,382. In addition, the Order bars Manning from employment by any Idaho financial institution, except with the prior written consent of the Director.

**ASSISTANCE IN CRIMINAL PROSECUTIONS**

**March 24, 2016**

**JACQUELINE MANNING, Boise, ID.** – During July 2015, Manning was charged with grand theft in connection with her actions as an employee of Boise U.S. Employees Federal Credit Union. On November 25, 2015, Manning pleaded guilty to grand theft and was sentenced on March 22, 2016. Beyond being ordered to pay restitution of $213,302, Manning received a sentence of 14 years to be served in the Idaho State Department of Corrections prison, 4 determinate years and 10 indeterminate. Significant portions of the investigation and prosecutorial assistance were provided by Jeff Flora and others in the Department of Finance.
NEWS RELEASE

For Immediate Release April 17, 2017

DEPARTMENT OF FINANCE SUES RECIDIVIST TO CEASE VIOLATIONS

Idahoans Warned About Investment Scheme Run by Man of Many Names

Boise, Idaho . . . The Idaho Department of Finance today announced a securities civil complaint against Richard F. “Rick” Guyon, an individual currently under the supervision of the U.S. correctional system. Guyon operates as or on behalf of DBAs or entities named in the lawsuit including, Thompson Enterprises Holding Group, LLC; Thompson Enterprises, LTD; and Thompson Capital Management.

The six count complaint alleges that Guyon raised over $2 million from Idaho investors and violated state securities law by a) engaging in a scheme or artifice to defraud, b) making false and misleading statements, c) engaging in an unlawful conversion of investor funds, d) selling unregistered securities, and e) failing to register as required by Idaho law. The complaint indicates that other parties may have materially aided Guyon in his scheme and they may be named in the lawsuit at a later date.

According to the complaint, Guyon previously was convicted of federal financial crimes including bank fraud, and was released from prison in May 2015. Guyon is believed to have used aliases in Idaho and elsewhere including Rick Garrison, Rich Thompson, Mark Thompson and Michael Banks.

The Department of Finance lawsuit seeks an injunction from further violations, restitution to affected Idaho investors and other restrictions on Guyon’s future business practices. Idahoans should be advised that Guyon is not legally authorized to offer or sell securities investments or to otherwise manage the money of Idaho investors. Investors who have given Guyon or his entities or associates money, or who have been approached by Guyon, are asked to contact the Department of Finance at (208) 332-8004 or Idaho toll-free at (888) 346-3378. A copy of the lawsuit can be found at http://www.finance.idaho.gov/Securities/Actions/Civil/Guyon/Complaint_Guyon.pdf or on the Department’s website at http://finance.idaho.gov under “civil actions.”

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The Idaho Department of Finance reminds all investors that a legitimate securities salesperson must be properly licensed, and his or her firm must be registered with FINRA, the Securities and Exchange Commission, or a state securities regulator. Verify that your securities salesperson is properly licensed by contacting the Department at (208) 332-8004 or toll-free at (888) 346-3378. Press releases and a copy of the civil complaint can be found on the Internet at http://finance.idaho.gov or by contacting the Department.
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</table>
000. LEGAL AUTHORITY (RULE 0).
This chapter is promulgated pursuant to Section 30-14-605, Idaho Code. (3-24-05)

001. TITLE AND SCOPE (RULE 1).

01. Title. The title of this chapter is the “Securities Rules of the Idaho Department of Finance”; and may be cited as IDAPA 12.01.08, “Rules Pursuant to the Uniform Securities Act (2004).” (3-24-05)

02. Implementation. These rules implement statutory intent with respect to the offer and sale of securities and the giving of investment advice in the state of Idaho by licensed individuals and others. (3-24-05)

002. WRITTEN INTERPRETATIONS -- AGENCY ACCESS -- FILINGS (RULE 2).
Written interpretations of these rules, if any, are available by mail from the Idaho Department of Finance, P.O. Box 83720, Boise, Idaho 83720-0031. Interpretive opinions including no-action letters are rendered only in writing. Informal discussions with the Administrator or Department staff shall not be taken to signify any determination or approval concerning the matters discussed. (3-24-05)

003. SECURITIES EXEMPTIONS, OPINIONS, AND NO-ACTION LETTERS (RULE 3).
Interpretative Opinions. The Administrator, in his discretion, may honor requests from interested persons for formal interpretive opinions and no-action positions, including consideration of waivers, relating to an actual specific factual circumstance where appropriate and in the public interest, on the basis of facts stated and submitted in writing, with respect to the provisions of the Act or any rule or statement of policy adopted thereunder, provided such requests satisfy and conform to the following requirements: (3-24-05)

01. Written Requests. Such requests shall be in writing and shall include or be accompanied by all information and material required by any statute, rule or statement of policy under which an exception or exemption may be claimed, including but not limited to, copies of prospectuses or offering circulars if applicable or appropriate. (3-24-05)

02. Narrative. The letter should contain a brief narrative of the fact situation and should set out all of the facts necessary to reach a conclusion in the matter; however, such narratives should be concise and to the point. (3-24-05)

03. Hypotheticals Not Considered. The names of the company or companies, organization or organizations and all other persons involved should be stated and should relate and be limited to a particular factual circumstance. Letters relating to hypothetical situations will not warrant a formal response. (3-24-05)

04. Fee. Each request for a no-action position or interpretive opinion letter shall be accompanied by payment of a fee in the amount of fifty dollars ($50). (3-24-05)

004. ADMINISTRATIVE APPEALS (RULE 4).
Administrative appeals are not available within the department. (3-24-05)

005. INCORPORATION BY REFERENCE (RULE 5).

01. Incorporated Documents. IDAPA 12.01.08, “Rules Pursuant to the Uniform Securities Act (2004),” adopts and incorporates by reference the full text of the following Statements of Policy and guidelines adopted by the North American Securities Administrators Association (NASAA): (3-24-05)

a. “Loans and Other Material Affiliated Transactions,” as adopted with amendments through March 31, 2008; (3-29-17)
b. “Options and Warrants,” as adopted with amendments through March 31, 2008; (3-29-17)

c. “Corporate Securities Definitions,” as adopted with amendments through March 31, 2008; (3-29-17)

d. “Impoundment of Proceeds,” as adopted with amendments through March 31, 2008; (3-29-17)

e. “Preferred Stock,” as adopted with amendments through March 31, 2008; (3-29-17)

f. “Promotional Shares,” as adopted with amendments through March 31, 2008; (3-29-17)

g. “Promoters’ Equity Investment,” as adopted with amendments through March 31, 2008; (3-29-17)

h. “Specificity in Use of Proceeds,” as adopted with amendments through March 31, 2008; (3-29-17)

i. “Underwriting Expenses, Underwriter’s Warrants, Selling Expenses, and Selling Securities Holders,” as adopted with amendments through March 31, 2008; (3-29-17)

j. “Unsound Financial Condition,” as adopted with amendments through March 31, 2008; (3-29-17)

k. “Unequal Voting Rights,” as adopted March 31, 2008; (3-29-17)

l. “Debt Securities,” as adopted April 25, 1993; (3-24-05)

m. “NASAA Guidelines Regarding Viatical Investments,” as adopted October 1, 2002; (3-24-05)


02. Availability of Referenced Documents. Copies of the “NASAA Statements of Policy” are available at the following locations:

a. NASAA, 750 First Street, N.E., Suite 1140, Washington, D.C. 20002. (3-24-05)

b. Department of Finance, 800 Park Blvd., Suite 200, Boise, ID 83712. (3-29-17)


006. OFFICE MAILING ADDRESS AND STREET ADDRESS (RULE 6). The mailing address of the department is Idaho Department of Finance, P.O. Box 83720, Boise, Idaho 83720-0031. The street address of the department is Idaho Department of Finance, 800 Park Blvd., Suite 200, Boise, ID 83712. The telephone numbers of the department include (208) 332-8000, Administration; and (208) 332-8004, Securities Bureau. The telephone number of the facsimile machine is (208) 332-8099. All filings with the department in connection with rulemaking or contested cases shall be made with the Administrator of the Idaho Department of Finance, and shall include an original and one (1) copy. (3-29-17)

007. PUBLIC RECORDS ACT COMPLIANCE (RULE 7). All rules contained in this chapter are public records. (3-24-05)

008. -- 009. (RESERVED) (3-24-05)

010. DEFINITIONS (RULE 10). (3-24-05)


02. Administrator. The Director of the Department of Finance. (3-24-05)
03. **Agent of Issuer.** The term “agent of issuer” is used interchangeably with the term “issuer agent” through these rules. (3-24-05)

04. **CRD.** Central Registration Depository. (3-24-05)

05. **Department.** The Idaho Department of Finance. (3-24-05)

06. **EFD.** Electronic Filing Depository. (3-29-17)

07. **FINRA.** Financial Industry Regulatory Authority. (3-29-17)

08. **Form ADV.** The Uniform Application for Investment Adviser Registration. (3-24-05)

09. **Form ADV-H.** The Uniform Application for a Temporary or Continuing Hardship Exemption. (3-24-05)

10. **Form ADV-W.** The Uniform Request for Withdrawal of Investment Adviser Registration. (3-24-05)

11. **Form BD.** The Uniform Application for Broker-Dealer Registration. (3-24-05)

12. **Form BDW.** The Uniform Request for Withdrawal from Registration as a Broker-Dealer. (3-24-05)

13. **Form BR.** The Uniform Application for Broker-Dealer Branch Registration. (3-29-17)

14. **Form D.** The federal form entitled “Notice of Sale of Securities Pursuant to Regulation D, Section 4(6) and or Uniform Limited Offering Exemption.” (3-24-05)

15. **Form NF.** The Uniform Notice Filing Form. (3-24-05)

16. **Form 1-A.** A federal securities registration form of that number. (3-24-05)

17. **Form S-18.** A federal securities registration form of that number. (3-24-05)

18. **Form U-1.** The Uniform Application to Register Securities. (3-24-05)

19. **Form U-2.** The Uniform Consent to Service of Process. (3-24-05)

20. **Form U-4.** The Uniform Application for Securities Industry Registration or Transfer. (3-24-05)

21. **Form U-5.** The Uniform Request for Withdrawal of Securities Industry Registration or Transfer. (3-24-05)

22. **Form U-7.** The Uniform Small Company Offering Registration Form. (3-24-05)

23. **IARD.** Investment Adviser Registration Depository. (3-24-05)

24. **NASAA.** The North American Securities Administrators Association, Inc. (3-24-05)

25. **NASD.** The National Association of Securities Dealers, Inc. (3-24-05)

26. **NASDAQ.** The National Association of Securities Dealers Automated Quotations. (3-24-05)

27. **SEC.** The U.S. Securities and Exchange Commission. (3-24-05)

28. **Transact Business.** For purposes of the Act, to “transact business” shall mean to buy or to sell or
contract to buy or to sell or dispose of a security or interest in a security for value. It shall also mean any offer to buy or offer to sell or dispose of, and every solicitation of clients or of any offer to buy or to sell, a security or interest in a security for value. With respect to investment advisers and investment adviser representatives, “transact business” shall include preparation of financial plans involving securities, recommendations to buy or sell securities or interests in a security for value, and solicitation of investment advisory clients.


30. Unsolicited Order or Offer.

a. As used in these rules, an order or offer to buy is considered “unsolicited” if:

i. The broker-dealer has not made a direct or indirect solicitation or recommendation that the customer purchase the security; and

ii. The broker-dealer has not recommended the purchase of the security to the customer, either directly or in a manner that would bring its recommendation to the customer; and

iii. The broker-dealer has not volunteered information on the issuer to the customer; and

iv. The customer has previously, and independent of any information furnished by the broker-dealer, decided to buy the security.

b. Any offer or order to buy from a customer whose first knowledge of the specific security or issuer was volunteered to him by the broker-dealer shall be regarded as a solicited order.

c. Any claim of exemption pursuant to Section 30-14-202(6), Idaho Code, shall be supported by the broker-dealer’s certificate that the transaction in question was, in fact, unsolicited.

011. -- 019. (RESERVED)

020. APPLICATION FOR REGISTRATION OF SECURITIES (RULE 20).

01. Registration by Coordination. A registration statement to register securities by coordination shall contain the following:

a. The Form U-1 and accompanying documents (including subscription agreement);

b. A consent to service of process (Form U-2) in compliance with Section 30-14-611, Idaho Code;

c. A copy of the prospectus, including financial statements where:

i. The prospectus for a securities registration by coordination under Section 30-14-303, Idaho Code, shall be prepared using the forms required under the Securities Act of 1933, and

ii. All historical financial statements in the registration statement shall be in conformity with generally accepted accounting principles (GAAP) and financial statements filed with a registration statement by coordination shall comply with the requirements of the United States Securities and Exchange Commission.

d. All exhibits filed with the United States Securities and Exchange Commission in connection with the registration statement;

e. The filing fee specified in Section 30-14-305(b), Idaho Code; and

f. Any additional information or documents requested by the Department.
02. Registration by Qualification. A registration statement to register securities by qualification shall contain the following in addition to the requirements of Section 30-14-304, Idaho Code:

a. Financial Statements. Except for SCOR applications, registration statements filed pursuant to Section 30-14-304, Idaho Code, shall contain audited financial statements of the issuer for its last two (2) fiscal years. An issuer with less than one (1) year of operations may file reviewed financial statements until the end of its first fiscal year. Registration statements filed with SCOR applications on the Form U-7 shall contain the financial statements specified in the instructions to the Form U-7.

b. Unaudited Interim Financial Statements. If the audited financial statements or unaudited financial statements required in Subsection 020.02.a. of this rule are not current to within four (4) months of the date of filing of the registration statement, additional unaudited financial statements as of the issuer’s last fiscal quarter or any later date designated by the Administrator shall be included.

c. Small Company Offering Registration (SCOR). A SCOR registration statement shall contain the following:

i. The Form U-1 and accompanying documents (including subscription agreement);

ii. An executed Form D;

iii. A consent to service of process (Form U-2) in compliance with Section 30-14-611, Idaho Code;

iv. For SCOR offerings, the prospectus to be used shall be the Form U-7, as adopted and revised by NASAA in September 1999;

v. The filing fee specified in Section 30-14-305(b), Idaho Code; and

vi. Any additional information or documents requested by the Department.

d. Registration statements by qualification shall contain the following:

i. The Form U-1 and accompanying documents (including subscription agreement);

ii. A consent to service of process (Form U-2) in compliance with Section 30-14-611, Idaho Code;

iii. Financial statements prepared in accordance with Subsection 020.02.a. of this rule;

iv. A copy of the prospectus containing the information or records specified in Sections 30-14-304(b)(1) through 304(b)(18), Idaho Code;

v. The prospectus shall be prepared using one of the following forms: Part II of Form 1-A of Regulation A of the Securities Act of 1933; Parts I and II of Form SB-2 of the Securities Act of 1933; Form U-7; or any other applicable form used to prepare a prospectus under the Securities Act of 1933, if approved by the department.

03. Other Forms. Any other applicable form used to prepare a prospectus under the Securities Act of 1933, if approved by the Department, containing:

a. The filing fee specified in Section 30-14-305(b), Idaho Code; and

b. Any additional information or documents requested by the Department.

021. AMENDMENTS TO REGISTRATION STATEMENT (RULE 21).
01. Amendments Required. A correcting amendment to an effective registration statement shall be prepared and submitted to the Department any time that the information contained therein becomes inaccurate or incomplete in any material respect. The responsibility for identifying and reporting a material change lies with the registrant. (3-24-05)

02. Contents of Amendment Filing. Each filing of a correcting amendment to a registration statement shall contain a copy of each item of the registration statement which has been changed, with all changes clearly marked. To be complete, a filing of a correcting amendment to the registration statement shall contain a report of material changes setting forth a summary of each material change and indicating the location of such change in the documents filed. Neither the Administrator nor any member of his staff shall be held to have taken notice of any item of material change not summarized in such a report. (3-24-05)

03. Time of Filing and Undertaking. Every registration statement shall contain an undertaking by the applicant to file correcting amendments to the registration statement whenever the information in the registration statement becomes inaccurate or incomplete in any material respect by the earlier of:

a. Two (2) business days after filing such amendment with the SEC; or

b. Fifteen (15) business days following the event giving rise to the amendment.

c. If not registered with the SEC, registrants shall file an amended registration statement if required within fifteen (15) business days following the event giving rise to the amendment. (3-24-05)

04. Effect of Failure to Amend. Solicitation of prospective investors through utilization of a prospectus containing information which is inaccurate or incomplete in any material respect is a violation of Section 30-14-501, Idaho Code, and constitutes a basis for the suspension or revocation of the registration under Section 30-14-306(a)(1), Idaho Code. Nothing in Section 021, of these rules, shall be construed to require any open-end investment company registered under the 1940 Act and the Act to disclose fluctuations in its investment portfolio. (3-24-05)

022. FINANCIAL STATEMENTS (RULE 22).

01. Application of Regulation S-X. As to definitions, qualifications of accountants, content of accountant’s certificates, requirements for consolidated or combined statements, and actual form and content of financial statements, the Administrator shall apply Regulation S-X of the SEC (17 CFR Part 210) in its most currently amended form as of the date of the filing of the application to all financial statements filed with the Department in connection with the registration of securities. (3-24-05)

02. Financial Statements Incorporated by Reference. Where financial statements in a prospectus are incorporated by reference from another document, the Administrator may require that such other document be filed with the Department and be delivered to investors with the prospectus. (3-24-05)

03. Application of Antifraud Provisions. Any financial statement distributed in connection with the offer or sale of securities under the Act shall be subject to the provisions of Section 30-14-501, Idaho Code. Any financial statement filed with the Department shall be subject to the provisions of Section 30-14-505, Idaho Code. (3-24-05)

023. -- 035. (RESERVED)

036. NASAA STATEMENTS OF POLICY -- REGISTERED OFFERINGS (RULE 36). The Department will apply the applicable statement(s) of policy adopted by NASAA and incorporated herein by reference pursuant to Section 005, of these rules, to an offering seeking registration in Idaho when conducting a review to determine whether an offering is fair, just and equitable. Such an offering must comply with the requirements of such policy or policies, unless waived by the Administrator. (3-24-05)

037. REGISTRATION OF DEBT SECURITIES (RULE 37). In addition to the requirements contained in the NASAA Statement of Policy Regarding Debt Securities, as adopted
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on April 25, 1993, the issuer of debt securities will incorporate the following standards: (3-24-05)

01. Suitability. In establishing standards of fairness and equity, the Department has established the following investor suitability guidelines for debt offerings registered under the Act: (3-24-05)

a. No more than ten percent (10%) of any one (1) Idaho investor’s net worth (exclusive of home, home furnishings, and automobiles) shall be invested in the securities being registered with the Department; and either (3-24-05)

b. A gross income of forty-five thousand dollars ($45,000) and a net worth of forty-five thousand dollars ($45,000) (exclusive of home, home furnishings and automobiles); or (3-24-05)

c. A net worth of one hundred fifty thousand dollars ($150,000) (exclusive of home, home furnishings and automobiles). (3-24-05)

02. Department May Establish Standards. The suitability standard in Subsection 037.01 of this rule is a guideline. Higher or lower suitability standards may be established or may be required by the Department as a condition of registration. (3-24-05)

03. Standards To Be Disclosed. The suitability standards must be disclosed in the prospectus. (3-24-05)

038. WITHDRAWAL/ABANDONMENT OF A REGISTRATION STATEMENT (RULE 38).

01. Withdrawal. The withdrawal of an application (prior to effectiveness) may be permitted by the Administrator upon the written request of the applicant. (3-24-05)

02. Abandonment. The abandonment of an application, where there has been no activity on the application by the applicant for a period of six (6) months or more, may be considered to signify a request for withdrawal. (3-24-05)

03. Time Limit. An application for registration of securities pursuant to Section 30-14-303 or 30-14-304, Idaho Code, shall be deemed abandoned if such registration is not effective in the state of Idaho within one (1) year from the date of receipt by the Department of the initial filing of the application for registration. (3-24-05)

04. Abandoned Applications Not Reinstated. Once deemed abandoned, the original application shall not be reinstated. A new application including the registration statement, appropriate exhibits and filing fees shall be required. (3-24-05)

039. REPORT OF COMPLETION OF OFFERING (RULE 39).

01. Completion Statement. Within thirty (30) days of the completion of a registered offering in Idaho, the registrant shall provide a written statement to the Department that states the following: (3-24-05)

a. The date the offering was completed in Idaho; and (3-24-05)

b. The number and amount of registered securities sold in Idaho, for SCOR offerings and offerings registered by qualification. (3-24-05)

02. Signatures. The written statement must be signed by an officer, director or agent of the issuer or by an authorized signatory of the registrant. (3-24-05)

040. ANNUAL REPORT FOR THE RENEWAL OF A REGISTRATION STATEMENT (RULE 40).

To renew a registration statement for an additional year, the registrant shall file the following with the Department before the anniversary of the effective date of the registration statement in Idaho: (3-24-05)

01. Cover Letter. A cover letter requesting renewal; (3-24-05)
02. **Consent to Service.** A consent to service of process (Form U-2) in accordance with Section 30-14-611, Idaho Code; and

03. **Filing Fee.** A filing fee of three hundred dollars ($300) for all registered offerings.

**041. SUBSCRIPTION AGREEMENT (RULE 41).**

The subscription agreement shall contain, among other things, an acknowledgment by the subscriber that he has received a copy of the prospectus. Each completed subscription agreement shall be kept in the office of the issuer or broker-dealer for a period of five (5) years and be subject to inspection by the Department.

042. **DELIVERY OF PROSPECTUS (RULE 42).**

As a condition of registration, an applicant shall comply with the following:

01. **Registration by Qualification.** A person offering or selling a security under a registration by qualification, other than through a broker-dealer, shall deliver a copy of the final prospectus to each prospective purchaser before or at the time of the confirmation of a sale made by or for the account of the person.

02. **Registration by Coordination.** A person offering or selling a security under a registration by coordination shall deliver a copy of the prospectus as required by the Securities Act of 1933.

**043. REGISTRATIONS -- NOTICE OF INTENDED IDAHO BROKER -- DEALER OR AGENT (RULE 43).**

At the time of filing of an application for registration of any security required to be registered in Idaho, written notice shall be provided to the Department of the name of at least one (1) broker-dealer or agent, registered as such in this state, that is intended or qualified to offer or sell such security in Idaho. The Administrator may deny or revoke effectiveness of any registration pending receipt of the notice or may hold the application without further review until the notice has been received.

**044. RECORDS TO BE PRESERVED BY ISSUERS (RULE 44).**

01. **Required Records.** All issuers who effect sales of registered securities, other than through a broker-dealer, shall preserve the following records for at least three (3) years following the expiration of the registration:

a. Copies of all documents contained in the registration statement;

b. Copies of all advertisements, including a record of the dates, names and addresses of media carrying those advertisements;

c. Copies of all communications received and sent by the issuer pertaining to the offer, sale and transfer of the securities, including purchase agreements and confirmations; and

d. A list of the name, address and telephone number of each investor to whom the securities were sold, and for each such person, information regarding:

i. The type of securities sold;

ii. The number and amount of securities sold;

iii. The type of consideration paid; and

iv. The name of the agent that sold the securities.

02. **Retention Period.** An issuer will need to retain the records set forth in Subsection 044.01 of this rule for each investor at least three (3) years after the investor’s investment has terminated, even if more than three (3) years has lapsed since the expiration of the registration.
03. **Form.** Records may be stored in paper form or electronically. (3-24-05)

### 045. EXAMINATION OF APPLICATION (RULE 45).

The Department shall conduct a special examination of each application for registration under Sections 30-14-303 and 30-14-304, Idaho Code, to determine the adequacy of disclosure and to fulfill the Department’s obligations under Section 30-14-306, Idaho Code. This examination shall be based upon material contained in the registration statement and any other documentation which the applicant may be required to submit. Each application for registration shall be accompanied by the filing fee set forth in Section 30-14-305(b), Idaho Code. The examination report shall consist of the Department’s written comments regarding the filing. (3-24-05)

### 046. ON-SITE EXAMINATION OF ISSUERS (RULE 46).

The business and records of issuers offering and/or selling securities in, or out of, Idaho may be subject to periodic on-site examinations by the Administrator, or his designee, at such times as the Administrator determines necessary for the protection of the public. (3-24-05)

### 047. ADVERTISING (RULE 47).

**01. Definitions.** The following words and terms, when used in Section 047, of these rules, shall have the following meaning, unless the context clearly indicates otherwise: (3-24-05)

a. “Sales literature” means material published, or designed for use, in a newspaper, magazine or other periodicals, radio, television, telephone solicitation or tape recording, videotaped display, signs, billboards, motion pictures, telephone directories (other than routine listings), other public media and any other written communication distributed or made generally available to customers or the public including, but not limited to, prospectuses, pamphlets, circulars, form letters, seminar texts, research reports, surveys, performance reports or summaries and reprints or excerpts of other sales literature or advertising to include publications in electronic format. (3-24-05)

b. “Sales literature package” means all submissions of sales literature to the Department under one (1) posting or delivery relating to a specific issue of securities. (3-24-05)

**02. Filing Requirement.** Pursuant to Section 30-14-504, Idaho Code, this rule requires the filing of all sales literature for review and response by the Administrator before use or distribution in Idaho. A complete filing shall consist of the sales literature package and a representation by the applicant, issuer or broker-dealer, that reads substantially as follows: “I ------ hereby attest and affirm that the enclosed sales literature or advertising package contains no false or misleading statements or misrepresentations of material facts, and that all information set forth therein is in conformity with the Company’s most recently amended registration statement as filed with the Department on or about -------.” (3-29-17)

**03. Exemption From Filing.** The following types of sales literature are excluded from the filing requirements set forth herein: (3-24-05)

a. Sales literature which does nothing more than identify a broker-dealer or investment adviser, and/or offer a specific security at a stated price; (3-29-17)

b. Internal communications that are not distributed to the public; (3-24-05)

c. Prospectuses, preliminary prospectuses, prospectus supplements and offering circulars which have been filed with the Department as part of a registration statement, including a final printed copy if clearly identified as such; (3-24-05)

d. Sales literature solely related to changes in a name, personnel, location, ownership, offices, business structure, officers or partners, telephone or teletype numbers; (3-29-17)

e. Sales literature filed with and approved by FINRA, the SEC, or other regulatory agency with substantially similar requirements; (3-29-17)
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f. Sales literature relating to certain federal covered securities as set forth in Section 30-14-504(b), Idaho Code. (3-29-17)

04. Piecemeal Filings. The Department will not approve any sales literature package until a complete filing is received. Piecemeal filings will not be accepted and will result in the disapproval of any materials submitted therewith. (3-24-05)

05. Application of Antifraud Provisions. Sales literature used in any manner in connection with the offer or sale of securities is subject to the provisions of Section 30-14-501, Idaho Code, whether or not such sales literature is required to be filed pursuant to Section 30-14-504, Idaho Code, or Section 047 of these rules. Further, sales literature filed with the Department is subject to the provisions of Sections 30-14-501 and 30-14-505, Idaho Code. Sales literature should be prepared accordingly and should not contain any ambiguity, exaggeration or other misstatement or omission of material fact, which might confuse or mislead an investor. (3-29-17)

06. Prohibited Disclosures. Unless stating that the Administrator or Department has not approved the merits of the securities offering or the sales literature, no sales literature shall contain a reference to the Administrator or Department unless such reference is specifically requested by the Administrator. (3-24-05)

048. DEPARTMENT ACCESS (RULE 48). Each issuer examined shall provide the personnel of the Department access to business books, documents, and other records. Each issuer shall provide personnel with office space and facilities to conduct an on-site examination, and assistance in the physical inspection of assets and confirmation of liabilities. Failure of any issuer to comply with any provision hereof shall constitute a violation of Section 048, of these rules, and shall be a basis for denial, suspension or revocation of the registration or application for registration or other administrative or civil action by the Department. (3-24-05)

052. ISSUER AGENT REGISTRATION (RULE 52). Any individual not exempted pursuant to Sections 30-14-402(b)(3), (4) or (5), Idaho Code, must be registered as an issuer agent or comply with the registration requirement of Section 30-14-402(a), Idaho Code, if the individual is compensated in connection with the agent’s participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in those securities. (3-29-17)

053. FEDERAL COVERED SECURITIES (RULE 53).

01. Investment Company Notices. (3-24-05)

a. Notice Requirement. Pursuant to Section 30-14-302, Idaho Code, prior to the offer in this state of a series or portfolio of securities of an investment company that is registered, or that has filed a registration statement, under the Investment Company Act of 1940, that is not otherwise exempt under Sections 30-14-201 through 30-14-203, Idaho Code, the issuer must file a notice with the Administrator relating to such series or portfolio of securities. (3-24-05)

b. Content of Notice. Each required notice shall include the following: (3-24-05)

i. A properly completed Form NF; (3-24-05)

ii. A consent to service of process (Form U-2); (3-24-05)

iii. A filing fee of three hundred dollars ($300) for mutual funds and one hundred dollars ($100) for unit investment trusts; and (3-29-17)

iv. Notification of SEC effectiveness. (3-24-05)

c. Renewal of Notice. The effectiveness of a notice required pursuant to Subsection 053.01.a. of this rule may be renewed each year for an additional one (1) year period of effectiveness by filing on or before the
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expiration of the effectiveness of such notice:

i. A properly completed Form NF clearly indicating the state file number of the Notice to be renewed;

ii. A consent to service of process (Form U-2) in accordance with Section 30-14-611, Idaho Code; and

iii. A renewal fee of three hundred dollars ($300) for mutual funds and one hundred dollars ($100) for unit investment trusts.

d. Amendments. Amendment filings are required for the following:

i. Issuer name change;

ii. Address change for contact person; and

iii. Notification of termination or completion.

e. Other Documents. Documents other than those required in Subsections 053.01.b., 053.01.c., and 053.01.d. of this rule, unless specifically requested by the Department, should not be filed with the Department. Documents that should be filed with the Department only if specifically requested include, but are not limited to, registration statements, prospectuses, amendments, statements of additional information, quarterly reports, annual reports, and sales literature.

02. Regulation D Rule 506 Notice Filing.

a. Notice Requirement. Issuers offering a security in this state in reliance upon Section 30-14-301, Idaho Code, by reason of compliance with Regulation D, Rule 506, adopted by the United States Securities and Exchange Commission, shall be required to file a notice with the Department or with EFD pursuant to the authority of Section 30-14-302(c), Idaho Code, if a sale of a security in this state occurs as a result of such offering.

b. Terms of Notice Filing. The issuer shall file with the Department or with EFD no later than fifteen (15) days after the first sale of a security in this state for which a notice is required under Subsection 053.02.a. of this rule:

i. One (1) copy of the SEC-filed Form D; and

ii. The notice filing fee of fifty dollars ($50).

iii. A cover letter should be included in the notice filing which states the date in which the first sale of securities occurred in Idaho.

c. Terms of Late Notice Filing. An issuer failing to file with the Administrator as required by Subsection 053.02.b. of this rule may submit its notice filing as required in Subsection 053.02.b. of this rule with an additional fifty dollars ($50) late filing payment within thirty (30) days after the first sale of a security in this state. Failure to file a notice on or before the thirtieth day after the first sale of a securities in Idaho will result in the inability of the issuer to rely on Section 30-14-302(c), Idaho Code, for qualification of the offering in Idaho.

d. Issuer Agent Registration. Pursuant to Section 30-14-402(b)(5), Idaho Code, an individual who represents an issuer who effects transactions in a federal covered security under Section 18(b)(4)(D) of the Securities Act of 1933 (15 U.S.C. 77r(b)(4)(D)) is not exempt from the registration requirements of Section 30-14-402(a), Idaho Code, if the individual is compensated in connection with the agent’s participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in those securities. In addition, if such person is registered as a broker-dealer or agent in another state or with FINRA, or affiliated with a broker-dealer registered in another state, with the SEC or FINRA, then such person must also be similarly registered in Idaho.
054. NOT FOR PROFIT DEBT SECURITIES NOTICE FILING (RULE 54).

01. Securities Exempt. With respect to the offer or sale of a note, bond, debenture, or other evidence of indebtedness, such issuers relying upon the exemption from registration provided in Section 30-14-201(7), Idaho Code, shall file a notice with the Administrator at least thirty (30) days prior to the first offering of sale pursuant to such claim. Such exemption shall become effective thirty (30) days after the filing of a complete notice if the Administrator has not disallowed the exemption. (3-24-05)

02. Notice Information. The notice required in Subsection 054.01 of this rule shall specify, in writing, the material terms of the proposed offer or sale to include, although not limited to, the following: (3-24-05)
   a. The identity of the issuer; (3-24-05)
   b. The amount and type of securities to be sold pursuant to the exemption; (3-24-05)
   c. A description of the use of proceeds of the securities; and (3-24-05)
   d. The person or persons by whom offers and sales will be made. (3-24-05)

03. Notice Requirements. The following items must be included as a part of the notice in Subsection 054.01 of this rule: (3-24-05)
   a. The offering statement, if any; and (3-24-05)
   b. A consent to service of process (Form U-2). (3-24-05)

04. Sales and Advertising Literature. All proposed sales and advertising literature to be used in connection with the proposed offer or sale of the securities shall be filed with the Administrator only upon request. (3-24-05)

05. NASAA Statements of Policy or Guidelines. The Statements of Policy or guidelines adopted by NASAA may be applied, as applicable, to the proposed offer or sale of a security for which a notice must be filed pursuant to this rule. Failure to comply with the provisions of an applicable Statement of Policy or guideline promulgated by NASAA may serve as the grounds for disallowance of the exemption from registration provided by Section 30-14-201(7), Idaho Code. (3-24-05)

06. Waiver. The Administrator may waive any term or condition set forth in this rule. (3-24-05)

055. MORTGAGE NOTE EXEMPTION (RULE 55).

01. Investment Contract or Profit-Sharing Agreement. The exemption specified in Section 30-14-202(11), Idaho Code, shall not extend to any transaction in a security in the nature of an investment contract or profit-sharing agreement. (3-24-05)

02. Definition “Offered and Sold as a Unit.” As used in Section 30-14-202(11), Idaho Code, “offered and sold as a unit” means an offer and sale of the entire mortgage or other security agreement to a single purchaser at a single sale. (3-24-05)

056. MANUAL EXEMPTION (RULE 56).
For the purpose of the manual exemption (Section 30-14-202(2), Idaho Code), the following securities manuals or portions of the manuals are recognized. (3-24-05)
   a. Best’s Insurance Reports- Life-Health. (3-24-05)
   b. Mergent’s Industrial Manual. (3-24-05)
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057. MINING, OIL OR GAS EXPLORATION EXEMPTION REQUIREMENTS (RULE 57).

01. Legal Opinion for Extractive Industries. If the Department deems it necessary or advisable in the public interest or for the protection of investors, it may require an issuer engaged in mining, gas, or oil exploration or extraction to submit an opinion of counsel on the nature of the title held to the property noting any defects or liens or both, and the principal terms of any lease or option with respect to the property. If continued possession of the property by the issuer depends upon the satisfaction of certain working conditions, describe these conditions and state the extent to which they have been met. The Department may require other issuers to submit a status of title to any real estate which is material to the business of the issuer.

02. Quarterly Reports. The issuer shall file quarterly reports, on the “Quarterly Report Form for Small Mining Issues,” during the time the securities remain registered. Such reports are due within thirty (30) days following the end of the issuer’s quarter. Failure to comply with this rule could be grounds for suspension or revocation of a permit.

03. Advertising. The only advertising of exempt mining securities, whether on radio, television, print media, or other medium, shall be restricted to announcing the securities offering and stating the name and address of the issuer, the type of security, the underwriter, and where additional information may be obtained.

04. Offering Circulars. All offers of the security must be accompanied by a complete, current offering circular previously reviewed by the Administrator adequate to satisfy the antifraud provisions of the Act.

058. STOCK EXCHANGE LISTED SECURITIES (RULE 58).

Stock exchanges specified by or approved under Section 30-14-201(6), Idaho Code, are as follows:

01. The New York Stock Exchange;
02. The American Stock Exchange;
03. The NASDAQ Global Market and Global Select Market;
04. The Chicago Stock Exchange;
05. The Chicago Board Options Exchange;
06. Tier I of the Pacific Stock Exchange; and
07. Tier I of the Philadelphia Stock Exchange, Inc.

059. NOTICE FILINGS FOR TRANSACTIONS UNDER REGULATION D, RULE 505 (RULE 59).

01. Exempt Securities. Pursuant to Section 30-14-203(1), Idaho Code, transactions that are exempt securities under 17 CFR 230.505 are exempt from Section 30-14-301, Idaho Code. As a condition of this exemption, the issuer shall comply with the requirements in Subsection 059.02 of this rule.

02. Disqualification. Unless upon a showing of good cause and without prejudice to any other action by the Administrator, the Administrator determines that it is not necessary under the circumstances that the exemption provided by Subsection 059.01 be denied, the exemption shall not be available for the offer or sale of securities if the issuer, any of the issuer’s predecessors, any affiliated issuer, any of the issuer’s directors, officers, general partners, beneficial owners of ten percent (10%) or more of any class of its equity securities, any of the issuer’s promoters presently connected with the issuer in any capacity, any underwriter of the securities to be offered, or any partner, director or officer of such underwriter.
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### 03. Exceptions

Subsection 059.02 of this rule shall not apply if:

a. The party subject to the disqualification is licensed or registered to conduct securities related business in the state in which the order, judgment or decree creating the disqualification was entered against such party; (3-24-05)

b. Before the first offer under this exemption, the state securities administrator, or the court or regulatory authority that entered the order, judgment, or decree, waives the disqualification; or (3-24-05)

c. The issuer establishes that it did not know and in the exercise of reasonable care, based on a factual inquiry, could not have known that a disqualification existed under Subsection 059.02 of this rule. (3-29-17)

### 04. Notice Filings for Rule 505

The notice filing required for transactions in Idaho under 17 CFR 230.505, shall consist of the following:

a. One (1) copy of the SEC filed electronic Form D; (3-29-17)

b. Copy of the private placement memorandum. (3-29-17)

c. Each notice shall be filed with the Department no later than ten (10) business days prior to effecting a sale in Idaho. (3-24-05)

### 05. Amendments

During the period of the offering, the issuer shall take steps necessary to insure that all material information contained in the notice filing remains current and accurate. (3-24-05)

### 06. Nonaccredited Investors

In all sales to nonaccredited investors in this state, one (1) of the following conditions must be satisfied or the issuer and any person acting on its behalf shall have reasonable grounds to believe and after making reasonable inquiry, shall believe that one (1) of the following conditions is satisfied:

a. The investment is suitable for the purchaser upon the basis of the facts, if any, disclosed by the purchaser as to the purchaser’s other security holdings, financial situation and needs. For the purpose of this condition only, it may be presumed that if the investment does not exceed ten percent (10%) of the investor’s net worth, it is suitable. (3-24-05)

b. The purchaser either alone or with her purchaser representative(s) has such knowledge and experience in financial and business matters that she is or they are capable of evaluating the merits and risks of the prospective investment. (3-24-05)

### 07. Due Diligence

Nothing in this rule is intended to relieve registered securities broker-dealers or
agents from the due diligence, suitability, or know your customer standards or any other requirements of law otherwise applicable to such registered person. (3-24-05)

08. Disclosure. Nothing in this exemption is intended to or should be construed as in any way relieving issuers or persons acting on behalf of issuers from providing disclosure to prospective investors adequate to satisfy the antifraud provisions of the Act. (3-24-05)

09. Denial, Suspension, Revocation, Condition or Limitation of Exemption. Any issuer relying on the exemption under Regulation D, Rule 505 may be subject to the enforcement remedies provided in Section 30-14-204, Idaho Code, if it fails to satisfactorily address issues raised by the Department in comment letters or otherwise. (3-24-05)

10. Issuer Agent Registration. Pursuant to Section 30-14-402(b)(9), Idaho Code, an individual who represents an issuer who effects transactions that are exempt securities under 17 CFR 230.505 and exempt from Section 30-14-301, Idaho Code, is not exempt from the registration requirements of Section 30-14-402(a), Idaho Code, if the individual is compensated in connection with the agent’s participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in those securities. In addition, if such person is registered as a broker-dealer or agent in another state or with FINRA, or affiliated with a broker-dealer registered in another state, with the SEC or FINRA, then such person must also be similarly registered in Idaho. (3-29-17)

060. REGISTRATION OR EXEMPTION OF “BLIND POOL” OFFERINGS PROHIBITED (RULE 60). An offering in which it is proposed to issue stock or other equity interest without an allocation of proceeds to sufficiently identifiable properties or objectives shall be considered a “blind pool” offering and one in which the duty to provide full disclosure cannot be met. Because of the inability or failure to make full disclosure, the Department is of the position that the offering would work a fraud upon purchasers and, therefore, the offering may not be registered or qualify for an exemption from registration in Idaho. (3-24-05)

061. CROSS-BORDER TRANSACTIONS EXEMPTION (RULE 61). By authority delegated to the Administrator in Section 30-14-203, Idaho Code, transactions effected by a Canadian broker-dealer and its agents that meet the requirements for exemption from registration pursuant to Section 084 of these rules, are determined to be classes of transactions for which registration is not necessary or appropriate for the protection of investors and are exempt from Sections 30-14-301 and 30-14-504, Idaho Code. (3-24-05)

062. DESIGNATED MATCHING SERVICES (RULE 62).

01. In General. Sections 30-14-301 through 30-14-305, Idaho Code, shall not apply to any offer or sale of a security by an issuer in a transaction that meets the requirements of this rule. A designated matching service shall not be deemed a broker-dealer subject to registration within the meaning of the Act or the rules thereunder. (3-24-05)

02. Definitions. The following words and terms, when used in this rule, shall have the following meanings, unless the context clearly indicates otherwise. (3-24-05)

a. Designated Matching Service. Means a matching service designated by the Administrator under Section 062 of these rules. (3-24-05)

b. Designated Matching Service Facility. Means a computer system operated, or a seminar or meeting conducted, by a designated matching service. (3-24-05)

c. Individual Accredited Investor. Means any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his or her purchase, exceeds one million dollars ($1,000,000) or any natural person who had an individual income in excess of two hundred thousand dollars ($200,000) in each of the two (2) most recent years or joint income with that person’s spouse in excess of three hundred thousand dollars ($300,000) in each of those years and has a reasonable expectation of reaching the same income level in the current year. In addition each purchaser must evidence such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment. The term “individual accredited investor” shall also include any self-directed employee benefit plan with investment decisions made solely by persons...
that are “individual accredited investors” as defined in Subsection 062.02.c. of this rule, and the individual retirement account of any such individual accredited investor. (3-24-05)

d. Investor Member. Means an investor who has been properly qualified by and uses a designated matching service. Either of the following investors may be properly qualified: any institutional investor as described in Section 30-14-102(11), Idaho Code, or an individual accredited investor as defined in this rule. (3-29-17)
e. Issuer Member. Means an issuer who uses a designated matching service facility. (3-24-05)
f. Summary Business Plan. Means a brief statement specifically describing the issuer, its management, its products or services, and the market for those products or services. Other information, including, specifically, financial projections, must not be included in a summary business plan. (3-24-05)

03. Application. A person may apply to the Administrator to be a designated matching service by filing such forms as required by the Administrator. No designation will be made unless the applicant demonstrates that it:

a. Owns, operates, sponsors, or conducts a matching service facility limited to providing investor members with the summary business plans and identities of issuer members; (3-24-05)
b. Will not be involved in any manner in the sale, offer for sale, solicitation of a sale or offer to buy, a security other than as set forth in Subsection 062.03.a. of this rule; (3-24-05)
c. Will make a reasonable factual inquiry to determine whether an investor member is properly qualified; (3-24-05)
d. Is a governmental entity, quasi-governmental entity, an institution of higher education or an Idaho nonprofit corporation that is associated with a governmental or quasi-governmental entity or an institution of higher education; (3-24-05)
e. Does not employ any person required to be registered under the Act as a broker-dealer, investment adviser, agent, or investment adviser representative; (3-24-05)
f. Does not have, and does not employ any person who has a business relationship with any investor member or issuer member other than to provide such member access to the matching service facility; (3-24-05)
g. Charges fees only in an amount necessary to cover its reasonable operating costs and that are unrelated to the amount of money being raised by any issuer member or the amount of securities sold by any issuer member; (3-24-05)
h. Agrees to not use any advertisement of its matching service facility that advertises any particular issuer or any particular securities or the quality of any securities or that is false or misleading or otherwise likely to deceive a reader thereof; and (3-24-05)
i. Meets such other conditions as the Administrator considers appropriate for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of the Act, and the rules thereunder. (3-24-05)

04. Designation Consistent with Act. Designation under this rule is not available to any matching service formed in a manner that constitutes part of a scheme to violate or evade the provisions of the Act or rules thereunder. (3-24-05)

05. Withdrawal of Designation. The Administrator, upon ten (10) days notice and hearing before the Administrator or a hearing officer, may withdraw a person’s designation as a matching service if the person does not meet the standards for designation provided in this rule. (3-24-05)

06. Disqualifications. (3-24-05)
a. No exemption under this rule shall be available for the securities of any issuer if the issuer:
   (3-24-05)
   i. Within the last five (5) years, has filed a registration statement which is the subject of a currently
      effective registration stop order entered by the United States Securities and Exchange Commission or any state
      securities administrator;
      (3-24-05)
   ii. Within the last five (5) years, has been convicted of any criminal offense in connection with the
      offer, purchase, or sale of any security or any felony involving fraud or deceit or a misdemeanor involving financial
      fraud;
      (3-24-05)
   iii. Is the subject of any state or federal administrative enforcement order, entered within the last five
      (5) years, finding fraud or deceit in connection with the purchase or sale of any security; or
      (3-24-05)
   iv. Is the subject of any order, judgment or decree of any court of competent jurisdiction, entered
      within the last five (5) years, temporarily, preliminarily or permanently restraining or enjoining such party from
      engaging in or continuing to engage in any conduct or practice involving fraud or deceit in connection with the
      purchase or sale of any security.
      (3-24-05)

b. For purposes of this rule, the term “issuer” includes:
   (3-24-05)
   i. Any of the issuer’s predecessors or any affiliated issuer;
      (3-24-05)
   ii. Any of the issuer’s directors, officers, general partners, or beneficial owners of ten percent (10%)
      or more of any class of its equity securities (beneficial ownership meaning the power to vote or direct the vote or
      the power to dispose or direct the disposition of such securities);
      (3-24-05)
   iii. Any of the issuer’s promoters presently connected with the issuer in any capacity, including:
       (3-24-05)
       (1) Any person who, acting alone or in conjunction with one (1) or more other persons, directly or
           indirectly takes initiative in founding and organizing the business or enterprise of an issuer; or
           (3-24-05)
       (2) Any person who, in connection with the founding and organizing of the business or enterprise of an
           issuer, directly or indirectly receives in consideration of services or property, or both services and property, ten
           percent (10%) or more of any class of securities of the issuer or ten percent (10%) or more of the proceeds from
           the sale of any class of such securities; however, a person who receives such securities or proceeds either solely as
           underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning
           of Subsection 062.06.b.iii. of this rule, if such person does not otherwise take part in founding and organizing the
           enterprise.
           (3-24-05)
       iv. Any underwriter of the issuer.
           (3-24-05)

c. The exemption under this rule is not available to an issuer that is in the development stage that
   either has no specific business plan or purpose or had indicated that its business plan is to engage in a merger or
   acquisition with an unidentified company or companies, or other entity or person.
   (3-24-05)

07. Notice of Transaction. The issuer shall file with the Administrator a notice of transaction, consent
    to service of process (Form U-2), and a copy of its summary business plan within fifteen (15) days after the first sale
    in this state.
    (3-24-05)

063. -- 077. (RESERVED)

078. IMPLEMENTATION OF CRD (RULE 78).

01. Designation and Use of CRD System. Pursuant to Section 30-14-406, Idaho Code, the
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Administrator designates the web-based Central Registration Depository (CRD) operated by FINRA to receive and store filings and collect related fees from broker-dealers, agents and investment adviser representatives on behalf of the Administrator. Forms U-4, U-5, BD, BR, and BDW shall be used to register or terminate agents, investment adviser representatives or broker-dealers, respectively, in the state of Idaho through the CRD system. The CRD system will be utilized to effect FINRA registration as well as registration, termination, and renewal in the state.

02. Registrations Not Automatic. A filing of Form U-4, BD, or BR with the CRD system does not constitute an automatic registration in Idaho. Broker-dealers and investment advisers should not consider agents or investment adviser representatives registered until such approval from the state of Idaho has been received by them through CRD.

03. Electronic Signature. When a signature or signatures are required by the particular instructions of any filing to be made through CRD, a duly authorized officer of the applicant or the applicant him or herself, as required, shall affix his or her electronic signature to the filing by typing his or her name in the appropriate fields and submitting the filing to CRD. Submission of a filing in this manner shall constitute irrefutable evidence of legal signature by any individuals whose names are typed on the filing.

079. IMPLEMENTATION OF IARD (RULE 79).

01. Designation. Pursuant to Section 30-14-406, Idaho Code, the Administrator designates the web-based Investment Adviser Registration Depository (IARD) operated by FINRA to receive and store filings and collect related fees from investment advisers on behalf of the Administrator.

02. Use of IARD. Unless otherwise provided, all investment adviser applications, amendments, reports, notices, related filings and fees required to be filed with the Administrator pursuant to the rules promulgated under the Act, shall be filed electronically with and transmitted to IARD. The following additional conditions relate to such electronic filings:

a. Electronic Signature. When a signature or signatures are required by the particular instructions of any filing to be made through IARD, a duly authorized officer of the applicant or the applicant him or herself, as required, shall affix his or her electronic signature to the filing by typing his or her name in the appropriate fields and submitting the filing to IARD. Submission of a filing in this manner shall constitute irrefutable evidence of legal signature by any individuals whose names are typed on the filing.

b. When Filed. Solely for purposes of a filing made through IARD, a document is considered filed with the Administrator when all fees are received and the filing is accepted by IARD on behalf of the state.

03. Electronic Filing. The electronic filing of any particular document and the collection of related processing fees shall not be required until such time as IARD provides for receipt of such filings and fees and thirty (30) days notice is provided by the Administrator. Any documents or fees required to be filed with the Administrator that are not permitted to be filed with or cannot be accepted by IARD shall be filed directly with the Administrator.

04. Hardship Exemptions. Subsection 079.04 of this rule provides two (2) “hardship exemptions” from the requirements to make electronic filings as required by the rules.

a. Temporary Hardship Exemption.

i. Investment advisers registered or required to be registered under the Act who experience unanticipated technical difficulties that prevent submission of an electronic filing to IARD may request a temporary hardship exemption from the requirements to file electronically.

ii. To request a temporary hardship exemption, the investment adviser must file Form ADV-H which can be found at 17 CFR 279.3 in paper format with the Administrator where the investment adviser’s principal place of business is located, no later than one (1) business day after the filing (that is the subject of the Form ADV-H) was due; and submit the filing that is the subject of the Form ADV-H in electronic format to IARD no later than seven (7)
business days after the filing was due. (3-24-05)

iii. Effective Date - Upon Filing. The temporary hardship exemption will be deemed effective upon receipt by the Administrator of the complete Form ADV-H. Multiple temporary hardship exemption requests within the same calendar year may be disallowed by the Administrator. (3-24-05)

b. Continuing Hardship Exemption. (3-24-05)

i. Criteria for Exemption. A continuing hardship exemption will be granted only if the investment adviser is able to demonstrate that the electronic filing requirements of this rule are prohibitively burdensome. (3-24-05)

ii. To apply for a continuing hardship exemption, the investment adviser must file Form ADV-H which can be found at 17-CFR 279.3 in paper format with the Administrator at least twenty (20) business days before a filing is due; and, if a filing is due to more than one (1) securities regulator, the Form ADV-H must be filed with the Administrator where the investment adviser's principal place of business is located. The Administrator who receives the application will grant or deny the application within ten (10) business days after the filing of Form ADV-H. (3-24-05)

iii. Effective Date - Upon Approval. The exemption is effective upon approval by the Administrator. The time period of the exemption may be no longer than one (1) year after the date on which the Form ADV-H is filed. If the Administrator approves the application, the investment adviser must, no later than five (5) business days after the exemption approval date, submit filings to IARD in paper format (along with the appropriate processing fees) for the period of time for which the exemption is granted. (3-24-05)

080. BROKER-DEALER REGISTRATION -- APPLICATION/RENEWAL (RULE 80).

01. Initial Application -- FINRA Member Firms. Broker-dealers applying for initial registration pursuant to Section 30-14-406, Idaho Code, and who are contemporaneously applying for FINRA membership or who are a FINRA member, shall file: (3-29-17)

a. With CRD, a completed Form BD, including Schedules A-D; (3-29-17)

b. With CRD, a filing fee as specified in Section 30-14-410, Idaho Code; (3-24-05)

c. With CRD, the Form BR. (3-29-17)

02. Initial Application -- Non-FINRA Member Firms. Broker-dealers applying for initial registration pursuant to Section 30-14-406, Idaho Code, and who are not contemporaneously applying for FINRA membership or are not a FINRA member, shall file with the Department: (3-29-17)

a. A completed Form BD, including Schedules A-E; (3-24-05)

b. The filing fee specified in Section 30-14-410, Idaho Code; (3-24-05)

c. Audited financial statements; (3-24-05)

d. Documentation of compliance with the minimum capital requirements of Section 087 of these rules; (3-24-05)

e. Designation and qualification of a principal officer; (3-24-05)

f. A list of the addresses, telephone numbers and resident agents of all office locations within the state of Idaho, to be provided within sixty (60) days of becoming registered; (3-24-05)

g. A copy of the written supervisory procedures of the broker-dealer; (3-24-05)
h. Any additional documentation, supplemental forms and information as the Administrator may deem necessary. (3-24-05)

03. Incomplete Applications. After a period of six (6) months from date of receipt, an incomplete application will automatically be considered abandoned and withdrawn if the requirements have not been fulfilled. (3-24-05)

04. Annual Renewal.

a. A FINRA member shall renew its registration by submitting the renewal fee specified in Section 30-14-410, Idaho Code, to the CRD according to their policies and procedures. A non-FINRA member shall renew its registration by submitting to the Department current information required for initial registration, and the renewal fee specified in Section 30-14-410, Idaho Code. (3-29-17)

b. It is required that an application for the renewal of the registration of a broker-dealer must be filed with the Department before the registration expires, which is the thirty-first day of December next following such registration, per the provisions of Section 30-14-406(d), Idaho Code. Any registration that is not renewed within that time limit will be deemed to have lapsed, thus requiring the broker-dealer to reapply for registration with the Department in accordance with the requirements of the Act. (3-24-05)

05. Updates and Amendments.

a. A broker-dealer must file with CRD, in accordance with the instructions in Form BD, any amendments to the broker-dealer’s Form BD. All broker-dealers must assure that current and accurate information is on file with the Department at all times. If information in an application for registration becomes inaccurate or incomplete, additional information must be submitted through updates on the Form BD or by direct notice to the Department. (3-24-05)

b. An amendment will be considered to be filed promptly if the amendment is filed within thirty (30) days of the event that requires the filing of the amendment. (3-29-17)

c. Litigation Notice. Any broker-dealer shall notify the Administrator in writing or through the CRD of any civil, administrative, or criminal complaint, petition, or pleading issued or filed against him and of any bankruptcy proceeding filed by or against him within thirty (30) days of his receipt of the initial pleading. This requirement shall not include minor traffic violations or minor civil actions unrelated to the registrant’s business as a broker-dealer. (3-24-05)

d. Notice of Address. Every broker-dealer shall provide the Department, with an address sufficiently descriptive to allow service of process pursuant to the Idaho Rules of Civil Procedure. (3-24-05)

e. Change of Name. If a registered broker-dealer desires to change its name, notice of such an intent must be submitted to the CRD or this Department for non-FINRA members, either before or within a reasonable time after the effective date of the change. The name change will not be effective in this state until the notice is received. (3-29-17)

06. Completion of Filing. An application for initial or renewal registration is not considered filed for purposes of Section 30-14-406, Idaho Code, until the required fee and all required submissions have been received by the Administrator. (3-24-05)

07. Deferral of Effectiveness. The Administrator may defer the effective date of any registration until noon on the forty-fifth day after the filing of any amendment completing the application. (4-11-06)

081. WITHDRAWAL OF BROKER -- DEALER AND AGENT REGISTRATION (RULE 81).

01. Application Withdrawal. Withdrawal from registration as a broker-dealer or agent becomes effective thirty (30) days after receipt of an application to withdraw or within such shorter period of time as the Administrator may determine, unless a revocation or suspension proceeding is pending when the application is filed.
or a proceeding to revoke or suspend or to impose conditions upon the withdrawal is instituted within sixty (60) days after the application is filed. If a proceeding is pending or instituted, withdrawal becomes effective at such time and upon such conditions as the Administrator by order determines. If no proceeding is pending or instituted and withdrawal automatically becomes effective, the Administrator may nevertheless institute a revocation or suspension proceeding under Section 30-14-412, Idaho Code, within one (1) year after withdrawal became effective and enter a revocation or suspension order as of the last date on which registration is effective. (3-24-05)

02. Broker-Dealer. The application for withdrawal of registration as a broker-dealer shall be completed by following the instructions on Form BDW and filing Form BDW with CRD. (3-24-05)

03. Agents. The application for withdrawal of registration as an agent shall be completed by following the instructions on Form U-5 and filed upon Form U-5 with CRD. (3-24-05)

082. WITHDRAWAL OF AGENT OF ISSUER REGISTRATION (RULE 82).

01. Pending Revocation or Suspension. Withdrawal from registration as an agent of issuer becomes effective thirty (30) days after receipt of an application to withdraw or within such shorter period of time as the Administrator may determine, unless a revocation or suspension proceeding is pending when the application is filed or a proceeding to revoke or suspend or to impose conditions upon the withdrawal is instituted within sixty (60) days after the application is filed. If a proceeding is pending or instituted, withdrawal becomes effective at such time and upon such conditions as the Administrator by order determines. If no proceeding is pending or instituted and withdrawal automatically becomes effective, the Administrator may nevertheless institute a revocation or suspension proceeding under Section 30-14-412, Idaho Code, within one (1) year after withdrawal became effective and enter a revocation or suspension order as of the last date on which registration is effective. (3-24-05)

02. Agent of Issuer. The application for withdrawal of registration as an agent of issuer shall be completed by following the instructions on Form U-5 and filed upon Form U-5 with the Department. (3-24-05)

083. BROKER-DEALER AGENT/ISSUER AGENT REGISTRATION (RULE 83).

01. Broker-Dealer Agents. Agents of broker-dealers applying for initial registration in the state of Idaho pursuant to Section 30-14-406, Idaho Code, shall file the following: (3-24-05)

   a. With CRD, a completed Form U-4; (3-24-05)
   b. With CRD, the filing fee specified in Section 30-14-410, Idaho Code; (3-24-05)
   c. With CRD, proof of successful completion of the applicable examinations specified in Section 103 of these rules; (3-24-05)
   d. With the Department, any additional documentation, supplemental forms and information as the Administrator may deem necessary; (3-24-05)
   e. With the Department, Subsections 083.01.a. through 083.01.d. of this rule, for any agent of a non-FINRA member. (3-29-17)

02. Agents of Issuer. (3-24-05)

   a. Agents of issuers applying for initial registration in the state of Idaho pursuant to Section 30-14-406, Idaho Code, shall file the following with the Department: (3-24-05)
      i. A completed Form U-4; (3-24-05)
      ii. The fee specified in Section 30-14-410, Idaho Code; (3-24-05)
      iii. Proof of successful completion of the applicable examination(s) specified in Section 103 of these rules; (3-24-05)
iv. Proof of a bond of a surety company duly authorized to transact business in this state, said bond to be in the sum of ten thousand dollars ($10,000) and conditioned upon faithful compliance with the provisions of the Act by the agent, such that upon failure to so comply by the agent, the surety company shall be liable to any and all persons who may suffer loss by reason thereof. Provided, however, that the obligation of the surety bond must be maintained at all times in the amount therein provided; and provided further, that a certificate of deposit issued by any bank in the state of Idaho and assigned to the Administrator in an amount equal to the bond which would otherwise be required may be accepted by the administrator in lieu of a bond, if the certificate of deposit is maintained at all times in the amount and manner herein provided during the term for which the registration is effective and for three (3) years thereafter; (3–24–05)

v. Any additional documentation, supplemental forms and information as the Administrator may deem necessary. (3–24–05)

b. An individual who represents an issuer that effects transactions in a federal covered security under Section 18(b)(3) (transactions relating to “qualified purchasers” as that term may be defined by the SEC) or 18(b)(4)(D) (commonly known as Regulation D, Rule 506) of the Securities Act of 1933 is not exempt from the registration requirements of Section 30-14-402(a), Idaho Code, if the individual is compensated, directly or indirectly, for participation in the specified securities transactions. (3–24–05)

c. Exceptions for officers. If there are not more than two (2) officers of an issuer, such officers may be registered as agents for a particular original offering of the issuer’s securities without being required to pass such written examination or file an agent’s bond as required by Subsection 083.02.a.iii. and 083.02.a.iv. of this rule, unless such person has registered under this rule within the prior five (5) years. (3–24–05)

03. Incomplete Applications. After a period of six (6) months from date of receipt, an incomplete application will automatically be considered abandoned and withdrawn if the requirements have not been fulfilled. (3–24–05)

04. Annual Renewal.

a. Broker-Dealer Agent. Agents of FINRA members shall renew their registrations by submitting the renewal fee specified in Section 30-14-410, Idaho Code, to the CRD. Agents of non-FINRA members shall renew their registrations by submitting a completed renewal application and a renewal fee as specified in Section 30-14-410, Idaho Code. (3–29–17)

b. Issuer Agent. Issuer agents shall renew their registrations by submitting a completed renewal application and a renewal fee as specified in Section 30-14-410, Idaho Code. (3–24–05)

05. Updates and Amendments.

a. A broker-dealer agent or agent of issuer must file with CRD, or with this Department, in accordance with the instructions in Form U-4, any amendments to the broker-dealer agent’s or issuer agent’s Form U-4. It is the responsibility of each broker-dealer agent or issuer agent to assure that current and accurate information is on file with the Department at all times. If information in an application for registration becomes inaccurate or incomplete, additional information must be submitted through updates on the Form U-4 or by direct notice to the Department. (3–24–05)

b. An amendment will be considered to be filed promptly if the amendment is filed within thirty (30) days of the event that requires the filing of the amendment. (3–29–17)

c. Litigation Notice. Any broker-dealer agent or issuer agent shall notify the Administrator in writing or through the CRD of any civil, administrative, or criminal complaint, petition, or pleading issued or filed against him and of any bankruptcy proceeding filed by or against him within thirty (30) days of his receipt of the initial pleading. This requirement shall not include minor traffic violations or minor civil actions unrelated to the registrant’s business as a broker-dealer. (3–24–05)
d. Notice of Address. Every broker-dealer agent and issuer agent shall provide the Department with an address sufficiently descriptive to allow service of process pursuant to the Idaho Rules of Civil Procedure. (3-24-05)

e. Change of Name. If a registered broker-dealer agent or issuer agent changes his or her name, notice of such must be submitted to the CRD or this Department within a reasonable time after the effective date of the change. The name change will not be effective in this state until the notice is received. (3-24-05)

06. Completion of Filing. An application for initial or renewal registration is not considered complete for purposes of Section 30-14-406(c), Idaho Code, until the required fee and all required amendments, including submissions requested by the Department, have been received by the Department. (3-24-05)

07. Deferral of Effectiveness. The Administrator may defer the effective date of any registration until noon on the forty-fifth day after the filing of any amendment completing the application. (4-11-06)

084. CROSS-BORDER LICENSING EXEMPTION (RULE 84).
By authority delegated to the Administrator in Section 30-14-401(d), Idaho Code, a Canadian broker-dealer meeting all of the following conditions is determined to be exempt from the registration requirement in Section 30-14-401(a), Idaho Code:

01. Canadian Broker-Dealer. The broker-dealer is registered in Canada, does not have an office or other physical presence in this state, and is not an office or branch of a broker-dealer domiciled in the United States. (3-24-05)

02. Registered Broker-Dealer. The broker-dealer is registered with or a member of a Canadian self-regulatory organization, stock exchange, or the Bureau des Services Financiers and maintains that registration or membership in good standing. (3-24-05)

03. Customers. The broker-dealer and its agents effect transactions in securities with or for, or induce or attempt to induce the purchase or sale of any security by:

a. An individual from Canada that temporarily resides or is temporarily present in this state and with whom the broker-dealer had a bona fide broker-dealer-customer relationship before the individual entered the United States; or

b. An individual present in this state whose transactions relate to a self-directed, tax advantaged Canadian retirement plan of which the individual is the holder or contributor. (3-24-05)

04. Disclosure. The broker-dealer prominently discloses in writing to its clients in this state that the broker-dealer and its agents are not subject to the full regulatory requirement of the Act. (3-24-05)

05. Jurisdiction. Neither the broker-dealer nor its agents disclaim the applicability of Canadian law or jurisdiction to any transaction conducted pursuant to this exemption. (3-24-05)

06. Anti-Fraud Provisions. The broker-dealer and its agents comply with the antifraud provisions of the Act and of federal securities laws. (3-24-05)

07. Consent to Service. Prior to or contemporaneously with the first transaction in Idaho, the broker-dealer must file a consent to service of process (Form U-2) in a manner that effectively appoints the Administrator as agent for service of process. (3-24-05)

08. Provide Requested Information. Any Canadian broker-dealer or agent relying on this exemption shall, upon written request, furnish the Department any information relative to a transaction covered by Section 084, of these rules, that the Administrator deems relevant. (3-24-05)

085. RELICENSING (FORMERLY TEMPORARY AGENT TRANSFER (TAT) SYSTEM) (RULE 85).
01. Relicensing Agents. Transfer of agents from one broker-dealer to another shall be effected pursuant to, and in accordance with, the NASAA/CRD relicensure program which allows for an automatic temporary license. (3-24-05)

02. Relicensing Investment Adviser Representatives. Transfer of investment adviser representatives from one (1) investment adviser to another shall be effected pursuant to, and in accordance with, the NASAA/CRD relicensure program which allows for an automatic temporary license. (3-24-05)

03. Temporary License Expiration. An agent or investment adviser representative may not transact business in Idaho after the expiration of a temporary license unless a permanent license has been issued. In all cases, the Administrator retains the right to deny, suspend, or revoke a temporary license for the causes listed in Section 30-14-412, Idaho Code. (3-24-05)

086. AGENT TERMINATION (RULE 86). Termination notice pursuant to the requirements of Section 30-14-408, Idaho Code, shall be given by filing within thirty (30) calendar days of termination, a completed Form U-5. For agents terminating registration with a FINRA member, such notice shall be filed with the CRD. For agents terminating registration with a non-FINRA member, such notice shall be filed with the Department. (3-29-17)

087. NET CAPITAL REQUIREMENTS FOR BROKER-DEALERS (RULE 87). Every registered broker-dealer shall have and maintain an adjusted net capital in compliance with 17 CFR 240.15c3-1 under the Securities Exchange Act of 1934, as currently amended. (3-24-05)

088. RECORDS REQUIRED FOR BROKER-DEALERS (RULE 88).

01. Required Books and Records. Unless otherwise provided by order of the SEC, each broker-dealer registered or required to be registered under the Act shall make, maintain and preserve books and records in compliance with the SEC rules 17a-3 (17 CFR 240.17a-3), 17a-4 (17 CFR 240.17a-4), 15g-9 (17 CFR 240.15g-9) and 15c2-11 (17 CFR 240.15c2-11), which are adopted and incorporated by reference. (3-24-05)

02. Compliance. To the extent that the SEC promulgates changes to the above referenced rules, broker-dealers in compliance with such rules as amended are not subject to enforcement action by the Department for violation of this rule to the extent that the violation results solely from the broker-dealer's compliance with the amended rule. (3-24-05)

089. INVESTMENT ADVISER REGISTRATION -- APPLICATION/RENEWAL (RULE 89).

01. Initial Application. The application for initial registration as an investment adviser, pursuant to Section 30-14-406, Idaho Code, shall be made by completing Form ADV which can be found at 17 CFR 279.1 in accordance with the form instructions and by filing the form with IARD. The application for initial registration shall also include the following: (3-24-05)

a. Proof of compliance by the investment adviser with the examination requirements of Section 103 of these rules; (3-24-05)

b. A bond of a surety company duly authorized to transact business in this state, said bond to be in the sum of twenty-five thousand ($25,000) and conditioned upon faithful compliance with the provisions of the Act by the investment adviser such that upon failure to so comply by the investment adviser, the surety company shall be liable to any and all persons who may suffer loss by reason thereof. Except that an investment adviser that has its principal place of business in a state other than this state shall be excluded from these bonding requirements provided that such investment adviser is registered as an investment adviser in the state where it maintains its principal place of business and is in compliance with such state’s bonding or minimum net worth requirements; (3-29-17)

c. A copy of the investment advisory contract to be executed by Idaho clients; (3-24-05)

d. A balance sheet, prepared substantially in accordance with Generally Accepted Accounting Principles, dated as of the investment adviser’s prior fiscal year-end; however, if the investment adviser has not been
in operation for an entire year, a balance sheet dated within ninety (90) days of filing shall be submitted; (3-29-17)

e. The fee required by Section 30-14-410, Idaho Code; and; (3-24-05)

f. Any other information the Department may reasonably require. (3-24-05)

02. Incomplete Applications. After a period of six (6) months from the date of receipt by the Department, an incomplete application will automatically be considered abandoned and withdrawn if the requirements have not been fulfilled. (3-24-05)

03. Annual Renewal. The application for annual renewal registration as an investment adviser shall be filed with IARD according to their policies and procedures. The application for annual renewal registration shall include the fee required by Section 30-14-410, Idaho Code. (3-24-05)

04. Applications Prior to Expiration. An application for the renewal of the registration of an investment adviser must be filed with the Department before the registration expires, which is the thirty-first day of December next following such registration, per the provisions of Section 30-14-406(d), Idaho Code, unless an order is in effect under Section 30-14-412, Idaho Code. Any registration that is not renewed within that time limit will be deemed to have lapsed, thus requiring the investment adviser to reapply for registration with the Department in accordance with the requirements of the Act. (3-29-17)

05. Updates and Amendments.

a. An investment adviser must file with IARD, in accordance with the instructions in Form ADV, any amendments to the investment adviser’s Form ADV. All investment advisers must assure that current and accurate information is on file with the Department at all times. If information in an application for registration becomes inaccurate or incomplete, additional information must be submitted through updates on the Form ADV or by direct notice to the Department. An amendment will be considered to be filed promptly if the amendment is filed within thirty (30) days of the event that requires the filing of the amendment. (3-24-05)

b. Within ninety (90) days of the end of the investment adviser’s fiscal year, an investment adviser must file a copy of the investment adviser’s balance sheet as of the prior fiscal year-end. (3-24-05)

c. Litigation Notice. Any investment adviser shall notify the Administrator in writing or through the IARD of any civil, administrative, or criminal complaint, petition, or pleading issued or filed against him and of any bankruptcy proceeding filed by or against him within thirty (30) days of his receipt of the initial pleading. This requirement shall not include minor traffic violations or minor civil actions unrelated to the registrant’s business as an investment adviser. (3-24-05)

d. Notice of Address. Every investment adviser shall provide the Department, through IARD, with an address sufficiently descriptive to allow service of process pursuant to the Idaho Rules of Civil Procedure. (3-29-17)

06. Completion of Filing. An application for initial or renewal registration is not considered filed for purposes of Section 30-14-406, Idaho Code, until the required fee and all required submissions have been received by the Administrator and until the investment adviser is registered in the jurisdiction where it maintains its principal place of business. (3-29-17)

07. Deferral of Effectiveness. The Administrator may defer the effective date of any registration until noon on the forty-fifth day after the filing of any amendment completing the application. (4-11-06)

090. INVESTMENT ADVISER REPRESENTATIVE REGISTRATION - APPLICATION/RENEWAL (RULE 90).

01. Initial Application. The application for initial registration as an investment adviser representative pursuant to Section 30-14-406, Idaho Code, shall be made by completing Form U-4 in accordance with the form instructions and by filing Form U-4 with CRD. The application for initial registration also shall include the following: (3-24-05)
**IDAHO ADMINISTRATIVE CODE**

**Department of Finance**

**Rules Pursuant to the Uniform Securities Act (2004)**

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<tr>
<th>Section</th>
<th>Description</th>
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<td>02.</td>
<td><strong>Incomplete Applications.</strong> After a period of six (6) months from the date of receipt by the Department, an incomplete application will automatically be considered abandoned and withdrawn if the requirements have not been fulfilled.</td>
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<tr>
<td>03.</td>
<td><strong>Annual Renewal.</strong> The application for annual renewal registration as an investment adviser representative shall be filed with CRD. The application for annual renewal registration shall include the fee required by Section 30-14-410, Idaho Code.</td>
</tr>
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| 04. | **Updates and Amendments.**
  | a. The investment adviser representative is under a continuing obligation to update information required by Form U-4 as changes occur. All investment adviser representatives must assure that current and accurate information is on file with the Department, through CRD, at all times. If information in an application for registration becomes inaccurate or incomplete, additional information must be submitted through updates on the Form U-4.
  | b. An investment adviser representative and the investment adviser must file promptly with CRD any amendments to the representative’s Form U-4. An amendment will be considered to be filed promptly if the amendment is filed within thirty (30) days of the event that requires the filing of the amendment.
  | c. Litigation Notice. Any investment adviser representative shall notify the Administrator in writing, through CRD, of any civil, administrative, or criminal complaint, petition, or pleading issued or filed against him and of any bankruptcy proceeding filed by or against him within thirty (30) days of his receipt of the initial pleading. This requirement shall not include minor traffic violations or minor civil actions unrelated to the registrant’s business as an investment adviser representative.
  | d. Change of Name. If a registered investment adviser representative changes his or her name, notice of such must be submitted to the CRD or this Department either before or within a reasonable time after the effective date of the change. The name change will not be effective in this state until the notice is received.
  | e. Notice of Address. Every investment adviser representative shall provide the Department, through CRD, with an address sufficiently descriptive to allow service of process pursuant to the Idaho Rules of Civil Procedure. |
| 05. | **Completion of Filing.** An application for initial or renewal registration is not considered filed for purposes of Section 30-14-406, Idaho Code, until the required fee and all required submissions have been received by the Administrator. |
| 06. | **Dual Registration Exemption.** A person may transact business in this state as an investment adviser representative if he is registered as an agent pursuant to Section 30-14-402, Idaho Code, and is employed by a broker-dealer registered pursuant to Section 30-14-401, Idaho Code, and
  | a. The person’s investment advisory activities are limited to recommending the investment advisory services of an investment adviser registered under Section 30-14-403, Idaho Code, or a federal covered adviser that has made a notice filing pursuant to Section 30-14-405, Idaho Code, and all such recommendations are made on behalf of the employing broker-dealer;
  | b. The person is not compensated directly for making such recommendations; and
  | c. The person provides written notice to the administrator that he is relying on this exemption from the requirement to be registered as an investment adviser representative.
07. **Deferral of Effectiveness.** The Administrator may defer the effective date of any registration until noon on the forty-fifth day after the filing of any amendment completing the application. (4-11-06)

**091. WITHDRAWAL OF INVESTMENT ADVISER AND INVESTMENT ADVISER REPRESENTATIVE REGISTRATION (RULE 91).**

01. **Application Withdrawal.** Withdrawal from registration as an investment adviser or investment adviser representative becomes effective thirty (30) days after receipt of an application to withdraw or within such shorter period of time as the Administrator may determine, unless a revocation or suspension proceeding is pending when the application is filed or a proceeding to revoke or suspend or to impose conditions upon the withdrawal is instituted within sixty (60) days after the application is filed. If a proceeding is pending or instituted, withdrawal becomes effective at such time and upon such conditions as the Administrator by order determines. If no proceeding is pending or instituted and withdrawal automatically becomes effective, the Administrator may nevertheless institute a revocation or suspension proceeding under Section 30-14-412, Idaho Code, within one (1) year after withdrawal became effective and enter a revocation or suspension order as of the last date on which registration is effective. (3-24-05)

02. **Investment Adviser.** The application for withdrawal of registration as an investment adviser shall be completed by following the instructions on Form ADV-W which can be found at 17 CFR 279.2 and filed upon Form ADV-W with IARD. (3-24-05)

03. **Investment Adviser Representative.** The application for withdrawal of registration as an investment adviser representative shall be completed by following the instructions on Form U-5 and filed upon Form U-5 with CRD. (3-24-05)

**092. NOTICE FILING REQUIREMENTS FOR FEDERAL COVERED ADVISERS (RULE 92).**

01. **Notice Filing.** The notice filing for a federal covered adviser pursuant to Section 30-14-405, Idaho Code, shall be filed with IARD on an executed Form ADV which can be found at 17 CFR 279.1. A notice filing of a federal covered adviser shall be deemed filed when the fee required by Section 30-14-410, Idaho Code, and the Form ADV are filed with and accepted by IARD on behalf of the state. (3-24-05)

02. **When Deemed Filed.** The Administrator will deem filed Part 2 of Form ADV if a federal covered adviser provides, within five (5) days of a request, Part 2 of Form ADV to the Administrator. Because the Administrator deems Part 2 of the Form ADV to be filed, a federal covered adviser is not required to submit Part 2 of Form ADV to the Administrator unless requested. (3-29-17)

03. **Renewal.** The annual renewal of the notice filing for a federal covered adviser pursuant to Section 30-14-405, Idaho Code, shall be filed with IARD. The renewal of the notice filing for a federal covered adviser shall be deemed filed when the fee required by Section 30-14-410(e), Idaho Code, is filed with and accepted by IARD on behalf of the state. (3-24-05)

04. **Updates and Amendments.** A federal covered adviser must file with IARD, in accordance with the instructions in the Form ADV, any amendments to the federal covered adviser’s Form ADV. (3-24-05)

**093. RECORDS REQUIRED OF INVESTMENT ADVISERS (RULE 93).**

Pursuant to provisions of the Act, every investment adviser registered or required to be registered under the Act shall make and keep true, accurate and current books and records as listed in 17 CFR 275.204-2 under the Investment Advisers Act of 1940, as currently amended. (3-29-17)

**094. CLIENT CONTRACTS - INVESTMENT ADVISERS (RULE 94).**

01. **Contract.** As used in this rule, “investment advisory contract” means any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account for a person other than an investment company, as defined in the Investment Company Act of 1940, as amended. (3-24-05)
### Section 02. Contents of Client Contract

No investment adviser shall enter into, extend, or renew any investment advisory contract, or in any way perform any investment advisory contract entered into, extended, or renewed, after the effective date of this rule, unless such contract is in writing and contains the following:

a. Provides that an investment adviser shall not receive compensation based on a share of capital gains upon or capital appreciation of funds or any portion of the funds of the client, except as exempted in 17 CFR 275.205-3 under the Investment Adviser Act of 1940;

b. Provides that no assignment of the contract shall be made by the investment adviser without the written consent of the client;

c. Provides that if the investment adviser is a partnership, the investment adviser shall notify the client of any change in the membership of such partnership within a reasonable time after such change;

d. Provides the investment adviser’s policy regarding termination of the contract, in compliance with 17 CFR 275.204-3(b);

e. Detailed description of the services to be provided;

f. Terms of the contract;

g. Amount of the advisory fee, the formula for computing the fee, and the amount of any prepaid fee to be returned in the event of contract termination or non-performance;

h. Discloses whether the contract grants discretionary power to the investment adviser;

i. A contract may not contain any provision that limits or purports to limit the liability of the investment adviser for conduct or omission arising from the advisory relationship that does not conform to the Act, applicable federal statutes, or common law fiduciary standard of care; or the remedies available to the client at law or equity or the jurisdiction where any action shall be filed or heard.

### Section 095. Investment Adviser Brochure Rule (Rule 95)

An investment adviser registered or required to be registered under the Act shall, in accordance with 17 CFR 275.204-3 under the Investment Advisers Act of 1940, deliver to each advisory client and prospective advisory client with a written disclosure statement that may be either a copy of Part 2 of its Form ADV which complies with 17 CFR 275.201(b) of the Investment Advisers Act of 1940, or a written document containing at least the information then so required by Part 2 of Form ADV.

### Section 096. Requirements for Custody (Rule 96)

If an investment adviser registered or required to be registered under the Act maintains custody of client funds, it shall be done in accordance with the requirements and standards set forth in 17 CFR 275.206(4)-2 of the Investment Advisers Act of 1940.

### Section 097. Investment Adviser Affiliation with Broker-Dealers/Issuers/Agents (Rule 97)

If an investment adviser becomes affiliated with a broker-dealer or issuer, he will be under a continuing obligation to make full disclosure of the affiliation to all parties to the affiliation, and must provide written notice to the Administrator of any material changes concerning any affiliation. Compliance with Part 2 of Uniform Form ADV and delivery of Part 2 of that form, or of a separate brochure or document containing substantially the same information that meets the requirements of the federal brochure rule, will be deemed to be in compliance with this rule.

### Section 098. Names Used by Broker-Dealers and Investment Advisers (Rule 98)

a. Broker-dealers, Broker-dealer Agents. Upon written request, the Administrator, in his discretion, may allow use by a broker-dealer of the name of an entity which is not registered with the Department as a broker-dealer.
dealer if, in all communications and advertising, a notation is prominently displayed indicating that all securities transactions are made through a named registered broker-dealer. However, any and all payments received must be in the name of the registered broker-dealer. The Administrator may impose any further conditions or restrictions on the use of the nonregistered name that he deems appropriate for the protection of the public. Except as provided in this rule, the use of unregistered names by a broker-dealer is prohibited. (3-24-05)

b. Investment Advisers, Investment Adviser Representatives. All advising, transactions, communications, and advertising regarding securities and the conducting of business as an investment adviser must be accomplished under the name of the investment adviser that is currently registered with the Department. Upon written request, the Administrator, in his discretion, may allow use by an investment adviser or investment adviser representative of the name which is not registered with the Department. (3-24-05)

02. Change of Name. If a registered broker-dealer, investment adviser, investment adviser representative or agent desires a name change, notice of such an intent must be submitted through CRD or to the Department within thirty (30) days after the effective date of the change. The name change will not be effective in this state until the notice is received. Any notice of a name change must include a copy of the rider to be attached to the investment adviser’s surety bond, if such bond is required, reflecting the name change. (3-24-05)

099. CIRCUMVENTION OF ORDERS PROHIBITED (RULE 99).
A broker-dealer, investment adviser, agent, or investment adviser representative may not circumvent the imposition of an order denying registration or revoking registration by withdrawing the application through the CRD system after such order has been issued. Such action will not be recognized by the Administrator, and will have no effect on the outcome of the order. (3-24-05)

100. WAIVER BY ADMINISTRATOR (RULE 100).
The Administrator may, either upon request or upon his own motion, waive or modify the application of any particular section to a particular agent, broker-dealer or investment adviser when, in his opinion, just and reasonable cause exists for such action and the waiving or modifying of such rule would not be contrary to the provisions of the Act or to the public interest. (3-24-05)

101. NOTIFICATION OF OPENING, CLOSING OR RELOCATION OF BRANCH OFFICES (RULE 101).
Any broker-dealer or investment adviser, registered as such with the Department, shall notify the Administrator in writing or through CRD, no later than thirty (30) days after the opening, closing or relocation of any branch office. For purposes of this rule, “branch office” is defined by FINRA. (3-29-17)

102. CANCELLATION OF REGISTRATION OR APPLICATION -- GROUNDS (RULE 102).
If the Administrator finds that any registrant or applicant for registration is no longer in existence or has ceased to do business as a broker-dealer, investment adviser, salesman or investment adviser representative, or is subject to an adjudication of mental incompetence or to the control of a committee, conservator or guardian, or cannot be located after reasonable search, the Administrator may by order cancel the registration or application. (3-24-05)

103. EXAMINATION REQUIREMENTS (RULE 103).

01. Examination Required. The following examinations are required for the following applicants: (3-24-05)

a. Broker-dealer agent application. General agents of securities broker-dealers are required to take and pass:

   i. The applicable FINRA examination; and (3-24-05)

   ii. Either the Series 63 or the Series 66 examination. (3-24-05)

b. Investment adviser representative and investment adviser qualifying officer application. Applicants for registration as investment adviser representatives or as an investment adviser qualifying officer shall take and pass: (3-24-05)
### Chapter 3B—State Regulatory Update—Idaho

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**i.** The Series 65; or (3-24-05)

**ii.** The Series 66 and Series 7 examinations. (3-24-05)

**c.** Specialized agent of a broker-dealer, issuer agent and qualifying officer for non-FINRA broker-dealer application. Specialized agents of broker-dealers, issuer agents and qualifying officers for non-FINRA broker-dealers application are required to take and pass:

| i. | The applicable FINRA examination; and (3-29-17) |
| ii. | Either the Series 63 or the Series 66 examination. (3-24-05) |

**d.** Sales of Viaticals. Persons selling viatical investments are required to take and pass the Series 7 examination. (3-24-05)

**02. Specialized Examination Authority.** Any registration granted pursuant to a specialized examination will be restricted, and the registrant will be authorized to effect securities transactions only in securities of the type specified by the conditions of the license. (3-24-05)

**03. Investment Adviser Representatives - Waiver.** An applicant for investment adviser representative or investment adviser qualifying officer registration may qualify for a waiver of the examination requirement if the applicant currently holds one (1) of the following designations:

| a. | Certified Financial Planner (CFP) awarded by the Certified Financial Planner Board of Standards, Inc.; (3-24-05) |
| b. | Chartered Financial Consultant (ChFC) awarded by the American College, Bryn Mawr, Pennsylvania; (3-24-05) |
| c. | Chartered Financial Analyst (CFA) awarded by the Institute of Chartered Financial Analysts; (3-24-05) |
| d. | Personal Financial Specialist (PFS) awarded by the American Institute of Certified Public Accountants; (3-24-05) |
| e. | Chartered Investment Counselor (CIC) awarded by the Investment Counsel Association of America, Inc.; or (3-24-05) |
| f. | Such other professional designation as the Administrator may by rule or order recognize. (3-24-05) |

**04. Waiver.** The Administrator, in his sole discretion, may waive any examination required by this rule upon a sufficient showing of good cause and upon any conditions he may impose. (3-24-05)

**104. FRAUDULENT, DISHONEST AND UNETHICAL PRACTICES - BROKER-DEALER, BROKER-DEALER AGENTS, ISSUER AGENTS, INVESTMENT ADVISERS, INVESTMENT ADVISER REPRESENTATIVES (RULE 104).**

**01. Fraudulent, Dishonest and Unethical Practices.** Any broker-dealer, agent, issuer agent, investment adviser or investment adviser representative who engages in one (1) or more of the practices identified in Subsections 104.02 through 104.47 of this rule shall be deemed to have engaged in one (1) or both of the following:

| a. | An “act, practice, or course of business that operates or would operate as a fraud or deceit” as used in Section 30-14-501 and Section 30-14-502, Idaho Code; (3-29-17) |
| b. | A dishonest and unethical practice as used in Section 30-14-412(d)(13), Idaho Code, and such |
conduct may constitute grounds for denial, suspension, or revocation of registration or such other action authorized by statute.  

(3-24-05)

c. This rule is not intended to be all-inclusive, and thus, acts or practices not enumerated herein may also be deemed fraudulent, or dishonest and unethical.  

(3-24-05)

02. Delivery Delays. Engaging in a pattern of unreasonable and unjustifiable delays in the delivery of securities purchased by any of its customers and/or in the payment upon request of free credit balances reflecting completed transactions of any of its customers.  

(3-24-05)

03. Churning. Inducing trading in a customer's account which is excessive in size or frequency in view of the financial resources and character of the account.  

(3-24-05)

04. Unsuitable Recommendations.

a. Recommending to a customer the purchase, sale, or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer, agent, or issuer agent.  

(3-29-17)

b. Recommending to a customer, to whom investment advice is provided, the purchase, sale, or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the customer on the basis of information furnished by the customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by the investment adviser or investment adviser representative.  

(3-29-17)

05. Unauthorized Transactions. Executing a transaction on behalf of a customer without authorization to do so.  

(3-24-05)

06. Discretionary Authority. Exercising any discretionary power in effecting a transaction for a customer's account without first obtaining written discretionary authority from the customer, unless the discretionary power relates solely to the time and/or price for the executing of orders.  

(3-24-05)

07. Margin Accounts. Executing any transaction in a margin account without securing from the customer a properly executed written margin agreement before or promptly after the initial transaction in the account.  

(3-24-05)

08. Segregation of Client Securities. Failing to segregate customers' free securities or securities held in safekeeping.  

(3-24-05)

09. Hypothecating Customer Securities. Hypothecating a customer's securities without having a lien thereon unless the broker-dealer secures from the customer a properly executed written consent before or promptly after the initial transaction, except as permitted by rules of the Securities and Exchange Commission.  

(3-24-05)

10. Unreasonable Price, Commission. Entering into a transaction with or for a customer at a price not reasonably related to the current market price of the security or receiving an unreasonable commission or profit.  

(3-24-05)

11. Failure to Supervise. Failure by a broker-dealer or investment adviser to exercise diligent supervision over the securities activities of all its broker-dealer agents, investment adviser representatives and employees as set forth in Section 105 of these rules.  

(3-24-05)

12. Unreasonable Fees. Charging unreasonable and inequitable fees for services performed, including miscellaneous services such as collection of monies due for principal, dividends or interest, exchange or transfer of securities, appraisals, safekeeping, or custody of securities and other services related to its securities business.  

(3-24-05)
13. **Sales at the Market.** Representing that a security is being offered to a customer “at the market” or a price relevant to the market price unless such broker-dealer knows or has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by such broker-dealer, or by any such person for whom the broker-dealer is acting or with whom the broker-dealer is associated in such distribution, or any person controlled by, controlling, or under common control with such broker-dealer. (3-24-05)

14. **Manipulative, Deceptive or Fraudulent Practices.** Effecting any transaction in, or inducing the purchase or sale of, any security by means of any manipulative, deceptive, or fraudulent device, practice, plan, program, design, or contrivance, which may include:
   a. Effecting any transaction in a security which involves no change in the beneficial ownership thereof; (3-24-05)
   b. Entering an order or orders for the purchase or sale of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties for the purpose of creating a false or misleading appearance of active trading in the security or a false or misleading appearance with respect to the market for the security. However, nothing in Subsection 104.14, of this rule, prohibits a broker-dealer from entering bona fide agency cross transactions for customers; or (3-24-05)
   c. Effecting, alone or with one (1) or more other persons, a series of transactions in any security creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others. (3-24-05)

15. **Loss Guarantees.** Guaranteeing a customer against loss in any securities account of such customer carried by the broker-dealer or in any securities transaction effected by the broker-dealer or in any securities transaction effected by the broker-dealer with or for such customer. (3-24-05)

16. **Bona Fide Price Reports.** Publishing or circulating, or causing to be published or circulated, any notice, circular, advertisement, newspaper article, investment service, or communication of any kind which purports to report any transaction as a purchase or sale of any security unless such broker-dealer believes that such transaction was a bona fide purchase or sale of such security; or which purports to quote the bid price or asked price for any security, unless such broker-dealer believes that such quotation represents a bona fide bid for, or offer of, such security. (3-24-05)

17. **Deceptive or Misleading Advertising.** Using any advertising or sales presentation in such a fashion as to be deceptive or misleading. (3-24-05)

18. **Disclosure of Control.** Failing to disclose that the broker-dealer or investment adviser is controlled by, controlling, affiliated with, or under common control with the issuer of any security before entering into any contract with or for a customer for the purchase or sale of such security, the existence of such control to such customer, and if such disclosure is not made in writing, it shall be supplemented by the giving or sending of written disclosure at or before the completion of the transaction. (3-24-05)

19. **Bona Fide Distribution.** Failing to make a bona fide public offering of all of the securities allotted to a broker-dealer for distribution, whether acquired as an underwriter, a selling group member, or from a member participating in the distribution as an underwriter or selling group member by, among other things, transferring securities to a customer, another broker-dealer or a fictitious account with the understanding that those securities will be returned to the broker-dealer or its nominees or parking or withholding securities. (3-24-05)

20. **Customer Communication.** Failure or refusal to furnish a customer, upon reasonable request, information to which the customer is entitled, or to respond to a formal written request or complaint. (3-24-05)

21. **Loans from Customers.** Borrowing money or securities from a customer, unless the customer is a broker-dealer, an affiliate, or a financial institution engaged in the business of loaning funds or securities, or immediate family. For purposes of this rule, the term “immediate family” means parents, mother-in-law, father-in-law, husband, wife, brother, sister, brother-in-law, sister-in-law, son-in-law, daughter-in-law, and children. (3-24-05)
22. **Loans to Customers.** Loaning money to a customer, other than an immediate family member, unless the broker-dealer or investment adviser is a financial institution engaged in the business of loaning funds or the customer is an affiliate of the broker-dealer or investment adviser. (3-29-17)

23. **Unrecorded Transactions.** Effecting securities transactions not recorded on the regular books or records of the broker-dealer which the agent represents, unless the transactions are authorized in writing by the broker-dealer prior to execution of the transaction. (3-24-05)

24. **Fictitious Accounts.** Establishing or maintaining an account containing fictitious information in order to execute transactions which would otherwise be prohibited. (3-24-05)

25. **Profit/Loss Sharing.** Sharing directly or indirectly in profits or losses in the account of any customer without the written authorization of the customer and the broker-dealer which the agent represents. (3-24-05)

26. **Splitting Commissions.** Dividing or otherwise splitting the agent's commissions, profits, or other compensation from the purchase or sale of securities with any person not also registered in Idaho as an agent for the same broker-dealer, or for a broker-dealer under direct or indirect common control. (3-24-05)

27. **Unsolicited Transactions.** Marking any order tickets or confirmations as unsolicited when in fact the transaction was solicited. (3-24-05)

28. **FINRA and NASD Rules Compliance.** Failing to comply with any applicable provision of the NASD Conduct Rules and any other FINRA Rules or any applicable fair practice or ethical standard promulgated by the Securities and Exchange Commission or by a self-regulatory organization approved by the Securities and Exchange Commission. (3-29-17)

29. **Contradicting Prospectus Information.** Contradicting or negating the importance of any information contained in a prospectus or other offering materials with intent to deceive or mislead. (3-24-05)

30. **Inside Information.** In connection with the offer, sale, or purchase of a security, falsely leading a customer to believe that the broker-dealer, agent, investment adviser or investment adviser representative is in possession of material, non-public information which would impact the value of the security, or communicating to customers or other persons bona fide information not generally available to the public that may be used in the person’s decision to buy, sell, or hold a security. (3-29-17)

31. **Contradictory Recommendations.** In connection with the solicitation of a sale or purchase of a security, engaging in a pattern or practice of making contradictory recommendations to different investors of similar investment objective for some to sell and others to purchase the same security, at or about the same time, when not justified by the particular circumstance of each investor. (3-24-05)

32. **Prospectus Delivery.** Failure to comply with any prospectus delivery requirement promulgated under federal law. (3-24-05)

33. **Penny Stock Sales.** Effect any transaction in, or to induce or attempt to induce the purchase or sale of, any penny stock by any customer except in accordance with the requirements as set forth in the 1934 Securities Exchange Act, Section 15(h) and the rules and regulations prescribed thereunder. (3-29-17)

34. **Misrepresentations Concerning Advisory Services.** To misrepresent to any advisory client, or prospective advisory client, the qualifications of the investment adviser, investment adviser representative or any employee of the investment adviser, or to misrepresent the nature of the advisory services being offered or fees to be charged for such service, or to omit to state a material fact necessary to make the statements made regarding qualifications, services, or fees, in light of the circumstances under which they are made, not misleading. (3-24-05)

35. **Unreasonable Advisory Fees.** Charging a client an unreasonable advisory fee. (3-24-05)

36. **Conflicts of Interest.** Failing to disclose to clients in writing before any advice is rendered any material conflict of interest relating to the adviser or any of its employees which could reasonably be expected to
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impair the rendering of unbiased and objective advice including:

a. Compensation arrangements connected with advisory services to clients which are in addition to compensation from such clients for such services; and

b. Charging a client an advisory fee for rendering advice when a commission for executing securities transactions pursuant to such advice will be received by the adviser or its employees.

37. Guaranteeing Specific Results. Guaranteeing a client that a specific result will be achieved (gain or no loss) with advice which will be rendered.


39. Disclosure of Private Information. Disclosing the identity, affairs, or investments of any client unless required by law to do so, or unless consented to by the client.

40. Advisory Contract Disclosures. Entering into, extending, or renewing any investment advisory contract unless such contract is in writing and discloses, in substance the services to be provided, the term of the contract, the advisory fee, the formula for computing the fee, the amount of prepaid fee to be returned in the event of contract termination or non-performance, whether the contract grants discretionary power to the adviser and that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract.

41. Protection of Non-Public Information. Failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information, or that are contrary to the provisions of Section 204A, and rules associated with it, of the Investment Advisers Act of 1940.

42. Advisory Contract to Comply with Federal Law. To indicate, in an advisory contract, any condition, stipulation, or provisions binding any person to waive compliance with any provision of the Act or of the Investment Advisers Act of 1940, or any other practice contrary to the provisions of Section 215, and rules associated with it, of the Investment Advisers Act of 1940.

43. Waiver of State or Federal Law Prohibited. Engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative in contrary to the provisions and associated rules of Section 206(4) of the Investment Advisers Act of 1940, notwithstanding the fact that such investment adviser is not registered or required to be registered under Section 203 of the Investment Advisers Act of 1940.

44. Fraudulent, Deceptive or Manipulative Acts. Engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative in contrary to the provisions and associated rules of Section 206(4) of the Investment Advisers Act of 1940, notwithstanding the fact that such investment adviser is not registered or required to be registered under Section 203 of the Investment Advisers Act of 1940.

45. Outside Business Activities - Selling Away. Any agent or investment adviser representative associated with a broker-dealer or investment adviser registered under the Act shall not engage in business activities, for which he receives compensation either directly or indirectly, outside the scope of his regular employment unless he has provided prior written notice to his employer firm.

46. Third Party Conduct. Engaging in conduct or any act, indirectly or through or by any other person, which would be unlawful for such person to do directly under the provisions of the Act or any rules thereunder, or engaging in other conduct such as nondisclosure, incomplete disclosure, or deceptive practices shall be deemed an unethical business practice. The federal statutory and regulatory provisions referenced herein shall apply to investment advisers and federal covered advisers, to the extent permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290).

47. Misleading Filings. For purposes of Section 30-14-505, Idaho Code, the term “proceeding” includes, but is not limited to, any investigation, examination or other inquiry initiated by the Department.

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105. SUPERVISION OF AGENTS, INVESTMENT ADVISER REPRESENTATIVES AND EMPLOYEES (RULE 105).

01. Supervision Required. Every broker-dealer, investment adviser, and designated supervisor shall exercise diligent supervision over the securities activities of all of his agents, investment adviser representatives and employees. (3-24-05)

02. Broker-Dealer Procedures. Every agent and employee of the broker-dealer shall be subject to the supervision of a supervisor designated by such broker-dealer. The supervisor may be the broker-dealer in the case of a sole proprietor, or a partner, officer, office manager, or any other qualified person. (3-24-05)

03. Written Compliance Procedure. Every broker-dealer shall establish, maintain and enforce written procedures, a copy of which shall be kept in each business office, which shall set forth the procedures adopted by the broker-dealer to comply with the following duties imposed by this rule, and shall state at which business office or offices the broker-dealer keeps and maintains the records required by Section 30-14-411, Idaho Code: (3-24-05)

   a. The review and written approval by the designated supervisor of the opening of each new customer account; (3-24-05)

   b. The frequent examination of all customer accounts to detect and prevent irregularities or abuses, including a review for churning and switching of securities in customers’ accounts, as well as unsuitable recommendations and sales of unregistered securities; (3-24-05)

   c. The prompt review and written approval by the designated supervisor of all securities transactions and all correspondence pertaining to the solicitation or execution of all securities transactions; (3-24-05)

   d. The review of back office operations, i.e., all systems and procedures, including the currency and accuracy of books and records, the status and causes of “Fa ils to Receive” and “Fa ils to Deliver,” net capital, credit extensions and financial reports; (3-24-05)

   e. The review of form, content and filing of all correspondence related in any way to the purchase or sale or solicitation for the purchase or sale of securities; (3-24-05)

   f. The review and written approval by the designated supervisor of the delegation by any customer of discretionary authority with respect to his account to a stated agent or associate of the broker-dealer and the prompt written approval of each discretionary order entered on behalf of that account; and (3-24-05)

   g. The prompt review and written approval of the handling of all customer complaints. As used in these rules, “complaint” is considered to be any written statement by a customer or by any person acting for a customer which complains about the activities of the broker-dealer, agent or associate in connection with the solicitation or execution of a transaction or the disposition of funds of that customer. (3-24-05)

04. Investment Adviser Procedures. Every investment adviser shall establish, maintain and enforce written procedures, a copy of which shall be kept in each business office, which shall set forth procedures reasonably designed to prevent violation of the Idaho Uniform Securities Act and Rules and comply with the following duties as applicable to the business of the investment adviser: (3-29-17)

   a. The review and written approval by the designated supervisor of the opening of each new customer account; (3-24-05)

   b. The frequent examination of all customer accounts to detect and prevent irregularities or abuses, including a review for unsuitable recommendations and recommendations of unregistered securities; (3-24-05)

   c. The prompt review and written approval by the designated supervisor of all securities recommendations and all correspondence pertaining to the solicitation or execution of all securities recommendations; (3-24-05)
d. The review of form, content and filing of all correspondence related in any way to the recommendation of the purchase of any securities; (3-24-05)

e. The prompt review and written approval of the handling of all customer complaints. As used in these rules, a “complaint” is considered to be any written statement by a customer, or by any person acting for a customer, questioning the activities of the investment adviser or representative in connection with recommendations concerning, or disposition of, funds in the account. (3-24-05)

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Chapter 3C
British Columbia Securities Commission Update

DOUGLAS MUIR
Director of Enforcement
British Columbia Securities Commission
Vancouver, British Columbia

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1. **Introduction**

This is an update on recent trends or current topics relating to securities regulation in British Columbia. I focus on BC, but some of the content applies across Canada. I also focus on Enforcement issues, but I refer to a few corporate finance and capital markets matters.

The opinions in this update are my own, and do not represent the policies or positions of the British Columbia Securities Commission (BCSC) or the Government of British Columbia.

2. **Overview of the Canadian Regulatory Landscape**

In Canada, securities Commissions such as the BCSC, the Alberta Securities Commission (ASC), or the Ontario Securities Commission (OSC), or departments within government ministries, regulate the capital markets. Each province and territory has its own securities legislation, and much of it is uniform or harmonized across Canada.

The various regulators cooperate through an umbrella organization known as the Canadian Securities Administrators (CSA). The CSA’s objective is to improve, coordinate and harmonize regulation of the Canadian capital markets to ensure close collaboration in the delivery of regulatory programs and securities law enforcement.
The CSA’s Policy Coordination Committee, consisting of the 8 principal regulators (BC, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick and Nova Scotia) oversees and coordinates policy initiatives. Eighteen CSA Committees develop policy and deliver regulatory programs, including Corporate Finance, Compliance, Enforcement, Legislative and Regulatory Coordination and Investor Education committees. Staff from the various Commissions are committee members.

The BCSC

The BCSC is a self-funded, independent provincial government agency responsible for administering the BC Securities Act and reports to the BC Ministry of Finance. It consists of approximately 250 staff and eight Commissioners appointed by the provincial government, including six independent Commissioners, a chair and vice-chair. The Commissioners serve as the BCSC’s board of directors and also sit as members of the Commission’s administrative tribunal.

Our Executive Director is our Chief Administrative Officer, and oversees staff in our six divisions, each lead by a Director. The Divisions are: Communications and Education, Capital Markets Regulation, Corporate Finance, Enforcement, Corporate Services and Economic Analysis.

The BCSC leads oversight of the Mutual Fund Dealers Association (MFDA) and oversees the conduct of the TSX Venture Exchange (TSX-V), CDS Clearing and Depository Services Inc., and Investment Industry Regulatory Organization of Canada (IIROC).

The BCSC is a signatory to the International Organization of Securities Commissions (IOSCO) MMOU and a member of the Committee on Enforcement and the Exchange of Information (Committee 4). The BCSC is also a signatory to several other information sharing and supervision memoranda of understanding.

The BC government is a participating jurisdiction in the Cooperative Capital Markets Regulatory System (CMRA), along with the governments of New Brunswick, Ontario, Prince Edward Island, Saskatchewan, Yukon and Canada. This is a government-led initiative, and part of the BCSC’s mandate is to support this initiative. More on CMRA below.

3. Enforcement Update

Overview of BCSC enforcement

Under the BC Securities Act, the BCSC can deal with misconduct in two ways: as an administrative contravention or as a quasi-criminal offence. In addition, the BCSC can also recommend criminal charges under the Criminal Code (a Federal statute) with respect to conduct related to securities, such as fraud.
The Executive Director makes allegations of administrative contraventions and Commission tribunal panels, usually comprised of three Commissioners, hear the allegations. Commission panels have broad powers to issue orders, including powers to

- prohibit people from the capital markets: from trading securities, from being officers and directors, registrants, engaging in investor relations activities, etc.
- order administrative penalties up to $1 million per contravention
- order persons to pay to the Commission amounts obtained as result of their contraventions

A contravention of the *Securities Act* is not required before a panel can issue a prohibition order - the panel only needs to find, after a hearing, that it is in the public interest to issue an order.

Most BCSC’s proceedings are administrative proceedings, and Commission panels hear and rule on the allegations. Our administrative proceedings are run much like a trial, with some key differences. For example, the rules of evidence do not apply and exhibits are entered that may not be admissible in court.

Quasi-criminal and criminal allegations are prosecuted by Crown Counsel, following a referral from the BCSC, and heard by the court, usually Provincial Court (our lowest Court). Quasi-criminal or criminal convictions can result in jail sentences.

**Enforcement Activity in 2016**

Last year, the BCSC issued 13 administrative sanction decisions. Across Canada, there were 109 concluded matters last year (matters were a final decision was issued or a settlement reached)\(^1\). Of those 109 matters:

- 54% involved illegal distribution of securities and 19% involved fraud
- there were 93 individual respondents and 168 companies
- 57% were concluded before a tribunal, 21% by a settlement agreement and 22% by a court decision
- Approximately $36.7 million was ordered in fines or administrative penalties for fraud contraventions, and $9.5 million for illegal distribution of securities

The number of concluded matters in 2016, and the amount of penalties, are lower than in 2015 (145 concluded cases), but similar to 2014 (105 concluded cases).

**Settlements**

The OSC entered into several no-contest settlements in 2016. The settling parties paid over $15 million in voluntary payments and undertook to repay investors almost $350 million.

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\(^1\) [CSA 2016 Enforcement Report](#)
The OSC introduced no-contest settlements in 2014. Factors the OSC will consider before entering into no-contest settlement include the extent of cooperation, self-reporting and remedial steps taken by the settling part; the extent of investor harm; and whether there is an agreement to pay persons affected by the misconduct.

**Reciprocal Orders**

Another development is with respect to reciprocal orders. Securities regulators can reciprocate orders related to securities misconduct issued in another jurisdiction. In most jurisdictions, this requires an application before a tribunal panel, and the underlying order forms the basis for the new order. Usually no additional evidence is called and often hearings are in writing. This provides for an efficient process, and reciprocal orders limit a person’s ability to hop from one jurisdiction to another to commit misconduct. Securities regulators issued 127 reciprocal orders last year.

In 2016, three jurisdictions - Nova Scotia, Quebec and New Brunswick - added automatic reciprocal order provisions to their statutes. (Alberta added this feature in 2015). Orders issued by another Canadian securities regulator automatically have effect in these four jurisdictions.

**Whistleblower Programs**

In June 2016, the Ontario Securities Act was amended to add anti-reprisal provisions for whistleblower protection. In July 2016, the OSC introduced its whistleblower program, which includes an Office of the Whistleblower and permits awards for information that provide meaningful assistance.

In June 2016, the Autorité des marchés financiers (AMF), the Quebec regulator, announced their whistleblower program. The AMF’s program does not allow for awards for whistleblowers.

The ASC recently announced that it will explore the creation and implementation of a whistleblower program that does not include awards.

Note that the draft Capital Markets Act, one of the proposed pieces of legislation under the CMRA, includes anti-reprisal provisions for whistleblower protection.

**Joint Serious Offence Teams (JSOT)**

In 2013, the OSC formed its JSOT, which it describes as

an enforcement partnership between the OSC, the RCMP [Royal Canadian Mounted Police] Financial Crime program and the OPP’s [Ontario Provincial Police] Anti-Rackets
Branch. The team combines police resources and Criminal Code tools – such as the ability to do undercover surveillance and the power to arrest – with the OSC’s specialized team of litigators, accountants and computer forensic experts.

The AMF is part of three integrated teams comprised of members from the AMF, the RCMP and Sûreté du Québec (the Quebec provincial police force).

In December 2016 the ASC announced its JSOT, to investigate and prosecute quasi-criminal cases under the Alberta Securities Act and certain securities-related criminal offences under the Criminal Code of Canada.

Although at this point we do not have a formal team with the RCMP, the BCSC works closely with the RCMP and other police agencies, sharing information, resources, and expertise.

**Binary Options**

Binary options fraud continue to be a serious problem, causing significant harm to the public. In recent years, there has been a proliferation of websites that purport to offer binary options trading. They may all simply be frauds. No company is authorized to sell binary options in Canada.

The websites attract victims because they are slick and professional looking, are prominent on internet search results, offer easy payment by credit card and other online payment methods, and produce early results which prompt victims to chase more returns.

We’ve seen high pressure sales tactics, unsolicited texts, cold calls, social media and recovery room scams. The fraudsters layer the schemes deeply – with domain names held under fake names, boiler rooms located in one company, bank accounts in another.

The BCSC, along with our CSA colleagues, have tackled the problem of binary options fraud through public warnings and education. We have formed a Binary Options Task Force and in March, the CSA ran a very successful advertising campaign about the dangers of binary options fraud: “An all-or-nothing proposition that could take it all - and leave you with nothing”.

We continue to proactively search for binary options websites, take in complaints, and warn the public, and we work with regulators and enforcement agencies around the world.

**BCSC’s Strategy 5**

The BCSC’s current Strategic Plan includes a new Enforcement strategy - Strategy 5. The goal of the strategy goal is to reduce securities fraud through detection, disruption, and deterrence.

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2 The BCSC’s March 2, 2016 news release update on binary options fraud is [here](http://example.com).

3 The CSA resource site for binary options fraud is [www.binaryoptionsfraud.ca](http://www.binaryoptionsfraud.ca).
The goal of Strategy 5 is to create an unwelcome environment for fraud, an environment where there is a disincentive to commit fraud. We are using an integrated approach and will refocus our enforcement efforts on intelligence gathering; early intervention; criminal investigations; and collections of fines.

Below is the text of Strategy 5:

Strategy 5: Reduce securities fraud through detection, disruption, and deterrence

Securities fraud causes significant harm to BC investors and loss of confidence in our capital markets. Securities fraudsters thrive in secrecy and can be difficult to detect. We will develop an integrated approach to creating an environment that discourages fraudulent securities activities. Creating this environment will also enhance the efficiency of legitimate securities activities on the capital markets as market participants will gain increased confidence in the systems in place. Components of the approach will include:

1. **Enhancing intelligence gathering.** This includes two initiatives: building our capacity to obtain intelligence both covertly and overtly, and strengthening relationships through education and outreach with key information sources that can alert us to fraudulent activity, including financial institutions, the police, the public, and other regulators.

2. **Expanding early intervention tactics.** To disrupt fraudulent activity, we will enhance our capacity to quickly intervene, including by refining our processes to more deftly deploy our statutory tools.

3. **Strengthening criminal investigation.** This includes three initiatives: making earlier decisions on the appropriate investigative stream (criminal or administrative); expanding our criminal enforcement capacity to investigate targeted fraud cases for referral to the Crown; and increasing public awareness of our criminal investigations.

4. **Revising our collections strategy.** We will implement a more visible and robust collections process that runs from identifying and preserving assets during the course of an investigation to taking a strategic approach to collections efforts following hearing decisions.

Taken together, the components of this strategy will create stronger deterrence against investment fraud. We will develop new ways to act rapidly on intelligence and information we obtain to disrupt fraudulent securities activities – the most effective way to prevent investor losses is to prevent a fraudulent investment from happening. Increased criminal investigations will enhance the prospect of criminal sanctions, often the only effective deterrents for fraudulent misconduct. And our targeted and persistent collections efforts will aim to increase our sanctions collections rate, raising the cost of engaging in fraudulent activity.
Our Service Plan was effective April 1 and we are in the process of putting operational plans into effect.

**Beaudette v. Alberta (Securities Commission), 2016 ABCA 9**

In the recent case of *Beaudette v. Alberta (Securities Commission)*, 2016 ABCA 9, the Alberta Court of Appeal upheld a lower court ruling which found that the investigative powers in the Alberta Securities Act, which are similar to those in many other Canadian provinces, do not violate the Canadian Charter of Rights and Freedoms. On June 30, 2016, the Supreme Court of Canada refused to hear an appeal of the Court of Appeal’s decision.

The ASC had summonsed Mr. Beaudette to attend an interview and give compelled testimony. He refused to attend and argued, among other things, that the legislation provision which allowed the ASC to compel information, combined with another provision which allowed the ASC to share compelled information, violated the Charter, in particular his right under section 7 of the Charter. Section 7 states:

> Everyone has the right to life, liberty and security of the person and the right not to be deprived thereof except in accordance with the principles of fundamental justice.

Note that the British Columbia Securities Act has similar investigation and sharing provisions, as do many of the other Securities Acts in Canada. Also note that two British Columbia investigators were authorized under the ASC investigation order which is not an unusual practice.

The Court of Appeal summarized Mr. Baudette’s argument as follows:

Principally, he argues that the requirement to provide information and documents concerning his securities activities in North America, coupled with the possibility that the ASC might share that information with other state authorities and, in particular, the United States, infringes his right to liberty guaranteed under s. 7 of the Canadian Charter of Rights and Freedoms (“Charter”).

*Beaudette*, paragraph 2

He argued that the legislation provisions lacked derivative use immunity and therefore violated his Charter rights, and pointed to other Canadian securities statutes that he claimed offered protection. The Court of Appeal stated, in paragraph 23:

The appellant aims his s. 7 attack at the absence from the statute of what he called a “guarantee of accompanying use and derivative use immunity” which he characterizes

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4 The Supreme Court of Canada does not provide reasons for its refusal to hear appeals.
5 Section 169.1 of the BC Securities Act allows the BCSC to share information with a variety of parties, including a “law enforcement agency, government, governmental authority, securities regulatory authority or financial regulatory authority ... in British Columbia or elsewhere”.
as “a condition precedent to any constitutionally valid compulsion”. On this point it is noteworthy that, while the appellant also argued that securities statutes in some other provinces of Canada were superior to Alberta’s statute in protecting his asserted privilege against self-incrimination, he did not point to any statute giving him such a “guarantee” against what American authorities might do.

The lower Alberta court (the Court of Queen’s Bench) dismissed his application, and the Alberta Court of Appeal upheld that decision. In its decision, the Court of Appeal

- Noted that

  [s]peculation about a potential future breach has not met [the burden that there is a real nexus or consequence for life, liberty or security of the person] since the early Charter era. Mere allegations of possible foreign state actions associated with Canadian state actions are not proof that those events are likely to happen. (paragraph 21)

- Reiterated the significance of the fact that the securities industry is highly regulated:

  … the s. 7 liberty interest is engaged “where state compulsions or prohibitions affect important and fundamental life choices”. Such choices do not include the election to participate in a highly regulated industry, with its necessarily attendant regulatory rules and consequences thereof. (paragraph 31)

- Commented on the suggestion that the Canadian regulator was an “agent” of a foreign regulator:

  The fact that evidence that might be useful in the courts of a foreign rule of law democracy with which Canada has friendly relations may become easier for that foreign state’s authorities to locate or acquire because of the operation of a Canadian law does not make the Canadian law per se the author or sponsor of an infringement of s 7 of the Charter. (paragraph 46)

- And addressed the argument about the “predominant purpose” of a regulatory investigation:

  While it has been said that the balance between regulatory investigations and the privilege against self-incrimination sometimes raises questions of “predominant purpose” in a specific case, the terms of s 42 of the [Securities Act] in light of the Act as whole strike a balance between the privilege against self-incrimination and the principle that relevant evidence should be available in a search for the truth: see Jarvis, at paras 67-68. The chambers judge found as a
fact that, in issuing the Summons, the ASC had no predominant purpose in the
texture of a criminal investigation. (paragraph 42).

Ultimately the Court of Appeal dismissed the appeal, finding that Mr. Beaudette

...failed to make out his claim that the combination of ss. 42 and 46 of the [Securities
Act] against him involves a generalized breach of liberty under s. 7 of the Charter or that
he faced infringement of his right to liberty as an individual under s. 7 of the Charter
contrary to a principle of fundamental justice.

Beaudette, paragraph 56

While Beaudette is not the first time our Courts have dealt with the issue of Securities
Commissions sharing information to assists the enforcement of foreign laws6, it does decide a
specific argument that has been raised in several Canadian jurisdictions with respect to
Commissions’ investigation powers and information sharing.

4. Cooperative Capital Market Regulatory System

The Canadian federal government and the Provinces of Ontario, British Columbia,
Saskatchewan, New Brunswick, and Prince Edward Island, and the Yukon Territory, have signed
on to a memorandum of understand setting out the terms and conditions of a Cooperative
Capital Markets Regulatory System.

Some of the key features of the system will include:

• participating provincial and territorial jurisdictions will enact uniform legislation
  addressing all matters in respect of the regulation of capital markets within their
  jurisdictions.
• federal legislation will address criminal matters and systemic risk in national capital
  markets and data collection.
• a common regulator, the Capital Markets Regulatory Authority (CMRA), will administer
  the provincial and federal legislation and regulations under authority delegated.
• The Cooperative System will feature a single regulator which will administer a single set
  of rules designed to protect investors and support efficient capital markets.
• a Council of Ministers, made up of Ministers responsible for securities regulation in each
  provincial and territorial participating jurisdiction, and the federal Minister of Finance,
  will provide accountability to the legislative bodies of participating jurisdictions

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• draft legislation has been published, and is available on the Cooperative System website: http://ccmr-ocrmc.ca/.

Some recent CMRA updates:

• On May 5, 2016, Department of Finance Canada released for public comment a revised consultation draft of the Capital Markets Stability Act, which deals with national data collection, systemic risk related to capital markets and criminal enforcement

• On July 22, 2016, the Ministers announced the CMRA’s initial board of directors. The board is made up of 15 individuals with a range of relevant capital markets knowledge and expertise who, as a group, are broadly representative of the regions of Canada

• Also on July 22, 2016, the Ministers announced amended implementation milestones: participating jurisdictions will use best efforts to enact legislation by June 30, 2018, and the Authority is expected to be operational in 2018.

• On November 17, 2016, Kevan Cowan, the Chief Regulator of the CMRA was announced. Kevan was the President of TSX Markets and the TSX Venture Exchange, and corporate and securities law, as a partner at a major national Canadian law firm.

• In January, 2017, the initial management team was announced (Heads of Communications, Finance, Information Services, and Facilities)

5. Other initiatives

Fintech

Fintech has been a very hot topic lately. The BCSC has a long-standing tradition of consulting with industry and working to develop regulatory solutions that support entrepreneurs and companies in launching new ways of conducting business. To that end, the BCSC has a dedicated Tech Team to address questions relating to fintech business, such as robo-advisors; online lenders (loan funding and lending); and crowdfunding portals.

In January and February, 2017, we conducted a survey and participated in several outreach events, all designed to broaden our knowledge and understanding of the impact of regulation on these types of businesses, and to provide fintech and tech companies with information and resources.

On February 23, 2017, the CSA launched a regulatory sandbox. This initiative supports businesses seeking to offer innovative products, services and applications. Companies with “genuine technological innovation” can be given the opportunity to register or receive relief from registration requirements and could be permitted to test services and products throughout Canada. Businesses can deal with local securities regulators, who can decide whether to refer the business to the CSA regulatory sandbox.
Client Relationship Model – Phase 2 (CRM2)

On July 15, 2013, amendments to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations (CRM-2 amendments) became effective. The goal of these amendments is to provide clear and full disclosure to clients of the performance of their investments and all fees associated with their accounts. The amendments were phased in on July 15, 2014, July 15, 2015, and July 15, 2016.

Under CRM-2, advisors must provide to their clients, among other things, expanded account statements, annual reports on investment performance, charges and compensation.

We ran the “Take a Look” campaign in October 2016 to encourage investors to pay attention to the fees they pay for investment products and advice.

We also conducted a study and determined that BC investors have some significant gaps in fee knowledge: 28 per cent do not know how their advisor is paid, 36 per cent are not familiar with the types of fees they pay for the investment products they own, and only half (51 per cent) know the total of amount of direct fees they paid in the past 12 months7.

We released five new videos8 to raise awareness about changes to how advisors must report to investors on the costs and performance of their investments, as well as the content of their accounts.

Three other regulatory initiatives

Three other recent regulatory initiatives that may be of interest:

- CSA Staff Notice 51-348 *Staff’s Review of Social Media Used by Reporting Issuers* - This Notice is a summary of findings and expectations regarding disclosure by reporting issuers on social media. Three key areas for improvement are identified in the Notice:
  
  - Selective or early disclosure when some investors receive material information through social media that other investors do not receive because it is not generally disclosed.
  
  - Misleading and unbalanced social media disclosure where information is not sufficient to provide a complete picture or is inconsistent with information already disclosed by issuers on the System for Electronic Document Analysis and Retrieval (SEDAR).

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7 The results of our study are available on our investor education website, [investright.org](http://investright.org).

8 Available on our [website](http://investright.org).
o Insufficient social media governance policies in place to support social media activity

- **CSA Staff Notice 54-305 Meeting Vote Reconciliation Protocols** – these voluntary protocols contain expectations and guidance for improving the tabulation of proxy votes. The protocols deal with these areas:
  o generating and sending vote entitlement information
  o setting up vote entitlement accounts
  o sending proxy vote information and tabulating and recording proxy votes
  o informing beneficial owners of rejected/pro-rated votes.

- **Multilateral Staff Notice 51-347 Disclosure of cyber security risks and incidents** – this notice from BCSC, OSC and AMF staff provides disclosure expectations for reporting issuers on cyber security issues, based on findings from a review conducted by the CSA. (Cyber security is a priority area for the CSA, and the subject of a September 27, 2016 staff notice, Staff Notice 11-332 Cyber Security). Notice 51-347 states:

  The review focused on whether and how issuers had addressed cyber security issues in their risk factor disclosure, including whether the disclosure described potential impacts of a cyber attack on the issuer’s business, what kind of material information could be exposed as a result, and who was responsible for the issuer’s cyber security strategy. We also searched for disclosure about any previous cyber security incidents.
Chapter 3D

State Regulatory Update—Alaska

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House Bill 170
AK Securities Act; Penalties; Crt. Rules
Brief Sectional Analysis

**SECTIONS 1 – 14 (pp. 1-11)** include the corresponding changes to statutes that refer to former AS 45.55 provisions that have been moved to AS 45.56.

**SECTIONS 15 – 24 (pp. 11-14)** modify AS 45.55 as necessary to delete references to statutes that have no bearing on the Alaska Native Claims Settlement Act corporations because of the enactment of AS 45.56.

**SECTION 25 (p. 15)** proposed new Chapter AS 45.56.

**Article 1. General Provisions (p. 15)**

Sec. 45.56.105. Securities registration requirement – same as current law (AS 45.55.070). Securities must be registered before offer or sale unless federally covered or exempt.

**Article 2. Exemptions from Registration of Securities (pp. 15-30)**

Sec. 45.56.205. Exempt securities – generally the same as current law (AS 45.55.900(a)) with a few additions including securities issued by an insurance company; certain options, warrants and rights that are not federal covered securities; certain cooperatives and equipment trust certificates.

Sec. 45.56.210. Exempt transactions – similar to current law (AS 45.55.900(b)), reorganized with additions reflecting transactions allowed under the Uniform Securities Act of 2002 (USA).

Sec. 45.56.220. Small intrastate securities offerings (referred to as “crowdfunding”) – allows for offerings within Alaska of up to $1,000,000 with a maximum single investment of $10,000, incorporated into the Alaska Securities Act by SB 126 (2016).

Sec. 45.56.230. Disqualifier – prohibits persons who have been subject to regulatory action or participated in certain crimes from using exemptions from the registration requirement.

Sec. 45.56.240. Waiver and modification – broadens the administrator’s authority to waive or change requirements or conditions for exemptions.

Sec. 45.56.250. Denial, suspension, revocation, condition, or limitation of exemptions – same as current law, although the appeal rights and hearing information is moved to Article 6.
Chapter 3D—State Regulatory Update—Alaska

Article 3. Registration of Securities and Notice Filing of Federal Covered Securities. (pp. 30-42)

No significant changes to registration provisions from AS 45.55. Material changes noted by section.

**Sec. 45.56.305. Securities registration by coordination** – registration statement must be on file with the Administrator for 20 days (may be reduced by regulation). References to prompt notice by telegram are deleted.

**Sec. 45.56.310. Securities registration by qualification** – adds a new requirement that registrants disclose pending litigation that may materially affect the issuer or litigation that is known to be contemplated but not yet filed.

**Sec. 45.56.320. Securities registration filings** – allows the administrator to set escrow time by regulation or order for certain securities issued to a promoter or to other persons at a price substantially less than the public offering price.

**Sec. 45.56.330. Notice filing of federal covered securities** – adds fees for late filings.

**Sec. 45.56.340. Viatical settlement interests** – combines current AS 45.55.120 and AS 45.55.905(c) to explain the joint regulation of these interests by the Securities and Insurance statutes.

**Sec. 45.56.350. Waiver and modification** – the administrator’s waiver authorities are consolidated in this section instead of throughout the chapter.

**Sec. 45.56.360. Denial, suspension, and revocation of securities registration** – adds requirement to establish regulations explaining what conduct may be fraud upon purchasers; unreasonable discounts, compensation, profits (including options, etc.) and terms that are unfair, unjust or inequitable.


Firm, salesperson, and adviser registration (licensing) provisions are reorganized into one article, making it more user-friendly than current law. Notable changes are listed below.

**Sec. 45.56.405. Broker-dealer registration requirement and exemptions** – includes a new exemption to facilitate ongoing broker-customer relationships with customers who have established a second or other residence and clarifies the number of transactions a broker-dealer may effect annually (3) if not registered in Alaska.

**Sec. 45.56.410. Limited registration of Canadian broker-dealers and agents** – changes annual renewal to December 31 from December 1 for easier state and firm processing.

**Sec. 45.56.420. Registration exemption for merger and acquisition broker** – this new provision exempts merger and acquisition brokers from registration (licensing) requirements because these transactions are typically between knowing parties with adequate legal counsel and scrutiny. The
exemption is not available if the broker actually handles the securities exchanged in the transaction, otherwise represents an issuer or public shell company, or is subject to an SEC action.

Sec. 45.56.430. Agent registration requirement and exemptions – the rewrite of this section includes a statement of the types of business covered here instead of in a definitional section.

Sec. 45.56.435. Investment adviser registration requirement and exemptions – includes a per client exemption similar to the broker-dealer exemption in Sec. 45.56.405.

Sec. 45.56.440. Investment adviser representative registration requirement and exemptions – these provisions mirror the broker-dealer agent requirements in Sec. 45.56.430.

Sec. 45.56.445. Federal covered investment adviser notice filing requirement – these provisions are not separately stated in the current law.

Sec. 45.56.450. Registration by broker-dealer, agent, investment adviser, and investment adviser representative – combines provisions in current statute and regulations and extends the automatic registration from 30 to 45 days unless the registration is denied.

Sec. 45.56.455. Succession and change in registration of broker-dealer or investment adviser – clarifies that an organizational change can generally be completed by amendment instead of a new registration (for instance a sole proprietorship moving to a limited liability company).

Sec. 45.56.460. Termination of employment or association of agent and investment adviser representative and transfer of employment or association – requires the registrant file a notification with the division. Allows for an immediate temporary effective registration with a new firm when there is no new disciplinary information added.

Sec. 45.56.465. Withdrawal of registration of broker-dealer, agent, investment adviser, and investment adviser representative – extends the effective date of registration withdrawal up to 60 days and allows a revocation proceeding to commence within one year.

Sec. 45.56.470. Filing fees – are established and may be paid through a designee by regulation.

Sec. 45.56.475. Post registration requirements – in addition to current requirements, adds the provision for continuing education by regulation.

Sec. 45.56.480. Protecting older and vulnerable adults from financial exploitation – adds a new provision adopting model legislation to protect vulnerable adults from financial exploitation that requires certain individuals to report financial exploitation of an older Alaskan or vulnerable adult to Adult Protective Services and the Administrator. Also allows a broker dealer or investment adviser to delay a financial disbursement if it may result in financial exploitation. Provides immunity for good faith reports and financial disbursement delays.

Sec. 45.56.485. Denial, revocation, suspension, withdrawal, restriction, condition, or limitation of registration – in addition to current provisions, allows the administrator to bar a
person or firm from registration including for actions taken by other regulators. Civil penalty for registrants is increased from $2,500-$10,000 per violation to up to $100,000 per violation.

**Article 5. Fraud and Liabilities. (pp. 70-72)**

**Sec. 45.56.505. General fraud** – same as current AS 45.55.010.

**Sec. 45.56.510. Prohibited conduct in providing investment advice** – allows administrator to define prohibited conduct by regulation.

**Sec. 45.56.520. Misleading filings** – same as current AS 45.55.160.

**Sec. 45.56.530. Misrepresentations concerning registration or exemption** – same content as AS 45.55.170.

**Sec. 45.56.540. Evidentiary burden** – similar content to current AS 45.55.900(c) and adds the citation to affirmative defense in criminal law.

**Sec. 45.56.550. Filing of sales and advertising literature** – same content as AS 45.55.150.

**Sec. 45.56.560. Qualified immunity** – registered persons are not liable to other registered persons, under state defamation laws, for statements contained in disclosure records required to be filed with the administrator for purposes of licensing and potential discipline.

**Article 6. Administration and Judicial Review. (pp. 72-93)**

**Sec. 45.56.605. Administration** – adds a new provision allowing the administrator to develop and implement investor education initiatives and accept grants or donations for investor education.

**Sec. 45.56.610. Administrative files and opinions** – requires the administrator keep records according to a retention schedule and outlines publicly disclosable documents.

**Sec. 45.56.615. Public records; confidentiality** – clarifies and specifies record confidentiality.

**Sec. 45.56.620. Uniformity and cooperation with other agencies** – expands opportunity for coordination with governmental units, regulatory organizations for collaborative efforts including regulation and enforcement to reduce the burden of raising capital by small business.

**Sec. 45.56.625. Securities investor education and training fund** – creates an investor education and training fund within the general fund. 33% of the money received from civil penalties may be used for investor education and training if appropriated by the legislature.

**Sec. 45.56.630. Service of process** – same as current AS 45.55.980.

**Sec. 45.56.635. Applicability of the chapter** – same as current AS 45.55.980.

**Sec. 45.56.640. Regulations, forms, orders, interpretative opinions, and hearings** – combines existing AS 45.55.950 and 45.55.970 and clarifies that GAAP compliant financial statements may only be required as allowed by federal law.
Sec. 45.56.645. Investigations and subpoenas – similar to existing AS 45.55.910 and allows broader cooperation with other regulators.

Sec. 45.56.650. Administrative enforcement – time period for a respondent to request a hearing after an action is taken is extended from 15 days to 30 days. Civil penalties are increased from $2,500 for a single violation and $25,000 for multiple violations to a maximum of $100,000 for a single violation with no cap for multiple violations. If a victim is an “older person” (a person over 60 years old) or a “vulnerable adult,” the respondent is subject to treble damages. Restitution and actual costs of investigation may be ordered. The administrator may deny the use of securities exemptions under Article 2 and registration (licensing) exemptions under Article 4 if a person violates the Act. The administrator may petition the Superior Court to enforce a final order and the Court may hold a person in contempt for violating an order of the administrator, punishable by up to $100,000 per violation, in addition to any administrative penalties that were originally assessed.

Sec. 45.56.655. Civil enforcement – the administrator may seek remedies such as asset freezes, an order of rescission, restitution, and civil penalties of up to $100,000 per violation, and all damages may be trebled if the victim is an “older person” (person over 60 years of age) or “vulnerable adult.”

Sec. 45.56.660. Civil liability – outlines instances where the seller is liable to the purchaser and potential remedies (actual damages including interest as determined by the court); also describes instances where the buyer may be liable to the seller.

Sec. 45.56.665. Rescission offers – outlines the rescission offer process, including a new requirement that the offeror must demonstrate the ability to pay and then actually pay as promised.

Sec. 45.56.670. Criminal enforcement – intentional violations of the Act and fraud are generally punishable as class C felonies punishable by imprisonment under AS 12.55.125, or a fine of up to $100,000, or both. Individuals who intentionally alter or destroy evidence are guilty of a class C felony and may be imprisoned as provided in AS 12.55.125, assessed a fine of not more the $500,000, or both.

Sec. 45.56.675. Judicial review – appellants have 30 days to request review of a final order.

Article 7. Miscellaneous and Additional General Provisions. (pp. 93-104)

Sec. 45.56.710. Reimbursement of expenses incident to examination or investigation – expands recovery of expenses from current AS 45.55.915 to cover all examination expenses including staff time, travel and per diem.

Sec. 45.56.720. Electronic records and signatures – facilitates filing of electronic records and signatures. Consumers must consent and have the option to withdraw such consent.

Sec. 45.56.730. References to federal statutes – a list of all federal statutes referenced in the Act.

Sec. 45.56.740. References to federal agencies – notes that a reference to an agency of the United States is also a reference to a successor agency.
Sec. 45.56.900. Definitions. Updates federal citations. New definitions include:
  - Disqualifier
  - Filing
  - Institutional investor (reflects federal law)
  - Insurance company
  - Insured
  - International Banking Institution
  - Offer to purchase
  - Older person – a person that is age 60 or older (from AS 47.65.290(6))
  - Price amendment
  - Record
  - Self-regulatory organization
  - Sign
  - Vulnerable adult (from AS 47.24.900(21))

Sec. 45.56.995. Short title. This chapter may be cited as the Alaska Securities Act.

SECTIONS 26 – 28 (pp. 104-109). Citations are modified to reflect Chapter 45.56 in place of Chapter 45.55 references; federal law citations are updated.

SECTION 29 (p. 109) – Repeals statutes that are no longer needed in AS 45.55 because they do not apply to Alaska Native Claims Settlement Act corporation proxy solicitations.

SECTION 30 (p. 109) – Amends indirect Court Rules relating to changes in AS 45.56.

SECTION 31 (p. 110) – Allows the department to adopt transition regulations.

SECTION 32 (p. 110) – Amends the law to effect transition and application of AS 45.55 for existing proceedings, existing rights and duties.

SECTION 33 (p. 110-111) – Reviser’s instruction to rename AS 45.55 to Alaska Native Claims Settlement Act Corporations Proxy Solicitations and Initial Issuance of Stock.

SECTION 34 (p. 111) – Conditional effect of certain provisions upon constitutionally required vote of each house.

SECTION 35-36 – January 1, 2018 effective date, except for section 31.
AN ACT

Establishing an exemption for the offering and sale of certain securities.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

THE ACT FOLLOWS ON PAGE 1
AN ACT

Establishing an exemption for the offering and sale of certain securities.

*Section 1.* AS 45.55 is amended by adding a new section to article 4 to read:

**Sec. 45.55.175. Exemption for certain security sales and offerings.** (a) An offer or sale of securities conducted solely in this state to a person who has established residency in this state by an issuer in a transaction that meets the requirements of this section is exempt from the requirements of AS 45.55.070 - 45.55.120 and 45.55.150 and is subject to the following limitations:

1. the issuer of the security shall be a for-profit corporation, another for-profit entity, or a business cooperative, have its principal place of business in this state, and be licensed by the department;

2. the transaction must meet the requirements of the federal exemption for intrastate offerings in 15 U.S.C. 77c(a)(11) (Securities Act of 1933) and 17 C.F.R. 230.147; the securities must be offered to and sold only to persons who have established residency in this state at the time of purchase; before any offer or sale
under this exemption, the seller shall obtain documentary evidence from each prospective purchaser that provides the seller with a reasonable basis to believe the investor has established residency in this state;

3 the sum of all cash and other consideration to be received for all sales of the security in reliance on this exemption may not exceed $1,000,000, less the aggregate amount received for all sales of securities by the issuer within the 12 months before the first offer or sale made in reliance on this exemption;

4 the issuer may not accept more than $10,000 from a single purchaser during a 12-month period unless the purchaser is an accredited investor as defined by 17 C.F.R. 230.501;

5 the issuer reasonably believes that all purchasers of securities are purchasing for investment and not for sale in connection with a distribution of the security;

6 a commission or remuneration may not be paid or given, directly or indirectly, for any person's participation in the offer or sale of securities for the issuer unless the person is registered as a broker-dealer, agent, investment adviser representative, or state investment adviser under AS 45.55.030 or 45.55.035;

7 the issuer of the security shall deposit in an escrow account in a bank or other depository institution authorized to do business in this state all funds received from investors until the minimum target dollar amount for the security offering is met; the issuer shall file the escrow agreement with the administrator, and the contents of the escrow agreement must include a statement that the proceeds of the sale under this section will not be released from the escrow account until the minimum target dollar amount for the security offering is met; all funds shall be used in accordance with representations made to investors;

8 not less than 10 days before the use of a general solicitation or within 15 days after the first sale of a security under this exemption if general solicitation has not been used before the sale, whichever occurs first, the issuer shall provide a notice to the administrator as prescribed in regulations for this section; the notice must specify that the issuer is conducting an offering in reliance on this exemption and must contain the names and addresses of
Chapter 3D—State Regulatory Update—Alaska

(A) the issuer;

(B) officers, directors, and any person who controls the issuer;

(C) all persons who will be involved in the offer or sale of securities on behalf of the issuer; and

(D) the bank or other depository institution in which investor funds will be deposited;

(9) the issuer may not be, either before or as a result of the offering,

(A) an investment company as defined by 15 U.S.C. 80a-1 - 80a-64 (Investment Company Act of 1940), or subject to the reporting requirements of 15 U.S.C. 78m or 78o (Securities Exchange Act of 1934); or

(B) a broker-dealer, agent, investment adviser representative, or state investment adviser subject to AS 45.55.030 or 45.55.035;

(10) the issuer shall inform all purchasers that the securities have not been registered under AS 45.55.070 - 45.55.120, are exempt from AS 45.55.150, and may not be resold unless the securities are registered or qualify for an exemption from registration under AS 45.55.900; in addition, the issuer shall make the disclosures required by 17 C.F.R. 230.147(f);

(11) the issuer shall require all purchasers to sign the following statement at the time of sale: "I acknowledge that I am investing in a high-risk, speculative business venture, that I may lose all of my investment, and that I can afford the loss of my investment";

(12) this exemption may not be used in conjunction with any other exemption under this chapter, except the exemption related to institutional investors under AS 45.55.030(c) and for offers and sales to persons who control the issuer; sales to persons who control the issuer do not count toward the limitation in (3) of this subsection;

(13) this exemption may not be construed to remove a person from the anti-fraud and other provisions under AS 45.55.010 - 45.55.028, and the exemption may not be construed to provide relief from another provision of this chapter other than as expressly stated.

(b) The administrator may by order deny or revoke the exemption specified in
this section with respect to a specific security if the administrator finds that the sale of
the security would work or tend to work a fraud on the purchasers of the security. An
order under this subsection may not operate retroactively. A person may not be
considered to have violated the order because of an offer or sale effected after the
entry of an order under this subsection if the person sustains the burden of proof that
the person did not know and, in the exercise of reasonable care, could not have known
of the order.

(c) The department shall assess a person who makes application to the
department for an exemption under this section a filing fee as prescribed in regulations
for this section.

(d) Exemption from registration under this section is not available for a
security or transaction if the issuer, or any of its officers, persons in control, or
promoters, is subject to a disqualifier described in the regulations adopted under 15
U.S.C. 78c(a)(39) (Dodd-Frank Wall Street Reform and Consumer Protection Act) as
of the date of the transaction or offer.

(e) In this section,

(1) "control" means having the power, directly or indirectly, to direct
the management or policies of the issuer, whether through ownership of securities, by
contract, or otherwise;

(2) "department" means the Department of Commerce, Community,
and Economic Development;

(3) "residency" has the meaning given in AS 01.10.055.

* Sec. 2. AS 45.55.900(b) is amended to read:

(b) The following transactions are exempted from AS 45.55.070 and
45.55.075:

(1) a transaction between the issuer or other person on whose behalf
the offering is made and an underwriter, or among underwriters;

(2) a transaction in a bond or other evidence of indebtedness secured
by a real or chattel mortgage or deed of trust, or by an agreement for the sale of real
estate or chattels, if the entire mortgage, deed of trust, or agreement, together with all
the bonds or other evidence of indebtedness, secured under those documents, is
offered and sold as a unit;

(3) a transaction by an executor, administrator, sheriff, marshal, receiver, trustee in bankruptcy, guardian, or conservator;

(4) an offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in 15 U.S.C. 80a-1 - 80a-64 (Investment Company Act of 1940), pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity;

(5) sales by an issuer

(A) to not more than 10 persons in this state other than those designated in (4) of this subsection during a period of 12 consecutive months, regardless of whether the seller or any of the buyers is then present in this state, if

(i) a commission or other remuneration is not paid or given directly or indirectly for soliciting a prospective buyer in this state;

(ii) a legend is placed on the certificate or other document evidencing ownership of the security, stating that the security is not registered under this chapter and cannot be resold without registration under this chapter or exemption from it; and

(iii) offers are made without public solicitation or advertisement;

(B) to not more than 25 persons in this state other than those designated in (4) of this subsection during a period of 12 consecutive months, regardless of whether the seller or any of the buyers is then present in this state, if

(i) the sales are made solely in this state;

(ii) before a sale, each prospective buyer is furnished information that is sufficient to make an informed investment decision, which information shall be furnished to the administrator upon request; in this sub-subparagraph, "information that is sufficient to make an
informed investment decision" includes a business plan, an income and expense statement, a balance sheet, a statement of risks, and a disclosure of any significant negative factors that may affect the outcome of the investment;

(iii) commissions or other remuneration meet the requirements of this chapter and are made only to persons registered under AS 45.55.040;

(iv) a legend is placed on the certificate or other document evidencing ownership of the security, stating that the security is not registered under this chapter and cannot be resold without registration under this chapter or exemption from it;

(v) the issuer obtains a signed agreement from the buyer acknowledging that the buyer is buying for investment purposes and that the securities will not be resold without registration under this chapter; and

(vi) offers are made without public solicitation or advertisement;

(C) to not more than 10 persons who are to receive the initial issue of shares of a nonpublicly traded corporation, limited liability company, limited partnership, or limited liability partnership if the requirements of (B)(ii) - (iv) and (vi) of this paragraph are met;

(D) to the buyer of an enterprise or a business and the assets and liabilities of the enterprise or business if

(i) the transfer of stock to the buyer is solely incidental to the sale of the enterprise or business and its assets and liabilities;

(ii) the seller provides full access to the buyer of the books and records of the enterprise or business; and

(iii) a legend is placed on the certificate or other document evidencing ownership of the security, stating that the security is not registered under this chapter and cannot be resold without registration under this chapter or exemption from it;
an offer or sale of a preorganization certificate or subscription if

(A) a commission or other remuneration is not paid or given
directly or indirectly for soliciting a prospective subscriber;

(B) the number of subscribers does not exceed 10; and

(C) a payment is not made by any subscriber;

(7) a transaction under an offer to existing security holders of the issuer, including persons who, at the time of the transaction, are holders of convertible securities, nontransferable warrants, or transferable warrants exercisable not later than 90 days after their issuance, if a commission or other remuneration, other than a standby commission, is not paid or given directly or indirectly for soliciting a security holder in this state;

(8) an offer, but not a sale, of a security for which registration statements have been filed under both this chapter and 15 U.S.C. 77a - 77bbbb (Securities Act of 1933) if a stop order or refusal order is not in effect and a public proceeding or examination looking toward an order is not pending under either this chapter or 15 U.S.C. 77a - 77bbbb (Securities Act of 1933);

(9) an isolated nonissuer transaction, regardless of whether effected through a broker-dealer, if the seller is not a promoter or controlling person as the administrator may define by regulation or order or if the administrator at the request of the seller waives the requirement that the seller not be a promoter or controlling person;

(10) a nonissuer transaction effected by or through a registered broker-dealer under an unsolicited order or offer to buy; however, the administrator may by regulation require that the customer acknowledge on a specified form that the sale was unsolicited, and that a signed copy of each form be preserved by the broker-dealer for a specified period;

(11) a transaction executed by a bona fide pledgee without intending to evade this chapter;

(12) a transaction incident to a right of conversion or a statutory or judicially approved reclassification, recapitalization, reorganization, quasi-reorganization, stock split, reverse stock split, merger, consolidation, or sale of assets;
(13) a stock dividend, regardless of whether the corporation distributing the dividend is the issuer of the stock, if nothing of value is given by stockholders for the dividend other than the surrender of a right to a cash or property dividend when each stockholder may elect to take the dividend in cash or property or in stock;

(14) an act incident to a statutory vote by security holders on a merger, consolidation, reclassification of securities, or sale of assets in consideration of the issuance of securities of another issuer;

(15) the offer or sale by a registered broker-dealer, acting either as principal or agent, of securities previously sold and distributed to the public if the securities

(A) are sold at prices reasonably related to the current market price at the time of sale, and, if the broker-dealer is acting as agent, the commission collected by the broker-dealer on account of the sale is not in excess of usual and customary commissions collected with respect to securities and transactions having comparable characteristics;

(B) do not constitute the whole or a part of an unsold allotment to or subscription or participation by the broker-dealer as an underwriter of the securities or as a participant in the distribution of the securities by the issuer, by an underwriter, or by a person or group of persons in substantial control of the issuer or of the outstanding securities of the class being distributed; and

(C) have been lawfully sold and distributed in this state under this chapter;

(16) offers or sales of certificates of interest or participation in oil, gas, or mining rights, titles, or leases, or in payments out of production under those rights, titles, or leases, if the purchasers

(A) are or have been during the preceding two years engaged primarily in the business of exploring for, mining, producing, or refining oil, gas, or minerals; or

(B) have been found by the administrator upon written application to be substantially engaged in the business of exploring for,
mining, producing, or refining oil, gas, or minerals so as not to require the protection provided by AS 45.55.070;

(17) a nonissuer transaction by a registered agent of a registered broker-dealer, and a resale transaction by a sponsor of a unit investment trust registered under 15 U.S.C. 80a-1 - 80a-64 (Investment Company Act of 1940), in a security of a class that has been outstanding in the hands of the public for at least 90 days if, at the time of the transaction,

(A) the issuer of the security is actually engaged in business and not in the organization stage or in bankruptcy or receivership and is not a blank check, blind pool, or shell company whose primary plan of business is to engage in a merger or combination of the business with, or an acquisition of, an unidentified person or persons;

(B) the security is sold at a price reasonably related to the current market price of the security;

(C) the security does not constitute the whole or part of an unsold allotment to, or a subscription or participation by, the broker-dealer as an underwriter of the security;

(D) a nationally recognized securities manual, which may be designated by rule or order of the administrator, or a document filed with the United States Securities and Exchange Commission that is publicly available through the United States Securities and Exchange Commission's electronic data gathering and retrieval system, contains

(i) a description of the business and operations of the issuer;

(ii) the names of the issuer's officers and directors, if any, or, in the case of an issuer not domiciled in the United States, the corporate equivalents of the issuer's officers and directors in the issuer's country of domicile;

(iii) an audited balance sheet of the issuer dated not earlier than 18 months before the transaction or, in the case of a reorganization or merger in which parties to the reorganization or
merger had that audited balance sheet, a pro forma balance sheet; and

(iv) an audited income statement for each of the issuer's
immediately preceding two fiscal years or for the period of existence of
the issuer if the issuer has been in existence for less than two years or,
in the case of a reorganization or merger where the parties to the
reorganization or merger had that audited income statement, a pro
forma income statement; and

(E) the issuer of the security has a class of equity securities
listed on a national securities exchange registered under 15 U.S.C. 78a - 78lll
(Securities Exchange Act of 1934) or designated for trading on the National
Association of Securities Dealers Automated Quotation System, unless the
issuer of the security

(i) is a unit investment trust registered under 15 U.S.C.
80a-1 - 80a-64 (Investment Company Act of 1940);
(ii) including predecessors, has been engaged in
continuous business for at least three years; or
(iii) has total assets of at least $2,000,000 based on an
audited balance sheet dated not earlier than 18 months before the
transaction or, in the case of a reorganization or merger in which the
parties to the reorganization or merger had that balance sheet, a pro
forma balance sheet;

(18) an offer or a sale of a security by an issuer that has a specific
business plan or purpose, is not in the development stage, and has not indicated that its
business plan is to engage in a merger or acquisition with an unidentified company or
other entity or person, under the following conditions:

(A) sales of securities are made only to persons who are or the
issuer reasonably believes are accredited investors as defined in 17 C.F.R.
230.501(a), as that regulation exists on or after October 1, 2013;
(B) the issuer reasonably believes that all purchasers are
purchasing for investment and not with the view to or for sale in connection
with a distribution of the security; a resale of a security sold in reliance on this
exemption is presumed to be with a view to distribution and not for investment if the resale occurs not later than 12 months after sale, except a resale under a registration statement under AS 45.55.070 - 45.55.120 or to an accredited investor under an exemption available under this chapter;

(C) the exemption in this paragraph is not available to an issuer if the issuer, a predecessor of the issuer, an affiliated issuer, a director, an officer, or a general partner of the issuer, a beneficial owner of 10 percent or more of a class of the issuer's equity securities, a promoter of the issuer presently connected with the issuer in any capacity, an underwriter of the securities to be offered, or a partner, a director, or an officer of the underwriter

(i) within the last five years has filed a registration statement that is the subject of a currently effective registration stop order entered by a state securities administrator or the United States Securities and Exchange Commission;

(ii) within the last five years has been convicted of a criminal offense in connection with the offer, purchase, or sale of a security, of a criminal offense involving fraud or deceit, or of a felony;

(iii) is currently subject to a state or federal administrative enforcement order or judgment entered in the past five years finding fraud or deceit in connection with the purchase or sale of a security; or

(iv) is currently subject to an order, judgment, or decree of a court of competent jurisdiction entered in the past five years, temporarily, preliminarily, or permanently restraining or enjoining the person from engaging in or continuing to engage in conduct or a practice involving fraud or deceit in connection with the purchase or sale of a security;

(D) the nonavailability of the exemption under (C) of this paragraph does not apply if

(i) the person subject to the disqualification is licensed or registered to conduct securities related business in the state in which
the order, judgment, or decree creating the disqualification was entered against the person;

(ii) before the first offer under this exemption, the state securities administrator or the court or regulatory authority that entered the order, judgment, or decree waives the disqualification; or

(iii) the issuer establishes that it did not know and, in the exercise of reasonable care, based on a factual inquiry, could not have known that a disqualification existed under this paragraph;

(E) a general announcement of the proposed offering may be made by any means and may include only the following information unless the administrator specifically permits additional information:

(i) the name, address, and telephone number of the issuer of the security;

(ii) the name, a brief description, and the price, if known, of the security to be issued;

(iii) a brief description in 25 words or less of the business of the issuer;

(iv) the type, number, and aggregate amount of securities being offered;

(v) the name, address, and telephone number of the person to contact for additional information;

(vi) a statement that sales will be made only to accredited investors;

(vii) a statement that money or other consideration is not being solicited or will not be accepted by way of this general announcement; and

(viii) a statement that the securities have not been registered with or approved by a state securities agency or the United States Securities and Exchange Commission and are being offered and sold under an exemption from registration;

(F) the issuer in connection with any offer may provide
information in addition to the general announcement under (E) of this paragraph if the information is delivered

(i) through an electronic database that is restricted to persons who have been prequalified as accredited investors; or

(ii) to a prospective purchaser that the issuer reasonably believes is an accredited investor;

(G) a telephone solicitation is not permitted unless, before placing the call, the issuer reasonably believes that the prospective purchaser being solicited is an accredited investor;

(H) dissemination of the general announcement of the proposed offering to persons who are not accredited investors does not disqualify the issuer from claiming this exemption;

(I) the issuer shall file a notice of the transaction with the administrator, a copy of the general announcement, and the fee for exemption filings established by regulation within 15 days after the first sale in this state;

(19) an offer to repay, under AS 45.55.930, the buyer of a security if the offeror first files with the administrator a notice specifying the terms of the offer at least 10 days before the offer is made;

(20) a transaction involving only family members who are related, including related by adoption, within the fourth degree of affinity or consanguinity, or involving only those family members and the corporations, partnerships, limited liability companies, limited partnerships, limited liability partnerships, associations, joint-stock companies, or trusts that are organized, formed, or created by those family members or at the direction of those family members;

(21) a security that is not part of an initial issue of stock covered by AS 45.55.138, but that is issued by a corporation organized under state law in accordance with 43 U.S.C. 1601 et seq. (Alaska Native Claims Settlement Act), if the corporation qualifies for exempt status under 43 U.S.C. 1625(a);

(22) a transaction exempt under AS 45.55.175.
Title 3. Commerce, Community, and Economic Development.


Chapter 08. Securities.

Article

1. Registration, Notice, and Regulation of Broker-Dealers, Agents, State Investment Advisers, and Federal Covered Advisers, and Investment Adviser Representatives (3 AAC 08.005 – 3 AAC 08.075)

2. Registration and Notice of Securities (3 AAC 08.080 – 3 AAC 08.230)

3. Alaska Native Claims Act Corporations: Solicitation of Proxies (3 AAC 08.300 – 3 AAC 08.365)

4. “Regulation D” Registration and Notice Procedure (3 AAC 08.500 – 3 AAC 08.540)

5. Small Corporate Offering Registration SCOR Procedure (3 AAC 08.600 – 3 AAC 08.650)

6. Viatical Settlement Interests (3 AAC 08.700 – 3 AAC 08.740)

7. [GENERAL PROVISIONS (3 AAC 08.900 – 3 AAC 08.950)] Small Intrastate Securities Offerings (3 AAC 08.810 – 3 AAC 08.895)

8. General Provisions (3 AAC 08.900 – 3 AAC 08.950)

3 AAC 08 is amended by adding a new section to read:

3 AAC 08.086. Notice filing requirement for federal crowdfunding offerings. (a) An issuer that offers and sells securities in this state in an offering exempt under 15 U.S.C. 77r(b)(4) (sec. 18(b)(4) of the Securities Act of 1933) and 17 C.F.R. Part 227 (Regulation Crowdfunding)
and that has its principal place of business in this state or sells 50 percent or greater of the aggregate amount of the offering to residents of this state shall file with the administrator

(1) a completed NASAA Uniform Notice of Federal Crowdfunding Offering form; and

(2) the filing fee required by 3 AAC 08.920(a)(13).

(b) If the issuer has its principal place of business in this state, the filing required under (a) of this section shall be filed with the administrator when the issuer makes its initial Form C filing concerning the offering with the SEC. If the issuer does not have its principal place of business in this state but state residents have purchased 50 percent or greater of the aggregate amount of the offering, the filing required under (a) of this section shall be filed when the issuer becomes aware that those purchases have met this threshold and in no event later than 15 days from the date of completion of the offering.

(c) The initial notice is effective for one year following the effective date of the filing.

(d) For each additional one-year period in which the same offering is continued, an issuer conducting an offering under 17 C.F.R. Part 227 (Regulation Crowdfunding) may renew its notice filing by filing, on or before the expiration of the notice filing,

(1) a completed NASAA Uniform Notice of Federal Crowdfunding Offering form marked “renewal”; and

(2) the filing fee required by 3 AAC 08.920(a)(13). (Eff. ____/___/____, Register ____)

Authority:  AS 45.55.950
The introductory language of 3 AAC 08.506(a) is amended to read:

(a) An issuer offering a federal covered security in a transaction that is not a public offering for the purposes of 15 U.S.C. 77d(2) and 15 U.S.C. 77r(b)(4)(D) (secs. 4(a)(2) and 18(b)(4)(D) of the Securities Act of 1933) shall file with the administrator through the EFD system no later than 15 days after the first sale of that federal covered security in this state . . .

3 AAC 08.506(b) is amended to read:

(b) A notice filing under this section is effective

(1) only if the administrator receives through the EFD system each item required by (a) of this section; and

(2) on the date that the administrator receives through the EFD system the last of the items required by (a) of this section.

3 AAC 08.506(c) is amended to read:

(c) After receipt of the items required (a) of this section, the administrator will issue through the EFD system a certificate of notice as of the date of receipt of those items. Sales may occur before the effective date of the notice filing under this section.

3 AAC 08.506(d) is amended to read:

(d) A notice filing under this section is valid for one year from the effective date established under (b) of this section. To renew a notice, the issuer must submit the items required
by (a) of this section to the administrator through the EFD system, as if the issuer were making an initial filing. The administrator will not accept a renewal earlier than 60 days before the expiration date of the filing.

(Eff. 5/24/84, Register 90; am 4/19/2000, Register 154; am 1/17/2016, Register 217; am ___/___/____, Register ____)

Authority: AS 45.55.075  AS 45.55.950

3 AAC 08.520(a)(l) is amended to read:

(1) an advertisement, article, notice, or other communication published in a newspaper, magazine, or similar medium, [OR] broadcast over television or radio, or available on an unrestricted, publicly accessible website; and

(Eff. 4/19/2000, Register 154; am ___/___/____, Register ____)

Authority: AS 45.55.110  AS 45.55.950

3 AAC 08 is amended by adding new sections to read:

Article 7. Small Intrastate Securities Offerings.

Section

810. Notice filing requirements

820. Required disclosures

830. Escrow agreement

840. Advertising and solicitation

850. Evidence of residency
860. Recordkeeping requirements

870. Website operated by issuer

880. Website operated by third party

895. Definitions relating to small intrastate securities offerings

3 AAC 08.810. Notice filing requirements. (a) In an offering conducted in reliance upon the crowdinvesting exemption in AS 45.55.175, the issuer shall file with the administrator, not later than 10 days before the use of a general solicitation or not later than 15 days after the first sale of a security,

(1) a completed notice filing form as prescribed by the administrator;

(2) the nonrefundable notice filing fee required by 3 AAC 08.920(a)(12);

(3) a copy of all advertising and other materials directed to or to be supplied to prospective purchasers in the offering;

(4) a copy of the offering document and disclosures to be provided to prospective purchasers;

(5) a copy of the escrow agreement between the issuer and an escrow agent in which the offering proceeds will be deposited; and

(6) a copy of any agreement between the issuer and a third-party website operator, if applicable.

(b) A notice filing under this section is effective for one year from the date the administrator receives all the items required by (a) of this section. To renew a notice in which the same offering is continued, the issuer shall submit the items required by (a) of this section, as if
the issuer were making an initial filing.

(c) An issuer who has filed a notice filing under this section shall update any material change on the notice filing form and file it with the administrator not later than 30 days from the date of the change.

(d) To claim an exemption under AS 45.55.175, an issuer must have an active business license issued under AS 43.70. (Eff. ___/___/____, Register ____)

Authority: AS 45.55.175, AS 45.55.950

3 AAC 08.820. Required disclosures. (a) Before any offer or sale of a security under AS 45.55.175, the issuer shall contemporaneously provide to each prospective purchaser the following disclosures:

(1) the name and physical address of the issuer, officers, directors, and controlling persons;

(2) a description of the experience and qualifications of the issuer, officers, directors, and controlling persons;

(3) a description of the business, including how long it has been in operation and the specific reason for the offering;

(4) a discussion in plain language of the significant factors material to the offering, including those that make the offering speculative or risky;

(5) the total offering amount and how the issuer expects to use the proceeds of the offering, including compensation and expenses related to the offering;
(6) the minimum target offering amount the issuer is seeking to raise through the offering and the deadline to raise the minimum target offering amount;

(7) the terms and conditions of the securities being offered, the total amount of securities that are outstanding before the offering, and the total amount of securities being offered or sold in reliance on the exemption in AS 45.55.175; and

(8) a description of any litigation or legal proceedings within the past five years, if any, involving the issuer or any persons associated with the issuer.

(b) The issuer shall inform all investors that the securities exempted under 3 AAC 08.810 - 3 AAC 08.895 are not registered with the state, that they are subject to a limitation on resale and investors may not be able to sell their securities promptly or may only be able to sell them at a substantial discount from the offering price. On the cover page of the offering document, the disclosure must contain in all capital letters in 12 point font or larger the following language:

"THESE SECURITIES ARE BEING SOLD IN RELIANCE ON AN EXEMPTION TO THE FEDERAL SECURITIES REGISTRATION REQUIREMENTS UNDER SECTION 3(a)(11) OF THE SECURITIES ACT OF 1933 AND UNDER AS 45.55.175 OF THE ALASKA SECURITIES ACT. THESE SECURITIES CAN ONLY BE SOLD TO RESIDENTS OF ALASKA AND ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE. INVESTORS SHOULD BE AWARE THAT THEY WILL BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THIS INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.

IN MAKING AN INVESTMENT DECISION, INVESTORS SHOULD RELY ON THEIR OWN EXAMINATION OF THE ISSUER AND THE TERMS REVEALED IN THESE OFFERING DOCUMENTS, INCLUDING THE MERITS AND RISKS INVOLVED.

THESE SECURITIES HAVE NOT BEEN RECOMMENDED BY ANY FEDERAL OR STATE AUTHORITY OR REGULATORY COMMISSION NOR HAVE THEY CONFIRMED THE ACCURACY OR DETERMINED THE ADEQUACY OF THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL
(c) At the time of sale the issuer shall require all investors to sign the following acknowledgement: “I acknowledge that I am investing in a high-risk, speculative business venture, that I may lose all of my investment, and that I can afford the loss of my investment.”

(Eff. ___/___/____, Register ____)

Authority: AS 45.55.175 AS 45.55.950

3 AAC 08.830. Escrow agreement. (a) An issuer conducting an offering under AS 45.55.175 shall enter into an escrow agreement with an escrow agent located in this state that includes the following terms:

(1) all offering proceeds shall be maintained in an account controlled by the escrow agent;

(2) all offering proceeds will be released to the issuer only when the aggregate capital raised from all investors is equal to or greater than the minimum target offering amount; and

(3) if the issuer does not raise the minimum target offering amount by the offering deadline, the escrow agent shall release and return all proceeds directly to investors.

(b) The escrow agent may not be affiliated with the issuer, any third-party website operator assisting with the offering, or any officers, directors, controlling persons, or affiliates of the issuer or of any third-party website operator assisting with the offering. (Eff. ___/___/____, Register ____)

Authority: AS 45.55.175 AS 45.55.950
3 AAC 08.840. Advertising and solicitation. (a) An issuer may engage in public advertising or general solicitation of securities in an offering relying on the exemption in AS 45.55.175 if

(1) the issuer files a copy of the advertising or solicitation materials with the administrator at least 10 days before the use of those materials;

(2) the advertisement or solicitation is directed only to residents of this state; and

(3) before advertising or solicitation materials are viewed, each person viewing the materials affirmatively certifies that they are a resident of this state.

(b) Advertising or solicitation materials may contain only the following information:

(1) the name and contact information of the issuer;

(2) a brief description of the general type of business of the issuer;

(3) the type of security offered;

(4) the minimum target offering amount and total offering amount;

(5) a description of how the issuer will use the funds;

(6) the deadline for raising funds through the offering;

(7) the issuer’s logo; and

(8) a link to the issuer’s website in which the securities are offered or sold or to a third-party website in which the securities are advertised.

(c) The advertisement, including any advertisement through a website, must clearly state that the advertisement does not constitute an offer to sell a security and must include contact or
other relevant information notifying an interested person how the person can obtain the required disclosure information.

(d) Advertising to the general public without regard to residency, or advertising information outside the scope of this section is prohibited. (Eff. ___/___/____, Register ____)

Authority: AS 45.55.175 AS 45.55.950

3 AAC 08.850. Evidence of residency. (a) At or before the time an issuer accepts any funds or an irrevocable commitment to invest by a person in an offering conducted in reliance on the exemption in AS 45.55.175, the issuer shall obtain evidence that the person is a resident of this state.

(b) For purposes of (a) of this section, the following is a nonexclusive list of evidence that the person is a resident of this state, unless the issuer has knowledge that the person is not a resident of this state:

(1) a copy of a valid driver’s license or official personal identification card issued by this state;

(2) a copy of a current voter registration issued by this state; or

(3) a copy of property tax records showing the person owns and occupies property in this state as the person’s principal residence. (Eff. ___/___/____, Register ____)

Authority: AS 45.55.175 AS 45.55.950

3 AAC 08.860. Recordkeeping requirements. (a) An issuer that has filed or is required to file under the exemption in AS 45.55.175 shall keep and maintain written or electronic records
relating to offers and sales of securities made in reliance on the exemption for at least five years following the termination of the offering. These records must include

1. the issuer’s filings with the administrator required by 3 AAC 08.810 and 3 AAC 08.840, together with any amendments;
2. evidence of state residency consistent with 3 AAC 08.850 from each investor in the offering;
3. a manually or electronically signed copy of the investor acknowledgement required by 3 AAC 08.820(c) for each investor in the offering; and
4. all other correspondence or other communications with prospective purchasers and investors.

(b) Records under (a) of this section are subject to reasonable periodic, special, or other examination by the administrator, as the administrator considers necessary or appropriate in the public interest or for the protection of investors. An audit or examination may be made at any time and without prior notice and the administrator may charge a fee associated with the examination as described in 3 AAC 08.015(b). (Eff. __/__/____, Register ____)  

Authority:  AS 45.55.175  AS 45.55.915  AS 45.55.950  AS 45.55.910

3 AAC 08.870. Website operated by issuer. (a) An issuer relying on the exemption in AS 45.55.175 may use a website operated by the issuer to advertise, offer, and sell securities if the issuer
(1) segregates all advertising materials and information relating to the offer and sale of securities on a webpage that is not accessible by the general public;

(2) provides a disclaimer on its website explaining that access to securities offerings on the website is limited to residents of this state only and that offers and sales of securities are limited to residents of this state only;

(3) requires an affirmative representation by a visitor to the website that the visitor is a state resident before the visitor can view securities-related offering materials on the website; and

(4) supplies the administrator with the address of each webpage where the offering material is located on the notice form required by 3 AAC 08.810(a)(1) and provides the administrator with full access to each webpage at all times.

(b) An issuer using its own website to advertise, offer, and sell securities is not required to comply with 3 AAC 08.880. (Eff. ____/____/____, Register ____)

Authority:  AS 45.55.175  AS 45.55.950

3 AAC 08.880. Website operated by third party. (a) An issuer relying on the exemption in AS 45.55.175 may use a website operated by a third party to advertise securities. A third-party website shall

(1) be operated by an entity that

(A) has its principal place of business in this state;

(B) is incorporated or organized in this state; and

(C) has an active business license issued under AS 43.70;
(2) provide a disclaimer on its website explaining that access to securities offerings on the third-party website is limited to residents of this state only and that offers and sales of securities are limited to residents of this state only;

(3) require an affirmative representation by a visitor to the third-party website that the visitor is a state resident before the visitor can view securities-related advertising materials on the third-party website;

(4) maintain and preserve the following records for a period of five years from the date of the document or communication:

(A) records of any compensation received for acting as a third-party website, including the name of the payor, the date of the payment, and the name of the issuer;

(B) any agreement or contract between the third-party website and an issuer;

(C) any correspondence or other communications with issuers; and

(D) ledgers or other records that reflect all assets and liabilities, income and expense, and capital accounts;

(5) file with the administrator a notice form as prescribed by the administrator and pay the filing fee required by 3 AAC 08.920(a)(14); and

(6) update any material change on the third-party website notice form and file it with the administrator not later than 30 days from the date of the change.

(b) A third-party website may not
(1) solicit, sell, or effect transactions in securities unless it is a registered broker-dealer under AS 45.55.030 or a funding portal as defined by 17 C.F.R. 227.300(c)(2), as revised as of May 16, 2016 and adopted by reference;

(2) offer investment advice or recommendations;

(3) compensate employees, agents, or other persons for the solicitation of securities or based on the sale of securities displayed or referenced on the third-party website;

(4) hold, manage, possess, or otherwise handle investor funds or securities;

(5) be affiliated with or under common control with an issuer whose securities appear on the third-party website;

(6) hold a financial interest in an issuer as compensation for services provided to or on behalf of an issuer; or

(7) employ a director, officer, controlling person, or any affiliated person having management authority over the third-party website who has been the subject of any disqualifier described in the regulations adopted under 15 U.S.C. 78c(a)(39).

(c) Records of a third-party website under this section are subject to reasonable periodic, special, or other examination by the administrator, as the administrator considers necessary or appropriate in the public interest or for the protection of investors. An audit or examination may be made at any time and without prior notice and the administrator may charge a fee associated with the examination as described in 3 AAC 08.015(b).

(d) A third-party website notice filing under this section expires on December 31 of each year and must be renewed by filing an updated notice form and the annual fee with the
Register ____, _____ 2017 COMMERCE, COMMUNITY, AND EC. DEV.

administrator in order to continue operating as a third-party website. (Eff. / / , Register ____)

Authority: AS 45.55.175 AS 45.55.915 AS 45.55.950

AS 45.55.910

3 AAC 08.895. Definitions relating to small intrastate securities offerings. In 3 AAC 08.810 - 3 AAC 08.895,

(1) “general solicitation” includes

(A) an advertisement, article, notice, or other communication published in

a newspaper, magazine, or similar medium broadcast over television or radio, or

available on an unrestricted, publicly available website; and

(B) a seminar or meeting to which attendees are invited by general

solicitation or general advertising;

(2) “third-party website” means a website operated by anyone other than the

issuer to advertise securities offered under AS 45.55.175. (Eff. / / , Register ____)

Authority: AS 45.55.175 AS 45.55.910 AS 45.55.950

3 AAC 08.910(1)(A) is repealed and readopted to read:

(1) manual exemptions

(A) for the purpose of the “manual exemption” under

AS 45.55.900(b)(l7), the following publications that contain information prescribed at

AS 45.55.900(b)(l7) are “nationwide recognized securities manuals”:

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(i) Mergent’s *Industrial Manual*;

(ii) Mergent’s *Bank and Finance Manual*;

(iii) Mergent’s *Public Utility Manual*;

(iv) Mergent’s *Municipal and Governmental Manual*;

(v) Mergent’s *Transportation Manual*;

(vi) Mergent’s *OTC Industrial Manual*;

(vii) Mergent’s *OTC Unlisted Manual*;

(viii) Mergent’s *International Manual*;

(ix) OTC Market Group’s *OTCQX Market*;

(x) OTC Market Group’s *OTCQB Market*;

(Eff. 2/20/72, Register 41; am 3/24/76, Register 57; am 2/9/78, Register 65; am 11/18/90, Register 116; am 9/8/91, Register 119; am 10/1/99, Register 151; am 6/8/2001, Register 158; am 3/4/2015, Register 213; am ___/___/____, Register ____)

**Authority:**  AS 45.55.900     AS 45.55.950

3 AAC 08.920(a)(6) is amended to read:

(6) a person filing or required to file a notice under AS 45.55.900, except under AS 45.55.900 (b)(19) **or (22)**, shall pay a nonrefundable fee of $50;

3 AAC 08.920(a) is amended by adding new paragraphs to read:

(12) a person filing a notice under AS 45.55.175 shall pay a nonrefundable fee of $150;
(13) a person filing a notice under 3 AAC 08.086 shall pay a nonrefundable fee of $50;

(14) a person filing a notice under 3 AAC 08.880 shall pay a nonrefundable fee of $50.

(Eff. 2/20/72, Register 41; am 10/1/99, Register 151; am 4/19/2000, Register 154; am 4/20/2000, Register 154; am 1/4/2013, Register 205; am 3/4/2015, Register 213; am 1/17/2016, Register 216; am 3/20/2016, Register 217; am ___/___/____, Register ____)

Authority: AS 45.55.110  AS 45.55.175  AS 45.55.980

AS 45.55.139  AS 45.55.950

3 AAC 08.950 is amended by adding a new paragraph to read:

(76) “EFD system” means the Electronic Filing Depository system provided by the North American Securities Administrators Association. (Eff. 2/20/72, Register 41; am 10/1/99, Register 151; am 4/19/2000, Register 154; am 4/20/2000, Register 154; am 12/7/2006, Register 180; am 3/4/2015, Register 213; am 1/17/2016, Register 217; am ___/___/____, Register ____)

Authority: AS 45.55.950  AS 45.55.990
Chapter 3E

State Regulatory Update—Oregon

DAVID TATMAN
Chief of Enforcement
Oregon Division of Financial Regulation
Salem, Oregon

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SUMMARY

The following summary is not prepared by the sponsors of the measure and is not a part of the body thereof subject to consideration by the Legislative Assembly. It is an editor’s brief statement of the essential features of the measure.

Requires certain securities professionals to report suspected financial exploitation of vulnerable persons to Department of Consumer and Business Services.

Punishes failure to report by maximum of $2,000 fine.

Permits certain securities professionals to report suspected financial exploitation to certain third parties.

Permits broker-dealers and state investment advisers to delay disbursements in order to investigate suspected financial exploitation.

A BILL FOR AN ACT

Relating to reporting of suspected financial abuse; creating new provisions; and amending ORS

59.991.

Be It Enacted by the People of the State of Oregon:

SECTION 1. Sections 2 to 7 of this 2017 Act are added to and made a part of ORS 59.005 to 59.451.

SECTION 2. As used in sections 2 to 7 of this 2017 Act:

(1)(a) “Financial exploitation” means:

(A) Wrongfully taking assets, funds or property belonging to or intended for the use of another person;

(B) Alarming another person by conveying a threat to wrongfully take or appropriate money or property of the person if the person would reasonably believe that the threat conveyed would be carried out;

(C) Misappropriating, misusing or transferring without authorization any money from any account held jointly or singly by another person; or

(D) Failing to use the income or assets of another person effectively for the support and maintenance of the person.

(b) “Financial exploitation” does not include a transfer of money or property that is made for the purpose of qualifying a person for Medicaid benefits or for any other state or federal assistance program, or the holding and exercise of control over money or property after such a transfer.

(2) “Financial institution” has the meaning given that term in ORS 706.008.

(3) “Qualified individual” means an individual who is:

(a) A salesperson;

NOTE: Matter in boldfaced type in an amended section is new; matter [italic and bracketed] is existing law to be omitted. New sections are in boldfaced type.
(b) An investment adviser representative; or

c) A person who serves in a supervisory, compliance or legal capacity for a broker-dealer
or state investment adviser, or who is otherwise identified in the written supervisory pro-
cedures of a broker-dealer or state investment adviser.

(4) “Trust company” has the meaning given that term in ORS 706.008.

(5) “Vulnerable person” has the meaning given that term in ORS 124.100.

SECTION 3. (1) Except as provided in subsection (4) of this section, a qualified individual
who has reasonable cause to believe that financial exploitation of a vulnerable person with
whom the qualified individual comes into contact has occurred, has been attempted or is
being attempted shall, as soon as is practicable, notify the Department of Consumer and
Business Services, either orally or in writing.

(2) A notification made under subsection (1) of this section must include the following
information, if known:

(a) The identity and address of the vulnerable person;

(b) The identity of all persons that the qualified individual believes are responsible for the
suspected or attempted financial exploitation; and

(c) The nature and extent of the suspected or attempted financial exploitation.

(3) Upon receipt of a notification under subsection (1) of this section, the department
shall:

(a) Immediately forward the notification to the Department of Human Services;

(b) If it reasonably appears that a violation of the Oregon Securities Law or rules adopted
thereunder has occurred or is occurring, promptly investigate the suspected or attempted
financial exploitation; and

(c) If it reasonably appears that a crime has been committed or attempted, promptly
notify a law enforcement agency.

(4) Subsection (1) of this section does not apply to a qualified individual who is employed
by a financial institution or trust company.

SECTION 4. (1) If a qualified individual has reasonable cause to believe that financial
exploitation of a vulnerable person with whom the qualified individual comes into contact has
occurred, has been attempted or is being attempted, the qualified individual may notify any
third party who was previously designated by the vulnerable person to receive information
from the qualified individual regarding the vulnerable person, or whom the qualified individ-
ual is otherwise permitted to notify under state or federal law or customer agreement.

(2) Disclosure may not be made under this section to any third party that is suspected
of actual or attempted financial exploitation or other abuse of the vulnerable person.

SECTION 5. (1) A broker-dealer or state investment adviser may delay a disbursement
from an account of a vulnerable person or an account on which a vulnerable person is a
beneficiary if:

(a) The broker-dealer, the state investment adviser or a qualified individual reasonably
believes that the requested disbursement might result in financial exploitation of a vulner-
able person; and

(b) The broker-dealer or state investment adviser:

(A) Within two business days of the request for disbursement, provides written notifica-
tion of the delay and the reason for the delay to all parties authorized to transact business
on the account, except to any party that is suspected to have engaged in actual or attempted
financial exploitation of the vulnerable person;

(B) Within two business days of the request for disbursement, notifies the Department of Consumer and Business Services and the Department of Human Services of the delay and the reason for the delay; and

(C) Conducts an internal review of the suspected financial exploitation and reports the results of the review to the Department of Consumer and Business Services and the Department of Human Services.

(2) A delay of a disbursement under this section may not extend beyond the earlier of:

(a) Fifteen business days after the date on which the broker-dealer or state investment adviser first delayed disbursement of the funds; or

(b) The date on which a determination is made by the broker-dealer or state investment adviser that the disbursement will not result in financial exploitation of the vulnerable person.

(3) Notwithstanding subsection (2) of this section, upon request of the Department of Consumer and Business Services, a delay of a disbursement under this section may extend beyond 15 business days after the date on which the broker-dealer or state investment adviser first delayed disbursement of the funds, but not beyond the earliest of:

(a) Twenty-five business days after the date on which the broker-dealer or state investment adviser first delayed disbursement of the funds;

(b) The date on which an order terminating the delay is entered by a court of competent jurisdiction; or

(c) The date on which the department issues an order terminating the delay.

(4) The department or a broker-dealer or state investment adviser that initiated a delay of a disbursement under this section may petition a court of competent jurisdiction for an order delaying or enjoining a disbursement of funds or for other protective relief on the grounds that financial exploitation of a vulnerable person is otherwise likely to occur.

SECTION 6. Qualified individuals, broker-dealers and state investment advisers are not liable under state law for the following actions, if performed in good faith, with reasonable cause and with the exercise of reasonable care:

(1) Disclosing information under section 3, 4 or 7 of this 2017 Act;

(2) Failing to notify a vulnerable person of a disclosure of information under section 3, 4 or 7 of this 2017 Act; or

(3) Delaying a disbursement under section 5 of this 2017 Act.

SECTION 7. (1) Upon request of the Department of Consumer and Business Services, the Department of Human Services or a law enforcement agency, a broker-dealer or state investment adviser shall provide copies of records related to any suspected financial exploitation of a vulnerable person to the requester. The records may include historical records if relevant to suspected financial exploitation of a vulnerable person.

(2) A record made available to an agency under this section is not a public record for purposes of ORS 192.410 to 192.505.

(3) Nothing in this section limits the authority of the Department of Consumer and Business Services to access or examine the books and records of broker-dealers and state investment advisers as otherwise provided by law.

SECTION 8. ORS 59.991 is amended to read:

59.991. (1) Except as provided in [subsection (3)] subsections (3) and (4) of this section, violation
of any provision of ORS 59.005 to 59.451, 59.710 to 59.830, 59.991 and 59.995 or any rule adopted by
the Director of the Department of Consumer and Business Services under ORS 59.005 to 59.451,
59.710 to 59.830, 59.991 and 59.995, except ORS 59.315 (2) or 59.810, is a Class B felony.
(2) Violation of ORS 59.315 (2) or 59.810 is a Class A misdemeanor.
(3) This section does not apply to a failure to file a notice and pay a fee under ORS 59.049 (1),
(2) or (3), nor to a failure to file a notice and pay a fee pursuant to ORS 59.165 (7), nor to a failure
to pay a fee pursuant to ORS 59.175 (8), nor to a violation of any rule adopted by the director under
ORS 59.049 (1), (2) or (3), 59.165 (7) or 59.175 (8).
(4) Notwithstanding subsection (1) of this section, violation of section 3 of this 2017 Act
or of any rule adopted by the director for administration of sections 2 to 7 of this 2017 Act
is a Class A violation.
A-Engrossed

Senate Bill 96

Ordered by the Senate February 20
Including Senate Amendments dated February 20

Printed pursuant to Senate Interim Rule 213.28 by order of the President of the Senate in conformance with pre-session filing rules, indicating neither advocacy nor opposition on the part of the President (at the request of Governor Kate Brown for Department of Consumer and Business Services)

SUMMARY

The following summary is not prepared by the sponsors of the measure and is not a part of the body thereof subject to consideration by the Legislative Assembly. It is an editor's brief statement of the essential features of the measure.

Requires broker-dealers and state investment advisers to maintain errors and omissions insurance policy in amount of at least $1 million as condition of state licensure, if broker-dealer or state investment adviser has discretionary trading authority or has custody of client funds.

Becomes operative on July 31, 2018.

A BILL FOR AN ACT

Relating to conditions of licensure for persons dealing in securities; creating new provisions; and amending ORS 59.175, 59.225, 59.255, 59.331, 59.991 and 59.995.

Be It Enacted by the People of the State of Oregon:

SECTION 1. ORS 59.175 is amended to read:

59.175. (1) The Director of the Department of Consumer and Business Services by rule shall establish procedures for notice filings required of federal covered investment advisers as well as procedures for licensing broker-dealers, state investment advisers, investment adviser representatives and salespersons. The director may coordinate notice filings or licensing with any national registration, licensing or notice filing system.

(2) The director may require an applicant for a license as a broker-dealer or state investment adviser, including the applicant's partners, directors, officers or any person occupying a similar status or performing similar functions, and any person directly or indirectly controlling such applicant and a person for whom application for a license as a salesperson or investment adviser representative is made, to pass an examination on such person's knowledge and understanding of the Oregon Securities Law and the securities business. The director may establish by rule a fee for the examination.

(3) The director may make such further examination of the applicant and the applicant's affairs as the director deems advisable and may require by rule or order that the applicant publish an announcement of the application in such manner as the director may specify.

(4)(a) Except as otherwise provided in paragraph (b) or (c) of this subsection, every applicant for a license as a broker-dealer or state investment adviser shall file with the director a corporate surety bond or irrevocable letter of credit issued by an insured institution as defined in ORS 706.008 or such other security as the director may approve by rule running to the State of Oregon in a sum to be established by rule of the director, but in no event more than $100,000.

(b) Licensed broker-dealers subject to section 15 of the Securities Exchange Act of 1934, as

NOTE: Matter in boldfaced type in an amended section is new; matter [italic and bracketed] is existing law to be omitted.
New sections are in boldfaced type.

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amended, are not required to comply with paragraph (a) of this subsection, nor are such licensed
broker-dealers required to comply with any net capital requirements imposed by the director by rule
or otherwise.

(c) A licensed state investment adviser who has its principal place of business in a state other
than this state shall be exempt from the requirements of paragraph (a) of this subsection and [shall
be further exempt] from any net capital requirements imposed by the director by rule or otherwise,
[provided that any such] as long as the licensed state investment adviser is:

(A) Registered or licensed as a state investment adviser in the state where it maintains its
principal place of business; and

(B) [is] In compliance with [such state’s] the bonding or net capital requirements of the state
where it maintains principal place of business.

(5)(a) Except as otherwise provided in paragraph (b) or (c) of this subsection, every ap-
plicant for a license or renewal of a license as a broker-dealer or state investment adviser
shall file with the director proof that the applicant maintains an errors and omissions in-
surance policy in an amount of at least $1 million from an insurer authorized to transact
insurance in this state or from any other insurer approved by the director according to
standards established by rule.

(b) A licensed broker-dealer subject to section 15 of the Securities Exchange Act of 1934,
as amended, is not required to comply with paragraph (a) of this subsection.

(c) A licensed state investment adviser who has its principal place of business in a state
other than this state is exempt from the requirements of paragraph (a) of this subsection.

[(5)(a)] (6)(a) Subject to paragraph (b) of this subsection, if the application, surety bond, irrev-
vocable letter of credit or other security, errors and omissions insurance policy and fees are in
order and the director is satisfied that the application should not be denied upon one or more of the
grounds specified in ORS 59.205 to 59.225, the director shall license the broker-dealer, state invest-
ment adviser, salesperson or investment adviser representative.

(b) If the director determines under ORS 59.205 or 59.215 that a condition or restriction should
apply to the license, the director, at the time the license is issued, shall specify in writing to the
licensee the condition or restriction applicable to the license.

[(6)] (7) A licensee under ORS 59.165 shall amend the license application when there are mate-
rial changes in the information contained in the original application.

[(7)] (8) An applicant for or a person holding a license issued under ORS 59.005 to 59.451 may
file with the director a trade name, as defined in ORS 647.005, or an assumed business name, as
defined in ORS 648.005. The trade name or assumed business name shall be filed in a form and
manner established by rule by the director. If the application is complete and the fee described in
subsection [(8)] (9) of this section is paid, the director shall issue an order authorizing the licensee
to operate under the trade name or assumed business name. The order shall remain in effect until
canceled, suspended or revoked.

[(8)] (9) The director shall charge and collect fees for:

(a) An application for a license as a broker-dealer or state investment adviser;
(b) An application to renew a license as a broker-dealer or state investment adviser;
(c) An application for a license as a salesperson;
(d) An application to renew a license as a salesperson;
(e) An application for a license as an investment adviser representative;
(f) An application to renew a license as an investment adviser representative;
(g) A notice filing for a federal covered investment adviser;
(h) A notice filing renewal for a federal covered investment adviser; and
(i) A filing for use of a trade name or an assumed business name.

[(9)(a)] (10)(a) The director shall set the fees described in subsection [(8)] (9) of this section in an amount that the director determines is equal as nearly as possible to the national midpoint for similar fees charged by all other state regulatory agencies within the United States responsible for regulating securities.

(b) The director may adjust the amount of a fee described in subsection [(8)] (9) of this section every two years to reflect changes in the national midpoint for a similar fee.

(c) In determining the national midpoint for similar fees under this section, the director may consider national midpoints determined by the North American Securities Administrators Association, the National Association of Securities Dealers or the United States Securities and Exchange Commission.

[(10)] (11) Except as provided in this subsection, the fees under this section are not refundable.

The director may provide for a method of equitably adjusting the payment of fees for broker-dealers, federal covered investment advisers, state investment advisers, salespersons and investment adviser representatives when the director determines that the changes in filing periods and expiration dates under ORS 59.185 are not equitable for the person making the payment.

SECTION 2. ORS 59.225 is amended to read:

59.225. (1) If the Director of the Department of Consumer and Business Services finds that an applicant or licensee has ceased to do business as a broker-dealer, state investment adviser, investment adviser representative or salesperson, or has failed to maintain a bond or other security required by ORS 59.175 (4), or has failed to maintain an errors and omissions insurance policy required by ORS 59.175 (5), or is subject to an adjudication of mental incompetence or to the control of a [committee,] conservator or guardian, or cannot be located after reasonable search, the director may cancel the license or application.

(2)(a) A broker-dealer, state investment adviser, investment adviser representative or salesperson may withdraw a license by filing an application to withdraw. Unless the director determines that the license should be suspended or revoked, the director shall allow the withdrawal subject to any conditions, limitations and restrictions the director may impose.

(b) A federal covered investment adviser may terminate a notice filing pursuant to ORS 59.165 (7) by providing the director with written notice of such termination in accordance with the procedures established by the director.

(3) When an investment adviser representative of a federal covered investment adviser begins or terminates an association with such federal covered investment adviser, the federal covered investment adviser or investment adviser representative shall promptly notify the director in writing in accordance with the procedures established by the director.

(4) The suspension of a license of a broker-dealer or state investment adviser shall suspend the license of any salesperson of the broker-dealer or the license of any investment adviser representative of the state investment adviser. The revocation, cancellation, withdrawal or expiration of a license of a broker-dealer or state investment adviser shall cancel the license of any salesperson of the broker-dealer or the license of any investment adviser representative of the state investment adviser.

(5) The suspension of a registration of securities suspends the license of any salesperson licensed to the issuer or owner of the securities. The revocation, cancellation, withdrawal or expiration of
the registration of securities cancels the license of any salesperson licensed to the issuer or owner
of the securities.

SECTION 3. ORS 59.255 is amended to read:

59.255. (1) Whenever it appears to the Director of the Department of Consumer and Business
Services that a person has engaged, is engaging or is about to engage in an act or practice constit-
tuting a violation of any provision of the Oregon Securities Law or any rule or order of the director,
the director may bring suit in the name and on behalf of the State of Oregon in the circuit court
of any county of this state to enjoin the acts or practices and to enforce compliance with the Oregon
Securities Law or such rule or order. Upon a proper showing, a permanent or temporary injunction,
restraining order or writ of mandamus shall be granted.

(2) The court may fine the person against whom the order is entered not more than $20,000 for
each violation, which shall be entered as a judgment and paid to the General Fund of the State
Treasury. Each violation is a separate offense. In the case of a continuing violation, each day's
continuance is a separate violation, but the maximum penalty for any continuing violation shall not
exceed $100,000. If the court finds that the defendant has violated any provision of the Oregon Se-
curities Law or any such rule or order, the court may appoint a receiver, who may be the director,
for the defendant or the defendant's assets. The court may not require the director to post a bond.

(3) The court may award reasonable attorney fees to the director if the director prevails in an
action under this section. The court may award reasonable attorney fees to a defendant who pre-
vails in an action under this section if the court determines that the director had no objectively
reasonable basis for asserting the claim or no reasonable basis for appealing an adverse decision
of the trial court.

(4) The director may include in any action authorized by this section:

(a) A claim for restitution or damages under ORS 59.115, 59.127 or 59.137, on behalf of the per-
sons injured by the act or practice constituting the subject matter of the action. The court shall
have jurisdiction to award appropriate relief to such persons, if the court finds that enforcement of
the rights of such persons by private civil action, whether by class action or otherwise, would be
so burdensome or expensive as to be impractical; or

(b) A claim for disgorgement of illegal gains or profits derived. Any recovery under this para-
graph shall be turned over to the General Fund of the State Treasury unless the court requires
other disposition.

(5) The provisions of this section do not apply to:

(a) A failure to file a notice and pay a fee pursuant to ORS 59.049 (1), (2) or (3);
(b) A failure to file a notice and pay a fee pursuant to ORS 59.165 (7);
(c) A failure to pay a fee pursuant to ORS 59.175 (8) or
(d) A violation of any rule adopted by the director pursuant to ORS 59.049 (1), (2) or (3), or
59.165 (7) or 59.175 (8).]

SECTION 4. ORS 59.331 is amended to read:

59.331. (1) Subject to subsection (2) of this section and after providing notice and an opportunity
to participate to the Director of the Department of Consumer and Business Services, the Attorney
General may:

(a) Make public or private investigations within or outside this state as the Attorney General
considers necessary to:

(A) Determine whether a person has violated or is about to violate any provision of the Oregon
Securities Law or any rule or order of the director adopted or issued under the Oregon Securities
Law; or

(B) Aid in the enforcement of the Oregon Securities Law or any rule or order of the director
adopted or issued under the Oregon Securities Law.

(b) Require or permit a person to file a statement in writing, under oath or otherwise as the
Attorney General determines, as to all the facts and circumstances concerning a matter to be in-
vestigated.

(c) Administer oaths and affirmations, subpoena witnesses, compel the attendance of witnesses,
take evidence and require the production of books, papers, correspondence, memoranda, agreements
or other documents or records that the Attorney General considers relevant or material to an in-
vestigation.

(d) Bring suit in the name and on behalf of the State of Oregon in the circuit court of any
county to:

(A) Enjoin any acts or practices the Attorney General has reason to believe that a person has
engaged, is engaging or is about to engage in that constitute a violation of any provision of the
Oregon Securities Law or any rule or order of the director adopted or issued under the Oregon
Securities Law; or

(B) Enforce compliance with the Oregon Securities Law or any rule or order of the director
adopted or issued under the Oregon Securities Law.

(2) The Attorney General may take action under subsection (1) of this section only in connection
with any of the following alleged violations or cases:

(a) Alleged violations involving companies whose securities are listed on the New York Stock
Exchange, the American Stock Exchange or the National Association of Securities Dealers Auto-

mated Quotation System, Inc. National Market System;

(b) Cases in which the Attorney General is pursuing or intends to pursue an investigation or
litigation under ORS 166.715 to 166.735;

(c) Cases in which the Attorney General is pursuing or intends to pursue an investigation or
litigation under ORS 336.184 and 646.605 to 646.652; or

(d) Cases in which the Attorney General is pursuing or intends to pursue an investigation or
litigation under ORS 646.705 to 646.805.

(3) The Attorney General may take action under subsection (1) of this section with respect to
cases described in subsection (2)(b), (c) or (d) of this section only after receiving the director's con-
sent. The director may elect to be a named party in any action the Attorney General takes.

(4) Each witness who appears before the Attorney General under a subpoena issued under this
section shall receive the fees and mileage provided for witnesses in ORS 44.415 (2). If a person fails
to comply with a subpoena issued under this section or if a party or witness refuses to testify on
any matters, the judge of the circuit court of any county, on the application of the Attorney General,
shall compel obedience by proceedings for contempt as in the case of disobedience of the require-
ments of a subpoena issued from the court or a refusal to testify in the court.

(5) In an action brought under this section, a court:

(a) Shall grant a permanent or temporary injunction, restraining order or writ of mandamus
upon a proper showing by the Attorney General under subsection (1)(d) of this section.

(b) May award reasonable attorney fees to:

(A) The Attorney General if the Attorney General prevails in an action under this section.

(B) A defendant if the defendant prevails in an action under this section and the court deter-
mines that the Attorney General had no objectively reasonable basis for asserting the claim or no
reasonable basis for appealing an adverse decision of the trial court.

(6) The Attorney General may include any of the following in an action authorized by this section:

(a) A claim for restitution or damages under ORS 59.115, 59.127 or 59.137, on behalf of the persons injured by the act or practice constituting the subject matter of the action. If the court finds that enforcement of the rights of the injured persons by private civil action, whether by class action or otherwise, would be so burdensome or expensive as to be impractical, the court has jurisdiction to award appropriate relief to the injured persons.

(b) A claim for disgorgement of illegal gains or profits derived. The Attorney General shall deposit any moneys recovered under this paragraph in the General Fund of the State Treasury unless the court requires other disposition.

(c) A claim for the appointment of a receiver of any property derived by means of any act or practice that constitutes a violation of any provision of the Oregon Securities Law or any rule or order of the director adopted or issued under the Oregon Securities Law and of any books of account and papers relating to the property. Property for which a receiver may be appointed includes other property with which the property derived by means of a violation has been commingled if the property cannot be identified in kind because of the commingling. The receiver shall take possession of the property, books and papers and shall liquidate the property for the benefit of all persons who intervene in the action and establish an interest in the property. Subject to the approval of the court, the expenses and attorney fees of the receiver and any expenditures required in the liquidation proceeding shall be paid out of the funds of the receivership. The receiver may be the Attorney General. The court may not require the Attorney General to post a bond.

(d) A claim for a fine of not more than $20,000 for each violation. The fine shall be entered as a judgment and paid to the General Fund of the State Treasury. Each violation is a separate offense. In the case of a continuing violation, each day's continuance is a separate violation, but the maximum penalty for any continuing violation may not exceed $100,000.

(7) This section does not apply to:

(a) A failure to file a notice and pay a fee under ORS 59.049 (1), (2) or (3);

(b) A failure to file a notice and pay a fee under ORS 59.165 (7);

(c) A failure to pay a fee under ORS 59.175 [(8)] (9);

(d) A violation of any rule adopted by the director under ORS 59.165 (7); or

(e) A company that the director has licensed under ORS 59.165.

SECTION 5. ORS 59.991 is amended to read:

59.991. (1) Except as provided in subsection (3) of this section, violation of any provision of ORS 59.005 to 59.451, 59.710 to 59.830, 59.991 and 59.995 or any rule adopted by the Director of the Department of Consumer and Business Services under ORS 59.005 to 59.451, 59.710 to 59.830, 59.991 and 59.995, except ORS 59.315 (2) or 59.810, is a Class B felony.

(2) Violation of ORS 59.315 (2) or 59.810 is a Class A misdemeanor.

(3) This section does not apply to a failure to file a notice and pay a fee under ORS 59.049 (1), (2) or (3), nor to a failure to file a notice and pay a fee pursuant to ORS 59.165 (7), nor to a failure to pay a fee pursuant to ORS 59.175 [(8)] (9), nor to a violation of any rule adopted by the director under ORS 59.049 (1), (2) or (3), or 59.165 (7) or 59.175 (8).

SECTION 6. ORS 59.995 is amended to read:

59.995. (1) In addition to all other penalties and enforcement provisions provided by law, any person who violates or who procures, aids or abets in the violation of ORS 59.005 to 59.451, 59.710
to 59.830, 59.991 and 59.995 or any rule or order of the Director of the Department of Consumer and
Business Services shall be subject to a penalty of not more than $20,000 for every violation, which
shall be paid to the General Fund of the State Treasury.
(2) Every violation is a separate offense and, in the case of a continuing violation, each day's
continuance is a separate violation, but the maximum penalty for any continuing violation shall not
exceed $100,000.
(3) Civil penalties under this section shall be imposed as provided in ORS 183.745.
(4) This section does not apply to a failure to file a notice and pay a fee pursuant to ORS 59.049
(1), (2) or (3), nor to a failure to file a notice and pay a fee pursuant to ORS 59.165 (7), nor to a
failure to pay a fee pursuant to ORS 59.175 [(8)] (9), nor to a violation of any rule adopted by the
director under ORS 59.049 (1), (2) or (3),] or 59.165 (7) [or 59.175 (8)].
SECTION 7. The amendments to ORS 59.175, 59.225, 59.255, 59.331, 59.991 and 59.995 by
sections 1 to 6 of this 2017 Act become operative on July 31, 2018.
SECTION 8. The Department of Consumer and Business Services may take any action
before the operative date specified in section 7 of this 2017 Act that is necessary for the de-
partment to exercise, on and after the operative date specified in section 7 of this 2017 Act,
all of the duties, functions and powers conferred on the department by the amendments to
ORS 59.175, 59.225, 59.255, 59.331, 59.991 and 59.995 by sections 1 to 6 of this 2017 Act.
A-Engrossed

Senate Bill 769

Ordered by the Senate March 22
Including Senate Amendments dated March 22

Sponsored by COMMITTEE ON JUDICIARY

SUMMARY

The following summary is not prepared by the sponsors of the measure and is not a part of the body thereof subject to consideration by the Legislative Assembly. It is an editor's brief statement of the essential features of the measure.

Provides that person may not dispose of, or transfer to another person for disposal, material or media that display Social Security number unless person, before disposing of material or media, makes Social Security number unreadable or [prevents reconstruction of] unrecoverable or ensures that person that ultimately disposes of media or material makes Social Security number unreadable or unrecoverable.

A BILL FOR AN ACT

Relating to disposing of material that displays Social Security numbers; amending ORS 646A.620.

Be It Enacted by the People of the State of Oregon:

SECTION 1. ORS 646A.620 is amended to read:

646A.620. (1) Except as otherwise specifically provided by law, a person [shall] may not:

(a) Print a consumer's Social Security number on any materials not requested by the consumer or part of the documentation of a transaction or service requested by the consumer that are mailed to the consumer unless redacted;

(b) Print a consumer's Social Security number on any card required for the consumer to access products or services provided by the person;

(c) Publicly post or publicly display a consumer's Social Security number unless the Social Security number is redacted. As used in this paragraph, “publicly post or publicly display” means to communicate or otherwise make available to the public.

(d) Dispose of, or transfer to another person for disposal, material or media that display a consumer's Social Security number unless the person makes the Social Security number unreadable or unrecoverable or ensures that any person that ultimately disposes of the material or media makes the Social Security number unreadable or unrecoverable.

(2) This section does not prevent the collection, use[, or release of a Social Security number as required by state or federal law[, including statute, Oregon Rules of Civil Procedure] or rule adopted by the Chief Justice of the Supreme Court, the Chief Judge of the Court of Appeals or the judge of the Oregon Tax Court[, or] and does not prevent the use or printing of a Social Security number for internal verification or administrative purposes or [for enforcement of] to enforce a

NOTE: Matter in boldfaced type in an amended section is new; matter [italic and bracketed] is existing law to be omitted. New sections are in boldfaced type.

LC 4093
(3) This section does not apply to records that [are required by] must be made available to the public under state or federal law, including statute, Oregon Rules of Civil Procedure] or rule adopted by the Chief Justice of the Supreme Court, the Chief Judge of the Court of Appeals or the judge of the Oregon Tax Court, to be made available to the public.

(4) This section does not apply to a Social Security number in any of the following records or copies of records in any form or storage medium maintained or otherwise possessed by a court, the State Court Administrator or the Secretary of State:

(a) A record received on or before October 1, 2007;
(b) A record received after October 1, 2007, if, by state or federal statute or rule, the person that submitted the record could have caused the record to be filed or maintained in a manner that protected the Social Security number from public disclosure; or
(c) A record, regardless of the date created or received, that is:
(A) An accusatory instrument charging a violation or crime;
(B) A record of oral proceedings in a court;
(C) An exhibit offered as evidence in a proceeding; or
(D) A judgment or court order.
Creates exemption from Registration for 701 plans, adjust fees and makes technical changes.


**Repeal:** OAR 441-025-0010, 441-035-0040, 441-035-0270

This proposed rulemaking makes technical changes to several rules addressing new statutory sections at the state and federal levels. The rules propose repealing the "exchange exemption" and relying on the federal rules regarding exchanges. The proposed rules remove references to Standard and Poor's Manual which ceased publication in May 2016. In order to provide adequate options for broker-dealers and salespersons utilizing the "manual exemption" provided for in ORS 59.025(5) these rules propose adding the OTCQX and OTCQB Markets to the manual exemption for equity security offerings. The proposed rulemaking also makes changes to the registration requirements for SEC Rule 701 employee benefit stock option plans. The proposed rules would repeal the registration requirement, annual renewal, and salesperson licensing fees and establish a notice filing. The proposed rules also raise filing and renewal fees for investment company portfolios and reduce the fees related to broker-dealer salesperson registration renewals. The proposed rules are consistent with the intent of Oregon Revised Statute Chapter 59 to ensure licensing of individuals engaged in brokering or selling securities to the public.

**Adopted:** January 31, 2017

**Effective:** February 1, 2017
Self-Executing Registration Exemptions

(1) (a) The securities listed in ORS 59.025 are exempt from registration or notice filing requirements. Sales of securities listed in 59.025 may only be effected through licensed persons, unless a person is otherwise exempted by statute or rule. Except as provided in subsection (b) no filing or fee is required to utilize any registration exemption in 59.025.

(b) A renewable energy cooperative corporation must file with the director the information required under OAR 441-025-0125 in order to rely upon the exemption provided in ORS 59.025(12).

(2) Persons relying on exemptions from registration have the burden of proof, pursuant to ORS 59.275, in establishing the availability of an exemption.

General Requirements for Renewable Energy Cooperative Corporations

(1) In order to rely on the exemption under ORS 59.025(12), a renewable energy cooperative corporation must:

(a) Have a certificate of existence issued by the Oregon Secretary of State pursuant to ORS 62.065 and be in good standing;

(b) Meet all the conditions set out in 441-025-0122;

(c) Provide the disclosures in the manner required by 441-025-0123; and

(d) Make any required filings under 441-025-0125.

(2) Reliance on ORS 59.025(12) does not preclude renewable energy cooperative corporations from relying on other exemptions under 59.025 or 59.035, as appropriate, for the offer or sale of membership shares, capital stock, or other authorized securities.

Manual Exemption

Securities maintaining the following ratings by publishers of securities manuals are approved for the purpose of the exemption from registration in subsection (5) of ORS 59.025:

(1) Ratings of BBB or better for debt securities, and ratings of F-3 or better for commercial paper by Fitch Investors Service, Inc.

(2) Ratings of Baa or better for debt securities and ratings of P-3 or better for commercial paper by Moody's Investors Service.

Stat. Auth.: ORS 59.285
Stats. Implemented: ORS 59.025
Hist.: CC 13, f. 9-19-73, ef. 10-1-73; Renumbered from 815-030-0025.5; CC 1-1978, f. & ef. 1-4-78; Renumbered from 815-030-0020; FCS 4-1990, f. & cert. ef. 8-21-90; FCS 7-2000; f. & cert. ef. 6-2-00; FCS 9-2001, f. & cert. ef. 9-28-01
Chapter 3E—State Regulatory Update—Oregon

441-025-0050
Additional Exempt Employee Benefit Plans

Pursuant to ORS 59.025(15), securities issued in connection with an employee benefit plan are exempt from registration if the plan:

(1) Is subject to or voluntarily complies with Title I of the Employee Retirement Income Security Act of 1974, as amended, 29 U.S.C. §§ 1001-1191c;

(2) Meets the requirements of Section 403(b) of the Internal Revenue Code, 26 U.S.C. § 403(b); or

(3) Does not permit employee contributions.

Stat. Auth.: ORS 59.285
Stats. Implemented: ORS 59.025
Hist.: CC 3, f. 10-2-69, ef. 10-25-69; Renumbered from 815-010-0010; CC 2-1978, f. 6-5-78, ef. 6-10-78; Renumbered from 815-030-0025; FCS 3-1987(Temp), f. 9-24-87, ef. 9-28-87; FCS 5-1988, f. 3-22-88, cert. ef. 2-25-88; FCS 4-1990, f. & cert. ef. 8-21-90; FCS 7-2000; f. & cert. ef. 6-2-00; FCS 1-2012, f. & cert. ef. 7-9-12

441-035-0005
Self-Executing Transaction Exemptions

(1) Except for ORS 59.035(11), OAR 441-035-0045, OAR 441-035-0300 for certain compensatory benefit plans, and the Oregon Intrastate Offering Exemption (OIO) at 441-035-0070 et seq., exemptions available pursuant to ORS 59.035 are self-executing and do not require filing or a fee.

(2) Persons relying on exemptions from registration have the burden of proof, pursuant to ORS 59.275, in establishing the availability of an exemption.

441-035-0030
Manual Exemption

The following are approved for the purposes of the exemption granted under ORS 59.035(10)(c):

(1) The Mergent securities manual;

(2) Fitch Investors Service securities manual; and

(3) The OTCQX and OTCQB markets.

441-035-0045
Solicitation of Interest for Offering of Securities Pursuant to SEC Regulation A

(1) An offer, but not a sale, of a security made by or on behalf of an issuer for the sole purpose of soliciting an indication of interest in receiving a prospectus (or its equivalent) for such security is exempt under ORS 59.035(15) if all of the following conditions are satisfied:
(a) The issuer is or will be a business entity organized under the laws of one of the states or possessions of the United States or one of the provinces or territories of Canada, is engaged in or proposes to engage in a business other than petroleum exploration or production or mining or other extractive industries and is not a "blank check company," as such term is defined in OAR 441-045-0010(2);

(b) The offerer intends to conduct its offering pursuant to Regulation A under the Securities Act of 1933 and register the securities in Oregon under OAR 441-065-0020;

(c) At least 10 business days prior to the initial solicitation of interest under this rule, the offerer files with the Director:

(A) A completed solicitation of interest application on a form prescribed by the Director along with any other materials to be used to conduct solicitations of interest, including, but not limited to, the script of any broadcast to be made and a copy of any notice to be published;

(B) The minimum registration fee as set in OAR 441-065-0001;

(C) A completed Form U-4 (salesperson application available from the Securities Section) for at least one, but no more than five, issuer salespersons (each such salesperson must be a bona fide officer, director or employee of the issuer); and

(D) A salesperson licensing fee as set in OAR 441-175-0002 for each salesperson.

(d) At least five business days prior to usage, the offerer files with the Director any amendments to the foregoing materials or additional materials to be used to conduct solicitations of interest, except for materials provided to a particular offeree pursuant to a request by that offeree;

(e) No Solicitation of Interest Form, script, advertisement or other material which the offerer has been notified by the Director not to distribute is used to solicit indications of interest;

(f) Except for scripted broadcasts and published notices, the offerer does not communicate with any offeree about the contemplated offering unless the offeree is provided with the most current Solicitation of Interest Form at or before the time of the communication or within five days from the communication;

(g) During the solicitation of interest period, the offerer does not solicit or accept money or a commitment to purchase securities;

(h) No sale is made until at least seven days after delivery to the purchaser of a final prospectus, or in those instances in which delivery of a preliminary prospectus is allowed hereunder, a preliminary prospectus;

(i) The offerer does not know, and in the exercise of reasonable care, could not know that the issuer or any of the issuer's officers, directors, ten percent shareholders or promoters:

(A) Has filed a registration statement which is the subject of a currently effective registration stop order entered pursuant to any federal or state securities law within five years prior to the filing of the Solicitation of Interest Form.

(B) Has been convicted within five years prior to the filing of the Solicitation of Interest Form of any felony or misdemeanor in connection with the offer, purchase or sale of any security or any felony involving fraud or deceit, including, but not limited to, forgery, embezzlement, obtaining money under false pretenses, larceny, or conspiracy to defraud.
(C) Is currently subject to any federal or state administrative enforcement order or judgment entered by any state securities administrator or the Securities and Exchange Commission within five years prior to the filing of the Solicitation of Interest Form or is subject to any federal or state administrative enforcement order or judgment entered within five years prior to the filing of the Solicitation of Interest Form in which fraud or deceit, including, but not limited to, making untrue statements of material facts and omitting to state material facts, was found.

(D) Is subject to any federal or state administrative enforcement order or judgment which prohibits, denies, or revokes the use of any exemption from registration in connection with the offer, purchase or sale of securities.

(E) Is currently subject to any order, judgment, or decree of any court of competent jurisdiction temporarily or preliminarily restraining or enjoining, or is subject to any order, judgment or decree of any court of competent jurisdiction permanently restraining or enjoining, such party from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with the state entered within five years prior to the filing of the Solicitation of Interest Form.

(F) The prohibitions listed in paragraphs (A) through (E) of this subsection shall not apply if the person subject to the disqualification is duly licensed or registered to conduct securities related business in the state in which the administrative order or judgment was entered against such person or if the broker-dealer employing such party is licensed in this state and the Form B-D filed with this state discloses the order, conviction, judgment or decree relating to such person. No person disqualified under this subsection may act in a capacity other than that for which the person is licensed. Any disqualification caused by this action is automatically waived if the agency which created the basis for disqualification determines upon a showing of good cause that it is not necessary under the circumstances that the exemption be denied.

(2) A failure to comply with any condition of section (1) of this rule will not result in the loss of the exemption under ORS 59.035(15) for any offer to a particular individual or entity if the offerer shows:

(a) The failure to comply did not pertain to a condition directly intended to protect that particular individual or entity;
(b) The failure to comply was insignificant with respect to the offering as a whole; and
(c) A good faith and reasonable attempt was made to comply with all applicable conditions of section (1). Where an exemption is established only through reliance upon this section (2), the failure to comply shall nonetheless be actionable as a violation of the Act by the Director under ORS 59.245 and 59.255 and constitute grounds for denying, withdrawing or conditioning the exemption pursuant to 59.045 as to a specific security or transaction.

(3) The offerer shall comply with the requirements set forth below. Failure to comply will not result in the loss of the exemption under ORS 59.035(15), but shall be a violation of the Oregon Securities Law, be actionable by the Director under 59.245 and 59.255, and constitute grounds for denying, withdrawing or conditioning the exemption pursuant to 59.045 as to a specific security or transaction:

(a) Any published notice or script for broadcast must contain at least the identity of the chief executive officer of the issuer, a brief and general description of its business and products, and the following legends:
(A) AN OFFERING STATEMENT PURSUANT TO REGULATION A RELATING TO THESE SECURITIES HAS BEEN FILED WITH THE SECURITIES AND EXCHANGE COMMISSION.

INFORMATION CONTAINED IN THIS PRELIMINARY OFFERING CIRCULAR IS SUBJECT TO COMPLETION OR AMENDMENT. THESE SECURITIES MAY NOT BE SOLD NOR MAY OFFERS TO BUY BE ACCEPTED PRIOR TO THE TIME AN OFFERING CIRCULAR WHICH IS NOT DESIGNATED AS A PRELIMINARY OFFERING CIRCULAR IS DELIVERED AND THE OFFERING STATEMENT FILED WITH THE COMMISSION BECOMES QUALIFIED.

(B) THIS PRELIMINARY OFFERING CIRCULAR SHALL NOT CONSTITUTE AN OFFER TO SELL OR THE SOLICITATION OF AN OFFER TO BUY NOR SHALL THERE BE ANY SALES OF THESE SECURITIES IN ANY STATE IN WHICH SUCH OFFER, SOLICITATION OR SALE WOULD BE UNLAWFUL PRIOR TO REGISTRATION OR QUALIFICATION UNDER THE LAWS OF ANY SUCH STATE.

(C) WE MAY ELECT TO SATISFY OUR OBLIGATION TO DELIVER A FINAL OFFERING CIRCULAR BY SENDING YOU A NOTICE WITHIN TWO BUSINESS DAYS AFTER THE COMPLETION OF OUR SALE TO YOU THAT CONTAINS THE URL WHERE THE FINAL OFFERING CIRCULAR OR THE OFFERING STATEMENT IN WHICH SUCH FINAL OFFERING CIRCULAR WAS FILED MAY BE OBTAINED; and

(b) All communications with prospective investors made in reliance on this rule must cease after a registration statement is filed in this state, and no sale may be made until at least 20 calendar days after the last communication made in reliance on this rule.

(4) The Director may waive any condition of this exemption in writing, upon application by the offerer and cause having been shown. Neither compliance nor attempted compliance with this rule, nor the absence of any objection or order by the Director with respect to any offer of securities undertaken pursuant to this rule, shall be deemed to be a waiver of any condition of the rule or deemed to be a confirmation by the Director of the availability of this rule.

(5) Offers made in reliance on this rule will not result in a violation of ORS 59.055 by virtue of being integrated with subsequent offers or sales of securities unless such subsequent offers and sales would be integrated under federal securities laws.

(6) Issuers on whose behalf indications of interest are solicited under this rule may not make offers or sales in reliance on ORS 59.025(7), 59.035(5), 59.035(12) or OAR 441-035-0050 until six months after the last communication with a prospective investor made pursuant to this rule.

441-035-0300

Certain Compensatory Benefit Plans

(1) Except as provided in subsection (4) of this rule, under ORS 59.035(15), the offer and sale of securities by an issuer pursuant to a compensatory benefit plan offering that is exempt under SEC Rule 701 (17 CFR 230.701) is exempt from registration provided that the issuer submits:

(a) Notice to the Director on an approved form is provided no later than 30 days after the initial offer and sale of any a security subject to this exemption; and
(b) Payment of a fee of 1/10 of 1% of the amount offered in Oregon, with a minimum fee of $200 and a maximum fee of $1,500.

(c) Options to purchase securities become subject to the notice and fee requirements of this section when the option grant is made regardless of when the option becomes exercisable.

(2) This rule shall only apply to offers and sales where the federal exemption under 17 CFR 230.701 is available to the issuer for this offering.

(3) The filing is effective as of the date the securities sold in reliance on this exemption are offered and sold provided that the filing and fee requirements under subsection (1) or (4) are satisfied. Upon receipt of a filing, the Director shall provide written acknowledgment of the filing to the person submitting the request for the filing. An improvident failure by the Director to acknowledge the filing shall not invalidate the filing.

(4) (a) Failure to file the notice according to subsection (1)(a) of this rule does not affect the availability of this exemption provided that, within 15 business days after discovery of the failure to file or after demand by the director, whichever occurs first, the issuer files the notice and pays the Director a fee equal to the maximum aggregate fee payable had the transaction been qualified under subsection (1)(b) of this rule.

(b) Securities previously registered under OAR 441-065-0270 are not subject to the fee requirements of (1)(b) as a condition of reliance on this exemption.

(5) If an issuer becomes subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) after it has made offers in reliance on this exemption, the issuer may nevertheless rely on this exemption to sell the securities previously offered to the persons to whom those offers were made.

(6) Under ORS 59.015(18)(b)(B), an individual employed by the issuer of a security sold in reliance on this exemption is not required to be licensed in Oregon to offer or sell securities under the plan.

(7)(a) A filer shall amend the notice on a form approved by the director when there are material changes in the terms and conditions of the original notice or Plan. “Material changes in the terms and conditions of the original notice or plan” means an increase in the aggregate amount of securities to be offered in Oregon, change in the type of securities or change in the identity of the issuer or owner.

(b) Notice of an amendment to increase the aggregate amount of securities to be offered in Oregon shall include the fee calculated in accordance with subsection (1)(b), less amounts previously paid under the prior notice. The amendment fee may not be less than $100. (c) The notice is effective when received by the director.

(8) Offers and sales exempt under this rule are deemed to be a part of a single, discrete offering and are not subject to integration with any other offers or sales, whether registered under ORS 59.065 or otherwise exempt from registration under ORS 59.025 or ORS 59.035.

(9) This rule relates to transactions exempted from the registration requirements of ORS 59.065. These transactions are still subject to the antifraud, civil liability, or other provisions of the Oregon Securities Law.
441-049-1001

Fees for Federal Covered Securities Notice Filings

Pursuant to ORS 59.049, for new filings received on or after July 1, 2017 or renewal filings effective on or after July 1, 2017, the Director sets the following fees for notice filings for federal covered securities:

(1) For an investment company, other than a unit investment trust, an initial filing fee of $545 and renewal notice filing fee of $535 per portfolio. Issuers may submit filings containing multiple portfolios, provided the portfolios are identified in the Form NF and correct fees are paid.

(2) For a unit investment trust notice filing, an initial fee of $500 per portfolio and a renewal fee of $500 per portfolio. Issuers may submit filings containing multiple portfolios, provided the portfolios are identified in the Form NF and correct fees are paid.

(3) For a notice filing for offerings to qualified purchasers, or of federally exempt securities or federally exempt transactions pursuant to section 18(b)(3) or (4), other than section 18(b)(4)(E), of the Securities Act of 1933, as amended, a fee of $200. No renewal notice filing or fee is required.

(4) For a Regulation D Rule 506 offering notice filing, a fee of $250. No renewal notice filing or fee is required.

441-049-1011

Scope and Definitions

(1)(a) Scope of rule. The Notice Filing Rules (OAR 441-049-1011 to 441-049-1051) provide Oregon procedures for notice filings and renewals under ORS 59.049.

(b) Application of Notice Filing Rules:

(A) An offering under the Notice Filing Rules does not have to comply with OAR 441 Division 065 Registration of Securities or 441 Division 070 Renewal of Securities Registrations; and

(B) An effective offering under former OAR 441-025-0045 or an effective registered offering that qualifies for the Notice Filing Rules shall become subject to the Notice Filing Rules when the person that previously filed under former 441-025-0045 or securities offering registrant files under the notice filing renewal procedures in 441-049-1021(6).

(2) Definitions. As used in the Notice Filing Rules:

(a) "Investment company notice filing" means a filing by a mutual fund, unit investment trust or other investment company, that covers a security that would be a federal covered security pursuant to section 18(b)(2) of the Securities Act of 1933, as amended;

(b) "NASAA" means the North American Securities Administrators Association Inc.;

(c) "NASAA Form NF" means the Uniform Investment Company Notice Filing form adopted by the NASAA;

(d) "Notice Filing Rules" means the rules in OAR 441-049-1011 to 441-049-1051;

(e) "Offering to qualified purchaser," "federally exempt security" or "federally exempt transactions" means offerings of federal covered securities that are subject to section 18(b)(3) or
18(b)(4) of the Securities Act of 1933, as amended, but does not include section 18(b)(4)(E) of that Act;

(f) "Rule 506 offering" means an offering of federal covered securities that is subject to section 18(b)(4)(E) of the Securities Act of 1933, as amended;

(g) "SEC" means the Securities and Exchange Commission; and

(h) "SEC Form D" means "Form D; Notice of Exempt Offering of Securities.

441-049-1051

Rule 506 Offerings

A person offering a covered security under section 18(b)(4)(E) shall:

(1) (a) File a notice on SEC Form D not later than 15 days after the first sale of securities subject to the notice in Oregon;

(b) For the purposes of notice, submit to the director the aggregate amount offered in Oregon;

(A) An offering amount may be "Indefinite" if the amount being offered is undetermined or cannot be calculated at the present time, such as if the offering includes securities to be acquired upon the exercise or exchange of other securities or property and the exercise price or exchange value is not currently known or knowable.

(B) If an amount is definite but difficult to calculate without unreasonable effort or expense, provide a good faith estimate.

(2) Pay a fee as set in OAR 441-049-1001.

441-175-0002

Fees for Licensing or Notice Filing of Firms and Individuals

Pursuant to ORS 59.175, the director sets the following fees for licensing or notice filing of firms and individuals:

(1) For a broker-dealer, an initial license fee of $250 and a renewal license fee of $250;

(2) For a state investment adviser, an initial license fee of $200 and a renewal license fee of $200;

(3) For a federal covered investment adviser, an initial notice filing fee of $200 and a renewal notice filing fee of $200;

(4) For a broker-dealer salesperson, an initial license fee of $60 and a renewal license fee of $50;

(5) For an investment adviser representative, an initial license fee of $50 and a renewal license fee of $50;

(6) For an agent of an issuer, an initial license fee of $50 and a renewal license fee of $50; and

(7) For a filing for use of a trade name or an assumed business name, a one time fee of $50.
Exclusion from Definition of “Broker-Dealer”

ORS 59.015 excludes from the definition of "broker-dealer" the following persons, provided the person is not otherwise licensed as a broker-dealer, investment adviser, or salesperson:

(1) Any person who effects sales of securities that are exempt under subsection (14) of ORS 59.025 and OAR 441-025-0040.

(2) Any person who is a bona fide officer, director or employee of an issuer whose securities are registered under OAR 441-065-0035, while effecting sales of the securities without special compensation.

(3) Any person, who serves as a dealer manager for an exchange offer of securities which have been registered under OAR 441-065-0035 and who does not perform any active solicitation activities in this state.

(4) Any person who is a licensed Principal Real Estate Broker or Real Estate Broker acting on behalf of that person's Principal Real Estate broker, provided that all of the following conditions are met:

(a) The person is actively licensed with the Oregon Real Estate Commissioner;

(b) The person, with respect to securities subject to the Oregon Securities Law, ORS Chapter 59, only effects transactions in securities that are registered under 59.065, and:

(A) Involve interests in a general or limited partnership, joint venture, cooperative, or unincorporated association, but not a corporation, formed for the purpose of investment in specified real property, including condominium securities; or

(B) Involve resale of those securities described under paragraph (A) of this subsection.

(c) The person complies with the rules of fair practice under OAR 441-175-0050; and

(d) The person does not engage exclusively in the management of rental real estate as defined in ORS 696.010.

(5) The director may, by order, as to any person or type of security or sale, withdraw or condition the exclusions allowed under this rule if the action would be in the public interest and would be in accordance with the purposes of the Oregon Securities Law. No person shall be liable under the Oregon Securities Law by reason of the withdrawal of the exclusions allowed under this rule if the person sustains the burden of proof that the person did not know and, in the exercise of reasonable care, could not have known of such withdrawal.

Exclusion from Definition of “Investment Adviser”

ORS 59.015 excludes from the definition of "state investment adviser" the following persons, provided the person is not otherwise licensed as a broker-dealer, state investment adviser, mortgage broker, salesperson, or investment adviser representative:

(1) Any person who conducts no public advertising or general solicitation in this state and whose only clients in this state are "accredited investors" as that term is defined in OAR 441-035-0010.
(2) Any person who is a bona fide officer, director or employee of an issuer whose securities are registered under OAR 441-065-0035, while providing advice, analyses, reports or other advisory services regarding the securities without special compensation.

(3) Any person who serves as a dealer manager for an exchange offer of securities which has been registered under OAR 441-065-0035 and who does not perform any active solicitation in this state.

(4) Any person whose advice, analyses or reports relate only to securities exempted by subsection (14) of ORS 59.025 and OAR 441-025-0040.

(5) Any person who is a licensed Principal Real Estate Broker or Real Estate Broker acting on behalf of the Principal Real Estate broker if:

(a) The person is actively licensed with the Oregon Real Estate Commissioner;

(b) The person, with respect to securities activities, only renders advice, analyses, reports or other advisory services relating to securities that are registered under ORS 59.065, and:

(A) Involve interests in a general or limited partnership, joint venture, cooperative, or unincorporated association, but not a corporation, formed for the purpose of investment in specified real property, including condominium securities; or

(B) Involve the resale of those securities described in paragraph (A) of this subsection.

(c) The person complies with the rules of fair practice under OAR 441-175-0050; and

(d) The person does not engage exclusively in the management of rental real estate as defined in ORS 696.010.

(6) Any person who acts as a purchaser representative under OAR 441-065-0060 through 441-065-0230 if the activity is merely an incidental part of the person's usual activities or occupation.

(7) Any person who is licensed as a mortgage banker or mortgage broker under the provisions of ORS 59.840 to 59.965 and whose performance of advisory services relate solely to securities involving real estate paper, whose performance of the advisory services is solely incidental to the person's conduct of business as a mortgage banker or mortgage broker and who receives no special compensation for such services.

(8) The director may, by order, as to any person or type of security or sale, withdraw or condition the exclusions allowed under this rule if the action would be in the public interest and would be in accordance with the purposes of the Oregon Securities Law. No person shall be liable under the Oregon Securities Law by reason of the withdrawal of the exclusions allowed under this rule if the person sustains the burden of proof that the person did not know and, in the exercise of reasonable care, could not have known of such withdrawal.
Chapter 4A

Federal Transactional Hot Topics

Professor Daniel Morrissey
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I. **Main Characteristics of New Rules 147, 147A, and 504**

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<th>Type of Offering</th>
<th>Offering Limit</th>
<th>Restrictions on Offers/Solicitation</th>
<th>Issuer and Investor Requirements</th>
<th>Filing Requirement</th>
<th>Restriction on Resale</th>
<th>Blue Sky Law Preemption and Bad Actor Disqualification Provisions</th>
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<tr>
<td>Rule 147</td>
<td>None</td>
<td>No offers to out of state residents</td>
<td>All issuers must be organized and have principal place of business in state. Issuer must be doing business in state. All investors must be residents in state or issuer must have a reasonable belief as to that.</td>
<td>None</td>
<td>Interstate resales are restricted for six months from the sale to the original investor</td>
<td>State Law Preemption: No Bad Actor Provisions: Required by the majority of states at the state level</td>
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<tr>
<td>Rule 147A</td>
<td>None</td>
<td>Offers may be made to out of state residents and general solicitation on internet is allowed so long as sales are only made to in-state residents</td>
<td>Issuer may be incorporated outside the state so long as its principal place of business is in the state.</td>
<td>None</td>
<td>Interstate resales are restricted for six months from the sale to the original investor</td>
<td>State Law Preemption: No Bad Actor Provisions: Required by the majority of states at the state level</td>
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<tr>
<td>Rule 504</td>
<td>$5 million</td>
<td>General solicitation allowed so long as registration is made in a state requiring that investors get documents</td>
<td>Excludes investment companies, blank check companies or Exchange Act Reporting Companies</td>
<td>File Form D</td>
<td>No restrictions on resales so long as registration is made in a state requiring that investors get documents</td>
<td>State Law Preemption: No Bad Actor Provisions: Yes</td>
</tr>
</tbody>
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II. **Excerpts from SEC Releases Nos. 33-10238, 34-79161 – Oct. 26, 2016**

I. **INTRODUCTION AND BACKGROUND**

On October 30, 2015, we proposed amendments to Rule 147 and Rule 504 under the Securities Act to assist smaller companies with capital formation consistent with other public policy goals, including investor protection. In developing final rules, we considered recommendations by

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the Advisory Committee on Small and Emerging Companies (“ACSEC”)\(^7\) and the most recent SEC Government-Business Forum on Small Business Capital Formation (“Small Business Forum”)\(^8\) and comment letters received on the Proposing Release.\(^9\) Today we are amending Rule 147 and establishing a new Securities Act exemption, designated Rule 147A. We are also amending Rule 504 of Regulation D. We believe the final rules will facilitate capital formation by smaller companies by increasing the utility of the current Securities Act exemptive framework for smaller offerings while maintaining appropriate protections for investors. The final rules complement recent efforts by the

\(^7\) See Recommendation to the Commission by the Advisory Committee on Small and Emerging Companies to Modernize Rule 147 under the Securities Act of 1933 (Sept. 23, 2015) (“2015 ACSEC Recommendation”), available at http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-modernize-rule-147.pdf. The Commission established the ACSEC in 2011 with the objective of providing the Commission with advice on its rules, regulations and policies with regard to its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation, as they relate to:

(1) capital raising by emerging privately-held small businesses (emerging companies) and publicly traded companies with less than $250 million in public market capitalization (smaller public companies) through securities offerings, including private and limited offerings and initial and other public offerings; (2) trading in the securities of emerging companies and smaller public companies; and (3) public reporting and corporate governance requirements of emerging companies and smaller public companies. Advisory Committee on Small and Emerging Companies, SEC Rel. No. 33-9258 (Sept. 12, 2011) [76 FR 57769 (Sept. 16, 2011)].


\(^9\) The comment letters received in response to the Proposing Release are available at http://www.sec.gov/comments/s7-22-15/s72215.shtml.
U.S. Congress,\textsuperscript{10} state legislatures,\textsuperscript{11} and state securities regulators\textsuperscript{12} to modernize existing federal and state securities laws and regulations to assist smaller companies with capital formation. We believe our amendment to Rule 504 to increase its aggregate offering ceiling from $1 million to $5 million will significantly diminish the utility of Rule 505 and we are therefore repealing that rule.

Consistent with commenters’ suggestions\textsuperscript{13} and the recommendations of the 2015 Small Business Forum,\textsuperscript{14} we are retaining and modernizing Rule 147 under the Securities Act as a safe

\textsuperscript{10} Congress enacted the Jumpstart Our Business Startups Act of 2012 ("JOBS Act"), which was signed into law by President Obama on April 5, 2012. Pub. L. No. 112-106, 126 Stat. 306. Pursuant to Title II of the JOBS Act, the Commission adopted a new paragraph (c) of Rule 506 of Regulation D, removing the prohibition on general solicitation or general advertising for securities offerings relying on Rule 506. See SEC Rel. No. 33-9415 (July 10, 2013). Pursuant to Title IV of the JOBS Act, the Commission amended Regulation A in order to permit issuers to raise up to $50 million annually. See SEC Rel. No. 33-9741 (Mar. 25, 2015) ("2015 Regulation A Release"). Pursuant to Title III of the JOBS Act, the Commission adopted rules permitting companies to use the Internet to offer and sell securities through crowdfunding ("Regulation Crowdfunding"). See SEC Rel. No. 33-9974 (Oct. 30, 2015) ("Regulation Crowdfunding Adopting Release"). Congress also enacted the Fixing America’s Surface Transportation Act of 2015 ("FAST Act"), which was signed into law by President Obama on December 4, 2015. Pub. L. No. 114-94, Sec 129 Stat. 1312 (2015). The FAST Act includes several amendments to the federal securities laws, including a new exemption to Section 4 of the Securities Act for secondary sales of securities that are purchased by an accredited investor, among other requirements (Section 76001), and changes to facilitate initial public offerings by emerging growth companies (Sections 71001 through 71003).


\textsuperscript{12} See, e.g., D.C. MUN. REGS. tit. 26-B, § 250 (2014); GA. COMP. R. & REGS. 590-4-2-.08 (2011); IDAHO CODE ANN. § 30-14-203 (providing an exemption by order on a case-by-case basis); KAN. ADMIN. REGS. § 81-5-21 (2011).


\textsuperscript{14} See 2015 Small Business Forum Recommendations.
harbor for intrastate offerings exempt from registration pursuant to Securities Act Section 3(a)(11).

These amendments will modernize the safe harbor, while keeping within the statutory parameters of Section 3(a)(11), so that issuers may continue to rely upon the rule for offerings pursuant to state law exemptions, including crowdfunding provisions, that are conditioned upon compliance with Section 3(a)(11) and Rule 147.

Securities Act Section 3(a)(11) provides an exemption from registration under the Securities Act for “[a]ny security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.”15 In 1974, the Commission adopted Rule 147 under the Securities Act to provide objective standards for local businesses seeking to rely on Section 3(a)(11).16 The Rule 147 safe harbor was intended to provide assurances that the intrastate offering exemption would be used for the purpose Congress intended in enacting Section 3(a)(11), namely the local financing of companies by investors within the company’s state or territory.17 Rule 147 reflects this Congressional intent and generally relies upon state regulation to effectively protect investors.

Notwithstanding the importance of these limitations, due to developments in modern business practices and communications technology in the years since Rule 147 was adopted, we have determined that it is necessary to update the requirements of Rule 147 to ensure its continued utility.18 We are also establishing a new intrastate offering exemption under the Securities Act,

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18 The Commission has not amended Rule 147 since its adoption, other than in 2013 when the Commission adopted technical amendments to Rules 145, 147, 152 and 155 to update references to Section 4(2) of the Securities Act, which was renumbered as Section 4(a)(2) by Section 201(c) of the JOBS Act, Pub. L. No. 112-106, sec. 201(c), 126 Stat. 306, 314 (Apr. 5, 2012). See SEC Rel. No. 33-9414 [78 FR 44730] (July 10, 2013). See also ABA Letter; Milken Letter.
designated Rule 147A, that will further accommodate modern business practices and communications technology and provide an alternative means for smaller companies to raise capital locally.

We are adopting new Rule 147A pursuant to our general exemptive authority under Section 28 of the Securities Act, and therefore, new Rule 147A will not be subject to the statutory limitations of Section 3(a)(11). Accordingly, Rule 147A will have no restriction on offers, but will require that all sales be made only to residents of the issuer’s state or territory to ensure the intrastate nature of the exemption. Rule 147A also will not require issuers to be incorporated or organized in the same state or territory where the offering occurs so long as issuers can demonstrate the in-state nature of their business, which we believe will expand the number of businesses that will be able to seek intrastate financing under Rule 147A, as compared to amended Rule 147. Certain provisions of existing Rule 147 concerning legends and mandatory disclosures to purchasers and prospective purchasers will apply to offerings conducted pursuant to amended Rule 147 and Rule 147A.

As in current Rule 147, nothing in either amended Rule 147 or new Rule 147A will obviate the need for compliance with any applicable state law relating to the offer and sale of securities. Thus, states will retain the flexibility to adopt requirements that are consistent with their respective interests in facilitating capital formation and protecting their resident investors in intrastate securities offerings, including the authority to impose additional disclosure requirements regarding offers and sales made to persons within their state or territory, or the authority to limit the ability of certain bad actors from relying on applicable state exemptions. In addition, both federal and state antifraud provisions will continue to apply to offers and sales made pursuant to amended Rule 147 and new Rule 147A.

19 15 USC 77z-3. For the reasons discussed throughout this release, we find that the Rule 147A exemption being adopted today is necessary and appropriate in the public interest and consistent with the protection of investors.

20 See Rules 147(f) and 147A(f).
The staff will seek to collaborate with state regulators in gathering information about intrastate crowdfunding offerings and, based on the sharing of this information and other relevant inputs, the staff will undertake to study and submit a report to the Commission, no later than three years following the effective date of amended Rule 147 and new Rule 147A, on capital formation and investor protection in offerings under these rules. The report will include, but not be limited to, a review of information about:

1. the use of amended Rule 147 and new Rule 147A;
2. repeat use by the same issuers of amended Rule 147 or new Rule 147A;
3. the use by issuers of alternative federal offering exemptions concurrently or close in time to an offer or sale under amended Rule 147 or new Rule 147A;
4. fraud associated with, or issuer non-compliance with provisions of, amended Rule 147 or new Rule 147A;
5. the role of intrastate broker-dealers and other intermediaries in offerings conducted pursuant to amended Rule 147 or new Rule 147A; and
6. the application of state bad actor disqualification provisions in offerings conducted pursuant to amended Rule 147 or new Rule 147A to inform whether the Commission should consider including bad actor disqualification provisions in amended Rule 147 and new Rule 147A.

We also are amending Rule 504 of Regulation D under the Securities Act to increase the aggregate amount of securities that may be offered and sold pursuant to Rule 504 in any twelve-month period from $1 million to $5 million and to disqualify certain bad actors from participation in Rule 504 offerings. The higher offering ceiling amount will promote capital formation by increasing the flexibility of state securities regulators to implement coordinated review programs to facilitate
The bad actor disqualification provisions will provide for greater consistency across Regulation D. We believe these amendments to Rule 504 will significantly diminish the utility of Rule 505, which historically has been little utilized in comparison to Rule 506 of Regulation D. We, therefore, are repealing Rule 505.

III. New Rules 147A and 504 – Repeal of Rule 505

§ 230.147A Intrastate sales exemption.

(a) Scope of the exemption. Offers and sales by or on behalf of an issuer of its securities made in accordance with this section (§ 230.147A) are exempt from section 5 of the Act (15 U.S.C. 77e). This exemption is not available to an issuer that is an investment company registered or required to be registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.).

(b) Manner of offers and sales. An issuer, or any person acting on behalf of the issuer, may rely on this exemption to make offers and sales using any form of general solicitation and general advertising, so long as the issuer complies with the provisions of paragraphs (c), (d), and (f) through (h) of this section.

(c) Nature of the issuer. The issuer of the securities shall at the time of any offers and sales be a person resident and doing business within the state or territory in which all of the sales are made.

(1) The issuer shall be deemed to be a resident of the state or territory in which it has its principal place of business. The issuer shall be deemed to have its principal place of business in a

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21 The state registration of securities offerings under coordinated review programs is an example of the efforts being undertaken by the states to streamline the state registration process for issuers seeking to undertake multi-state registrations. These programs establish uniform review standards and are designed to expedite the registration process, thereby potentially saving issuers time and money. Participation in such programs is voluntary. The states have created coordinated review protocols for equity, small company and franchise offerings; direct participation program securities; and for certain offerings of securities pursuant to Regulation A. More information on coordinated review programs is available at http://www.nasaa.org/industry-resources/corporation-finance/coordinated-review/.
state or territory in which the officers, partners or managers of the issuer primarily direct, control and coordinate the activities of the issuer.

(2) The issuer shall be deemed to be doing business within a state or territory if the issuer satisfies at least one of the following requirements:

(i) The issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in or from the rendering of services within such state or territory;

Instruction to paragraph (c)(2)(i): Revenues must be calculated based on the issuer’s most recent fiscal year, if the first offer of securities pursuant to this section is made during the first six months of the issuer’s current fiscal year, and based on the first six months of the issuer’s current fiscal year or during the twelve-month fiscal period ending with such six-month period, if the first offer of securities pursuant to this section is made during the last six months of the issuer’s current fiscal year.

(ii) The issuer had at the end of its most recent semi-annual fiscal period prior to an initial offer of securities in any offering or subsequent offering pursuant to this section, at least 80% of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;

(iii) The issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to this section (§ 230.147A) in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory; or

(iv) A majority of the issuer’s employees are based in such state or territory.

Instruction to paragraph (c): An issuer that has previously conducted an intrastate offering pursuant to this section (§ 230.147A) or Rule 147 (§ 230.147) may not conduct another intrastate offering pursuant to this section (§ 230.147A) in a different state or territory, until the expiration of the time
period specified in paragraph (e) of this section (§ 230.147A(e)) or paragraph (e) of Rule 147 (§ 230.147(e)), calculated on the basis of the date of the last sale in such offering.

(d) **Residence of purchasers.** Sales of securities pursuant to this section (§ 230.147A) shall be made only to residents of the state or territory in which the issuer is resident, as determined pursuant to paragraph (c) of this section, or who the issuer reasonably believes, at the time of sale, are residents of the state or territory in which the issuer is resident. For purposes of determining the residence of purchasers:

(1) A corporation, partnership, limited liability company, trust or other form of business organization shall be deemed to be a resident of a state or territory if, at the time of sale to it, it has its principal place of business, as defined in paragraph (c)(1) of this section, within such state or territory.

*Instruction to paragraph (d)(1):* A trust that is not deemed by the law of the state or territory of its creation to be a separate legal entity is deemed to be a resident of each state or territory in which its trustee is, or trustees are, resident.

(2) Individuals shall be deemed to be residents of a state or territory if such individuals have, at the time of sale to them, their principal residence in the state or territory.

(3) A corporation, partnership, trust or other form of business organization, which is organized for the specific purpose of acquiring securities offered pursuant to this section (§ 230.147A), shall not be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory.

*Instruction to paragraph (d):* Obtaining a written representation from purchasers of in-state residency status will not, without more, be sufficient to establish a reasonable belief that such purchasers are in-state residents.
(e) **Limitation on resales.** For a period of six months from the date of the sale by the issuer of a security pursuant to this section (§ 230.147A), any resale of such security shall be made only to persons resident within the state or territory in which the issuer was resident, as determined pursuant to paragraph (c) of this section, at the time of the sale of the security by the issuer.

*Instruction to paragraph (e):* In the case of convertible securities, resales of either the convertible security, or if it is converted, the underlying security, could be made during the period described in paragraph (e) only to persons resident within such state or territory. For purposes of this paragraph (e), a conversion in reliance on section 3(a)(9) of the Act (15 U.S.C. 77c(a)(9)) does not begin a new period.

(f) **Precautions against interstate sales.** (1) The issuer shall, in connection with any securities sold by it pursuant to this section:

   (i) Place a prominent legend on the certificate or other document evidencing the security stating that: “Offers and sales of these securities were made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of six months from the date of the sale by the issuer of these securities, any resale of these securities (or the underlying securities in the case of convertible securities) shall be made only to persons resident within the state or territory of [identify the name of the state or territory in which the issuer was resident at the time of the sale of the securities by the issuer].”;  

   (ii) Issue stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, make a notation in the appropriate records of the issuer; and  

   (iii) Obtain a written representation from each purchaser as to his or her residence.

(2) The issuer shall, in connection with the issuance of new certificates for any of the securities that are sold pursuant to this section (§ 230.147A) that are presented for transfer during the
time period specified in paragraph (e), take the steps required by paragraphs (f)(1)(i) and (ii) of this section.

(3) The issuer shall, at the time of any offer or sale by it of a security pursuant to this section (§ 230.147A), prominently disclose to each offeree in the manner in which any such offer is communicated and to each purchaser of such security in writing a reasonable period of time before the date of sale, the following: “Sales will be made only to residents of the state or territory of [identify the name of the state or territory in which the issuer was resident at the time of the sale of the securities by the issuer]. Offers and sales of these securities are made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of six months from the date of the sale by the issuer of the securities, any resale of the securities (or the underlying securities in the case of convertible securities) shall be made only to persons resident within the state or territory of [identify the name of the state or territory in which the issuer was resident at the time of the sale of the securities by the issuer].”

(g) Integration with other offerings. Offers or sales made in reliance on this section will not be integrated with:

(1) Offers or sales of securities made prior to the commencement of offers and sales of securities pursuant to this section (§ 230.147A); or

(2) Offers or sales of securities made after completion of offers and sales of securities pursuant to this section (§ 230.147A) that are:

(i) Registered under the Act, except as provided in paragraph (h) of this section (§ 230.147A);

(ii) Exempt from registration under Regulation A (§§ 230.251 through 230.263);

(iii) Exempt from registration under Rule 701 (§ 230.701);

(iv) Made pursuant to an employee benefit plan;
(v) Exempt from registration under Regulation S (§§ 230.901 through 230.905);

(vi) Exempt from registration under section 4(a)(6) of the Act (15 U.S.C. 77d(a)(6)); or

(vii) Made more than six months after the completion of an offering conducted pursuant to this section (§ 230.147A).

Instruction to paragraph (g): If none of the safe harbors applies, whether subsequent offers and sales of securities will be integrated with any securities offered or sold pursuant to this section (§ 230.147A) will depend on the particular facts and circumstances.

(h) Offerings limited to qualified institutional buyers and institutional accredited investors. Where an issuer decides to register an offering under the Act after making offers in reliance on this section (§ 230.147A) limited only to qualified institutional buyers and institutional accredited investors referenced in section 5(d) of the Act, such offers will not be subject to integration with any subsequent registered offering. If the issuer makes offers in reliance on this section (§ 230.147A) to persons other than qualified institutional buyers and institutional accredited investors referenced in section 5(d) of the Act, such offers will not be subject to integration if the issuer (and any underwriter, broker, dealer, or agent used by the issuer in connection with the proposed offering) waits at least 30 calendar days between the last such offer made in reliance on this section (§ 230.147A) and the filing of the registration statement with the Commission.

§ 230.504 Exemption for limited offerings and sales of securities not exceeding $5,000,000.

* * * * *

(b) * * *

(2) The aggregate offering price for an offering of securities under this § 230.504, as defined in § 230.501(c), shall not exceed $5,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this § 230.504, in violation of section 5(a) of the Securities Act.
Instruction to paragraph (b)(2): If a transaction under § 230.504 fails to meet the limitation on the aggregate offering price, it does not affect the availability of this §230.504 for the other transactions considered in applying such limitation. For example, if an issuer sold $5,000,000 of its securities on January 1, 2014 under this § 230.504 and an additional $500,000 of its securities on July 1, 2014, this § 230.504 would not be available for the later sale, but would still be applicable to the January 1, 2014 sale.

(3) Disqualifications. No exemption under this section shall be available for the securities of any issuer if such issuer would be subject to disqualification under § 230.506(d) on or after January 20, 2017; provided that disclosure of prior “bad actor” events shall be required in accordance with § 230.506(e).

Instruction to paragraph (b)(3): For purposes of disclosure of prior “bad actor” events pursuant to § 230.506(e), an issuer shall furnish to each purchaser, a reasonable time prior to sale, a description in writing of any matters that would have triggered disqualification under this paragraph (b)(3) but occurred before January 20, 2017.

§ 230.505 [Removed and Reserved]

10. § 230.505 is removed and reserved.

IV. Articles by Dan Morrissey on These Topics


Reg A+, Reg CF, and 4(a)(7) Resales:
Recent Developments

Jon Norling
May 19, 2017

Regulation A+

• Raise up to $50 Million from accredited and non-accredited investors
• SEC Review process
• Two levels:
  • Tier 1: Up to $20MM
  • Tier II: Up to $50MM
Regulation A+ Developments:

- Issuers were suspended:
  - MedX, cannabis-related company, suspended due to failure to file accounting updates
  - NOT due to nature of business
- State AG Lawsuit challenging preemption authority

Regulation CF:

- Title III of the JOBS Act
- Regulation Crowdfunding
- $1M in 12 months
- Investor limits
- Transactions through Intermediaries
Regulation CF Developments

• FINRA Enforcement
• Limit increased to $1,070,000
• I license terminated
• Fraudulent transactions
• Increase in SAFE Agreements – most popular security
• Picking up steam
• Fix Crowdfunding Act

FAST RAISE RESALES:

• Part of the RAISE Provisions of the FAST Act
• Codified “4(a)(1/2)”
• Allow resales of private securities to accredited investors
• Alternative to Rule 144A
4(a)(7) Requirements:

- Resales of issued securities, not for sales by the Issuer
- Accredited Investors
- No general solicitation
- Seller must obtain from the Issuer
  - the exact name of the issuer and any predecessor;
  - the address of the issuer's principal executive offices;
  - the exact title and class of the security; the par or stated value of the security;
  - the number of shares or total amount of the securities outstanding
  - the name and address of the transfer agent
  - a statement of the nature of the business of the issuer
  - the names of the officers and directors of the issuer
  - Financials
- No Bad Actors
- Seller not an Issuer; can be a control person of the Issuer; not an underwriter
- “Operating Company” requirement
Chapter 5A

Hot Topics in Federal Securities Litigation—Presentation Slides

BRAD DANIELS
Stoel Rives LLP
Portland, Oregon
LEIDOS INC. V. INDIANA PERS

- Item 303 requires disclosure of “known trends or uncertainties” Actionable?
- 3rd Circuit and 9th Circuit: Item 303 does not create a duty to disclose
- 2nd Circuit: Disagrees with other circuits; failure to make Item 303 disclosure is actionable omission
- Supreme Court granted cert petition to resolve the circuit split
**CALPERS v. ANZ SECURITIES, INC.**

- Does *American Pipe* tolling apply to claims filed under Section 13 of Securities Act?
- CalPERS opted out of securities suit filed against Lehman Bros.
- 2nd Circuit held that case was time-barred; statutes of repose not subject to tolling
- Argument in April; bench appeared divided

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**CYAN v. BEAVER CTY. EMP. RET. FUND**

- Petition for cert filed May 2016 with significant support
- Question presented: Whether state courts have jurisdiction to hear class actions asserting claims solely under ‘33 Act
- District courts divided; California state courts continued jurisdiction
- Solicitor General asked to express opinion
**RETAIL DEPARTMENT STORE UNION V. HEWLETT PACKARD**

- Chairman and CEO resigned after allegations of relationship with independent contractor
- HP had publicly touted business’s high standards for ethics and compliance
- When, if ever, can an undisclosed violation of code of conduct be actionable fraud?
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Chapter 5B

Omnicare, Inc., One Year Later: Its Salutary Impact on Securities-Fraud Class Actions in the Lower Federal Courts

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OMNICARE, INC., ONE YEAR LATER:
ITS SALUTARY IMPACT ON SECURITIES-FRAUD
CLASS ACTIONS IN THE LOWER FEDERAL COURTS

by
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OMNICARE, INC., ONE YEAR LATER: ITS SALUTARY IMPACT ON SECURITIES-FRAUD CLASS ACTIONS IN THE LOWER FEDERAL COURTS

INTRODUCTION

Just over a year ago, on March 24, 2015, the U.S. Supreme Court issued its opinion in Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund. Omnicare held that a statement of opinion is only false under the federal securities laws if the speaker does not genuinely believe it, and is only misleading if it omits information that, in context, would cause the statement to mislead a reasonable investor. This ruling followed the path advocated in Washington Legal Foundation’s amicus brief in Omnicare. In the wake of the decision, the authors opined that it would “help defense counsel defeat claims that opinions were false or misleading in § 11 cases, as well as in cases brought under § 10(b) of the Securities Exchange Act.”

The Court’s ruling in Omnicare was a significant victory for the defense bar for two primary reasons. First, the Court made clear that an opinion is false only if it was not sincerely believed by the speaker at the time that it was expressed, a concept sometimes referred to as “subjective falsity.” The Court thus explicitly rejected the

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possibility that a statement of opinion could be false because “external facts show the
opinion to be incorrect,” because a company failed to “disclose[] some fact cutting the
other way,” or because the company did not disclose that others disagreed with its
opinion. As discussed below, this ruling resolved two decades’ worth of confusing and
conflicting case law regarding what makes a statement of opinion false, which had
often permitted meritless securities cases to survive dismissal motions.

Second, Omnicare declared that whether a statement of opinion (and by clear
implication, a statement of fact) was misleading “always depends on context.” The
Court emphasized that showing a statement to be misleading is “no small task” for
plaintiffs, and that the Court must consider not only the full statement being
challenged and the context in which it was made, but also other statements made by
the company, and other publicly available information, including the customs and
practices of the relevant industry.

Evaluating challenged statements in their broader context almost always
benefits defendants, because it helps the court better understand the challenged
statements and makes them seem fairer than they might in isolation. Omnicare now
explicitly requires courts to evaluate challenged statements within their broader
contexts.

Although Omnicare arose from a claim under § 11 of the Securities Act, all of its
core concepts are equally applicable to § 10(b) and other securities claims with similar
falsity elements. Due to the importance of its holdings and the detailed way in which
it explains them, *Omnicare* is the most significant post-Reform Act Supreme Court case to analyze the falsity element of a securities class-action claim, laying out the core principles of falsity in the same way that the Court did for scienter in its 2007 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* decision. If used correctly, *Omnicare* thus has the potential to be the most helpful securities case for defendants since *Tellabs*, providing attorneys with a blueprint for how to structure their falsity arguments in order to defeat more complaints on motions to dismiss.

Nevertheless, over the past year, some commentators and members of the defense bar have raised alarm about *Omnicare*, asserting the decision was a win for plaintiffs because it created a new area of potential liability for statements of opinion that were honestly held, but nonetheless misleading. One commentator warned that *Omnicare* will “give new life to securities cases involving false opinions,” while another cautioned that *Omnicare*’s misleading-statement analysis provided “an amorphous standard that is likely to lead to unpredictable results,” and that it should “provide little comfort to plaintiffs or defendants.”

The view that *Omnicare* was a plaintiff-friendly result seems to be based on two misconceptions: first, a misunderstanding of the law as it existed before *Omnicare*; second, a misunderstanding of the ruling itself. After breaking down these

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misconceptions, this WORKING PAPER surveys the lower courts’ decisions applying

*Omnicare* and concludes that, on the whole, courts are generally applying the decision as the Supreme Court intended—including in the Second Circuit’s recent decision in *Tongue v. Sanofi*.6

I. LAW BEFORE *OMNICARE* WAS A HOPELESS MUDDLE OF CONFLICTING STANDARDS

Some commentators have mistakenly argued that the law before *Omnicare* established a clear standard that favored defendants, namely that statements of opinion were actionable under this pre-*Omnicare* standard *only* if they misstated the speakers’ true opinion. But this is a misunderstanding of the law governing statements of opinion before *Omnicare*—which was anything but clear, as discussed at length in WLF’s *Omnicare amicus* brief.7 This confusion reigned despite the fact that the Supreme Court had previously addressed the issue in 1991 in *Virginia Bankshares v. Sandberg*.8 *Virginia Bankshares* established the so-called “subjective falsity” standard, holding that a statement of opinion may be actionable as a false statement of “fact” only to the extent to which it is a “misstatement of the psychological fact of the speaker’s belief in what he says.”

Yet, the *Virginia Bankshares* decision was itself hardly a paragon of clarity, and

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6816 F.3d 199 (2d Cir. 2016).


its holding took nearly 20 years to catch on. In the meantime, the most influential standard on statements of opinion continued to be the plaintiff-friendly one articulated in 1989 by the Ninth Circuit in *In re Apple Computer Securities Litigation*. That decision held that opinions are actionable if (1) they are not genuinely believed, (2) there is no reasonable basis for the belief, or (3) the speaker knows undisclosed facts that tend to seriously undermine the opinion.⁹

The tide began to change in 2009, when the Ninth Circuit applied *Virginia Bankshares* in *Rubke v. Capitol Bancorp Ltd.*,¹⁰ and held that plaintiffs bringing cases under Section 11 must plead that statements of opinion were subjectively false. The Second Circuit followed in the footsteps of *Rubke* in 2011, applying the *Virginia Bankshares* standard of subjective falsity in *Fait v. Regions Financial Corp.*¹¹

However, the *Rubke* court did not expressly consider or overrule the plaintiff-friendly *Apple* standard, which courts around the country continued to widely apply. Meanwhile, many other courts continued to ignore both *Apple* and *Virginia Bankshares*, and instead engaged in the amorphous discussion of whether statements of opinion were “soft” information or mere “puffery” that could not form the basis for any securities liability.

Adding to this confusion was the fact that neither *Rubke* nor *Fait* had attempted to address what made a statement of opinion “misleading,” the second

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⁹See, e.g., *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989).
¹⁰551 F.3d 1156 (9th Cir. 2009).
¹¹655 F.3d 105 (2d Cir. 2011).
half of the falsity standard articulated throughout the securities laws, including in § 10(b) and § 11.\textsuperscript{12} On one hand, the fact that the circuit courts had declined to reach the question of what could make a statement of opinion “misleading” left district courts to struggle on their own to lend meaning to that concept, with results that were sometimes disastrous from a defense point of view.\textsuperscript{13} On the other hand, this oversight led some defense attorneys to believe (incorrectly, as discussed below) that the Second and Ninth Circuits had simply eliminated the “misleading” half of the “false or misleading statement” element of the securities laws when it came to statements of opinion—and to argue that plaintiffs could not allege that a statement of opinion was misleading.

This hodgepodge of conflicting precedent culminated in the confused Sixth Circuit opinion that the Court reviewed in \textit{Omnicare}. That circuit court opinion jumbled concepts of falsity, materiality, and scienter to arrive at the conclusion that, under § 11, a statement of opinion can be “false” if it is later determined that the opinion was incorrect—even if it was genuinely believed by the speaker at the time.

\footnote{\textsuperscript{12}For example, Rule 10b-5 provides for liability if companies “make any untrue statement of a material fact” or “omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.” 15 U.S.C. § 78j; see also 15 U.S.C. § 77k(a) (Section 11 provides that there is liability for registration statements connected with public offerings if they “contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.”).}

\footnote{\textsuperscript{13}See, e.g., \textit{McGuire v. Dendreon Corp.}, 688 F. Supp. 2d 1239 (W.D. Wash. 2009) (implementing the subjective falsity requirement of \textit{Virginia Bankshares} and \textit{Rubke}, but holding an opinion may be “subjectively misleading” if the speaker does not reveal all facts “that he knew or should know would lead someone else to a different opinion.”).}
II. **OMNICARE WAS INITIALLY MISUNDERSTOOD**

The Supreme Court decision in *Omnicare* did not give a clear win to either the *Omnicare* plaintiffs or defendants—but that was because, as became clear during oral argument, the justices found the positions the parties advanced to be untenable. The Court overruled the holding of the Sixth Circuit by recognizing that a statement of opinion is only “false” if it was not genuinely believed. At the same time, the Court also rejected *Omnicare*’s position that a statement of opinion could never be misleading, holding that—like *any other statement*—a statement of opinion may indeed be misleading.

The Court sidestepped many potential landmines in articulating how a statement of opinion could be misleading, and instead established a clear test that was consistent with existing law. It emphasized that an opinion is not misleading just because “external facts show the opinion to be incorrect,” a company fails to disclose “some fact cutting the other way,” or the company does not disclose that some disagree with its opinion. The Court also rejected the Solicitor General’s plaintiff-friendly approach, which would have required that every opinion have a “reasonable basis.” Rather, the Court seized upon the approach that WLF had urged in its brief, finding that, as with a statement of fact, an opinion is misleading if it

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14 *Omnicare*, 135 S. Ct. at 1328.
15 *Id.* at 1329.
16 *Id.* at 1334.
17 WLF Amicus Br. at *23-29.*
omits information that is necessary to avoid giving a reasonable investor a false impression of the “real facts,” when the statement is taken as a whole and considered in its full context.

The Court then explained in detail, using hypothetical examples, how this standard applies to statements of opinion, emphasizing that whether a statement is misleading “always depends on context,” because a statement must be understood in its “broader frame,” including “in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information,” as well as the “customs and practices of the relevant industry.” Emphasizing that pleading the existence of a misleading opinion is “no small task” for plaintiffs, the Omnicare Court described the variety of contextual weapons that defense attorneys can use to fight against allegations that a statement of opinion—or any kind of statement—was misleading due to omission.

This portion of the ruling is perhaps the most significant one from the defense perspective. Good defense lawyers already took advantage of existing law, such as Tellabs, to supply courts with a wide variety of contextual information, including the text surrounding challenged statements, other statements filed with the SEC, and further information that was available to the market and subject to judicial notice. Tellabs, 551 U.S. at 322 (“courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and
matters of which a court may take judicial notice”). But now the Supreme Court has further mandated that such a contextual analysis is necessary, not only to determine the existence of scienter, but also to judge whether a statement can be viewed as misleading.

Defense counsel and other commentators who have opined that Omnicare was a plaintiff-friendly holding fundamentally misunderstand several aspects of the ruling. First, some have wrongly asserted that the Court opened up a “new” area of liability, claiming, for example, that Omnicare “offers more to plaintiffs than defendants” because “[i]t makes clear that the mere fact that a public disclosure expresses an opinion will not preclude liability under federal securities laws.”18 Statements of opinion have never enjoyed anything approaching complete immunity under the securities laws. The second element of the “false or misleading” standard had to apply to opinion statements in some way—the Omnicare Court merely clarified and specified how. The Court’s holding fits statements of opinion into the existing legal frameworks used by many circuits, including the Second and the Ninth Circuits, to analyze whether any statement is misleading due to an omission, under the plain language of §11 and Rule 10b-5.19

Second, the Court did not, contrary to some assessments of Omnicare, implement a “reasonable basis” test for opinions similar to the test the Solicitor

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18Supra n. 4.

19See, e.g., Brody v. Transitional Hosps. Corp., 280 F.3d 997 (9th Cir. 2002) (a statement is misleading due to omissions if it “affirmatively create[s] an impression of a state of affairs that differs in a material way from the one that actually exists”).
General advocated. The Solicitor General’s test would have implemented a standard close to the plaintiff-friendly *Apple* test to evaluate the “reasonableness” of the opinion itself, such that a genuinely held statement of opinion could nevertheless be false if a court later determined that the speaker did not have a “reasonable basis” to hold that opinion. Such a test would be deeply flawed because this kind of “reasonableness” inquiry is, in and of itself, entirely subjective, meaning that whether an opinion was true or false would hinge on someone else’s later opinion as to its “reasonableness.”

Although the *Omnicare* Court does use the word “reasonable,” it does so only to state (consistent with preexisting law) that whether an opinion statement is “misleading” due to an omission is dependent upon what the statement in its full context would convey to a *reasonable investor*. Because registration statements are “formal documents, filed with the SEC as a legal prerequisite for selling securities to the public,” the Court found that investors would reasonably assume that statements made in this context rested on a “meaningful inquiry,” and did not “reflect baseless, off-the-cuff judgments.” As the Court emphasized, this test is objective, far different from the subjective “reasonable basis” approach advocated by the Solicitor General.

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20 *Supreme Court’s Omnicare Decision Follows Middle Path Advocated by Lane Powell and WLF*, supra note 2; Claire Loebs Davis, *Omnicare Court Ponders Two Middle Paths: One Rocky, One Smooth*, D&O DISCOURSE BLOG (Nov. 6, 2014), http://www.dandodiscourse.com/2014/11/06/omnicare-court-ponders-two-middle-paths-one-rocky-one-smooth/.

21 *Omnicare*, 135 S. Ct. at 1330.
Whether based on misconceptions about the state of the previous law or misconceptions about the substance of *Omnicare*, the assertion that *Omnicare* is better for plaintiffs than defendants is simply wrong, as has been demonstrated by the lower court decisions discussed in this WORKING PAPER. *Omnicare* supplies the defense bar with powerful new tools, which if used correctly, will give defendants more opportunities to win difficult motions to dismiss, and allow companies and their executives greater freedom to speak without undue fear of liability. But if the defense bar fails to use these tools, *Omnicare* could fall through the cracks in the litany of Supreme Court securities cases, and its potential value to defendants will then be squandered.

### III. SECOND CIRCUIT’S SANOFI RULING EMPHASIZES SUBJECTIVE FALSITY, IMPORT OF CONTEXT

*Sanofi*, issued just shy of *Omnicare*’s one-year anniversary, is arguably the most significant post-*Omnicare* ruling thus far. Other circuit court decisions have recognized the impact of *Omnicare*, and the Fifth Circuit has specifically noted its importance in emphasizing that statements of both fact and opinion must be evaluated in the context in which they are made. With *Sanofi*, however, the Second Circuit became the first appeals court to discuss *Omnicare* in detail, and to examine the changes that it brought about in the previously governing law.

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23 *Owens v. Jastrow*, 789 F.3d 529 (5th Cir. 2015) (affirming dismissal of complaint for failure to plead scienter).
Sanofi was not, as some securities litigation defense lawyers have claimed, a “narrow” reading of the Court’s decision. Rather, it was a straightforward interpretation of Omnicare that emphasized the Supreme Court’s ruling on falsity, and the intensive contextual analysis required to show that a statement is misleading. It correctly took these concepts beyond the § 11 setting and applied them to allegations brought under § 10(b).

Statements about Lemtrada, a drug in development for treatment of multiple sclerosis, were at issue in the case. Sanofi and its predecessor had conducted “single-blind” clinical trials for Lemtrada (studies in which either the researcher or the patient does not know which drug was administered), despite the fact that the U.S. Food and Drug Administration had repeatedly expressed concerns about these trials and recommended “double-blind” clinical studies (studies in which both the researcher and the patient do not know which drug was administered).

The plaintiffs alleged that Sanofi’s failure to disclose FDA’s repeated warnings that a single-blind study might not be adequate for approval caused various statements made by the company to be misleading, including its projection that FDA would approve the drug, its expressions of confidence about the anticipated launch date of the drug, and its view that the results of the clinical trials were “unprecedented” and “nothing short of stunning.” Although FDA eventually approved Lemtrada without further clinical trials, the agency initially refused approval based in large part on the single-blind studies concern, causing a large drop in the price of
Sanofi stock.

In an opinion issued before *Omnicare*, the district court dismissed the claims, in part because it found that plaintiffs had failed to plead that the challenged statements of opinion were subjectively false under the standard employed by the Second Circuit in *Fait v. Regions Financial Corp*. The Second Circuit stated that it saw “no reason to disturb the conclusions of the district court,” but wrote to clarify the impact of *Omnicare* on prior Second Circuit law.\(^2^4\)

The court acknowledged that *Omnicare* affirmed the previous standard that a statement of opinion may be false “if either ‘the speaker did not hold the belief she professed’ or ‘the supporting fact she supplied were untrue.’”\(^2^5\) However, it noted that *Omnicare* went beyond the standard outlined by *Fait* in holding that “opinions, though sincerely held and otherwise true as a matter of fact, may nonetheless be actionable if the speaker omits information whose omission makes the statement misleading to a reasonable investor.”\(^2^6\)

In reality, *Omnicare* did not represent a change in Second Circuit law. Although *Fait* only discussed falsity, without considering what it would take to make an opinion “misleading,” prior Second Circuit law had been clear that “[e]ven a statement which is literally true, if susceptible to quite another interpretation by the reasonable

\(^{24}\text{Sanofi, 816 F.3d at 209.}\)

\(^{25}\text{Id. at 210 (quoting Omnicare, 135 S. Ct. at 1327).}\)

\(^{26}\text{Ibid.}\)
investor, may properly be considered a material misrepresentation.” Omnicare simply brought together these two lines of authority, by correctly clarifying that, like any other statement, a statement of opinion can be literally true (i.e., actually believed by the speaker), but can nonetheless omit information that can cause it to be misleading to a reasonable investor.

The Second Circuit highlighted the Omnicare Court’s focus on context, taking note of its statement that “an omission that renders misleading a statement of opinion when viewed in a vacuum may not do so once that statement is considered, as is appropriate, in a broader frame.” Since Sanofi’s offering materials “made numerous caveats to the reliability of the projections,” a reasonable investor would have considered the opinions in light of those qualifications. Similarly, the Second Circuit recognized that reasonable investors would be aware that Sanofi would be engaging in continuous dialogue with FDA that was not being disclosed, that Sanofi had clearly disclosed that it was conducting single-blind trials for Lemtrada, and that FDA had generally made clear through public statements that it preferred double-blind trials. In this broader context, the court found that Sanofi’s optimistic statements about the future of Lemtrada were not misleading even in the context of Sanofi’s failure to disclose FDA’s specific warnings regarding single-blind trials.

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27 Kleinman v. Elan Corp., 706 F.3d 145 (2d Cir. 2013) (citation and internal quotation marks omitted).
28 Sanofi, 816 F.3d at 210.
29 Id. at 211.
Under the *Omnicare* standards, the Second Circuit thus found nothing false or misleading about the challenged statements, holding that *Omnicare* imposes no obligation to disclose facts merely because they tended to undermine the defendants’ optimistic projections. In particular, the Second Circuit found that “*Omnicare* does not impose liability merely because an issuer failed to disclose information that ran counter to an opinion expressed in a registration statement.”\(^{30}\) It also reasoned that “defendants’ statements about the effectiveness of [the drug] cannot be misleading merely because the FDA disagreed with the conclusion—so long as Defendants conducted a ‘meaningful’ inquiry and in fact held that view, the statements did not mislead in a manner that is actionable.”\(^ {31}\)

### IV. DISTRICT COURT DECISIONS ILLUSTRATE THE IMPORTANCE OF *OMNICARE* TO DEFENDANTS

While *Sanofi* was the first circuit court decision to discuss *Omnicare* at length, more than a dozen district court decisions have examined the Supreme Court’s ruling, and many other lower courts have cited to the decision as important authority.

Although a few courts have stumbled, by and large the district courts have interpreted *Omnicare* correctly, as requiring that: 1) to plead the falsity of a statement of opinion, plaintiffs must show that it was not genuinely believed;\(^{32}\) 2) to show a

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\(^{30}\) *Id.* at 212.

\(^{31}\) *Id.* at 214.

statement of opinion was misleading due to an omission, plaintiffs must show that the statement as a whole would mislead a reasonable investor; and 3) context must be considered when deciding whether any statement is misleading, including the full context of the statement, other statements made by the company (including its risk warnings), and other information that is publicly available to investors.

District courts have used this framework to dismiss claims involving a wide variety of opinion statements in the wake of Omnicare, including statements:

- Regarding the savings expected from synergies brought about by a merger, in light of “abundant cautionary language” about the risks that these synergies may not be realized;

- Made in a conference call regarding an executive’s belief in the “strength” of a market, in light of the executive’s contemporaneous statements discussing the “weakening” and “softening” of the market;

- Indicating that a company’s “strong infrastructure and other characteristics” positioned it to “grow substantially by opening new stores at a rapid clip,” despite evidence of a generally poor infrastructure, in light of numerous risk factors that made “clear the real tentativeness of [the company’s] belief”;


• Indicating that a company’s financial statements present the financial position of a company fairly, when claim was only supported by conclusory assertions that the opinion “lacked a reasonable basis”.

• Regarding the adequacy of company reserves, when plaintiffs had failed to allege contemporaneous facts outside the public realm that made the statements misleading. Expressing optimism that certain drugs would be approved and a belief that their efficacy was supported by clinical trial results, finding that executives were “not required to take a gloomy, fearful or defeatist view of the future” but were instead ‘expected to be confident about their stewardship and the prospects of the business that they manage’.

• Indicating that an SEC investigation would not have a material adverse effect on a company, when there were no adequate allegations that the company had believed otherwise at the time.

This list will increase in size as defense lawyers better understand the range and power of *Omnicare*. For example, in cases challenging earnings forecasts—which are statements of opinion—*Omnicare* allows defendants to defend the truth of the forecasts, through the context of the complaint’s allegations and judicially noticeable materials, and use the Private Securities Litigation Reform Act’s Safe Harbor for forward-looking statements as a backup argument. This is a superior approach, because it avoids all-or-nothing reliance on the Safe Harbor, which many judges see as

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41 *Supra* note 35.
a “license to lie.”

CONCLUSION

A fair interpretation of Omnicare could, of course, allow a plaintiff’s complaint to go forward—such as when a court finds the allegations that an opinion was not honestly believed at the time that it was expressed are adequate, or when plaintiffs can show that defendants had misrepresented one of the facts underlying the opinion. Also, some of district courts have incorrectly applied Omnicare—such as by maintaining a discussion of opinions as “puffery” rather than under the Omnicare standard, describing the Omnicare standard as requiring that opinions have a “reasonable basis,” conflating the Omnicare standard with the standard for alleging scienter, or suggesting that the Omnicare analysis applies only to claims brought

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under Section 11.48

But on the whole, the district court decisions have shown the potential of the Omnicare ruling to serve as a useful tool for defendants. The Omnicare Court’s guidance is relatively easy for the district courts to correctly understand and apply. And, far from opening the door to new class actions brought on the basis of allegedly misleading opinions, these decisions help to show that Omnicare actually fortifies the defense against such claims, by making explicit the high bar that plaintiffs must clear to show that a statement was misleading when viewed in its full context.

48In re Genworth Fin. Inc. Sec. Litig., supra note 44.
Syllabus

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See United States v. Detroit Timber & Lumber Co., 200 U. S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

OMNICARE, INC., ET AL. v. LABORERS DISTRICT COUNCIL CONSTRUCTION INDUSTRY PENSION FUND ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT


The Securities Act of 1933 requires that a company wishing to issue securities must first file a registration statement containing specified information about the issuing company and the securities offered. See 15 U. S. C. §§77g, 77aa. The registration statement may also include other representations of fact or opinion. To protect investors and promote compliance with these disclosure requirements, §11 of the Act creates two ways to hold issuers liable for a registration statement’s contents: A purchaser of securities may sue an issuer if the registration statement either “contain[s] an untrue statement of a material fact” or “omit[s] to state a material fact . . . necessary to make the statements therein not misleading.” §77k(a). In either case, the buyer need not prove that the issuer acted with any intent to deceive or defraud. Herman & MacLean v. Huddleston, 459 U. S. 375, 381–382.

Petitioner Omnicare, a pharmacy services company, filed a registration statement in connection with a public offering of common stock. In addition to the required disclosures, the registration statement contained two statements expressing the company’s opinion that it was in compliance with federal and state laws. After the Federal Government filed suit against Omnicare for allegedly receiving kickbacks from pharmaceutical manufacturers, respondents, pension funds that purchased Omnicare stock (hereinafter Funds), sued Omnicare under §11. They claimed that Omnicare’s legal-compliance statements constituted “untrue statement[s] of . . . material fact” and that Omnicare “omitted to state [material] facts necessary” to make those statements not misleading.
Chapter 5B—Omnicare, Inc., One Year Later

OMNICARE, INC. v. LABORERS DIST. COUNCIL CONSTR. INDUSTRY PENSION FUND

Syllabus

The District Court granted Omnicare’s motion to dismiss. Because the Funds had not alleged that Omnicare’s officers knew they were violating the law, the court found that the Funds had failed to state a §11 claim. The Sixth Circuit reversed. Acknowledging that the statements at issue expressed opinions, the court held that no showing of subjective disbelief was required. In the court’s view, the Funds’ allegations that Omnicare’s legal-compliance opinions were objectively false sufficed to support their claim.

Held:

1. A statement of opinion does not constitute an “untrue statement of . . . fact” simply because the stated opinion ultimately proves incorrect. The Sixth Circuit’s contrary holding wrongly conflates facts and opinions. A statement of fact expresses certainty about a thing, whereas a statement of opinion conveys only an uncertain view as to that thing. Section 11 incorporates that distinction in its first clause by exposing issuers to liability only for “untrue statement[s] of . . . fact.” §77k(a) (emphasis added). Because a statement of opinion admits the possibility of error, such a statement remains true—and thus is not an “untrue statement of . . . fact”—even if the opinion turns out to have been wrong.

But opinion statements are not wholly immune from liability under §11’s first clause. Every such statement explicitly affirms one fact: that the speaker actually holds the stated belief. A statement of opinion thus qualifies as an “untrue statement of . . . fact” if that fact is untrue—i.e., if the opinion expressed was not sincerely held. In addition, opinion statements can give rise to false-statement liability under §11 if they contain embedded statements of untrue facts. Here, however, Omnicare’s sincerity is not contested and the statements at issue are pure opinion statements. The Funds thus cannot establish liability under §11’s first clause. Pp. 6–10.

2. If a registration statement omits material facts about the issuer’s inquiry into, or knowledge concerning, a statement of opinion, and if those facts conflict with what a reasonable investor, reading the statement fairly and in context, would take from the statement itself, then §11’s omissions clause creates liability. Pp. 10–20.

(a) For purposes of §11’s omissions clause, whether a statement is “misleading” is an objective inquiry that depends on a reasonable investor’s perspective. Cf. TSC Industries, Inc. v. Northway, Inc., 426 U. S. 438, 445. Omnicare goes too far by claiming that no reasonable person, in any context, can understand a statement of opinion to convey anything more than the speaker’s own mindset. A reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about the speaker’s basis for holding that view. Specifically, an issuer’s statement of opinion may fairly imply
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facts about the inquiry the issuer conducted or the knowledge it had. And if the real facts are otherwise, but not provided, the opinion statement will mislead by omission.

An opinion statement, however, is not misleading simply because the issuer knows, but fails to disclose, some fact cutting the other way. A reasonable investor does not expect that every fact known to an issuer supports its opinion statement. Moreover, whether an omission makes an expression of opinion misleading always depends on context. Reasonable investors understand opinion statements in light of the surrounding text, and §11 creates liability only for the omission of material facts that cannot be squared with a fair reading of the registration statement as a whole. Omnicare’s arguments to the contrary are unavailing. Pp. 10–19.

(b) Because neither court below considered the Funds’ omissions theory under the right standard, this case is remanded for a determination of whether the Funds have stated a viable omissions claim. On remand, the court must review the Funds’ complaint to determine whether it adequately alleges that Omnicare omitted from the registration statement some specific fact that would have been material to a reasonable investor. If so, the court must decide whether the alleged omission rendered Omnicare’s opinion statements misleading in context. Pp. 19–20.

719 F. 3d 498, vacated and remanded.

KAGAN, J., delivered the opinion of the Court, in which ROBERTS, C. J., and KENNEDY, GINSBURG, BREYER, ALITO, and SOTOMAYOR, JJ., joined. SCALIA, J., filed an opinion concurring in part and concurring in the judgment. THOMAS, J., filed an opinion concurring in the judgment.
Before a company may sell securities in interstate commerce, it must file a registration statement with the Securities and Exchange Commission (SEC). If that document either “contain[s] an untrue statement of a material fact” or “omit[s] to state a material fact . . . necessary to make the statements therein not misleading,” a purchaser of the stock may sue for damages. 15 U. S. C. §77k(a). This case requires us to decide how each of those phrases applies to statements of opinion.

I

The Securities Act of 1933, 48 Stat. 74, 15 U. S. C. §77a et seq., protects investors by ensuring that companies issuing securities (known as “issuers”) make a “full and fair disclosure of information” relevant to a public offering. Pinter v. Dahl, 486 U. S. 622, 646 (1988). The linchpin of the Act is its registration requirement. With limited exceptions not relevant here, an issuer may offer securities to the public only after filing a registration statement. See §§77d, 77e. That statement must contain specified
information about both the company itself and the security for sale. See §§77g, 77aa. Beyond those required disclosures, the issuer may include additional representations of either fact or opinion.

Section 11 of the Act promotes compliance with these disclosure provisions by giving purchasers a right of action against an issuer or designated individuals (directors, partners, underwriters, and so forth) for material misstatements or omissions in registration statements. As relevant here, that section provides:

“In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . [may] sue.” §77k(a).

Section 11 thus creates two ways to hold issuers liable for the contents of a registration statement—one focusing on what the statement says and the other on what it leaves out. Either way, the buyer need not prove (as he must to establish certain other securities offenses) that the defendant acted with any intent to deceive or defraud. Herman & MacLean v. Huddleston, 459 U. S. 375, 381–382 (1983).

This case arises out of a registration statement that petitioner Omnicare filed in connection with a public offering of common stock. Omnicare is the nation’s largest provider of pharmacy services for residents of nursing homes. Its registration statement contained (along with all mandated disclosures) analysis of the effects of various federal and state laws on its business model, including its acceptance of rebates from pharmaceutical manufacturers. See, e.g., App. 88–107, 132–140, 154–166. Of significance here, two sentences in the registration statement expressed Omnicare’s view of its compliance with legal
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requirements:

- “We believe our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state laws.” *Id.*, at 95.

- “We believe that our contracts with pharmaceutical manufacturers are legally and economically valid arrangements that bring value to the healthcare system and the patients that we serve.” *Id.*, at 137.

Accompanying those legal opinions were some caveats. On the same page as the first statement above, Omnicare mentioned several state-initiated “enforcement actions against pharmaceutical manufacturers” for offering payments to pharmacies that dispensed their products; it then cautioned that the laws relating to that practice might “be interpreted in the future in a manner inconsistent with our interpretation and application.” *Id.*, at 96. And adjacent to the second statement, Omnicare noted that the Federal Government had expressed “significant concerns” about some manufacturers’ rebates to pharmacies and warned that business might suffer “if these price concessions were no longer provided.” *Id.*, at 136–137.

Respondents here, pension funds that purchased Omnicare stock in the public offering (hereinafter Funds), brought suit alleging that the company’s two opinion statements about legal compliance give rise to liability under §11. Citing lawsuits that the Federal Government later pressed against Omnicare, the Funds’ complaint maintained that the company’s receipt of payments from drug manufacturers violated anti-kickback laws. See *id.*, at 181–186, 203–226. Accordingly, the complaint asserted, Omnicare made “materially false” representations about legal compliance. *Id.*, at 274. And so too, the complaint continued, the company “omitted to state [material] facts necessary” to make its representations not misleading.
Id., at 273. The Funds claimed that none of Omnicare’s officers and directors “possessed reasonable grounds” for thinking that the opinions offered were truthful and complete. Id., at 274. Indeed, the complaint noted that one of Omnicare’s attorneys had warned that a particular contract “carrie[d] a heightened risk” of liability under anti-kickback laws. Id., at 225 (emphasis deleted). At the same time, the Funds made clear that in light of §11’s strict liability standard, they chose to “exclude and disclaim any allegation that could be construed as alleging fraud or intentional or reckless misconduct.” Id., at 273.

The District Court granted Omnicare’s motion to dismiss. See Civ. No. 2006–26 (ED Ky., Feb. 13, 2012), App. to Pet. for Cert. 28a, 38a–40a, 2012 WL 462551, *4–*5. In the court’s view, “statements regarding a company’s belief as to its legal compliance are considered ‘soft’ information” and are actionable only if those who made them “knew [they] were untrue at the time.” App. to Pet. for Cert. 38a. The court concluded that the Funds’ complaint failed to meet that standard because it nowhere claimed that “the company’s officers knew they were violating the law.” Id., at 39a. The Court of Appeals for the Sixth Circuit reversed. See 719 F. 3d 498 (2013). It acknowledged that the two statements highlighted in the Funds’ complaint expressed Omnicare’s “opinion” of legal compliance, rather than “hard facts.” Id., at 504 (quoting In re Sofamor Danek Group Inc., 123 F. 3d 394, 401–402 (CA6 1997)). But even so, the court held, the Funds had to allege only that the stated belief was “objectively false”; they did not need to contend that anyone at Omnicare “disbelieved [the opinion] at the time it was expressed.” 719 F. 3d, at 506 (quoting Fait v. Regions Financial Corp., 655 F. 3d 105, 110 (CA2 2011)).

We granted certiorari, 571 U. S. ___ (2014), to consider how §11 pertains to statements of opinion. We do so in two steps, corresponding to the two parts of §11 and the
two theories in the Funds’ complaint. We initially address the Funds’ claim that Omnicare made “untrue statement[s] of . . . material fact” in offering its views on legal compliance. §77k(a); see App. 273–274. We then take up the Funds’ argument that Omnicare “omitted to state a material fact . . . necessary to make the statements [in its registration filing] not misleading.” §77k(a); see App. 273–274. Unlike both courts below, we see those allegations as presenting different issues. In resolving the first, we discuss when an opinion itself constitutes a factual misstatement. In analyzing the second, we address when an opinion may be rendered misleading by the omission of discrete factual representations. Because we find that the Court of Appeals applied the wrong standard, we vacate its decision.

In his concurrence, Justice Thomas contends that the lower courts’ erroneous conflation of these two questions should limit the scope of our review: We should say nothing about omissions, he maintains, because that issue was not pressed or passed on below. We disagree. Although the Funds could have written a clearer complaint, they raised a discrete omissions claim. See, e.g., App. 191 (”[T]he Company’s 2005 Registration Statement . . . omitted material information that was . . . necessary to make the Registration Statement not misleading”); id., at 273 (“The Registration Statement . . . omitted to state facts necessary to make the statements made not misleading, and failed to adequately disclose material facts as described above”). The lower courts chose not to address that claim separately, but understood that the complaint alleged not only misstatements but also omissions. See App. to Pet. for Cert. 38a (describing the Funds’ claims as relating to “misstatements/omissions” and dismissing the lot as “not actionable”); 719 F. 3d, at 501 (giving a single rationale for reversing the District Court’s dismissal of the Funds’ claims “for material misstatements and omissions”). And the omissions issue was the crux of the parties’ dispute before this Court. The question was fully briefed by both parties (plus the Solicitor General), and omissions played a starring role at oral argument. Neither in its briefs nor at argument did Omnicare ever object that the Funds’ omissions theory had been forfeited or was not properly before this Court. We therefore see no reason to ignore the issue.
II

The Sixth Circuit held, and the Funds now urge, that a statement of opinion that is ultimately found incorrect—even if believed at the time made—may count as an “untrue statement of a material fact.” 15 U. S. C §77k(a); see 719 F. 3d, at 505; Brief for Respondents 20–26. As the Funds put the point, a statement of belief may make an implicit assertion about the belief’s “subject matter”: To say “we believe X is true” is often to indicate that “X is in fact true.” Id., at 23; see Tr. of Oral Arg. 36. In just that way, the Funds conclude, an issuer’s statement that “we believe we are following the law” conveys that “we in fact are following the law”—which is “materially false,” no matter what the issuer thinks, if instead it is violating an anti-kickback statute. Brief for Respondents 1.

But that argument wrongly conflates facts and opinions. A fact is “a thing done or existing” or “[a]n actual happening.” Webster’s New International Dictionary 782 (1927). An opinion is “a belief[,] a view,” or a “sentiment which the mind forms of persons or things.” Id., at 1509. Most important, a statement of fact (“the coffee is hot”) expresses certainty about a thing, whereas a statement of opinion (“I think the coffee is hot”) does not. See ibid. (“An opinion, in ordinary usage . . . does not imply . . . definiteness . . . or certainty”); 7 Oxford English Dictionary 151 (1933) (an opinion “rests[s] on grounds insufficient for complete demonstration”). Indeed, that difference between the two is so ingrained in our everyday ways of speaking and thinking as to make resort to old dictionaries seem a mite silly. And Congress effectively incorporated just that distinction in §11’s first part by exposing issuers to liability not for “untrue statement[s]” full stop (which would have included ones of opinion), but only for “untrue statement[s] of . . . fact.” §77k(a) (emphasis added).

Consider that statutory phrase’s application to two hypothetical statements, couched in ways the Funds claim
are equivalent. A company’s CEO states: “The TVs we manufacture have the highest resolution available on the market.” Or, alternatively, the CEO transforms that factual statement into one of opinion: “I believe” (or “I think”) “the TVs we manufacture have the highest resolution available on the market.” The first version would be an untrue statement of fact if a competitor had introduced a higher resolution TV a month before—even assuming the CEO had not yet learned of the new product. The CEO’s assertion, after all, is not mere puffery, but a determinate, verifiable statement about her company’s TVs; and the CEO, however innocently, got the facts wrong. But in the same set of circumstances, the second version would remain true. Just as she said, the CEO really did believe, when she made the statement, that her company’s TVs had the sharpest picture around. And although a plaintiff could later prove that opinion erroneous, the words “I believe” themselves admitted that possibility, thus precluding liability for an untrue statement of fact. That remains the case if the CEO’s opinion, as here, concerned legal compliance. If, for example, she said, “I believe our marketing practices are lawful,” and actually did think that, she could not be liable for a false statement of fact—even if she afterward discovered a longtime violation of law. Once again, the statement would have been true, because all she expressed was a view, not a certainty, about legal compliance.

That still leaves some room for §11’s false-statement provision to apply to expressions of opinion. As even Omnicare acknowledges, every such statement explicitly affirms one fact: that the speaker actually holds the stated belief. See Brief for Petitioners 15–16; W. Keeton, D. Dobbs, R. Keeton, & D. Owen, Prosser and Keeton on the Law of Torts §109, p. 755 (5th ed. 1984) (Prosser and Keeton) (“[A]n expression of opinion is itself always a statement of . . . the fact of the belief, the existing state of
mind, of the one who asserts it”). For that reason, the CEO’s statement about product quality (“I believe our TVs have the highest resolution available on the market”) would be an untrue statement of fact—namely, the fact of her own belief—if she knew that her company’s TVs only placed second. And so too the statement about legal compliance (“I believe our marketing practices are lawful”) would falsely describe her own state of mind if she thought her company was breaking the law. In such cases, §11’s first part would subject the issuer to liability (assuming the misrepresentation were material).2

In addition, some sentences that begin with opinion words like “I believe” contain embedded statements of fact—as, once again, Omnicare recognizes. See Reply Brief 6. Suppose the CEO in our running hypothetical said: “I believe our TVs have the highest resolution available because we use a patented technology to which our competitors do not have access.” That statement may be read to affirm not only the speaker’s state of mind, as

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2Our decision in Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991), qualifies this statement in one respect. There, the Court considered when corporate directors’ statements of opinion in a proxy solicitation give rise to liability under §14(a) of the Securities Exchange Act, 15 U. S. C. §78n(a), which bars conduct similar to that described in §11. In discussing that issue, the Court raised the hypothetical possibility that a director could think he was lying while actually (i.e., accidentally) telling the truth about the matter addressed in his opinion. See Virginia Bankshares, 501 U. S., at 1095–1096. That rare set of facts, the Court decided, would not lead to liability under §14(a). See ibid. The Court reasoned that such an inadvertently correct assessment is unlikely to cause anyone harm and that imposing liability merely for the “impurities” of a director’s “unclean heart” might provoke vexatious litigation. Id., at 1096 (quoting Stedman v. Storer, 308 F. Supp. 881, 887 (SDNY 1969)). We think the same is true (to the extent this scenario ever occurs in real life) under §11. So if our CEO did not believe that her company’s TVs had the highest resolution on the market, but (surprise!) they really did, §11 would not impose liability for her statement.
described above, but also an underlying fact: that the company uses a patented technology. See Virginia Bankshares, Inc. v. Sandberg, 501 U. S. 1083, 1109 (1991) (SCALIA, J., concurring in part and concurring in judgment) (showing that a statement can sometimes be “most fairly read as affirming separately both the fact of the [speaker’s] opinion and the accuracy of the facts” given to support or explain it (emphasis deleted)). Accordingly, liability under §11’s false-statement provision would follow (once again, assuming materiality) not only if the speaker did not hold the belief she professed but also if the supporting fact she supplied were untrue.

But the Funds cannot avail themselves of either of those ways of demonstrating liability. The two sentences to which the Funds object are pure statements of opinion: To simplify their content only a bit, Omnicare said in each that “we believe we are obeying the law.” And the Funds do not contest that Omnicare’s opinion was honestly held. Recall that their complaint explicitly “exclude[s] and disclaim[s]” any allegation sounding in fraud or deception. App. 273. What the Funds instead claim is that Omnicare’s belief turned out to be wrong—that whatever the company thought, it was in fact violating anti-kickback laws. But that allegation alone will not give rise to liability under §11’s first clause because, as we have shown, a sincere statement of pure opinion is not an “untrue statement of material fact,” regardless whether an investor can ultimately prove the belief wrong. That clause, limited as it is to factual statements, does not allow investors to second-guess inherently subjective and uncertain assessments. In other words, the provision is not, as the Court of Appeals and the Funds would have it, an invitation to Monday morning quarterback an issuer’s opinions.
III

A

That conclusion, however, does not end this case because the Funds also rely on §11’s omissions provision, alleging that Omnicare “omitted to state facts necessary” to make its opinion on legal compliance “not misleading.” App. 273; see §77k(a). 3 As all parties accept, whether a statement is “misleading” depends on the perspective of a reasonable investor: The inquiry (like the one into materiality) is objective. Cf. TSC Industries, Inc. v. Northway, Inc., 426 U. S. 438, 445 (1976) (noting that the securities laws care only about the “significance of an omitted or misrepresented fact to a reasonable investor”). We therefore must consider when, if ever, the omission of a fact can make a statement of opinion like Omnicare’s, even if literally accurate, misleading to an ordinary investor.

Omnicare claims that is just not possible. On its view, no reasonable person, in any context, can understand a pure statement of opinion to convey anything more than the speaker’s own mindset. See Reply Brief 5–6. As long as an opinion is sincerely held, Omnicare argues, it cannot mislead as to any matter, regardless what related facts the speaker has omitted. Such statements of belief (concludes Omnicare) are thus immune from liability under §11’s second part, just as they are under its first. 4

3 Section 11’s omissions clause also applies when an issuer fails to make mandated disclosures—those “required to be stated”—in a registration statement. §77k(a). But the Funds do not object to Omnicare’s filing on that score.

4 In a different argument that arrives at the same conclusion, Omnicare maintains that §11, by its terms, bars only those omissions that make statements of fact—not opinion—misleading. See Reply Brief 3–5. The language of the omissions clause, however, is not so limited. It asks whether an omitted fact is necessary to make “statements” in “any part of the registration statement” not misleading; unlike in §11’s first clause, here the word “statements” is unmodified, thus including both fact and opinion. In any event, Omnicare’s alternative interpretation
That claim has more than a kernel of truth. A reasonable person understands, and takes into account, the difference we have discussed above between a statement of fact and one of opinion. See supra, at 6–7. She recognizes the import of words like “I think” or “I believe,” and grasps that they convey some lack of certainty as to the statement’s content. See, e.g., Restatement (Second) of Contracts §168, Comment a, p. 456 (1979) (noting that a statement of opinion “implies that [the speaker] . . . is not certain enough of what he says” to do without the qualifying language). And that may be especially so when the phrases appear in a registration statement, which the reasonable investor expects has been carefully word-smithed to comply with the law. When reading such a document, the investor thus distinguishes between the sentences “we believe X is true” and “X is true.” And because she does so, the omission of a fact that merely rebuts the latter statement fails to render the former misleading. In other words, a statement of opinion is not misleading just because external facts show the opinion to be incorrect. Reasonable investors do not understand such statements as guarantees, and §11’s omissions clause therefore does not treat them that way.

But Omnicare takes its point too far, because a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker’s basis for holding that view. And if the real facts are otherwise, but not provided, the opinion statement will mislead its audience. Consider an unadorned
statement of opinion about legal compliance: “We believe our conduct is lawful.” If the issuer makes that statement without having consulted a lawyer, it could be misleadingly incomplete. In the context of the securities market, an investor, though recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry—rather than, say, on mere intuition, however sincere.\(^5\) Similarly, if the issuer made the statement in the face of its lawyers’ contrary advice, or with knowledge that the Federal Government was taking the opposite view, the investor again has cause to complain: He expects not just that the issuer believes the opinion (however irrationally), but that it fairly aligns with the information in the issuer’s possession at the time.\(^6\) Thus, if a registration statement omits material facts about the issuer’s inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then §11’s omissions clause creates liability.\(^7\)

\(^5\) In some circumstances, however, reliance on advice from regulators or consistent industry practice might accord with a reasonable investor’s expectations.

\(^6\) The hypothetical used earlier could demonstrate the same points. Suppose the CEO, in claiming that her company’s TV had the highest resolution available on the market, had failed to review any of her competitors’ product specifications. Or suppose she had recently received information from industry analysts indicating that a new product had surpassed her company’s on this metric. The CEO may still honestly believe in her TV’s superiority. But under §11’s omissions provision, that subjective belief, in the absence of the expected inquiry or in the face of known contradictory evidence, would not insulate her from liability.

\(^7\) Omnicare contends at length that *Virginia Bankshares* forecloses this result, see Brief for Petitioners 16–21, relying on the following sentence: “A statement of belief may be open to objection . . . solely as a misstatement of the psychological fact of the speaker’s belief in what he says,” 501 U. S., at 1095. But Omnicare’s argument plucks that state-
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An opinion statement, however, is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way. Reasonable investors understand that opinions sometimes rest on a weighing of competing facts; indeed, the presence of such facts is one reason why an issuer may frame a statement as an opinion, thus conveying uncertainty. See supra, at 6–7, 11. Suppose, for example, that in stating an opinion about legal compliance, the issuer did not disclose that a single junior attorney expressed doubts about a practice’s legality, when six of his more senior colleagues gave a stamp of approval. That omission would not make the statement of opinion misleading, even if the minority position ultimately proved correct: A reasonable investor does not expect that every fact known to an issuer supports its opinion statement.8

8 We note, too, that a reasonable investor generally considers the specificity of an opinion statement in making inferences about its basis. Compare two new statements from our ever-voluble CEO. In the first, she says: “I believe we have 1.3 million TVs in our warehouse.” In the second, she says: “I believe we have enough supply on hand to meet
Moreover, whether an omission makes an expression of opinion misleading always depends on context. Registration statements as a class are formal documents, filed with the SEC as a legal prerequisite for selling securities to the public. Investors do not, and are right not to, expect opinions contained in those statements to reflect baseless, off-the-cuff judgments, of the kind that an individual might communicate in daily life. At the same time, an investor reads each statement within such a document, whether of fact or of opinion, in light of all its surrounding text, including hedges, disclaimers, and apparently conflicting information. And the investor takes into account the customs and practices of the relevant industry. So an omission that renders misleading a statement of opinion when viewed in a vacuum may not do so once that statement is considered, as is appropriate, in a broader frame. The reasonable investor understands a statement of opinion in its full context, and §11 creates liability only for the omission of material facts that cannot be squared with such a fair reading.

These principles are not unique to §11: They inhere, too, in much common law respecting the tort of misrepresentation.9 The Restatement of Torts, for example, recognizes that “[a] statement of opinion as to facts not disclosed and not otherwise known to the recipient may” in some circumstances reasonably “be interpreted by him as an implied statement” that the speaker “knows facts sufficient to justify him in forming” the opinion, or that he at least

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Section 11 is, of course, “not coextensive with common-law doctrines of fraud”; in particular, it establishes “a stringent standard of liability,” not dependent on proof of intent to defraud. Herman & MacLean v. Huddleston, 459 U. S. 375, 381, 388–389 (1983); see supra, at 2; infra, at 15, n. 11. But we may still look to the common law for its insights into how a reasonable person understands statements of opinion.
knows no facts “incompatible with [the] opinion.” Restatement (Second) of Torts §539, p. 85 (1976). When that is so, the Restatement explains, liability may result from omission of facts—for example, the fact that the speaker failed to conduct any investigation—that rebut the recipient’s predictable inference. See id., Comment a, at 86; id., Comment b, at 87. Similarly, the leading treatise in the area explains that “it has been recognized very often that the expression of an opinion may carry with it an implied assertion, not only that the speaker knows no facts which would preclude such an opinion, but that he does know facts which justify it.” Prosser and Keeton §109, at 760. That is especially (and traditionally) the case, the treatise continues, where—as in a registration statement—a speaker “holds himself out or is understood as having special knowledge of the matter which is not available to the plaintiff.” Id., at 760–761 (footnote omitted); see Restatement (Second) of Torts §539, Comment b, at 86 (noting that omissions relating to an opinion’s basis are “particularly” likely to give rise to liability when the speaker has “special knowledge of facts unknown to the recipient”); Smith v. Land and House Property Corp., [1884] 28 Ch. D. 7, 15 (App. Cas.) (appeal taken from Eng.) (opinion of Bowen, L. J.) (When “the facts are not equally known to both sides, then a statement of opinion by the one who knows the facts best . . . impliedly states that [the speaker] knows facts which justify his opinion”).

10 The Restatement of Contracts, discussing misrepresentations that can void an agreement, says much the same: “[T]he recipient of an assertion of a person’s opinion as to facts not disclosed” may sometimes “properly interpret it as an assertion (a) that the facts known to that person are not incompatible with his opinion, or (b) that he knows facts sufficient to justify him in forming it.” Restatement (Second) of Contracts §168, p. 455 (1979).

11 In invoking these principles, we disagree with Justice Scalia’s common-law-based opinion in two crucial ways. First, we view the common law’s emphasis on special knowledge and expertise as support-
And the purpose of §11 supports this understanding of how the omissions clause maps onto opinion statements. Congress adopted §11 to ensure that issuers “tell[] the whole truth” to investors. H. R. Rep. No. 85, 73d Cong., 1st Sess., 2 (1933) (quoting President Roosevelt’s message to Congress). For that reason, literal accuracy is not enough: An issuer must as well desist from misleading investors by saying one thing and holding back another. Omnicare would nullify that statutory requirement for all sentences starting with the phrases “we believe” or “we think.” But those magic words can preface nearly any conclusion, and the resulting statements, as we have shown, remain perfectly capable of misleading investors. See supra, at 11–12. Thus, Omnicare’s view would punch a hole in the statute for half-truths in the form of opinion statements. And the difficulty of showing that such statements are literally false—which requires proving an issuer did not believe them, see supra, at 7–8—would make that opening yet more consequential: Were Omnicare right, companies would have virtual carte blanche to assert opinions in registration statements free from worry
about §11. That outcome would ill-fit Congress’s decision to establish a strict liability offense promoting “full and fair disclosure” of material information. *Pinter*, 486 U. S., at 646; see *supra*, at 1–2.

Omnicare argues, in response, that applying §11’s omissions clause in the way we have described would have “adverse policy consequences.” Reply Brief 17 (capitalization omitted). According to Omnicare, any inquiry into the issuer’s basis for holding an opinion is “hopelessly amorphous,” threatening “unpredictable” and possibly “massive” liability. *Id.*, at 2; Brief for Petitioners 34, 36. And because that is so, Omnicare claims, many issuers will choose not to disclose opinions at all, thus “depriving [investors] of potentially helpful information.” Reply Brief 19; see Tr. of Oral Arg. 59–61.

But first, that claim is, just as Omnicare labels it, one of “policy”; and Congress gets to make policy, not the courts. The decision Congress made, for the reasons we have indicated, was to extend §11 liability to all statements rendered misleading by omission. In doing so, Congress no doubt made §11 less cut-and-dry than a law prohibiting only false factual statements. Section 11’s omissions clause, as applied to statements of both opinion and fact, necessarily brings the reasonable person into the analysis, and asks what she would naturally understand a statement to convey beyond its literal meaning. And for expressions of opinion, that means considering the foundation she would expect an issuer to have before making the statement. See *supra*, at 11–12. All that, however, is a feature, not a bug, of the omissions provision.

Moreover, Omnicare way overstates both the looseness of the inquiry Congress has mandated and the breadth of liability that approach threatens. As we have explained, an investor cannot state a claim by alleging only that an opinion was wrong; the complaint must as well call into question the issuer’s basis for offering the opinion. See
supra, at 11–12. And to do so, the investor cannot just say that the issuer failed to reveal its basis. Section 11’s omissions clause, after all, is not a general disclosure requirement; it affords a cause of action only when an issuer’s failure to include a material fact has rendered a published statement misleading. To press such a claim, an investor must allege that kind of omission—and not merely by means of conclusory assertions. See Ashcroft v. Iqbal, 556 U. S. 662, 678 (2009) (“Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice”). To be specific: The investor must identify particular (and material) facts going to the basis for the issuer’s opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context. See supra, at 11–14. That is no small task for an investor.

Nor does the inquiry such a complaint triggers ask anything unusual of courts. Numerous legal rules hinge on what a reasonable person would think or expect. In requiring courts to view statements of opinion from an ordinary investor’s perspective, §11’s omissions clause demands nothing more complicated or unmanageable. Indeed, courts have for decades engaged in just that inquiry, with no apparent trouble, in applying the common law of misrepresentation. See supra, at 14–15.

Finally, we see no reason to think that liability for misleading opinions will chill disclosures useful to investors. Nothing indicates that §11’s application to misleading factual assertions in registration statements has caused such a problem. And likewise, common-law doctrines of opinion liability have not, so far as anyone knows, deterred merchants in ordinary commercial transactions from asserting helpful opinions about their products. That absence of fallout is unsurprising. Sellers (whether of
Opinion of the Court

stock or other items) have strong economic incentives to . . . well, sell (i.e., hawk or peddle). Those market-based forces push back against any inclination to underdisclose.

And to avoid exposure for omissions under §11, an issuer need only divulge an opinion’s basis, or else make clear the real tentativeness of its belief. Such ways of conveying opinions so that they do not mislead will keep valuable information flowing. And that is the only kind of information investors need. To the extent our decision today chills misleading opinions, that is all to the good: In enacting §11, Congress worked to ensure better, not just more, information.

B

Our analysis on this score counsels in favor of sending the case back to the lower courts for decision. Neither court below considered the Funds’ omissions theory with the right standard in mind—or indeed, even recognized the distinct statutory questions that theory raises. See supra, at 4–5. We therefore follow our ordinary practice of remanding for a determination of whether the Funds have stated a viable omissions claim (or, if not, whether they should have a chance to replead).

In doing so, however, we reemphasize a few crucial points pertinent to the inquiry on remand. Initially, as we have said, the Funds cannot proceed without identifying one or more facts left out of Omnicare’s registration statement. See supra, at 17–18. The Funds’ recitation of the statutory language—that Omnicare “omitted to state facts necessary to make the statements made not misleading”—is not sufficient; neither is the Funds’ conclusory allegation that Omnicare lacked “reasonable grounds for the belief” it stated respecting legal compliance. App. 273–274. At oral argument, however, the Funds highlighted another, more specific allegation in their complaint: that an attorney had warned Omnicare that a
particular contract “carrie[d] a heightened risk” of legal exposure under anti-kickback laws. *Id.*, at 225 (emphasis omitted); see Tr. of Oral Arg. 42, 49; *supra*, at 4. On remand, the court must review the Funds’ complaint to determine whether it adequately alleged that Omnicare had omitted that (purported) fact, or any other like it, from the registration statement. And if so, the court must determine whether the omitted fact would have been material to a reasonable investor—*i.e.*, whether “there is a substantial likelihood that a reasonable [investor] would consider it important.” *TSC Industries*, 426 U. S., at 449.

Assuming the Funds clear those hurdles, the court must ask whether the alleged omission rendered Omnicare’s legal compliance opinions misleading in the way described earlier—*i.e.*, because the excluded fact shows that Omnicare lacked the basis for making those statements that a reasonable investor would expect. See *supra*, at 11–12. Insofar as the omitted fact at issue is the attorney’s warning, that inquiry entails consideration of such matters as the attorney’s status and expertise and other legal information available to Omnicare at the time. See *supra*, at 13. Further, the analysis of whether Omnicare’s opinion is misleading must address the statement’s context. See *supra*, at 14. That means the court must take account of whatever facts Omnicare *did* provide about legal compliance, as well as any other hedges, disclaimers, or qualifications it included in its registration statement. The court should consider, for example, the information Omnicare offered that States had initiated enforcement actions against drug manufacturers for giving rebates to pharmacies, that the Federal Government had expressed concerns about the practice, and that the relevant laws “could “be interpreted in the future in a manner” that would harm Omnicare’s business. See App. 95–96, 136–137; *supra*, at 3.
Opinion of the Court

*   *   *

With these instructions and for the reasons stated, we vacate the judgment below and remand the case for further proceedings.

It is so ordered.
JUSTICE SCALIA, concurring in part and concurring in the judgment.

Section 11 of the Securities Act of 1933 imposes liability where a registration statement “contain[s] an untrue statement of a material fact” or “omit[s] to state a material fact necessary to make the statements therein not misleading.” 15 U. S. C. §77k(a). I agree with the Court’s discussion of what it means for an expression of opinion to state an untrue material fact. But an expression of opinion implies facts (beyond the fact that the speaker believes his opinion) only where a reasonable listener would understand it to do so. And it is only when expressions of opinion do imply these other facts that they can be “misleading” without the addition of other “material facts.” The Court’s view would count far more expressions of opinion to convey collateral facts than I—or the common law—would, and I therefore concur only in part.

The common law recognized that most listeners hear “I believe,” “in my estimation,” and other related phrases as disclaiming the assertion of a fact. Hence the (somewhat overbroad) common-law rule that a plaintiff cannot establish a misrepresentation claim “for misstatements of opinion, as distinguished from those of fact.” W. Keeton, D. Dobbs, R. Keeton, & D. Owen, Prosser and Keeton on
Torts §109, p. 755 (5th ed. 1984) (Prosser & Keeton). A fraudulent misrepresentation claim based on an expression of opinion could lie for the one fact the opinion reliably conveyed: that the speaker in fact held the stated opinion. Restatement of Torts §525, Comment c, p. 60 (1938). And, in some circumstances, the common law acknowledged that an expression of opinion reasonably implied “that the maker knows of no fact incompatible with his opinion.” Id. §539(1), at 91. The no-facts-incompatible-with-the-opinion standard was a demanding one; it meant that a speaker’s judgment had to “var[y] so far from the truth that no reasonable man in his position could have such an opinion.” Restatement of Contracts §474(b), p. 902, and Comment b (1932). But without more, a listener could only reasonably interpret expressions of opinion as conveying this limited assurance of a speaker’s understanding of facts.

In a few areas, the common law recognized the possibility that a listener could reasonably infer from an expression of opinion not only (1) that the speaker sincerely held it, and (2) that the speaker knew of no facts incompatible with the opinion, but also (3) that the speaker had a reasonable basis for holding the opinion. This exceptional recognition occurred only where it was “very reasonable or probable” that a listener should place special confidence in a speaker’s opinion. Prosser & Keeton §109, at 760–761. This included two main categories, both of which were carve-outs from the general rule that “the ordinary man has a reasonable competence to form his own opinion,” and “is not justified in relying [on] the . . . opinion” of another. Restatement of Torts §542, Comment a, at 95. First, expressions of opinion made in the context of a relationship of trust, such as between doctors and patients. Second, expressions of opinion made by an expert in his capacity as an expert (for example, a jeweler’s statement of opinion about the value of a diamond). These exceptions
allowed a listener to deal with those special expressions of opinion as though they were facts. As the leading treatise put it, “the ordinary man is free to deal in reliance upon the opinion of an expert jeweler as to the value of a diamond [or] of an attorney upon a point of law.” Prosser & Keeton §109, at 761. But what reasonable person would assume that a lawyer’s assessment of a diamond or a jeweler’s opinion on a point of law implied an educated investigation?

The Court’s expansive application of §11’s omissions clause to expressions of opinion produces a far broader field of misrepresentation; in fact, it produces almost the opposite of the common-law rule. The Court holds that a reasonable investor is right to expect a reasonable basis for all opinions in registration statements—for example, the conduct of a “meaningful . . . inquiry,”—unless that is sufficiently disclaimed. Ante, at 12, 14–15, 18–20. Take the Court’s hypothetical opinion regarding legal compliance. When a disclosure statement says “we believe our conduct is lawful,” ante, at 12, the Court thinks this should be understood to suggest that a lawyer was consulted, since a reasonable investigation on this point would require consulting a lawyer. But this approach is incompatible with the common law, which had no “legal opinions are different” exception. See Restatement of Torts §545, at 102.

It is also incompatible with common sense. It seems to me strange to suggest that a statement of opinion as generic as “we believe our conduct is lawful” conveys the implied assertion of fact “we have conducted a meaningful legal investigation before espousing this opinion.” It is strange to ignore the reality that a director might rely on industry practice, prior experience, or advice from regulators—rather than a meaningful legal investigation—in concluding the firm’s conduct is lawful. The effect of the Court’s rule is to adopt a presumption of expertise on all
topics volunteered within a registration statement.

It is reasonable enough to adopt such a presumption for those matters that are required to be set forth in a registration statement. Those are matters on which the management of a corporation are experts. If, for example, the registration statement said “we believe that the corporation has $5,000,000 cash on hand,” or “we believe the corporation has 7,500 shares of common stock outstanding,” the public is entitled to assume that the management has done the necessary research, so that the asserted “belief” is undoubtedly correct. But of course a registration statement would never preface such items, within the expertise of the management, with a “we believe that.” Full compliance with the law, however, is another matter. It is not specifically required to be set forth in the statement, and when management prefaces that volunteered information with a “we believe that,” it flags the fact that this is not within our area of expertise, but we think we are in compliance.

Moreover, even if one assumes that a corporation issuing a registration statement is (by operation of law) an “expert” with regard to all matters stated or opined about, I would still not agree with the Court’s disposition. The Court says the following:

“Section 11’s omissions clause, as applied to statements of both opinion and fact, necessarily brings the reasonable person into the analysis, and asks what she would naturally understand a statement to convey beyond its literal meaning. And for expressions of opinion, that means considering the foundation she would expect an issuer to have before making the statement.” Ante, at 17 (emphasis added).

The first sentence is true enough—but “what she [the reasonable (female) person, and even he, the reasonable (male) person] would naturally understand a statement [of opinion] to convey” is not that the statement has the foun-
Opinion of SCALIA, J.

dation she (the reasonable female person) considers adequate. She is not an expert, and is relying on the advice of an expert—who ought to know how much “foundation” is needed. She would naturally understand that the expert has conducted an investigation that he (or she or it) considered adequate. That is what relying upon the opinion of an expert means.

The common law understood this distinction. An action for fraudulent misrepresentation based on an opinion of an expert* was only allowed when the expression of the opinion conveyed a fact—the “fact” that summarized the expert’s knowledge. Prosser and Keeton §109, at 761. And a fact was actionable only if the speaker knew it was false, if he knew he did not know it, or if he knew the listener would understand the statement to have a basis that the speaker knew was not true. Restatement of Torts §526, at 63–64. Ah!, the majority might say, so a speaker is liable for knowing he lacks the listener’s reasonable basis! If the speaker knows—is actually aware—that the listener will understand an expression of opinion to have a specific basis that it does not have, then of course he satisfies this element of the tort.

But more often, when any basis is implied at all, both sides will understand that the speaker implied a “reasonable basis,” but honestly disagree on what that means. And the common law supplied a solution for this: A speaker was liable for ambiguous statements—misunderstandings—as

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*At the time of the Act’s passage, the common law did not permit suit for negligent misrepresentation under the circumstances here. An action for negligent misrepresentation resting upon a statement of opinion would lie only if the opinion—a professional opinion—was “given upon facts equally well known to both the supplier and the recipient.” Restatement of Torts §552, Comment b, at 123 (1938). That is of course not the situation here. The typical opinion “given upon facts equally known to both the supplier and the recipient” is a lawyer’s legal advice on facts described by his client.
fraudulent misrepresentations only where he both knew of the ambiguity and intended that the listener fall prey to it. Id. §527, at 66. In other words, even assuming both parties knew (a prerequisite to liability) that the expression of opinion implied a “reasonable investigation,” if the speaker and listener honestly disagreed on the nature of that investigation, the speaker was not liable for a fraudulent misrepresentation unless he subjectively intended the deception. And so in no circumstance would the listener’s belief of a “reasonable basis” control: If the speaker subjectively believes he lacks a reasonable basis, then his statement is simply a knowing misrepresentation. Id. §526(a), at 63. If he does not know of the ambiguity, or knows of it, but does not intend to deceive, he is not liable. Id. §527, at 66. That his basis for belief was “objectively unreasonable” does not impart liability, so long as the belief was genuine.

This aligns with common sense. When a client receives advice from his lawyer, it is surely implicit in that advice that the lawyer has conducted a reasonable investigation—reasonable, that is, in the lawyer’s estimation. The client is relying on the expert lawyer’s judgment for the amount of investigation necessary, no less than for the legal conclusion. To be sure, if the lawyer conducts an investigation that he does not believe is adequate, he would be liable for misrepresentation. And if he conducts an investigation that he believes is adequate but is objectively unreasonable (and reaches an incorrect result), he may be liable for malpractice. But on the latter premise he is not liable for misrepresentation; all that was implicit in his advice was that he had conducted an investigation he deemed adequate. To rely on an expert’s opinion is to rely on the expert’s evaluation of how much time to spend on the question at hand.

The objective test proposed by the Court—inconsistent with the common law and common intuitions about statements of opinion—invites roundabout attacks upon ex-
pressions of opinion. Litigants seeking recompense for a corporation’s expression of belief that turned out, after the fact, to be incorrect can always charge that even though the belief rested upon an investigation the corporation thought to be adequate, the investigation was not “objectively adequate.”

Nor is this objective test justified by §11’s absence of a mens rea requirement, as the Court suggests. Ante, at 15 n.10. Some of my citation of the common law is meant to illustrate when a statement of opinion contains an implied warranty of reasonable basis. But when it does so, the question then becomes whose reasonable basis. My illustration of the common-law requirements for misrepresentation is meant to show that a typical listener assumes that the speaker’s reasonable basis controls. That showing is not contradicted by §11’s absence of a mens rea requirement.

Not to worry, says the Court. Sellers of securities need “only divulge an opinion’s basis, or else make clear the real tentativeness of [their] belief[s].” Ante, at 18. One wonders what the function of “in my estimation” is, then, except as divulging such hesitation. Or what would be sufficient for the Court. “In my highly tentative estimation?” “In my estimation that, consistent with Omnicare, should be understood as an opinion only?” Reasonable speakers do not speak this way, and reasonable listeners do not receive opinions this way. When an expert expresses an opinion instead of stating a fact, it implies (1) that he genuinely believes the opinion, (2) that he believes his basis for the opinion is sufficient, and (most important) (3) that he is not certain of his result. Nothing more. This approach would have given lower courts and investors far more guidance and would largely have avoided the Funds’ attack upon Omnicare’s opinions as though Omnicare held those opinions out to be facts.

I therefore concur only in part and in the judgment.
THOMAS, J., concurring in judgment

SUPREME COURT OF THE UNITED STATES

No. 13–435

OMNICARE, INC., ET AL., PETITIONERS v. LABORERS DISTRICT COUNCIL CONSTRUCTION INDUSTRY PENSION FUND ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

[March 24, 2015]

JUSTICE THOMAS, concurring in the judgment.

I agree with the Court that the statements of opinion at issue in this case do not contain an untrue statement of a material fact. 15 U. S. C. §77k(a); ante, at 6–9. I write separately because I do not think it advisable to opine, as the majority does, on an additional theory of liability that is not properly before us.

The question whether and under what circumstances an omission may make a statement of opinion misleading is one that we should have left to the lower courts to decide on remand. As the majority acknowledges, that question was never passed on below. See ante, at 19. With good reason: Apart from a few conclusory allegations in their complaint and some pro forma references to “misleading statements and omissions” in their briefs, respondents did not elaborate on the omissions theory of liability before either the District Court or the Court of Appeals. They certainly did not articulate the theory the majority now adopts until they filed their merits brief before this Court. And it was not until oral argument that they identified a factual allegation in their complaint that might serve to state a claim under that theory. See ante, at 19–20. This delay is unsurprising given that, although various Courts of Appeals have discussed the theory, they have been
reluctant to commit to it. See *MHC Mut. Conversion Fund, L. P. v. Sandler O’Neill & Partners, L. P.*, 761 F. 3d 1109, 1116 (CA10 2014) (“[I]t is difficult to find many [courts] actually holding a security issuer liable on this basis, . . . and . . . the approach has been questioned by others on various grounds”); see also *ibid.*, n. 5.

We should exercise the same caution. This Court rarely prides itself on being a pioneer of novel legal claims, as “[o]urs is a court of final review and not first view.” *Zivotofsky v. Clinton*, 566 U. S. __, ___ (2012) (slip op., at 12) (internal quotation marks omitted). Thus, as a general rule, “we do not decide in the first instance issues not decided below.” *Ibid.* (internal quotation marks omitted). This includes fashioning innovative theories of liability as much as it includes applying those theories to the circumstances of the case.

The Court has previously relied on a lower court’s failure to address an issue below as a reason for declining to address it here, even when the question was fairly presented in the petition and fully vetted by other lower courts. See, e.g., *CSX Transp., Inc. v. Alabama Dept. of Revenue*, 562 U. S. 277, 284, n. 5 (2011); see also *id.*, at 303, n. 3 (THOMAS, J., dissenting). Surely the feature that distinguishes this case—a novel legal theory that is not fairly included in the question presented—counsels more strongly in favor of avoidance.

As JUSTICE SCALIA’s concurrence reveals, the scope of this theory of liability is far from certain. And the highly fact-intensive nature of the omissions theory provides an additional reason not to address it at this time. The majority acknowledges that the facts a reasonable investor may infer from a statement of opinion depend on the context. And yet it opines about certain facts an investor may infer from an issuer’s legal compliance opinion: that such an opinion is based on legal advice, for example, or that it is not contradicted by the Federal Government.
THOMAS, J., concurring in judgment

See ante, at 12. These inferences may seem sensible enough in a vacuum, but lower courts would do well to heed the majority’s admonition that every statement of opinion must be considered “in a broader frame,” ante, at 14, taking into account all the facts of the statement and its context. Would that the majority had waited for the “broader frame” of an actual case before weighing in on the omissions theory.
Chapter 5B—Omnicare, Inc., One Year Later

No. 13-435

In the Supreme Court of the United States

OMNICARE, INC., et al.,
Petitioners,

V.

LABORERS DISTRICT COUNCIL
CONSTRUCTION INDUSTRY PENSION FUND, et al.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals
for the Sixth Circuit

BRIEF OF WASHINGTON LEGAL FOUNDATION
AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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37th Annual Northwest Securities Institute 5B–63
QUESTION PRESENTED

Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, provides a private remedy for a purchaser of securities issued under a registration statement filed with the Securities and Exchange Commission if the registration statement “contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” The question presented is as follows:

For purposes of a Section 11 claim, whether a plaintiff may plead that a statement of opinion was “untrue” merely by alleging that the opinion itself was objectively wrong, or whether the plaintiff must also allege that the statement was subjectively false—requiring allegations that the speaker’s actual opinion was different from the one expressed.
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INTEREST OF AMICUS CURIAE


WLF agrees with Petitioners that plaintiffs may only allege that an opinion is “false” under § 11 of the Securities Act of 1933 by pleading that the opinion was not genuinely believed by the speaker, and that the Sixth Circuit’s holding to the contrary conflicts with

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\(^1\) Pursuant to Rule 37.6 of the Rules of this Court, the undersigned hereby state that no counsel for Petitioners or Respondents authored any part of this brief, and no person other than amicus curiae or its counsel made any monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.3(a) of Rules of this Court, letters of consent from all parties to the filing of the brief are on file or have been submitted to the Clerk of the Court.
Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991). WLF writes separately to emphasize the importance of clarifying the standard for challenging “false” statements of opinion under all the federal securities laws. Such a clarification is needed to protect the expression of honest opinions by corporations and their officers and directors, as well as to guard the real interests of shareholders, who would be disadvantaged by a rule that deterred companies from openly sharing their opinions.

The holding in this case is important to all publicly held companies and their shareholders, because all companies disclose crucial information by means of opinions—such as subjective judgments regarding a company’s business and financial condition, risks and opportunities, and policies and priorities. But WLF is particularly concerned about the impact of this decision on technology and other growth companies, whose volatile stock prices make them especially vulnerable to abusive securities class actions. For example, life sciences companies with products under development operate in an uncertain atmosphere that renders many of their core disclosures inherently subjective. They must speculate on the risks and benefits of developing products, distill voluminous and complex clinical trial results that are readily subject to alternative interpretations, and characterize the ups and downs of their rollercoaster ride toward potential approval by the Food and Drug Administration. See Stuart R. Cohn & Erin M. Swick, The Sitting Ducks of Securities Class Action Litigation: Bio-Pharmas and the Need for
Improved Evaluation of Scientific Data, 35 Del. J. Corp. L. 911, 923-25, 928 (2010). By exposing corporate actors to liability whenever their subjective judgments are later determined to be “wrong,” the Sixth Circuit’s decision endangers the prosperity of these companies and their shareholders.

SUMMARY OF ARGUMENT

Opinions are ubiquitous in corporate communications. Corporations and their officers routinely share subjective judgments on issues as diverse as asset valuations, strength of current performance, risk assessments, product quality, loss reserves, and progress toward corporate goals. Many of these opinions are crucial to investors, providing them with unique information and insight. If corporate actors fear liability for sharing their genuinely held beliefs, they will be reluctant to voice their opinions, and shareholders would be deprived of this vital information.

The standard that the federal securities laws use to determine whether an opinion is “false” is therefore of widespread importance. Although this case only involves § 11 of the Securities Act of 1933, it poses a

2 Not surprisingly, securities litigation against such companies is on the rise, and is increasingly directed at such subjective statements. See Dechert Survey of Securities Fraud Class Actions Brought Against U.S. Life Sciences Companies 2-3 (2013), http://www.dechert.com/files/Publication/9a791e10-3b4c-4418-a424-55bff34354bf/Presentation/PublicationAttachment/81f9beb0-b2d4-45a2-b142-0174fd11d9c2/Dechert_Life_Sciences_Survey_03-13.pdf.
fundamental question: What causes an opinion or belief to be a “false statement of material fact”? The Court’s answer will affect the standards of pleading and proof for statements of opinion under other liability provisions of the federal securities laws, which likewise prohibit “untrue” or “false” statements of “material fact.” Despite the complexity the courts have injected into this issue, the answer is not complicated; it is a straightforward application of common sense. An opinion or belief is not “false” if it turns out to be wrong, if some (or even many) people disagree with it, or if a judge later decides it was unreasonable. Rather, a statement of opinion is only “false” if the opinion is not genuinely held; a statement of belief is only “untrue” if the belief is not actually believed.

This Court articulated the correct standard for judging the falsity of opinions in *Virginia Bankshares*, in which it held that an opinion may be actionable as a false statement of “fact,” to the extent to which it is a “misstatement of the psychological fact of the speaker’s belief in what he says.” 501 U.S. at 1095. This holding is correct as a matter of logic and statutory interpretation, and has been applied by several circuit courts, including the First, Second, Fourth, Fifth, and Ninth Circuits, to require plaintiffs to allege the subjective falsity of opinions.

Nevertheless, confusion has persisted within the courts, with some judges continuing to rely on outdated doctrines inconsistent with *Virginia Bankshares*. As a result, in some courts, opinions are deemed immaterial
as a matter of law, suggesting to investors that they have no recourse if companies falsely portray their beliefs. At the other end of the spectrum is the Sixth Circuit decision under review, which holds that a speaker may be liable even for the expression of an honest opinion, if someone determines in hindsight that the opinion was “wrong.” Pet. App. 16a-17a.


But, as Justice Powell observed, the goal of preventing corporate fraud must be balanced with the need to protect against “open-ended litigation [that] would itself be an invitation to fraud.” *Blue Chip Stamps*, 421 U.S at 760 (Powell, J., concurring). This balance is especially important because it is the shareholders who “ultimately bear the burden” of
meritless litigation. *Id.* at 761 n.5. Preventing such harm was one of the primary motivations behind the Private Securities Litigation Reform Act of 1995 ("Reform Act"). Congress knew that abusive litigation not only threatened corporate interests and damaged the U.S. economy, but that it also had a "chilling effect" on the "robustness and candor of disclosure" that ultimately harmed investors. H.R. Rep. No. 104-369, at 42-43 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730.

With this case, the Court has an opportunity to correct errors that have distorted the balance on both sides of the scale. In addition to reaffirming *Virginia Bankshares*, and emphasizing that the falsity of an opinion must hinge upon whether it is genuinely held, the Court can correct misguided precedent that has distorted how other elements of a securities fraud claim are applied in opinion cases—including the standards for misleading statements, scienter, and materiality. By clarifying the independent work done by each element, the Court can improve the fairness of securities class-action litigation across a wide range of cases. Companies would be assured that they would not face liability for sharing their honest judgments; shareholders would be assured that companies could not lie with impunity by simply casting their statements as opinions; and both would benefit from the application of clear and consistent standards.
ARGUMENT

I. Statements of Opinion Are a Common and Crucial Form of Disclosure.

A. Corporate Opinions Take Several Forms.

Before exploring the proper method for analyzing the falsity of opinions, it is important to understand what qualifies as an “opinion” under the securities laws. Current law provides no clear standard for making this determination, leaving most courts to make judgments on an ad hoc basis—often employing an “I know it when I see it” test. See Wendy G. Couture, Opinions Actionable as Securities Fraud, 73 La. L. Rev. 381, 401-04 (2013) (discussing the absence of a disciplined approach to identifying corporate opinions). The lack of a consistent standard predictably leads to inconsistent results, such that similar statements may be classified as statements of opinion, or not, depending upon the court. Compare Hill v. State St. Corp., No. 09CV12146-NG, 2011 WL 3420439, at *23 (D. Mass Aug. 3, 2011) (holding statement that assets are “high quality” is not an opinion) with Freidus v. ING Groep, N.V., 543 F. App’x 93, 95 (2d Cir. 2013) (holding statement that assets are “relatively high quality” is an opinion). A review of the literature and case law, and a sampling of recent company disclosures, yields four categories of corporate statements that are properly classified as opinions.

The first category encompasses all corporate statements that reflect an inherently subjective characterization, analysis, or judgment, about which
reasonable minds could differ. See Billhofer v. Flamel Techs., S.A., No. 07 CIV. 9920, 2012 WL 3079186, at *10 (S.D.N.Y. July 30, 2012) (“[T]he hallmark of an opinion is that it does not express ‘matters of objective fact’ which can be assessed against an ‘objective standard’ but instead conveys a belief or ‘judgment’ whose ‘determination is inherently subjective.’”) (quoting Fait v. Regions Fin. Corp., 655 F.3d 105, 110-13 (2d Cir. 2011)). Opinions in this category are not necessarily qualified by “I think” or “I believe,” and often involve crucial information. Examples include: fairness opinions, see, e.g., Rubke v. Capitol Bancorp Ltd., 551 F.3d 1156, 1162 (9th Cir. 2009); auditors’ reports or statements of compliance with financial standards, see, e.g., Buttonwood Tree Value Partners, LP v. Sweeney, No. SACV 10-00537-CJC(MLGx), 2012 WL 2086607, at *2 (C.D. Cal. June 7, 2012); evaluations of assets and the adequacy of loan loss reserves, see, e.g., Fait, 655 F.3d at 110, 113; characterization of clinical trial results, see, e.g., Wolfe v. Aspenbio Pharma, Inc., No. 11-CV-00165-REB-KMT, 2012 WL 4040344, at *8 (D. Colo. Sept. 13, 2012); appraisal of the strength of new technology, see, e.g., Hanon v. Dataproducts Corp., 976 F.2d 497, 502 (9th Cir. 1992); evaluation of trends and risks, see, e.g., Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 184 (3d Cir. 1988); and characterization of policies and practices, see, e.g., IBEW Local 90 Pension Fund v.

The second category includes personal beliefs, thoughts, motivations, or feelings conveyed by individual people or groups of people. These opinions might describe reasons for taking certain actions, see, e.g., Virginia Bankshares, 501 U.S. at 1087-88; feelings of optimism or confidence, see, e.g., City of Monroe Emps. Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 659 (6th Cir. 2005); worries or concerns, see, e.g., Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1212 (1st Cir. 1996); or feelings about people or projects, see, e.g., Kowal v. MCI Commc’ns Corp., 16 F.3d 1271, 1274-75 (D.C. Cir. 1994).

A third category involves the expression of the “belief of the [speaker], without certainty, as to the

3 Everyday examples abound. A review of a dozen recent investor conference calls conducted by random companies revealed opinions including: characterizations of “positive selling price changes,” a “strong new production flow,” a “good bidding environment,” “continued broad based organic growth,” and clinical trials that “exhibited significant meaningful and long-lasting results”; and assurances regarding the “attainment of significant regulatory milestones,” “demonstrable progress in advancing our . . . programs,” and that “we continue to manage our [risk] exposures carefully.”

4 Examples from recent conference calls include statements indicating that company officers “believe that we can accelerate . . . growth,” are “excited about our future opportunities together,” think it is “an important and exciting day,” and “feel much better today than we did last time we were on the call.”
existence of a fact.” Restatement (Second) of Torts § 538A (1977); see, e.g., In re MBIA, Inc. Sec. Litig., 700 F. Supp. 2d 566, 573 (S.D.N.Y. 2010). Such statements are typically made in situations where facts cannot be immediately confirmed, such as on investor conference calls, and are usually expressly qualified with a statement such as “I think.” Although the underlying information is factual, such statements are nonetheless opinions because they expressly represent only what the speaker believes to be true about the fact.

The final classification of opinions includes forward-looking statements, such as predictions, forecasts, statements of future plans, and evaluations of risks. Such opinions are given heightened statutory protection under the Reform Act’s safe harbor for forward-looking statements (“Safe Harbor”). 15 U.S.C. §§ 77z-2 and 78u-5 (1995). However, the Safe Harbor’s protections are limited to certain parties, so they do not govern all liability for forward-looking opinions, such as analyst ratings and recommendations. See, e.g., In re Credit Suisse First Boston Corp., 431 F.3d 36, 46-47 (1st Cir. 2005) (analyst buy ratings are actionable opinions under § 10(b)).

5 Recent conference call examples include officers’ statements that “I think the biggest acquisition [the company] had done is . . . $1 billion or so” and “I think the authorization remaining is roughly $40 million.”
B. Opinions About Current Conditions Can Be Just as Material as Forward-Looking Opinions.

For several decades, the Securities and Exchange Commission (“SEC”) prohibited companies from releasing “conjectures and speculations as to the future,” because it deemed them inherently unreliable, and believed the typical investor was “as competent as anyone to predict the future from the given facts.” Harry Heller, *Disclosure Requirements under Federal Securities Regulation*, 16 Bus. Law. 300, 307 (1961). This policy changed in the 1970s, and decades of debate ensued regarding whether such forecasts were too uncertain to ever be material, or so valuable that they were worthy of special protection. Courts were caught in this whipsaw. *See, e.g.*, *Raab v. General Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993) (contending forecasts are generally immaterial as a matter of law, while simultaneously asserting they should be protected because “liability would deter companies from discussing their prospects, and the securities markets would be deprived of the information those predictions offer.”).

The uncertainty was resolved when Congress passed the Safe Harbor in 1995, protecting a company’s material forward-looking statements if they are either accompanied by meaningful cautionary statements or made without actual knowledge of falsity. 15 U.S.C. §§ 77z-2 and 78u-5 (1995). Congress determined that such strong protections were necessary to encourage

Despite the fact that they enjoy such explicit protections, forward-looking opinions are not necessarily any more material than judgments about current conditions. Indeed, the opposite is often true. Forward-looking opinions are now typically accompanied by a bevy of cautionary statements, warning of all the factors that may cause them to be inaccurate. Even without these warnings, the uncertainty of such predictions is obvious. On the other hand, investors value opinions about current conditions from company insiders, because “[s]hareholders know that directors usually have knowledge and expertness far exceeding the normal investor’s resources . . . .” Virginia Bankshares, 501 U.S. at 1091; see Couture, supra, at 406 (“[T]he unique insights of companies and their officers and directors are essential to market efficiency.”).  

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6 Indeed, analysts often ask company officers for their opinions. During recent investor conference calls, analysts asked officers to “put some color” on their disclosures, “share with us what inning do you think we are in,” give their “mix of impressions,” discuss what they are “currently thinking,” and divulge which opportunities are the “most exciting.”
II. The Law Governing Opinions Is Muddled.

A. Early Law Embraced Caveat Emptor.

The schizophrenic nature of the current law governing statements of opinion can best be understood by tracing its evolution. Employing the doctrine of caveat emptor, courts long recognized “puffery” as a defense to the common law torts of deceit and fraudulent misrepresentation, reasoning that because salespeople were expected to “puff” up their products, such vague positive statements could not form the basis of a claim. See Restatement (Second) of Torts § 542 cmt. e (1977). Early on, this doctrine was incorporated into the securities laws, which were initially held to apply only to “facts,” and not “opinions.” See Harry Shulman, Civil Liability and the Securities Act, 43 Yale L. J. 227, 236, 249 (1933).

As courts began to reject the notion of caveat emptor as incompatible with the protective securities laws, the circuits diverged, developing differing standards for when opinions could be actionable. Some continued to hold that opinions were almost always immaterial as a matter of law. Others held statements of belief “may be actionable,” and imposed both subjective and objective standards to determine falsity. See, e.g., In re Apple Computer Sec. Litig., 886 F.2d 1109, 1113 (9th Cir. 1989) (holding opinions are actionable if they are not genuinely believed, there is no reasonable basis for the belief, or the speaker knows undisclosed facts that tend to seriously undermine the opinion); Eisenberg v. Gagnon, 766 F.2d 770, 776 (3d
Cir. 1985) (opinions are actionable if issued without a genuine belief or a reasonable basis).

B. Virginia Bankshares Held Opinions Can Be Actionable Only If Subjectively False.

In *Virginia Bankshares*, the Court definitively answered the question of whether corporate opinions could be material under the federal securities laws, finding there is “no serious question” that “such statements may be materially significant.” 501 U.S. at 1090-91. In addition to holding they could be material, the Court found corporate opinions could be actionable as “fact[s].” *Id.* at 1092. The Court reasoned that a statement of belief conveyed the “fact” that the speaker held that belief, and that it was open to challenge “solely as a misstatement of the psychological fact of the speaker’s belief in what he says.” *Id.* at 1095.7

The plaintiffs in *Virginia Bankshares* alleged that a company’s directors had been dishonest in claiming they supported a merger because it gave shareholders a “high value.” *Id.* at 1090. A jury found the directors guilty of violating Rule 14a-9, which prohibits statements in proxy materials that are “false or misleading with respect to any material fact . . . .” 17 C.F.R. § 240.14a-9 (1990). The Court assumed the

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7 This reasoning was consistent with prior scholarship examining opinions in the context of the tort of fraudulent misrepresentation. See, e.g., W. Page Keeton et. al., *Prosser and Keeton on the Law of Torts* § 109, at 755 (5th Ed. 1984) (a statement of opinion conveys the factual representation that the speaker believed the truth of the statement when made).
verdict meant the jury had found the directors “did not hold the beliefs or opinions expressed.” 501 U.S. at 1090. Implicitly holding that such a finding was necessary, the Court then examined whether a “disbelief or undisclosed motivation, standing alone” was sufficient to allege falsity. *Id.* at 1096. The Court found it was not, holding that plaintiffs must also demonstrate an opinion “expressly or impliedly asserted something false or misleading about its subject matter.” *Ibid.* Justice Scalia summarized the ruling with a characterization with which no member of the Court disagreed:

[T]he statement “In the opinion of the Directors, this is a high value for the shares” would produce liability if in fact it was not a high value and the directors knew that. It would not produce liability if in fact it was not a high value but the directors honestly believed otherwise.

*Id.* at 1108-09 (Scalia, J., concurring).

**C. Confusion Remains After Virginia Bankshares.**

*Virginia Bankshares* should have brought clarity and uniformity to the law governing corporate opinions. But the circuit courts were slow to embrace *Virginia Bankshares*, and there has been some disparity and confusion in its application. Meanwhile, a minority of courts have ignored *Virginia Bankshares* completely, continuing to invoke precedent incompatible with its holding. As a result, a thicket of contradictory standards remains. *See* Couture, *supra*, at 384 (courts
have adopted various tests for opinions “that are analytically unsound, that yield inconsistent results, and that fail to further the fundamental policy goal of the securities acts ‘to insure the maintenance of fair and honest markets.’”) (citation omitted).

A number of circuit courts have now correctly applied Virginia Bankshares to multiple sections of the securities laws, allowing plaintiffs to challenge opinions only by pleading subjective falsity. See Credit Suisse, 431 F.3d at 47 (applying Virginia Bankshares to § 10(b)); Fait, 655 F.3d at 110 (holding plaintiffs must allege opinion was “actually disbelieved” under §§ 11 and 12); Nolte v. Capital One Fin. Corp., 390 F.3d 311, 315 (4th Cir. 2004) (same); Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 670 (5th Cir. 2004) (holding plaintiffs must show opinion was not actually held under § 10(b)); Rubke, 551 F.3d at 1162 (holding plaintiffs must allege opinions were subjectively false under § 11).

At the same time, however, some courts still articulate a standard that suggests some kind of objective showing of falsity is sufficient. Although the Ninth Circuit applied Virginia Bankshares in 2009 through Rubke, it did not expressly overrule its incompatible three-part Apple standard. See Rubke, 551 F.3d at 1162 (implementing Virginia Bankshares without mention of how it intersects with Apple). As a result, some courts, both within and without the Ninth Circuit, continue to refer to the Apple standard, which allows false opinion claims that allege either subjective
falsity or that an opinion lacked a reasonable basis or was undermined by undisclosed facts. As explained \textit{infra} at 23-24, allowing opinions to be challenged on the basis that they are “unreasonable” or inconsistent with the facts subverts the subjective falsity requirement.

Increasing the confusion, some courts cite to both the \textit{Virginia Bankshares} line of cases and the \textit{Apple} standard, seemingly oblivious to their incompatibility. \textit{See}, e.g., \textit{In re XM Satellite Radio Holdings Sec. Litig.}, 479 F. Supp. 2d 165, 177 (D.D.C. 2007) (asserting it is applying the “doctrine established by \textit{Virginia Bankshares},” and then citing to, and actually applying, the \textit{Apple} standard); \textit{In re REMEC Inc. Sec. Litig.}, 702 F. Supp. 2d 1202, 1228-29 (S.D. Cal. 2010) (using the \textit{Apple} standard, but citing to \textit{Virginia Bankshares} and \textit{Rubke}); \textit{but see} \textit{McGuire v. Dendreon Corp.}, 688 F. Supp. 2d 1239, 1244 (W.D. Wash. 2009) (recognizing that \textit{Rubke} implicitly overruled \textit{Apple}).

Other courts have continued to cite directly to \textit{Apple} (or precedent stemming from \textit{Apple}), ignoring \textit{Virginia Bankshares} entirely. \textit{See}, e.g., \textit{Helwig v. Vencor, Inc.}, 251 F.3d 540, 557 (6th Cir. 2001) (\textit{en banc}); \textit{Slayton v. Am. Express Co.}, 604 F.3d 758, 775 (2d Cir. 2010); \textit{In re Allstate Life Ins. Co. Litig.}, No. CV-09-08162-PCT-GMS, 2013 WL 5161688, at *16 (D. Ariz. Sept. 13, 2013); \textit{Patrick v. Patrick}, No. 2:08cv450, 2010 WL 569740, at *3 (W.D. Pa. Feb. 12, 2010). Meanwhile, some courts invoke standards derived from sources other than \textit{Apple}, but which similarly allow
plaintiffs to assert the falsity of opinions without regard to the speaker’s state of mind. See, e.g., ACA Fin. Guar. Corp. v. Advest, Inc., 512 F.3d 46, 62 (1st Cir. 2008) (allowing liability for “unreasonable” opinions); In re Facebook, Inc., IPO Sec. & Derivative Litig., ___ F. Supp. 2d ___, 2013 WL 6621024, at *27 (S.D.N.Y. Dec. 12, 2013) (holding opinions actionable if not genuinely believed or unreasonable or worded as guarantees or supported by specific facts).

Finally, some courts still use the “puffery” doctrine to automatically discount allegations against opinions—essentially applying a different standard of materiality for statements of opinion. Although the puffery doctrine was declared at one time to have “all but gone the way of the dodo,” it has made a resurgence. See Jennifer O’Hare, The Resurrection of the Dodo: The Unfortunate Re-Emergence of the Puffery Defense in Private Securities Fraud Actions, 59 Ohio St. L. J. 1697, 1697 (1998) (quoting 7 Louis Loss & Joel Seligman, Securities Regulation 3434 (3d ed. 1991)). Courts define puffery in various ways, sometimes encompassing virtually all opinions, and sometimes just a subset. See, e.g., Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 372 (5th Cir. 2004) (holding “generalized, positive statements” are puffery); Grossman v. Novell, Inc., 120 F.3d 1112, 1119 (10th Cir. 1997) (finding “generalized statements of optimism that are not capable of objective verification” are puffery); Malin v. XL Capital Ltd., 499 F. Supp. 2d 117, 144 (D. Conn. 2007), aff’d, 312 F. App’x 400 (2d Cir.)
2009) (collecting cases and holding opinions are generally not actionable as puffery).

*Virginia Bankshares* created an obvious conflict with the extreme spectrum of the puffery doctrine, under which virtually all opinions are immaterial as a matter of law, by finding that there was “no serious question” that opinions *could be* material. 501 U.S. at 1090-91. Some courts have tried to reconcile this tension by casting subjective falsity as an exception to puffery, thus mixing up the concepts of materiality and falsity, and “characterizing apples as an exception to oranges.” Couture, *supra*, at 420; see, e.g., *Longman v. Food Lion, Inc.*, 197 F.3d 675, 683 (4th Cir. 1999) (opinions will “often not be actionable” as puffery, unless they are “both factual and material” because they are not genuinely believed, as in *Virginia Bankshares*).

**III. The Sixth Circuit Demonstrated a Basic Misunderstanding of Falsity.**

The somewhat muddled precedent governing statements of opinion culminated in the anomalous Sixth Circuit decision under review, which expressly contradicts the holding of *Virginia Bankshares* and of the other circuit courts to examine this issue. The Sixth Circuit began by drawing on precedent that is a close cousin to puffery, to construct a false dichotomy between the materiality of “hard” information (facts) and “soft” information (“matters of opinion and predictions”). Pet. App. 12a. The court then jumbled the concepts of materiality and falsity, postulating that
there is “generally no duty to disclose soft information” unless “knowledge of falsity is shown,” in which case, “opinions cease to be soft information’ and become hard facts.”\(^8\) \textit{Id.} at 14a (citing \textit{Kushner v. Beverly Enters., Inc.}, 317 F.3d 820, 831 (8th Cir. 2003)). Stumbling through the maze erected by this nonsensical proposition, the court eventually concluded that this disclosure standard only applies to § 10(b), finding that because § 11 provides for strict liability, “if the defendant discloses information that includes a material misstatement . . . a complaint may survive a motion to dismiss without pleading knowledge of falsity.” \textit{Id.} at 16a.

While this statement of law is correct as far as it goes, it illustrates the Sixth Circuit’s failure to distinguish the subjective falsity inquiry from “knowledge of falsity”—which, in turn, stems from its fundamental failure to examine how an opinion is different from a fact. It is not that an opinion requires a different standard of materiality (because it is “soft information”) or that it necessitates a stronger showing of scienter (because “knowledge of falsity” somehow transforms it into “hard information”). A statement of opinion is different because the “material fact” that it represents inherently implicates the speaker’s state of mind. Accommodation of this difference does not

\(^8\) This proposition also misstated the disclosure responsibilities under § 10(b), by asserting that a party who speaks on a subject has a duty to speak “fully.” Pet. App. 15a. No such duty exists, unless the failure to “speak fully” causes a statement to be misleading. \textit{See infra} at 25-26.
require an elaborate doctrine designed specifically for opinions. Rather, a straightforward application of the falsity requirement suffices: In order to show falsity, whether of facts or opinions, plaintiffs must plead that the fact represented by the statement was, in fact, “false.”

But the Sixth Circuit bypassed this threshold question of how an opinion might constitute a “false” statement of “fact.” Instead, it assumed, without discussion, that an opinion can be “indisputably wrong.” *Id.* at 16a. The court did not explain how this wrongness was to be demonstrated, or how the truth of a statement about someone’s state of mind can be explored *without* inquiring into that person’s state of mind. Instead, it mechanically equated any inquiry into a speaker’s thoughts with “scienter,” and formalistically concluded that because “scienter” is not required under § 11, such an inquiry is improper.

This superficial analysis ignores the reasoning of *Virginia Bankshares*, which examined the nature of statements of “reasons or belief” and the ways in which they are “factual”—“as statements that the directors do act for the reasons given or hold the belief stated[.]” 501 U.S. at 1092. Any inquiry into the truth or falsity of such beliefs thus necessitates an inquiry into whether the speakers “hold the belief stated. . . .” *Ibid.* For the *Virginia Bankshares* Court, this was clearly a question of falsity, *not* scienter. Indeed, the Court expressly reserved the question of whether or not scienter was required for liability under § 14(a), and
this open question had no effect on its analysis. *Id.* at 1090 n.5.

By improperly framing the question as whether “knowledge of falsity” of opinions is required, the Sixth Circuit transformed a falsity analysis into a scienter requirement, and concluded it would be “unwise for this Court to add an element to § 11 claims” based on “tea-leaf reading” of *Virginia Bankshares*. Pet. App. 19a. But the Sixth Circuit’s holding actually removes the element of falsity from § 11 claims challenging opinions. Under the Sixth Circuit’s rule, plaintiffs must show an opinion was false because it was not genuinely believed for a claim under § 14(a) or § 10(b), but not when bringing a § 11 claim. This would impose a different standard of falsity for § 11 claims than for the other securities laws, even though the laws employ essentially identical language. Pet. Br. 24 & n.6.

IV. **A Clear Subjective Falsity Rule Is Needed to Resolve Confusion and Promote Fairness.**

WLF agrees with Petitioners that the Sixth Circuit should be reversed, and the Court should hold that plaintiffs must plead subjective falsity to state a claim under § 11. But WLF also urges the Court to seize this opportunity to resolve the inconsistencies that plague the jurisprudence regarding statements of opinion. WLF thus writes separately to emphasize the need for a clear standard for the adjudication of corporate opinions under the securities laws—a standard that is faithful to both statutory text and Supreme Court

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precedent, and which emphasizes the importance of distinguishing between the elements of a securities fraud claim.


Falsity is the fundamental element of any claim brought under the securities laws, which generally forbid either “false” or “untrue” statements “of material fact.” See Pet. Br. 26 n.7. Because the securities statutes forbid false “statement[s] of material fact”—and not incorrect, unreasonable, or even “indisputably wrong” opinions—the proper standard must start by identifying the ways in which an opinion conveys a “fact.” As the Virginia Bankshares Court established, opinions are “factual” statements as to what the speaker believes. 501 U.S. at 1092. Since opinions only state the “fact” of the speaker’s belief, it directly follows that they are only “false” if the speaker does not genuinely believe them when they are uttered. See, e.g., Fait, 655 F.3d at 112.

Such an analysis precludes a showing of falsity that is based solely upon any “objective” standard. See In re Salomon Analyst AT&T Litig., 350 F. Supp. 2d 455, 466 (S.D.N.Y. 2004) (“It is not sufficient . . . to allege that an opinion was unreasonable, irrational, excessively optimistic, not borne out by subsequent events, or any other characterization that relies on hindsight or falls short of an identifiable gap between the opinion publicly expressed and the opinion truly held.”). The fallacy in such inquiries is clear: An
opinion is not “false” because a judge later surveys the facts and, with the benefit of both omniscience and hindsight, deems the opinion to have been unreasonable. Reasonableness is always in the beholder’s eye. Whether a statement is “reasonable” is itself an opinion, and a “reasonableness” standard would make a speaker liable for an honestly held opinion if someone else later reached a different subjective judgment. Indeed, there are many reasons why a company executive might hold a genuine belief that later appears to have been unreasonable, especially with the hindsight supplied by a negative outcome. See Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1129-30 (2d Cir. 1994) (“People in charge of an enterprise are not required to take a gloomy, fearful or defeatist view of the future; subject to what current data indicates, they can be expected to be confident about their stewardship and the prospects of the business that they manage.”).

Similarly, a speaker may genuinely hold an opinion even if other people disagree with him, or there are undisclosed facts that could undermine that belief. The existence of such facts, or such disagreement, does not render the speaker’s opinion a lie. And securities jurisprudence has long made clear that a statement (whether fact or opinion) is not “false” just because it is

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9 As the Virginia Bankshares Court observed, facts about the speaker’s knowledge of information supporting or discrediting his or her opinion could be used as circumstantial evidence regarding the speaker’s actual belief. 501 U.S. at 1092-93. But such facts, without more, are insufficient to show subjective falsity.
proven incorrect in hindsight. See, e.g., Shields, 25 F.3d at 1129.

This analysis, however, does not import a subjective falsity requirement into the standard for judging any objective facts that are included as part of an opinion. For example, corporate officers speaking in investor conference calls will often intertwine objective facts, subjective judgments (which should be examined as opinions), and statements that are expressly opinions. In such a case, the objective and subjective elements of the statement must be distinguished, with the plaintiffs required to allege specifically which part of each statement is false, and why. Then, the proper falsity analysis should be applied separately to the portions of the statement that constitute opinions, and to those that convey facts.

The subjective falsity analysis also does not control the evaluation of whether a statement is misleading due to omissions. Whether information is “soft” or “hard,” there is no general obligation to disclose it under the securities laws, even if investors may deem it material. Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1321-22 (2011); Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) (“Silence, absent a duty to

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10 A review of recent conference calls reveals numerous examples, such as: “Worldwide organic local-currency [growth] was 4.6% in the first quarter with volumes up 3.4% and selling prices up 1.2%. We continue to experience positive selling price changes across our businesses, boosted by world-class innovation and strong new production flow, both of which are important elements of [our] business model.”
disclose, is not misleading under Rule 10b-5.”). Absent an affirmative disclosure obligation, disclosure is required only when necessary “to make ... statements made, in the light of the circumstances under which they were made, not misleading.” Ibid. (quoting 17 CFR § 240.10b-5(b)); see also, e.g., 15 U.S.C. § 77k (Section 11 prohibits registration statements that “omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . .”).

It is thus error to examine whether a specific opinion is misleading in isolation. And unnecessary attempts to give meaning to the concept of “subjectively misleading” can result in the subjective falsity requirement being rendered essentially meaningless. See, e.g., McGuire, 688 F. Supp. 2d at 1244-45 (implementing the subjective falsity requirement of Virginia Bankshares and Rubke, but holding an opinion may be “subjectively misleading” if the speaker does not reveal all facts “that he knew or should know would lead someone else to a different opinion.”). Rather, the proper analysis of whether a disclosure was misleading requires examination of the statement in context (including the context provided by other public statements) and an evaluation of the allegedly omitted facts, to determine if the omissions caused the statement to “affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists.” Brody v. Transitional Hosps. Corp., 280 F.3d 997, 1006 (9th Cir. 2002); see also Halperin v. eBanker USA.com, Inc., 295 F.3d 352, 357
(2d Cir. 2002) (“The touchstone of the inquiry is not whether isolated statements within a document were true, but whether defendants’ representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a reasonable investor . . . ”). Because this inquiry necessarily considers a company’s statements holistically, no special standards need to be incorporated simply because an allegedly misleading statement contains opinions.

A hypothetical exemplar illustrates how a court should dissect each component of a statement, and each allegation of falsity, and analyze them separately. Suppose plaintiffs challenged this prototypical statement by a corporate officer:

Since we launched the new product, I believe we have made good progress. Demand has increased and customer feedback has been positive. I think our early numbers show roughly a 20% increase in units sold, and if this pattern continues, I would be very optimistic.

This statement includes three types of opinions identified supra at 7-10: an inherently subjective judgment (“customer feedback has been positive”); explicit expressions of belief (“I believe we have made good progress” and “I would be very optimistic”); and an uncertain expression of fact (“I think our early numbers show roughly a 20% increase in units sold”). All these opinions are only “false” to the extent that they were not genuinely believed by the speaker at the time of the statement. But the statement also includes
assertions of fact: that the new product has launched, that demand has increased, and that the company has received feedback from customers. If the accuracy of these factual assertions is challenged, a standard objective inquiry would suffice for evaluating falsity. See Virginia Bankshares, 501 U.S. at 1109-10 (Scalia, J., concurring) (advocating that normal principles governing misrepresentations should apply to facts asserted as part of an opinion).

The proper approach to analyzing this statement would therefore depend on the nature of the allegations. If plaintiffs alleged that progress was not “good,” customer feedback was not “positive,” or the early sales numbers had not shown a 20% increase in units sold, then they must adequately plead (and, ultimately, prove) that the speaker did not genuinely believe these statements. On the other hand, if plaintiffs alleged that at the time of the statement the product had not yet been launched, there had been no customer feedback, or demand had been plummeting, then falsity could be shown simply by demonstrating the statement was objectively untrue.

Finally, if plaintiffs claimed the statement was misleading because of omissions, they would need to examine the entire statement in context, identify which facts were allegedly omitted, and explain how those omissions caused the statement to create a false impression of the state of the company’s affairs. Here, plaintiffs might be able to show the statement was misleading, if, for example, it omitted mention of
serious supply problems that meant discontinuation of the new product and a decline in revenues, thereby rendering misleading the overall impression created by the statement that the new product would continue to benefit the company in the long term.

B. Failing to Preserve Scienter as a Separate Inquiry Leads to Errors.

The Sixth Circuit’s basic error was in failing to distinguish subjective falsity from scienter. It is not alone in making this mistake. Even courts that have otherwise applied Virginia Bankshares correctly have improperly conflated the two standards. See Credit Suisse, 431 F.3d at 48 (“[T]he subjective aspect of the falsity requirement and the scienter requirement essentially merge; the scienter analysis is subsumed by the analysis of subjective falsity.”). In some cases, such imprecision is harmless. But in others it can have significant consequences, such as when it led the Sixth Circuit to conclude that because § 11 does not require scienter, it also does not require a showing of subjective falsity. Pet. App. 19a.

In § 10(b) cases, this lack of clarity weakens both the scienter and the falsity standards. For example, some courts have applied the “recklessness” standard of scienter to subjective falsity, resulting in an incorrect holding that an opinion is false if it was “recklessly” held—the functional equivalent of showing an opinion was unreasonable. See Freedman v. Value Health, Inc., 958 F. Supp. 745, 753 (D. Conn. 1997). On the flip side, the conflation of falsity and scienter can also render
scienter meaningless, as courts conclude that because subjective falsity has been shown, scienter must follow. *City of Austin Police Ret. Sys. v. Kinross Gold Corp.*, 957 F. Supp. 2d 277, 301 (S.D.N.Y. 2013) (“[I]f it is satisfactorily alleged that the defendant did not [believe his stated opinion], the elements of both falsity and scienter are met.”).

Proper analysis requires the preservation of scienter as an independent element. This distinction makes clear that subjective falsity is about falsity, not scienter, and that the selfsame falsity standard should be used regardless of the level of intent required by the underlying statute. It also recognizes that, where both falsity and scienter are required, they remain fundamentally different questions. Subjective falsity asks: “Did the speaker honestly hold the opinion he expressed?” This question is essential because the nature of the falsity allegation necessitates inquiry into the speaker’s state of mind. While the scienter inquiry also explores the speaker’s state of mind, it asks a different question: “Did the speaker give a false opinion with an intent to mislead investors?” See Fait, 655 F.3d at 112 n.5 (“We do not view a requirement that a plaintiff plausibly allege that defendant misstated his truly held belief and an allegation that defendant did so with fraudulent intent as one and the same.”).

Courts often lose track of this real scienter inquiry, because they have become accustomed to using shorthand to refer to scienter as “knowledge of falsity.”
See, e.g., Pet. App. 14a. But as the Court has repeatedly made clear, scienter is about whether false statements were made with “a mental state embracing intent to deceive, manipulate, or defraud.” Ernst & Ernst, 425 U.S. at 193-94 n.12; Tellabs, 551 U.S. at 319. Similarly, where a recklessness standard is employed, it is not recklessness as to falsity, but rather recklessness as “an extreme departure from the standards of ordinary care, . . . present[ing] a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.” Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044-45 (7th Cir. 1977) (emphasis added).

It is true that, in many cases, falsity and scienter are “strongly inferred from the same set of facts,” such that some courts examine both elements in a single analysis. Ronconi v. Larkin, 253 F.3d 423, 429 (9th Cir. 2001). This may frequently be the case when the falsity analysis examines subjective falsity. But just because the facts necessary to prove each of these elements may sometimes, or even often, overlap, does not mean they are the same inquiry. Merck & Co. v. Reynolds, 559 U.S. 633, 649-50 (2010) (recognizing that for certain statements “to show them false is normally to show scienter as well,” but that the inquiries are nonetheless separate and “context specific”). Indeed, it is possible to have subjective falsity without scienter, or the converse, scienter without subjective falsity. In the hypothetical discussed supra at 27, all of the statements could have been subjectively true, yet
nonetheless made with intent to mislead: The speaker could have genuinely believed that progress had been “good” and customer feedback had been “positive,” yet could have expressed those opinions as part of a broader statement designed to mislead investors.

Conversely, speakers may express opinions they do not honestly hold for a variety of reasons, only one of which is an intent to mislead investors. For instance, corporate lies may be used to advance merger or contract negotiations, promote a product, boost morale, or preserve a company’s competitive edge. See Donald C. Langevoort, Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms), 146 U. Pa. L. Rev. 101, 113, 117 & n.52 (1997); id. at 107 (“[L]ies that influence investors may really be directed at other audiences (for example, customers or employees) in order to prevent ‘runs’ on external or internal resources.”). A speaker may overstate his opinion because he believes “puffing” is expected and “[a]n utterly candid statement of the company’s hopes and fears, with emphasis on the fears,” would be “taken to indicate that the prospects . . . were much grimmer than they were.” Eisenstadt v. Centel Corp., 113 F.3d 738, 746 (7th Cir. 1997) (Posner, J.) (“Where puffing is the order of the day, literal truth can be profoundly misleading, as senders and recipients of letters of recommendation well know.”). Or a speaker may express a false opinion because he or she is human, and humans lie for a wide variety of reasons, ranging from petty to idiosyncratic to sinister:
Saints may always tell the truth, but for mortals living means lying. We lie to protect our privacy (“No, I don’t live around here”); to avoid hurt feelings (“Friday is my study night”); to make others feel better (“Gee you’ve gotten skinny”); to avoid recriminations (“I only lost $10 at poker”); to prevent grief (“The doc says you’re getting better”); to maintain domestic tranquility (“She’s just a friend”); to avoid social stigma (“I just haven’t met the right woman”); for career advancement (“I’m sooo lucky to have a smart boss like you”); to avoid being lonely (“I love opera”); to eliminate a rival (“He has a boyfriend”); to achieve an objective (“But I love you so much”); to defeat an objective (“I’m allergic to latex”); to make an exit (“It’s not you, it’s me”); to delay the inevitable (“The check is in the mail”); to communicate displeasure (“There’s nothing wrong”); to get someone off your back (“I’ll call you about lunch”); to escape a nudnik (“My mother’s on the other line”); to namedrop (“We go way back”); to set up a surprise party (“I need help moving the piano”); to buy time (“I’m on my way”); to keep up appearances (“We’re not talking divorce”); to avoid taking out the trash (“My back hurts”); to duck an obligation (“I’ve got a headache”); to maintain a public image (“I go to church every Sunday”); to make a point (“Ich bin ein Berliner”); to save face (“I had too much to drink”); to humor (“Correct as usual, King Friday”); to avoid embarrassment (“That wasn’t me”); to curry favor (“I’ve read all your books”); to get a clerkship (“You’re the greatest living jurist”); to save a dollar (“I gave at the office”); or to maintain
innocence (“There are eight tiny reindeer on the rooftop”).

*United States v. Alvarez*, 638 F.3d 666, 674-75 (9th Cir. 2011) (Kozinski, J., concurring).¹¹

The correct standard thus preserves falsity and scienter as distinct inquiries, while recognizing that many of the same facts may be relevant to both. Thus, in a motion to dismiss a § 10(b) complaint challenging an opinion, the first task should be to inquire whether plaintiffs have pleaded specific facts to show subjective falsity. If not, a scienter inquiry is unnecessary. Only if falsity has been adequately pleaded would a court turn to the question of whether plaintiffs had established a “strong inference” that the false opinion had been uttered with an “intent to deceive, manipulate, or defraud” investors, rather than for some other purpose. *See Tellabs*, 551 U.S. at 319, 324.

**C. The Same Materiality Standard Applies to Statements of Fact and Opinion.**

Finally, a proper application of the subjective falsity standard means that the archaic “puffery” doctrine is no longer necessary to shield honest opinions from liability. Before *Virginia Bankshares*,

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¹¹ Because all circuits employ some type of recklessness standard, however, scienter could still be found if a speaker gave a false opinion without actually intending to mislead investors, but with severe or deliberate recklessness as to whether or not investors would be misled. Such an inquiry should involve a fact-specific examination of the context of the statement, the speaker’s state of mind, and the danger the statement actually posed of misleading investors.
the use of the puffery doctrine was understandable, as courts struggled to find a way to adequately protect statements of opinion. See Stefan J. Padfield, *Immaterial Lies: Condoning Deceit in the Name of Securities Regulation*, 61 Case W. Res. L. Rev. 143, 160-61, 179-80 (2010) (characterizing puffery as a “safety-valve” doctrine designed to “release the pressure created by frivolous suits”). But the puffery defense is a crude instrument without a sound analytical basis, making it no surprise that it has been applied in a haphazard manner that defies predictability. See id. at 159-60 (puffery includes “interpretations of materiality that at times sound like they sprang from the lips of Humpty Dumpty”); O’Hare, *supra*, at 1699 (criticizing the puffery defense for its lack of reasoned analysis).

The puffery defense is also incompatible with the Court’s guidance on the question of materiality. The proper materiality analysis does not ask whether a statement is material, but rather whether it is false or misleading “as to a material fact.” *Basic*, 485 U.S. at 238. Falsity is material if there is “a substantial likelihood” that a “reasonable investor” would view the withheld or misrepresented information as “having significantly altered the ‘total mix’ of information . . . .” *Id.* at 231-32. This analysis requires examination of the context of the statement and the allegations of falsity, to determine their significance to the reasonable investor under “all the circumstances.” *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). And it precludes the use of “bright-line”
standards, because “[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.” \textit{Basic}, 485 U.S. at 236.

Under this materiality standard, it is inappropriate to apply special rules for statements of opinion—whether by classifying them as “soft” information, or as “puffery.” Indeed, the puffery doctrine illustrates the Court’s concern that any attempt to employ bright-line rules will be both “overinclusive” and “underinclusive.” \textit{Basic}, 485 U.S. at 236. Puffery is overinclusive, and thus overprotective, because it gives investors the troubling message that companies may lie with impunity, as long as they couch their statements in subjective terms. \textit{See} O’Hare, \textit{supra}, at 1715-16, 1725-26 (puffery is based on the doctrine of \textit{caveat emptor}, which is outdated and at odds with the fundamental objectives of the securities laws). At the same time, because it does not apply any consistent standard, puffery is underinclusion, and thus underprotective. Corporate actors are unable to predict whether their opinions will be virtually immunized as puffery, or possibly subjected to liability under a standard that ignores whether they were honestly held. As a result, puffery is not a principled standard of liability on which either companies or investors can depend. \textit{See} Couture, \textit{supra}, at 411 (“A uniform and predictable test is imperative so that corporate actors are not afraid to speak, lest they inadvertently subject themselves to liability.”).
Although the puffery defense once served a purpose, it is now unnecessary. A disciplined implementation of the subjective falsity standard would replace the crude implement of puffery with a refined tool that has a firm basis in both logic and law, and which can be applied in a precise and consistent manner. Of course, plaintiffs must still allege that opinions are false or misleading in a material respect. And courts may still hold some opinions immaterial before even reaching the question of subjective falsity—including opinions that are akin to the traditional notion of sales “puffery.” A proper materiality analysis would arrive at this conclusion after taking into account unique characteristics of each opinion, including its degree of vagueness and the circumstances under which it was conveyed. See O’Hare, supra, at 1737-40. The key is that courts employ the same fundamental materiality standards for opinions as for any other statement, including examining the context, the allegations of falsity, and the effect on a reasonable investor when considered within the total “mix” of information.

By thus articulating consistent and principled standards for falsity, scienter, and materiality, the Court can achieve the proper balance in the implementation of the securities laws—promoting investor confidence, encouraging open and honest disclosure, and protecting against abusive litigation.
CONCLUSION

For the reasons discussed above, WLF respectfully asks the Court to reverse the Sixth Circuit’s decision, and to seize this opportunity to clarify the standards for analyzing statements of opinion under the securities laws.

Respectfully submitted,

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Chapter 5C

The Constitutionality of the Securities and Exchange Commission’s Administrative Enforcement Process

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Administrative Law Judges ("ALJs") are used by many federal agencies, including:

- Securities and Exchange Commission ("SEC")
- Equal Employment Opportunity Commission
- National Labor Relations Board
- Federal Reserve Board
- Federal Deposit Insurance Commission
- Federal Trade Commission


Under the Appointments Clause, all "Officers of the United States" must be appointed either by the President with the advice and consent of the Senate (in the case of principal officer) or by "the President alone … the Courts of Law, or … the Heads of Departments" (in the case of inferior officers).

The Appointments Clause, United States Constitution, Article 2, Section 2, Clause 2:

[The President] shall nominate, and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

Principal officers are, e.g.:

- Ambassadors
- Supreme Court Justices

Inferior officers – in contrast to employees – must be appointed by:

- the President,
- a Court of Law, or
- a Head of Department.

In *Buckley v. Valeo*, 424 U.S. 1, 96 S.Ct. 612, 46 L.Ed.2d 659 (1976) (per curiam), the Supreme Court held that an officer (whether principal or inferior) is "any appointee exercising significant authority pursuant to the laws of the United States." 424 U.S. at 126. Officers do not include "lesser functionaries subordinate to officers of the United States," who are employees and not subject to the same constitutional requirements. *Id.* at n. 162.
In Freytag v. Commissioner of Internal Revenue, 501 U.S. 868, 111 S.Ct. 2631, 115 L.Ed.2d 764 (1991), the question presented was whether the Tax Court had the authority to appoint special trial judges (“STJs”) under the Appointments Clause. Four categories of cases could be assigned to STJs. In the first three categories the STJs could make the final decision. In the fourth category, the STJs could only propose findings and an opinion.

The Tax Court assigned the petitioners’ case to the STJ, the STJ concluded the petitioners were liable, and the Tax Court adopted the opinion. Petitioners argued the Tax Court could not appoint the STJs because he as not a President, a court of law, or a department head. The government contended STJs were not inferior officers because they did not have authority to render a final decision.

The Supreme Court held:

- the STJ position was “established by Law,”
- the duties, salary and means of appointment of STJs are specified by statute, and
- STJs “perform more than ministerial tasks. They take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders. In the course of carrying out these important functions, the STJs exercise significant discretion.”

The Supreme Court unanimously held that STJs are inferior officers.

In Landry v. FDIC, 204 F.3d 1125 (D.C. Cir. 2000), the United States Court of Appeals for the D.C. Circuit considered whether ALJs working for the Federal Deposit Insurance Commission (“FDIC”) were inferior officers. The Landry court read Freytag to include the power to make “final decisions” as a required element to a finding that an ALJ is an officer. Under FDIC regulations, “[f]inal decisions are issued only by the FDIC Board of Directors,” and ALJs “can never render the decision of the FDIC.” Id. at 1133. The Landry court concluded that since the FDIC’s ALJs could not make “final decisions,” they were not inferior officers. Id. at 1134.

In 2002, through the Sarbanes-Oxley Act, Congress gave the SEC the power to employ administrative proceedings to bar any person who had violated securities laws from serving as an officer or director of a public company; previously the SEC could only seek such a remedy in court. Before 2010, SEC could only seek administrative sanctions in administrative proceedings, along with civil fines against broker-dealers and registered investment advisers. The Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-302, § 929P, 124 Stat. 1376, 1862-65 (2010) (“Dodd Frank”), expanded the penalties the SEC could seek through in-house courts, including fines for non-registered firms and individuals, including public companies and executives charged with accounting fraud. Dodd-Frank authorizes the SEC to file almost any case administratively rather than in a United States District Court. As Judge Jed S. Rakoff said in

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1 In Edmond v. United States, 520 U.S. 651, 117 U.S. 1573, 137 L.Ed.2d 917 (1997), the Supreme Court noted the term inferior officer “connotes a relationship with some higher ranking officer or officers below the President: Whether one if an ‘inferior’ officer depends on whether he has a superior.” 520 U.S. at 662.
his keynote address to the 2014 PLI Securities Regulation Institute, *Is the S.E.C. Becoming a Law Unto Itself?*, “the S.E.C. can today obtain through internal administrative proceedings nearly everything it might obtain by going to court.”

What do SEC ALJs do? They preside over hearings, issue subpoenas, manage discovery, examine witnesses and determine credibility, resolve evidentiary disputes, enter orders of default, sanction parties for contumacious conduct, decide dispositive motions, and enter initial decisions that often become final.

In August 2016, in *Raymond J. Lucia Cos. Inc. v. SEC*, 832 F.3d 277 (D.C. Cir. 2016), a panel of the United States Court of Appeals for the D.C. Circuit considered whether the SEC’s ALJs were “Officers.” The SEC conceded that its ALJs, selected by its Office of Administrative Law Judges, are not appointed by the President, a Court of Law, or a Head of Department; thus, if the court held the ALJ was an “Officer” then necessarily it would have found his or her appointment violated the Constitution. The *Lucia* panel’s test was whether or not the ALJs issued “final” decisions of the SEC; if yes, they were officers, if no, they were employees. The *Lucia* panel found the SEC ALJs were employees and not officers.

In *Bandimere v. U.S. Securities and Exchange Commission*, 844 F.3d 1168 (10th Cir. 2016), the SEC conceded that its ALJs are not appointed by the President, a Court of Law, or a Head of Department. The only question was whether an SEC ALJ is an inferior officer under the Constitution, or an employee. Following the Freytag model, a Tenth Circuit panel, on a 2-to-1 vote, held:

• the SEC ALJ position was “established by Law,”

• the duties, salary and means of appointment of SEC ALJs are specified by statute, and

• SEC ALJs “‘exercise significant discretion’ in ‘carrying out … important functions.’”

844 F.3d at 1179.

On February 16, 2017, the D.C. Circuit vacated the *Lucia* panel’s decision and granted a petition for re-hearing *en banc*. Oral argument is scheduled for May 24, 2017.
Chapter 6A
Oregon Community Public Offerings

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Presented by
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Month Year

THE PRESENTER

• Steven Boender is a partner in Stoel Rives' Corporate group and focuses his practice on corporate transactional matters, including mergers and acquisitions, financings and other corporate and securities issues. Steven has represented corporate clients and financial advisors on a variety of transactions, including acquisitions, joint ventures, restructurings and commercial contracts. He has assisted startup and emerging growth companies with formation, fundraising and structuring issues, as well as several joint development arrangements in the area of technology. He has represented issuers and underwriters in public offerings and private placements of debt, equity and convertible securities. Steven has also counseled a number of public company clients on securities compliance matters, including periodic reporting, current reporting, proxy statements, shelf registration statements, and employee benefit plan matters.
The JOBS Act in a Nutshell

THE JOBS ACT

• Liberalized access to equity capital for startup companies, early-stage companies and emerging growth companies.
  – Title I – “IPO On-Ramp” for Emerging Growth Companies.
  – Title II - Allows general solicitations of investors, previously prohibited, but still requires the investors to be accredited ($1 million net worth or $200k annual compensation). Number of investors in a company is unlimited.
  – Title III – Crowdfunding, discussed below.
  – Title IV – Regulation A+ "Mini IPO" private placement that includes unaccredited investors.
Title III of the JOBS Act and Regulation Crowdfunding

REGULATION CROWDFUNDING

- Title III of the JOBS Act took effect in May 2016 in the form of “Regulation Crowdfunding” or “Regulation CF”. Freed up qualifying companies to make securities offerings to investors who are not accredited, subject to some important restrictions. Key elements include:
  - If soliciting non-accredited investors, can only raise $1.07 million in a 12-month period.
  - Investors with income or net worth <$107,000 limited to lesser of 5% income/worth or $2,200 investment in any 12-month period. Investors with income and net worth >$107,000 limited to 10% of income, up to $107,000 total in any 12-month period. Net worth excludes primary residence; FINRA provides a helpful worksheet to calculate net worth.
  - Investment funds cannot participate.
  - Transactions must be conducted through a registered broker-dealer or “funding portal” that is registered with the SEC and a member of FINRA.
 TITLE III OF THE JOBS ACT (CONT.)

• Key elements continued
  – Certain disclosure obligations regarding the company and the offering, but financial statements need not be audited, but must be reviewed if raising more than $107,000.
  – Issuers that raise more than $535,000 must provide additional disclosures and audited financial statements annually.
  – Other procedural issues
    • Investors can back out up until the point that is 48 hours prior to the end of the offer period. Commitments received during this period cannot be canceled.
    • If the issuer makes a material change to the terms or information disclosure, prior committed investors have five business days to reconfirm investment decision.

State-Regulated Crowdfunding – The Federal Exemption
STATE-REGULATED CROWDFUNDING — THE FEDERAL EXEMPTION

• Section 3(a)(11) of the Securities Act of 1933 exempts intrastate offerings from registration requirements under federal securities law.

• What counts as an intrastate offering? (as of 4/20/17, new Rules 147 and 147A). Issuer’s principal office is in Oregon and at least one of the following:
  – At least 80% of issuer’s revenues during most recent fiscal year derived from operation of its business in Oregon.
  – At least 80% of issuer’s assets at the end of its most recent semi-annual period prior to the offering are located in Oregon.
  – At least 80% of the net proceeds from the offering are intended to be used in connection with the issuer’s business in Oregon.
  – At least a majority of the issuer’s employees are based in Oregon.
OREGON INTRASTATE OFFERING EXEMPTION

• Statutory Authority and Regime
  – Crowdfunding rules were implemented under the authority granted in ORS 59.035 to the Director of the Department of Consumer and Business Services to provide for additional exemptions from state registration requirements.
  – The applicable rules are set forth in OAR 441-035-0070 through 441-035-0230.

OREGON INTRASTATE OFFERING EXEMPTION

• Also called the “Oregon Community Public Offering”
• Basic Qualifications/Requirements
  – Issuers (only those incorporated or organized in Oregon with 50 or fewer employees) may raise up to $250,000, solely from residents of Oregon that are natural persons, without limitation as far as investor accreditation.
  – Maximum individual investment is $2,500.
  – Securities can be debt, equity, or some combination/hybrid.
  – Limited public advertising is permitted.
  – Offering materials are not registered or reviewed.
OREGON INTRASTATE OFFERING EXEMPTION

• Basic Qualifications/Requirements continued
  – Issuers must meet with a Business Technical Service Provider to review the issuer's business plan.
  – Offerings can be open up to 12 months, with a right to extend up to an additional 12 months.
  – Disclosure materials must be filed with the state - advertising copy, business plan, offering terms, etc.
  – General solicitation permitted as of October 2016 when SEC approved new Rule 147A.

OREGON INTRASTATE OFFERING EXEMPTION

• Key Terms and Provisions
  – "Business Technical Service Provider" – May be a Small Business Development Center, Economic Development District, or not-for-profit incubator, accelerator or business resource provider (only one has been approved to-date).
  – Proof of residency of investors – “Reasonably documentary basis”. This includes, but is not limited to, drivers license, state identification, or other document that indicates the person owns or occupies property in Oregon as his/her principal residence (e.g. voter registration).
  – Resales – Prohibited for 9 months following purchase. After that, standard ORS restrictions on, and exemptions for, resale apply.
OREGON INTRASTATE OFFERING EXEMPTION

• Key Terms and Provisions continued
  – Advertising/Solicitation
    • Must only be directed to Oregon residents, requires affirmative certification.
    • Typical “tombstone” information – limited description of the issuer and offering, with reference to detailed disclosure document.
    • Advertisement must state that it does not constitute an offer to sell a security, with instructions how interested persons can obtain the disclosure information, in writing, free of charge.
    • Third-party platforms that meet relevant requirements may be used to advertise the offerings (e.g., Hatch Oregon).
  – No commissions may be paid for the sales of securities.
  – Integration – Six-month window before and after offering.
  – “Bad Actors” disqualify an issuer

OREGON INTRASTATE OFFERING EXEMPTION

• Required Disclosures (“single written document”)
  – Name and address for issuer, each officer, principal, managing partner and 20% shareholder.
  – Experience and qualifications of issuer’s officers, principals, managing partners and other similar persons.
  – Description of business, including how long it has operated and the specific reason for the offering.
  – Plain language risk factors.
  – Use of proceeds, as well as compensation and expenses related to the offering.
OREGON INTRASTATE OFFERING EXEMPTION

- **Required Disclosures continued**
  - Minimum offering amount if applicable, and plans for use/distribution if minimum is not met.
  - Terms and conditions of securities, including total amount outstanding and total amount offered.
    - For stock, must state the percentage of ownership reflected by a single share, OR the total value of the business implied by the offering price.
    - For debt, interest rate and repayment terms.
  - Legal proceedings over the past five years.
  - Typical legend and resale/registration disclosures.

OREGON INTRASTATE OFFERING EXEMPTION

- **Investor Acknowledgment**
  - Investors must sign the following acknowledgment:

  “I have been provided and have reviewed the complete offering document, including the disclosures. I acknowledge that I am investing in a high-risk, business venture with no guarantee of success, that I may lose all of my investment, and that I can afford the loss of my investment. I understand this offering has not been reviewed by the State, and no authority has expressed an opinion on the merits or accuracy of this offering. By entering into this transaction with the issuer, I am affirmatively representing myself as an Oregon resident.”
OREGON INTRASTATE OFFERING EXEMPTION

• Ongoing Reporting Obligations
  – Issuers must provide reports at least twice per year.
  – Information can be provided via its website if it is provided within 45 days of the end of each fiscal half-year and remains accessible for at least 50 days. Written reports must be provided to shareholders upon request, and filed with the Director of the Department of Consumer and Business Services as soon as it is provided or made available to investors.
  – Reports must contain:
    • Director and officer compensation (cash and equity)
    • Explanation and discussion of operations and financial condition.
  – Certain other reports as may be required by the Director of the Department of Consumer and Business Services.

History of Oregon Community Public Offerings
HISTORY OF OREGON COMMUNITY PUBLIC OFFERINGS

- Has it worked in Oregon?
- 13 filings since the law was enacted (information below gathered from offering documents, Oregon Secretary of State, and general Internet searches).
  - WebLively, Inc., filed 1/20/15. No further information available, company has since been dissolved.
  - MacDougall & Sons Bat Company, Inc. filed 4/23/15. Manufacturer of wood baseball bats. Offering ends 4/30/17, currently raised $36,600 of $200,000 goal. Note disclosure documents do not provide what percentage of the company is reflected in that $200,000.
  - Grün Community Energy Public Benefit Company, filed 7/15/15. No further information available, though the entity still exists.
  - Diamond Crest Homes Inc., filed 8/21/15. No further information available, though the entity still exists.

Filings continued
- Bearded Eye LLC, filed 9/30/15. Software developer. No further information available, though the entity still exists.
- The Tannery Bar, filed 9/30/15. Bar and grill. Funding status not available, though the company is still operating.
- Publication Studio, filed 9/30/15. Book publisher. Funding status not available, and company announced cessation of operations in December 2016.
- Eggdrop LLC, filed 10/01/15. Subscription-based toy delivery services. Funding status not available, though the company is still operating.
- Two Tongues, LLC, filed 1/14/16. LGBT focused clothing company. Funding status not available, though no longer listed on Hatch Oregon site. Company appears to still be operating. Offering was for $70,000 in 5-year, 5% promissory notes.
HISTORY OF OREGON COMMUNITY PUBLIC OFFERINGS

• Filings continued
  – Bgood Bars LLC, filed 4/21/16. Energy bar producer. $18,200 of $70,000 goal funded. Offering, which ends 4/26/17, is for 5-year, 3% promissory notes.
  – Cloud Currencies Corp., filed 4/21/16. Mobile payment system. $2,500 of $250,000 goal funded. Offering, which ends 9/15/17, is for 4-year, 20% convertible promissory notes.
  – Smuggle Portland, filed 05/17/16. High-end cannabis accessories. Offering appears to have been terminated.
  – Carts and Tools Supply, Inc., filed 01/19/17. Small-farm-focused tool manufacturer. $200,000 goal reflects 15% of the equity of the company, though offered shares are non-voting. $3,500 raised to-date.

HISTORY OF OREGON COMMUNITY PUBLIC OFFERINGS

• Two success stories: Red Wagon Creamery and Agrarian Ales.
  – Note – It is unclear why these are not listed on State of Oregon listing of crowdfunding filings, perhaps they commenced their offerings prior to state listing of filings was made public.
  – Red Wagon Creamery
    • Handcrafted, natural ice cream producer. Raised full goal of $120,000 in its equity offering, representing 10% of the company, from 173 different investors. Offering was completed in about 9 months.
  – Agrarian Ales
    • Farmhouse brewery. Raised full goal of $95,000 in its equity offering, representing 19.5% of the company, from approximately 100 different investors. Offering was completed within one year of launch.
What Have We Learned?

WHAT HAVE WE LEARNED?

- The two large success stories had a few factors in common – locally-based, devoted following; retail presence; CPG business; customer-facing; proven ability to produce high-quality products. Presumably substantial crossover between investor base and consumer base.

- Tech-focused startups do not have this built-in base of potential investors, and ice cream is easier for average Joe to understand than, e.g., the blockchain. Seasoned entrepreneurs are sensitive to cap table complexity.

- Great ideas, or more fully developed ideas, especially in the tech space tend to attract the professional investor class, which can offer more money, advice, and contacts.

- Kickstarter and other non-equity means of crowdfunding will continue to be a popular fundraising source. By way of comparison, Kickstarter currently lists 47 active projects from Oregon-based entrepreneurs, and approximately 6,600 that have either been terminated or successfully funded.

- As a result, it seems likely that established consumer business will continue to be the most likely beneficiaries of the Oregon Community Public Offering, and that Oregon Community Public Offerings will remain a small, but important, niche player in the overall investing/funding ecosystem in the state.

- As it turns out, the key word is probably “Community”.
Chapter 6A—Oregon Community Public Offerings

Secretary of State
Certificate and Order for Filing
PERMANENT ADMINISTRATIVE RULES

I certify that the attached copies are true, full and correct copies of the PERMANENT Rule(s) adopted on Upon filing, by the Department of Consumer and Business Services, Division of Finance and Corporate Securities 441

Agency and Division Administrative Rules Chapter Number
Jenny Craig (503) 947-7484
Rules Coordinator Telephone
350 Winter St. NE, Rm. 410, Salem, OR 97301 Address
To become effective Upon filing. Rulemaking Notice was published in the November 2014 Oregon Bulletin.

RULE CAPTION
Establishes a securities registration exemption for Oregon intrastate offerings by Oregon small businesses.
Not more than 15 words that reasonably identifies the subject matter of the agency's intended action.

RULEMAKING ACTION
Secure approval of new rule numbers with the Administrative Rules Unit prior to filing.

ADOPT:

AMEND:

REPEAL:

RENUMBER:

AMEND AND RENUMBER:

Statutory Authority:
ORS 59.035

Other Authority:
17 CFR § 230.147 (SEC Rule 147)

Statutes Implemented:
ORS 59.035

RULE SUMMARY
Title III of the Jumpstart Our Business Startups Act (JOBS Act), enacted in 2012, created a federal exemption for equity crowdfunding. Federal rules under the JOBS exemption have not yet been finalized. Under the federal intrastate exemption, Oregon may enact its own exemption from securities registration for purely domestic offerings unrelated to federal law. ORS 59.035(15) provides that the Director of the Department of Consumer and Business Services may create transactional exemptions for securities through rule. This rulemaking establishes an exemption for small amounts raised by Oregon small businesses through a "community public offering" or what is generally referred to as "crowdfunding". The rules place certain substantive restrictions on Oregon businesses relying on the exemption, such as individual investor and total offering caps. The rulemaking activity also requires disclosures be given to prospective investors and places restrictions on general advertising of the securities to the public.

Jenny Craig jenny.m.craig@state.or.us Rules Coordinator Name Email Address
441-035-0070 **Policy and Purpose of the Oregon Intrastate Offering Exemption (OIO).**
Crowdfunding, or raising money through small investments from a large number of investors can provide smaller enterprises access to capital for new or expanded business ventures. OAR 441-035-0070 through OAR 441-035-0230, provide an exemption from the securities registration requirements under ORS 59.055 in limited circumstances in order to facilitate investment by Oregon residents in Oregon businesses while protecting investors.

441-035-0080 **Definitions.** For purposes of OAR 441-035-0070 through OAR 441-035-0230, the following definitions apply unless the context requires otherwise:
(1) “Business Technical Service Provider” means a Small Business Development Center as defined in OAR 123-022-0070, an Economic Development District as defined in 13 CFR 304.1, or a not-for-profit incubator, accelerator, or business resource provider approved by the Director.
(2) “Director” means the Director of the Department of Consumer and Business Services.
(3) “Issuer” has the same meaning as that term is defined in ORS 59.015(9). For the purposes of these rules, “issuer” includes persons with direct control over the Oregon business or over the offer or sale of securities exempted under these rules.
(4) “Offer” includes every attempt to dispose of an OIO security for value. The publication of any information and statements, and publicity efforts – including any advertising materials – in advance of or in connection with an OIO that contributes to the conditioning of the public mind or arousing public interest in the issuer or is intended to arouse public interest investing in the issuer or purchasing its securities - even though it does not contain an express “offer” - is an “offer” of OIO securities for purposes of this definition.
(5) “Offering Documents” means the representations and disclosures required under OAR 441-035-0120.
(6) “Oregon business” means a business formed under the laws of Oregon and registered with the Secretary of State of Oregon as a domestic business, with its principal office in Oregon, doing business in the state and having 50 or fewer employees.
(7) “Third Party Platform Provider” means an internet based platform provided by a business technical service provider or other entity authorized by the Director to post, on behalf of issuers, information related to OIOs to interested persons who certify Oregon residency.

441-035-0090 **Requirements for Exemption From Securities Registration.** The offer or sale of an OIO by an issuer shall be exempt from the securities registration requirements under ORS 59.055 if the offer or sale is conducted in accordance with the following:
(1) The issuer must be an existing Oregon business in good standing. The OIO exemption cannot be applied if the issuer, or a person affiliated with the issuer, would be disqualified under OAR 441-035-0210.
(2) The offer and sale must be conducted in accordance with Section 3(a)(11) of the Securities Act of 1933, as amended. For purposes of this requirement, it is sufficient that the offer and sale complies with Rule 147 under Section 3(a)(11).
(3)(a)OIO securities may only be offered or sold to natural persons who are residents of the state of Oregon.
(b) Prior to making any offer under this exemption, an interested person must make an affirmative declaration to the issuer or third party platform that they are an Oregon resident;
(c) Prior to any sale under the OIO exemption, the issuer must have a reasonable documentary basis to believe the prospective purchaser is a resident of Oregon and obtained the signed
acknowledgement required under OAR 441-035-0120(4). A reasonable documentary basis includes, but is not limited to:

(i) A current Oregon Driver License or a current personal identification card issued by the State of Oregon; or

(ii) A document that indicates the prospective purchaser owns or occupies property in the state as his or her principal residence, such as a current voter registration, or official business mail from a state or federal agency.

(4) The duration of an OIO will not exceed twelve (12) months, unless the issuer applies to extend the offering for a period not to exceed twelve (12) additional months. An issuer may apply to extend the offering by submitting an amended filing with the Director in conformance with these rules.

(5) All proceeds from the sale of OIO securities must be used in accordance with representations made to investors, including the disclosures required under OAR 441-035-0120.

(6) The aggregate purchase price of all OIO securities cannot exceed two hundred fifty thousand dollars ($250,000).

(7) An issuer may not accept more than two thousand five hundred dollars ($2,500) from any individual in reliance on the OIO exemption.

(8) Issuers offering or selling OIO securities must have met in person and reviewed their business plan with a business technical service provider prior to advertising, offering or selling securities.

(9) OIO securities sold pursuant to this exemption are limited to notes, stocks, and debentures.

441-035-0100 Resale Limitations. (1) An OIO security may not be resold during the nine (9) month period immediately after purchase, except:

(a) To the issuer; or

(b) Pursuant to an order of registration under ORS 59.065.

(2) After the immediate nine (9) month period has ended, an OIO security may also be sold pursuant to an available exemption to securities registration requirements under ORS 59.025 or 59.035 or accompanying rules.

441-035-0110 Required Filings. (1) Not less than seven (7) days prior to the advertisement, offer or sale of any OIO security, the issuer shall file a notice with the Director, in writing, that it plans to conduct an OIO and pay a $200 filing fee.

(2) The notice shall contain the following:

(a) The name(s) and address of the issuer and of all officers, directors, principals, managing partners and shareholders of the Oregon business possessing a 20% interest or more, or persons holding a substantially similar position.

(b) A copy of any proposed advertising materials, including a URL if a website will be used in connection with the offering, and name of the third party platform provider, if applicable;

(c) A brief description of the business and the specific project or product that is the reason for the offering;

(d) The minimum and maximum amounts issuer is seeking to raise through the offering or total offering amount;

(e) A copy of the offering documents;

(f) A form approved by the Director verifying that the issuer has met in person with a business technical service provider and reviewed the relevant business plan.
(3) The $200 filing fee, which will be used to defray the costs incurred in administering and enforcing these rules, must be made payable to the Department of Consumer and Business Services.

(4) The filing must be signed by the issuer or a duly authorized representative of the issuer certifying that the issuer has verified the material accuracy and completeness of the information.

(5) These filing requirements may be met by submitting a form adopted by the Director or through individual submission of all the information required by the rule.

441-035-0120 Required Disclosures

(1) Except as allowed under OAR 441-035-0130, prior to any offer or sale of an OIO security, each prospective investor must be given, in a single written document, the disclosures identified in subsection (2). For the purposes of this exemption, “in writing” includes printed, electronic, and internet media. An interested party must be given the option to receive the disclosures and subsequent reports in one or more formats, including printed copies at no charge.

(2) The disclosures required by these rules must include:

(a) The name(s) and physical address(es) of the issuer and of all officers, principals, managing partners and shareholders of the issuer holding a 20% interest or more, or persons holding a substantially similar position;

(b) A description of the experience and qualifications of the issuer officers, principals, managing partners and persons holding substantially similar positions;

(c) A description of the business, including how long it has been in operation and the specific reason for the offering;

(d) A discussion in plain language of the significant factors material to the offering, including those that make the offering speculative or risky;

(e) The total offering amount and how the issuer expects to use the proceeds of the offering, including compensation and expenses related to the offering.

(f) If an issuer needs to raise a minimum amount to achieve the stated funding goal, they must disclose that minimum offering amount and how the issuer intends to use funds raised through the offering if the minimum goal is not met, or if they intend to return the funds if the goal is not met;

(g) The terms and conditions of the securities being offered, the total amount of securities that are outstanding prior to the OIO, and the total amount of securities being offered or sold in reliance on the OIO exemption:

(i) If the issuer is offering stock, the terms and conditions must include either the percentage of ownership represented by a single share, or the total value of the Oregon business implied by the offering price.

(ii) If the issuer is offering notes or debentures, the terms and conditions must include the interest rate and specific terms of repayment.

(h) A description of any litigation or legal proceedings within the past five (5) years, if any, involving the issuer or any persons associated with the issuer.

(3) The issuer must inform all investors that the securities exempted by these rules are not registered with the state, that they are subject to a limitation on re-sale and investors may not be able to sell their securities promptly or may only be able to sell them at a substantial discount from the offering price. Disclosures must also contain the following language on the cover page of the offering document:
“THESE SECURITIES ARE BEING SOLD IN RELIANCE ON AN EXEMPTION TO THE FEDERAL SECURITIES REGISTRATION REQUIREMENTS UNDER SECTION 3(a)(11) OF THE SECURITIES ACT OF 1933 AND UNDER ORS 59.035 OF THE OREGON SECURITIES LAW. THESE SECURITIES CAN ONLY BE SOLD TO RESIDENTS OF OREGON AND ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE. INVESTORS SHOULD BE AWARE THAT THEY WILL BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THIS INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.

IN MAKING AN INVESTMENT DECISION, INVESTORS SHOULD RELY ON THEIR OWN EXAMINATION OF THE ISSUER AND THE TERMS REVEALED IN THESE OFFERING DOCUMENTS, INCLUDING THE MERITS AND RISKS INVOLVED.

THESE SECURITIES HAVE NOT BEEN RECOMMENDED BY ANY FEDERAL OR STATE AUTHORITY OR REGULATORY COMMISSION NOR HAVE THEY CONFIRMED THE ACCURACY OR DETERMINED THE ADEQUACY OF THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE. BUSINESS TECHNICAL SERVICE PROVIDERS HAVE NOT REVIEWED THE OFFERING DOCUMENTS AND CANNOT DETERMINE THE MERITS OF THIS OFFERING.”

(4) At the time of sale the issuer must require all purchasers to sign the following acknowledgement. For the purposes of this provision, “signed” includes a scanned, faxed or virtual signature:

"I have been provided and have reviewed the complete offering document, including the disclosures. I acknowledge that I am investing in a high-risk, business venture with no guarantee of success, that I may lose all of my investment, and that I can afford the loss of my investment. I understand this offering has not been reviewed by the State, and no authority has expressed an opinion on the merits or accuracy of this offering. By entering into this transaction with the issuer, I am affirmatively representing myself as an Oregon resident.”

441-035-0130 Advertising and Solicitation. Issuers and third party platform providers may engage in general advertising or solicitation of OIO securities provided that:

(1) The issuer files a copy of the advertising materials with the Director at least seven (7) days prior to use. The Director may prohibit the use of any advertisement that they consider false or misleading or otherwise not in compliance with these rules.

(2) The advertisement is directed only to Oregon residents. Prior to viewing advertising materials, each person must affirmatively certify that they are an Oregon resident. A person who does not or can not affirmatively certify that they are an Oregon resident may not view the advertising materials.

(3) The advertisement contains no more than the following information:

(a) The name and contact information of the issuer;

(b) A brief description of the general type of business of the issuer;

(c) Whether securities being offered are stocks, notes or debentures or a combination;

(d) The total offering amount;

(e) A description of how the issuer will use the funds;
(f) The duration of the OIO and deadline for raising funds through the offering; and
(g) The issuer’s logo;
(h) A link to the issuer’s website or the third party platform in which the securities are offered or sold.

(4) Any amendments to the advertising materials are filed with the Director.

(5) The advertisement, including any advertisement through a website, clearly states that the advertisement does not constitute an offer to sell a security and includes contact or other relevant information notifying an interested person how they can obtain the required disclosure information, in writing, free of charge.

(6) Advertising to the general public without regard to residency, or advertising information outside the scope of this rule is prohibited.

441-035-0140 Use of Internet General Requirements. (1) Websites that advertise or offer an OIO security must obtain an affirmative declaration from an interested person under 441-035-0090(3)(b) that the interested person is an Oregon resident prior to allowing access to any of the information allowed under OAR 441-035-0130 or to the offering documents under OAR 441-035-0120;

(2) Websites that advertise, offer or sell an OIO security must take reasonable steps to ensure that an investor’s financial and personal information is properly secured and kept private and must conform to ORS 646A.622.

441-035-0150 Use of the Internet by Issuers. (1)(a) An Oregon business using its existing website must segregate information related to the advertising, offer or sale of OIO securities on a webpage distinct from webpages accessible to the general public.

(b) An issuer may use a webpage to sell securities if the issuer obtains reasonable documentary evidence under 441-035-0090(3)(c) that the prospective purchaser is an Oregon resident prior to the sale.

441-035-0160 Use of the Internet by Third Party Platform Providers. (1) A third party platform provider may post advertising materials allowed under OAR 441-035-0130 and offering documents under OAR 441-035-0120 for OIO securities, under the following conditions:

(a) The platform is used to host for not less than five (5) OIO issuers;
(b) The platform does not solicit, sell, or effect transactions in securities unless it is a registered broker-dealer under ORS 59.015(a). However, a third party platform may:
(i) allow an investor to transmit investor funds to an unaffiliated third party that is licensed or authorized to transmit money;
(ii) allow an investor to transmit funds to the issuer; or
(iii) direct an unaffiliated third party to transmit investor funds to the issuer pursuant to an written agreement;
(iv) collect certification and documentary evidence regarding an interested party’s residency required by OAR 441-035-0090 provided the third party platform provider complies with the records requirement in OAR 441-035-0220.

(b) On portions of the platform accessible to the general public, a third party platform only makes viewable the general business and contact information of the issuer;
(c) The platform does not offer investment advice, endorse, or solicit for any issuer on the platform;
(d) The platform does not engage in secondary trading of an issuer’s securities; and
(e) A platform only charges a nominal flat fee for the upkeep of the website and may not obtain any interest in the issuer in return for posting information on the platform.

441-035-0170 Prohibited Offerings. The OIO exemption is unavailable for the following types of offerings:
(1) Offerings involving development stage companies without a specific business plan or purpose, or in which the issuer has indicated that its business is to engage in a merger or acquisition with an unidentified company or companies, or other unidentified entities or persons, or without an allocation of proceeds for sufficiently identifiable properties or objectives (e.g., “blank check” offerings);
(2) Offerings that involve the sale of securities other than notes, stocks, or debentures.
(3) Offerings involving petroleum exploration or production, mining, or any other extractive industries; or
(4) Offerings involving an investment company as defined and classified under Section 4 of the Investment Company Act of 1940.

441-035-0180 Prohibition on Commissions, Fees and Other Remuneration. No person may receive a commission, fee, or other remuneration for offering, soliciting or selling any OIO security.

441-035-0190 Integration.
(1) All separate sales of securities will be included as part of the OIO if, after considering the following elements, there are compelling reasons to treat the sale as part of the same offering. The elements to be considered are:
(a) Whether the sales are part of a single plan of financing;
(b) Whether the sales involved issuance of the same type of security;
(c) Whether the sales are made at or about the same time;
(d) Whether the same type of consideration is received; and
(e) Whether the sales are made for the same general purpose.
(2) Employee benefit plans. Offers and sales of any securities registered under OAR 441-065-0270 are not included for purposes of this rule.
(3) Sales of securities made more than six months prior to the offer or sale of securities in reliance on this exemption, or more than six months after the termination offer or sale of securities in reliance on this exemption will not be counted or included as sales made as part of the same offering under this rule if there are no sales of securities of the same or similar type by the issuer during either six month period other than sales of securities under an employee benefit plan registered under OAR 441-065-0270.

441-035-0200 Reporting. (1) An issuer of an OIO security shall provide a report to all individuals having an outstanding security interest obtained through this exemption at least twice a year. An issuer may satisfy the reporting requirement of this subdivision by making the information available on a Website if the information is made available within 45 days of the end of each fiscal half-year and remains available for at least 60 days. An issuer must provide a written copy of the report to any shareholder as requested. The report required by this section
shall be provided free of charge regardless of format. A copy of the report shall be filed with the Director at the same time it is provided to the issuer’s investors. The report must contain the following:
(a) Compensation received by each Director and executive officer, or person occupying a substantially similar role, including cash compensation earned since the previous report and on an annual basis and any bonuses, stock options, other rights to receive securities of the issuer or any affiliate of the issuer, or other compensation received.
(b) An explanation and discussion of the business operations and financial condition of the issuer such as a recent financial statement and profit and loss statement.
(c) The Director may require any issuer to file periodic reports to keep the information contained in the notice reasonably current and to disclose the progress of the offering.
(2)(a) The issuer must file a sales report with the Director no later than thirty (30) calendar days after the expiration of the offering in a form prescribed by the Director.
(b) A sales report must state the total amount raised through the offering, how many investors purchased securities through the offering, and whether, if funds were held in escrow the funds were released to the issuer.

441-035-0210 Bad Actors. (1) The OIO exemption is not available if, within five years prior to the offering, any of the following apply:
(a) An issuer or person affiliated with the issuer has filed a registration statement which is the subject of any pending proceeding or examination under section 8 of the Securities Act of 1933 or has been the subject of any refusal order or stop order thereunder.
(b) An issuer or person affiliated with the issuer is subject to any pending proceeding under SEC rule 258 promulgated under the Securities Act of 1933, or any similar section adopted under section 3(b) of the Securities Act of 1933, or to an order entered thereunder.
(c) An issuer or person affiliated with the issuer has been convicted of any felony or misdemeanor involving the offer, purchase, or sale of any security, or involving the making of any false filing related to the offer or sale of any security, or any felony or misdemeanor involving dishonesty.
(d) An issuer or a person affiliated with the issuer is, or has been, subject to a state administrative order or judgment containing findings that the issuer or person affiliated with the issuer engaged in fraud or deceit, including but not limited to, making untrue statements of material facts and omitting to state material facts, in connection with the purchase or sale of securities.
(e) An issuer or person affiliated with the issuer has ever been subject to any order, judgment, or decree of any court of competent jurisdiction or regulatory authority (including non-U.S. regulatory authorities) preliminarily, temporarily, or permanently restraining or enjoining such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing related to the offer or sale of any security.
(f) An issuer or a person affiliated with the issuer is the subject of a cease and desist order entered after notice and opportunity for hearing by the Director, a securities agency or administrator of another state or Canadian province or territory, the United States Securities and Exchange Commission or the United States Commodity Futures Trading Commission that contains allegations of securities fraud or misrepresentations in connection with investment offerings.
(2) The disqualification under this rule may not apply if:
(a) The Director determines that it is not necessary under the circumstances that an exemption be unavailable; and
(b) The issuer establishes that they did not know, and in the exercise of reasonable care could not have known, that a disqualification existed under this rule.

441-035-0220 Records. The issuer shall maintain the following records for inspection by the Director for four (4) years from the date the OIO is concluded.
1. Records relating to purchasers and materials and data relied upon to determine the qualifications of the purchasers;
2. Records relating to securities sales following the close of the offering that are considered as part of the offering; and
3. All disclosure, advertising, and purchaser acknowledgement materials used in connection with offerings.

441-035-0230 Burden of Proof. Under ORS 59.275, persons relying upon the OIO rules have the burden in any civil, criminal or administrative action brought under or in connection with Oregon Securities Law of proving that they satisfied all of the conditions of this exemption.
# Chapter 6B

## Washington State Equity Crowdfunding Update

**Joseph Wallin**  
Carney Badley Spellman PS  
Seattle, Washington

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The Washington State legislature has passed, and Washington Governor Inslee has signed, a technical improvements bill to Washington's equity crowdfunding law. The bill, HB 1593, makes a number of improvements to the existing law. Attached please find the following:

- A blog post I wrote about these improvements
- A copy of the bill as passed
- The existing statutes
- A list of the existing regulations
- Two different web pages published by the DFI

To summarize the changes, HB 1593 does the following:

1. Removes the requirement that offerings have to be in compliance with Section 3(a)(11) and Rule 147. Now Washington crowdfunding offerings will be able to access new securities Rule 147A, once the DFI finalizes new regulations.

2. Under Rule 147A, advertising across state lines will not disqualify you from using the exemption as long as you only take investments from residents of Washington State. Companies will no longer have to be incorporated in Washington State.

3. Companies will be able to sell convertible debt and convertible equity.

4. Accredited investors will be able to invest without regard to the individual investor limitations.

**How Much Can a Company Raise?**

$1M during any 12-month period.

**Individual Investor Limitations**

10% of income or net worth if income or net worth are over $100,000. 5% if less than $100,000. $2,000 in any event.

**What Are the Requirements?**

In general:

- File Crowdfunding Form with DFI; have the DFI approve it
- Pay $600 filing fee
- Have GAAP financials
- Retain an escrow agent
A Good Day For Equity Crowdfunding

Published on: April 26, 2017
Link: http://thestartuplawblog.com/a-good-day-for-equity-crowdfunding/

Yesterday was a good day for equity crowdfunding. Washington Governor Jay Inslee signed into law Washington HB 1593. This bill will make it easier for companies in Washington State to use Washington’s equity crowdfunding bill.

Thank you Governor Inslee, Representatives Brandon Vick (R-Ridgefield) and Steve Kirby (D-Tacoma), Senator Joe Fain, Cyrus Habib, and everyone else who supported this effort.

**HB 1593** will do the following:

- Harmonize the Washington law with the new SEC rules, including Rule 147A. Rule 147A is a new stand alone exemption outside of Section 3(a)(11) and rule 147. Companies can use Rule 147A without the advertising restrictions that complicate Section 3(a)(11)/Rule 147 offerings.
- Allow companies to use the Washington crowdfunding exemption without having to be incorporated in Washington State. Delaware corporations will be able to access the law.
- Allow accredited investors to invest an unlimited amount of money, up to the cap of $1M during any 12-month period.
- Not require public disclosure of executive officer and director compensation quarterly. Instead, companies will be required to make annual disclosure to their shareholders and the DFI.
- Sell equity other than common stock and preferred stock. Convertible debt and convertible equity will be allowed.

The next step is for the DFI to propose rules. They will seek comment, and so if you are interested in the process, it would be great to have you submit comments on the rules. If you would like to do this, feel free to email me or call me and I can help you do that.

Re the regulatory improvements, I would like to see:

1) The DFI change the rules on what types of preferred stock preferences have to be included in preferred stock terms
2) Allow revenue loans for companies that are generating sufficient revenue to pay back investors.
3) Allow the exemption to be used to purchase income producing real estate investments.

All in all, I am really pleased with the amendments. The new Washington State equity crowdfunding bill will be relatively easy to use. The big hurdles for companies using it will be:
1) They will have to complete and file the Crowdfunding Form with the DFI.
2) Pay the $600 filing fee.
3) Have GAAP compliant financial statements.
4) Hire an escrow agent to hold the funds until the minimum to close has been satisfied.

Companies that get approved by the DFI will be able to raise up to $1M from both accredited investors and non-accredited investors like who live in Washington State. Advertising will be allowed, even advertising on the Internet that might cross state lines—as long as you still only accept funds from Washington State residents.

For Washington companies that would like to raise money from friends and family, some of whom might not be accredited, the Washington equity crowdfunding approach is a good one to consider.
HOUSE BILL 1593

By Representatives Vick and Kirby

Read first time 01/24/17. Referred to Committee on Business & Financial Services.

AN ACT Relating to simplifying small securities offerings; amending RCW 21.20.880; and repealing RCW 21.20.883 and 21.20.886.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

Sec. 1. RCW 21.20.880 and 2014 c 144 s 3 are each amended to read as follows:

(1) Any offer or sale of a security is exempt from RCW 21.20.040 through 21.20.300 and 21.20.327, except as expressly provided, if:
(a) The issuer first files the offering with the director and the director declares the offering exempt ((by the director after:
(i) The issuer files the offering with the director; or
(ii) A portal working in collaboration with the director files the offering with the director on behalf of the issuer under RCW 21.20.883));
(b) The offering is conducted in accordance with ((the requirements of section 3(a)(11) of the securities act of 1933 and securities and exchange commission rule 147, 17 C.F.R. Sec. 230.147)) an applicable exemption from registration under the securities act of 1933;
(c) The issuer is an entity ((organized and)) doing business in the state of Washington;
(d) ((Each investor provides evidence or certification of residency in the state of Washington at the time of purchase;
(e))) The issuer files with the director an escrow agreement ((either directly or through a portal)) providing that all offering proceeds will be released to the issuer only when the aggregate capital raised from all investors equals or exceeds the minimum target offering, as determined by the director;
(((f))) (e) The aggregate purchase price of all securities sold by an issuer pursuant to the exemption provided by this section does not exceed one million dollars during any twelve-month period;
(((g))) (f) The aggregate amount sold to any investor, other than an "accredited investor" as that term is defined under the securities act of 1933, by one or more issuers during the twelve-month period preceding the date of the sale does not exceed:
(i) The greater of two thousand dollars or five percent of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than one hundred thousand dollars; or
(ii) Ten percent of the annual income or net worth of the investor, as applicable, up to one hundred thousand dollars, if either the annual income or net worth of the investor is one hundred thousand dollars or more;
(((h))) (g) The investor acknowledges by manual or electronic signature the following statement conspicuously presented at the time of sale on a page separate from other information relating to the offering: "I acknowledge that I am investing in a high-risk,
speculative business venture, that I may lose all of my investment, and that I can afford the loss of my investment;"
(((i))) (h) The issuer reasonably believes that all purchasers are purchasing for investment and not for sale in connection with a distribution of the security; and
(((j))) (i) The issuer and investor provide any other information reasonably requested by the director.
(2) Attempted compliance with the exemption provided by this section does not act as an exclusive election. The issuer may claim any other applicable exemption.
(3) For as long as securities issued under the exemption provided by this section are outstanding, the issuer shall provide ((a quarterly)) an annual report to the issuer's shareholders and the director ((by making such report publicly accessible, free of charge, at the issuer's internet web site address within forty-five days of the end of each fiscal quarter)) no later than one hundred twenty days after the end of the fiscal year covered by the report. An issuer may provide the report to its shareholders by posting a copy of the report on the issuer's web site. The report must contain the following information:
(a) Executive officer and director compensation, including specifically the cash compensation earned by the executive officers and directors since the previous report and on an annual basis, and any bonuses or other compensation, including stock options or other rights to receive equity securities of the issuer or any affiliate of the issuer, received by them; and
(b) A brief analysis by management of the issuer of the business operations and financial condition of the issuer.
(4) Securities issued under the exemption provided by this section may not be transferred by the purchaser during a one-year period beginning on the date of purchase, unless the securities are transferred:
(a) To the issuer of the securities;
(b) To an accredited investor;
(c) As part of a registered offering; or
(d) To a member of the family of the purchaser or the equivalent, or in connection with the death or divorce or other similar circumstances, in the discretion of the director.
(5) The director shall adopt disqualification provisions under which this exemption shall not be available to any person or its predecessors, affiliates, officers, directors, underwriters, or other related persons. The provisions shall be substantially similar to the disqualification provisions adopted by the securities and exchange commission pursuant to the requirements of section 401(b)(2) of the Jobs act of 2012 or, if none, as adopted in Rule 506 of Regulation D. Notwithstanding the foregoing, this exemption shall become available on June 12, 2014.
(6) Any type of equity or convertible debt security may be offered under the exemption provided under this section.
(7) Subject to RCW 21.20.450, the director may adopt, amend, or repeal rules to implement this section, including the establishment of filing and transaction fees sufficient to cover the costs of administering this section.
NEW SECTION. Sec. 2. The following acts or parts of acts are each repealed:

(1) RCW 21.20.883 (Portals—Qualifications and use—Requirements) and 2016 c 61 s 16 & 2014 c 144 s 4; and
(2) RCW 21.20.886 (Rule making for small securities offerings) and 2014 c 144 s 5.
RCW 21.20.880

Small securities offerings—Exemptions—Quarterly reports—Disqualification provisions.

*** CHANGE IN 2017 *** (SEE 1593.SL) ***

(1) Any offer or sale of a security is exempt from RCW 21.20.040 through 21.20.300 and 21.20.327, except as expressly provided, if:
   (a) The offering is first declared exempt by the director after:
      (i) The issuer files the offering with the director; or
      (ii) A portal working in collaboration with the director files the offering with the director on behalf of the issuer under RCW 21.20.883;
   (b) The offering is conducted in accordance with the requirements of section 3(a)(11) of the securities act of 1933 and securities and exchange commission rule 147, 17 C.F.R. Sec. 230.147;
   (c) The issuer is an entity organized and doing business in the state of Washington;
   (d) Each investor provides evidence or certification of residency in the state of Washington at the time of purchase;
   (e) The issuer files with the director an escrow agreement either directly or through a portal providing that all offering proceeds will be released to the issuer only when the aggregate capital raised from all investors equals or exceeds the minimum target offering, as determined by the director;
   (f) The aggregate purchase price of all securities sold by an issuer pursuant to the exemption provided by this section does not exceed one million dollars during any twelve-month period;
   (g) The aggregate amount sold to any investor by one or more issuers during the twelve-month period preceding the date of the sale does not exceed:
      (i) The greater of two thousand dollars or five percent of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than one hundred thousand dollars; or
      (ii) Ten percent of the annual income or net worth of the investor, as applicable, up to one hundred thousand dollars, if either the annual income or net worth of the investor is one hundred thousand dollars or more;
   (h) The investor acknowledges by manual or electronic signature the following statement conspicuously presented at the time of sale on a page separate from other information relating to the offering: "I acknowledge that I am investing in a high-risk, speculative business venture, that I may lose all of my investment, and that I can afford the loss of my investment";
   (i) The issuer reasonably believes that all purchasers are purchasing for investment and not for sale in connection with a distribution of the security; and
   (j) The issuer and investor provide any other information reasonably requested by the director.

(2) Attempted compliance with the exemption provided by this section does not act as an exclusive election. The issuer may claim any other applicable exemption.

(3) For as long as securities issued under the exemption provided by this section are outstanding, the issuer shall provide a quarterly report to the issuer’s shareholders and the
director by making such report publicly accessible, free of charge, at the issuer's internet web site address within forty-five days of the end of each fiscal quarter. The report must contain the following information:
(a) Executive officer and director compensation, including specifically the cash compensation earned by the executive officers and directors since the previous report and on an annual basis, and any bonuses or other compensation, including stock options or other rights to receive equity securities of the issuer or any affiliate of the issuer, received by them; and
(b) A brief analysis by management of the issuer of the business operations and financial condition of the issuer.
(4) Securities issued under the exemption provided by this section may not be transferred by the purchaser during a one-year period beginning on the date of purchase, unless the securities are transferred:
(a) To the issuer of the securities;
(b) To an accredited investor;
(c) As part of a registered offering; or
(d) To a member of the family of the purchaser or the equivalent, or in connection with the death or divorce or other similar circumstances, in the discretion of the director.
(5) The director shall adopt disqualification provisions under which this exemption shall not be available to any person or its predecessors, affiliates, officers, directors, underwriters, or other related persons. The provisions shall be substantially similar to the disqualification provisions adopted by the securities and exchange commission pursuant to the requirements of section 401(b)(2) of the Jobs act of 2012 or, if none, as adopted in Rule 506 of Regulation D. Notwithstanding the foregoing, this exemption shall become available on June 12, 2014.
[2014 c 144 § 3.]
NOTES:
Short title—2014 c 144: "This act may be known and cited as the Washington jobs act of 2014." [2014 c 144 § 1.]
Findings—Intent—2014 c 144: "The legislature finds that start-up companies play a critical role in creating new jobs and revenues. Crowdfunding, or raising money through small contributions from a large number of investors, allows smaller enterprises to access the capital they need to get new businesses off the ground. The legislature further finds that the costs of state securities registration often outweigh the benefits to Washington start-ups seeking to make small securities offerings and that the use of crowdfunding for business financing in Washington is significantly restricted by state securities laws. Helping new businesses access equity crowdfunding within certain boundaries will democratize venture capital and facilitate investment by Washington residents in Washington start-ups while protecting consumers and investors. For these reasons, the legislature intends to provide Washington businesses and investors the opportunity to benefit from equity crowdfunding." [2014 c 144 § 2.]
**RCW 21.20.883**

**Portals—Qualifications and use—Requirements.**

*** CHANGE IN 2017 *** (SEE 1593.SL) ***

(1) Only a local associate development organization, as defined in RCW 43.330.010, a port district, or an organization that qualifies as a portal pursuant to regulations promulgated by the director, may work in collaboration with the director to act as a portal under this chapter.

(2) A portal shall require, at a minimum, the following information from an applicant for exemption prior to offering services to the applicant or forwarding the applicant’s materials to the director:
   (a) A description of the issuer, including type of entity, location, and business plan, if any;
   (b) The applicant's intended use of proceeds from the offering;
   (c) Identities of officers, directors, managing members, and ten percent beneficial owners, as applicable;
   (d) A description of any outstanding securities; and
   (e) A description of any litigation or legal proceedings involving the applicant, its officers, directors, managing members, or ten percent beneficial owners, as applicable.

(3) Upon receipt of the information described in subsection (2) of this section, the portal may offer services to the applicant that the portal deems appropriate or necessary to meet the criteria for exemption under RCW 21.20.880 and 21.20.886. Such services may include assistance with development of a business plan, referral to legal services, and other technical assistance in preparation for a public securities offering.

(4) The portal shall forward the materials necessary for the applicant to qualify for exemption to the director for filing when the portal is satisfied that the applicant has assembled the necessary information and materials to meet the criteria for exemption under RCW 21.20.880 and 21.20.886.

(5) The portal shall work in collaboration with the director for the purposes of executing the offering upon filing with the director.

[2016 c 61 § 16; 2014 c 144 § 4.]

**NOTES:**

**Short title—Findings—Intent—2014 c 144:** See notes following RCW 21.20.880.

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**RCW 21.20.886**

**Rule making for small securities offerings.**

*** CHANGE IN 2017 *** (SEE 1593.SL) ***

The director must adopt rules to implement section 2, chapter 144, Laws of 2014 and RCW 21.20.880 subject to RCW 21.20.450 including, but not limited to:

(1) Adopting rules for filing with the director under RCW 21.20.880 and 21.20.883 by October 1, 2014;
(2) Establishing filing and transaction fees sufficient to cover the costs of administering this section and section 2, chapter 144, Laws of 2014 and RCW 21.20.880 and 21.20.883 by January 1, 2015; and
(3) Adopting any other rules to implement RCW 21.20.880 and 21.20.883 by April 1, 2015. The director shall take steps and adopt rules to implement this section by the dates specified in this section.

[2014 c 144 § 5.]

NOTES:
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CROWDFUNDING

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Crowdfunding in Washington

Raising Capital Through Small Contributions from a Large Number of Investors

Introduction

If you’re an entrepreneur in need of capital for your business, one option you may wish to consider is doing an equity crowdfunding offering. In Washington, an exemption from securities registration is available to allow a business to raise up to $1,000,000 in capital in a twelve month period by selling equity (ownership) interests in your business. This webpage does not address other types of crowdfunding, such as donation or rewards based crowdfunding.

Please note that the crowdfunding exemption is an option separate from the rules for raising capital through the Small Company Offering Registration (SCOR). If the requirements for conducting a crowdfunding offering do not match your company’s needs, you may instead be able to do a SCOR offering to raise up to $1,000,000 in capital for your business. For more information about SCOR, please visit our SCOR webpage.

Because the crowdfunding exemption is premised upon the offering qualifying for a specific exemption for “intrastate” offerings of securities under federal law, this webpage will first discuss the requirements of that federal exemption. The remainder of this webpage will discuss the basic requirements for using the crowdfunding exemption under Washington law. Please note that the text of this webpage contains hyperlinks to other sources of information you may wish to study.

Summary of Requirements

There are several requirements an offering must meet for the Washington crowdfunding exemption. The general requirements for conducting a crowdfunding offering are discussed below.

What are the federal requirements for doing a crowdfunding offering under Washington law?

In order to be able to raise capital under Washington’s crowdfunding exemption, the company must be able to establish that the offering qualifies for the federal exemption from registration under Section 3(a)(11) of the Securities Act of 1933 and Rule 147 adopted thereunder. Section 3(a)(11) provides an exemption from the securities registration requirements under federal law for offers and sales of securities that are made to residents of a single state where the issuer is organized and doing business within that same state. Rule 147 provides further guidance as to the availability of this exemption. In summary, Rule 147 provides that this exemption is available where:
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• The issuer of the securities is incorporated or otherwise legally organized under the laws of the state in which the offers or sales of securities will take place;
• The principal office of the issuer is located within the same state;
• The issuer must derive at least 80% of its gross revenues from the operation of a business located within the same state;
• At least 80% of the issuer’s assets are located within the same state; and
• The issuer uses at least 80% of the funds raised in the offering for the operation of the business within the same state.

It is important to note that while this is an abbreviated summary of federal Rule 147, all of these requirements must be satisfied to rely on this federal exemption and to be able to structure an offering under the Washington crowdfunding exemption.

You should also note that the ability to advertise a crowdfunding offering on a website may be limited by federal law. See U.S. Securities and Exchange Commission, Securities Act Rules (link is external): C&DI Questions 141.03, 141.04, and 141.05.

If the offering may otherwise qualify under these federal provisions, the next step is to understand the state level requirements for offerings under the Washington crowdfunding exemption. These requirements are discussed below.

What types of companies may use the Washington crowdfunding exemption?

The Washington crowdfunding exemption is available only to a corporation or centrally managed limited liability company or limited partnership that is resident and doing business within Washington at the time of any offer or sale of securities.

Further, the exemption is generally not available to certain types of issuers. The crowdfunding exemption provides for the use of a simplified offering document (the Washington Crowdfunding Form) that is designed to prompt an issuer to provide adequate disclosure to investors concerning the issuer, the securities offered, and the offering itself. Certain issuers may not be able to make adequate disclosure using the simplified form and will, therefore, be unable to utilize this exemption. The following issuers and programs will not be allowed to utilize the crowdfunding exemption unless written permission is obtained from the Securities Division based upon a showing that adequate disclosure can be made to investors using the Washington Crowdfunding Form:

• Holding companies, companies whose principal purpose is owning stock in, or supervising the management of, other companies;
• Investment companies subject to the Investment Company Act of 1940, including private equity funds;
• Portfolio companies, such as real estate investment trusts;
• Development stage companies that either have no specific business plan or purpose or have indicated that their business plan is to engage in merger or acquisition with an unidentified company or companies or other entity or person;
• Companies with complex capital structures;
• Blind pools;
• Commodity pools;
• Companies engaging in petroleum exploration or production or mining or other extractive industries;
• Equipment leasing programs; and
• Real estate programs.

What types of securities may be sold in an offering under the Washington crowdfunding exemption?

The Washington crowdfunding exemption is available only to equity offerings by the issuer of the securities. Convertible preferred stock may be allowed as long as the protections found in WAC 460-99C-030(5) apply. The exemption is not available to debt offerings or for resales of securities.

How much can an issuer raise in an offering under the Washington crowdfunding exemption?

The aggregate purchase price of all securities offered by an issuer in an offering made pursuant to the Washington crowdfunding exemption may not exceed $1,000,000. The offering may be declared exempt for a maximum of twelve months, and may be renewed for one additional twelve-month period.

Must the crowdfunding offering be made online or otherwise use a crowdfunding portal?

An offering under the Washington crowdfunding exemption is not required to be conducted online. Neither must an issuer use a funding portal or other intermediary to conduct the offering. The exemption may be used by an issuer to make a direct public offering of its own securities.

The crowdfunding rules do provide, however, that local associate development organizations, port districts, and registered broker-dealers may provide assistance to businesses that plan to conduct a crowdfunding offering.

What is the Washington Crowdfunding Form?

Issuers eligible for the crowdfunding exemption are required to use the Washington Crowdfunding Form to provide disclosure to investors in the offering. This form includes both “check-the-box” and question and answer formats for simplicity. It is designed for use by start-up companies and other small business issuers whose principals may prepare the form themselves without relying on the expertise of attorneys and accountants. The questions presented in the form are designed to elicit specific types of information of special relevance to start-up companies and other small businesses. Examiners from the
Securities Division may review and comment on the disclosure provided and may request revisions or additional disclosure before the offering is declared exempt.

One unique aspect of the form is that its questions present issues that a start-up or other small business may need to address to become successful. Thus, in providing responses, a company is compelled to create a business plan describing its anticipated steps to success. If the form is filled out properly, the assumptions and weaknesses in the plan should be evident, and these should be prominently disclosed as risk factors in the offering.

The Washington Crowdfunding Form may be downloaded on the Forms webpage. The Form is a Microsoft Word document that contains macros. When asked whether to enable macros in the document, you must select “Enable” in order for the Form to function properly.

**What are the financial statement requirements under the Washington crowdfunding exemption?**

The issuer must include its financial statements as of the end of the most recent fiscal year. If the date of the most recent fiscal year end is more than ninety days prior to the date of filing, the issuer must also submit a balance sheet and statement of income or operations for the issuer’s most recent fiscal quarter. While the financial statements need not be audited by an accountant, they must be prepared in accordance with generally accepted accounting principles in the United States (“U.S. GAAP”). If the company lacks the requisite accounting expertise to prepare financial statements in accordance with U.S. GAAP, we strongly encourage the company to obtain a compilation or review from a qualified accountant to ensure the proper preparation of the financial statements.

**Are there any ongoing reporting requirements under the Washington crowdfunding exemption?**

For as long as securities issued under the crowdfunding exemption remain outstanding, the issuer is required to provide a quarterly report to the issuer's shareholders by making such report publicly accessible, free of charge, at the issuer's internet web site address within 45 days of the end of each fiscal quarter. The report must contain the following information:

1. Executive officer and director compensation, including specifically the cash compensation earned by the executive officers and directors since the previous report and on an annual basis, and any bonuses or other compensation, including stock options or other rights to receive equity securities of the issuer or any affiliate of the issuer, received by them;
2. The names of the issuer’s owners of twenty percent or more of a class of outstanding securities, directors, officers, managing members and/or other persons occupying similar status or performing similar functions on behalf of the issuer; and
3. A brief analysis by management of the issuer of the business operations and financial condition of the issuer.
What filing requirements apply under the Washington crowdfunding exemption?

To use the Washington crowdfunding exemption, an issuer must first make a filing with the Securities Division. **The issuer must wait to commence the offering until it has received notice from the Securities Division that the offering has been declared exempt.**

The filing requirements include:

- Completed copy of the Washington Crowdfunding Form;
- Copy of the issuer’s articles of incorporation or other charter documents pursuant to which the issuer is organized and all amendments thereto;
- Copy of the issuer’s bylaws or operating agreement and all amendments thereto;
- Copy of any resolutions by directors or members concerning the securities to be issued in the offering;
- Financial statements for the most recent fiscal year and, if applicable, those for the interim period, prepared in accordance with U.S. GAAP;
- Copy of any agreement with a portal;
- Copy of the escrow agreement with an escrow agent located in Washington concerning the offering proceeds;
- Copy of the subscription agreement for the offering;
- Copies of any planned advertising; and
- A check in the amount of $600 for payment of the filing fee. Checks should be made payable to the “Washington State Treasurer.”

The Securities Division may request additional documentation after reviewing these materials.

**What is the target minimum offering amount?**

An issuer is required to set a minimum target offering amount and deadline to raise the minimum target offering amount in the Washington Crowdfunding Form. The minimum target offering amount must be sufficient, together with other sources of financing, to implement the business plan of the issuer. If the proceeds are insufficient, the Securities Division may require a revised minimum target offering amount. The deadline for raising the minimum target offering amount may be no longer than twelve months from the date the offering is declared exempt by the Securities Division. All funds raised in the offering must be deposited with an independent escrow agent until the minimum offering amount has been raised.

**May an investor cancel their investment prior to the time the minimum offering amount is raised?**

An investor in a crowdfunding offering may cancel an investment commitment for any reason until such time as the target minimum offering amount has been raised. If there is a
material change to the terms of the offering or to the information provided by the issuer in the Washington Crowdfunding Form before the minimum target offering amount has been raised, the issuer must send to any investor who has made an investment commitment notice of the material change and notice that the investor may cancel an investment commitment for any reason until such time as the target minimum offering amount has been raised.

**What are the investment limitations per investor under the Washington crowdfunding exemption?**

Under the Washington crowdfunding exemption, the aggregate amount of crowdfunded securities sold to any investor during the twelve months preceding the date of the sale, together with the securities to be sold to the investor in a particular crowdfunding offering, may not exceed the lesser of:

- $2,000 or 5% of the annual income or net worth of the investor, whichever is greater, if either the annual income or the net worth of the investor is <$100,000; or
- 10% of the annual income or net worth of the investor, up to $100,000, if either the annual income or net worth of the investor is ≥$100,000.

An investor’s net worth is calculated by subtracting his or her total liabilities from the value of his or her total assets excluding the investor’s primary residence. The issuer must have a reasonable belief that these limits have been satisfied which is generally accomplished by obtaining a representation from the investor that these limits are satisfied as long as the issuer has no reason to question such a representation.

**Word of Caution**

Undertaking a securities offering is a serious matter. It can be costly and will take time away from running your business. For more information on the general implications of conducting a securities offering, please consult our Raising Capital webpage.

In addition, while company personnel can prepare the information requested on the Washington Crowdfunding Form and file the appropriate documents with the Division, it is often beneficial for the company to seek the assistance of counsel experienced in securities law issues. Although assistance of experienced counsel adds a transactional cost to the company for the offering, the dollars invested may return important dividends in terms of more timely resolution of regulatory issues and achievement of an earlier offering date than would be the case without the assistance of experienced counsel.

The purpose of this document is to acquaint the small business person with the possibility of raising capital through the crowdfunding exemption. It SHOULD NOT be relied upon to actually make a securities offering. There are many additional important issues, of which a person making a securities offering should be aware. This document summarizes only some of the issues involved in conducting a crowdfunding offering.
Other Programs of Interest

SCOR

The Small Company Offering Registration ("SCOR") offers an optional method of registration that utilizes a question and answer disclosure document and enables corporations and limited liability companies (LLCs) to raise up to $1 million during a period of up to 12 months through the sales of securities to the public.

There are many advantages of seeking registration of a securities offering through a SCOR registration. First, the SCOR registration was designed to minimize costs for small businesses seeking to raise capital through a securities offering. The question and answer disclosure document utilized in a SCOR offering was designed so that it may be completed without the expertise of attorneys and accountants who are securities experts. The form may be copied and is used as the prospectus in soliciting investors.

Second, "merit" standards used by the Securities Division to review these registrations are somewhat more relaxed than those applied to larger public offerings.

Third, SCOR offerings are designed to be exempt from registration under federal securities laws by virtue of Securities and Exchange Commission (SEC) Rule 504 of Regulation D (link is external) or Section 3(a)(11) of the Securities Act of 1933 and Rule 147 (link is external) promulgated thereunder, so registration with the SEC is not required.

Finally, companies may use commissioned selling agents or sell the securities to the public themselves through classified ads or other means of mass solicitation, such as the internet. Investors are not limited as to number or type, nor is there any restriction on the amount that may be sold to any one person.

There are other registration and exemption provisions that may be used to raise capital. To acquaint yourself with the various options available in Washington, please review the Offering Options webpage.

Further Information

If you have additional questions about using the intrastate crowdfunding exemption in Washington, you should review the Crowdfunding FAQs available on our website. You should also review the text of the rules (link is external) applicable to the Washington crowdfunding exemption. The Division has other resources available to aid the small businessperson in evaluating the possibility of conducting a securities offering in the State of Washington through the Small Business Assistance section of our website. You may also contact us by telephone at 360-902-8760. You may also want to review the Securities and Exchange Commission’s Small Business Guide (link is external).

For more information on incorporating your business in the State of Washington, contact the Corporations Division of the Secretary of State:
Secretary of State
Corporations Division
P.O. Box 40234
Olympia, WA 98504-0234
(360) 725-0377
Website: www.sos.wa.gov/corps (link is external)

The State of Washington maintains a home page on the Internet providing access to sources of information concerning the operation of businesses in the State of Washington. The website is located at www.access.wa.gov (link is external).

Information on how to prepare a business plan may be available through Small Business Development Centers which are located throughout the state. You can locate your local Small Business Development Center online at www.wsbdc.org (link is external). The U.S. Small Business Administration also may be able to provide assistance to the entrepreneur. Regional offices are located in Seattle and Spokane. The organization maintains a website at www.sba.gov (link is external).
Frequently Asked Questions

The questions and answers set forth below pertain to equity crowdfunding offerings that are made under the intrastate crowdfunding exemption and the rules set forth in Title 460-99C. Additional information about the crowdfunding exemption is available on the Securities Division's Crowdfunding page.

Getting Started

What requirements do I have to follow to use the crowdfunding exemption?

In order to claim the crowdfunding exemption, issuers must first file with the Securities Division a complete Washington Crowdfunding Form and other exhibits required by WAC 460-99C-040. The filing must be accompanied by a fee of $600. Additional information on initial, renewal, and amendment filing requirements may be found below and on the Securities Division’s Crowdfunding page.

When can I start my crowdfunding offering?

After you have filed your crowdfunding materials with the Securities Division, you must wait until the Securities Division has declared the offering exempt in writing. You may not solicit investors or sell securities in the crowdfunding offering before that time.

How long will it take for the Securities Division to review my crowdfunding exemption filing and to declare the offering exempt?

You can expect a response from the Securities Division within three to four weeks of filing your crowdfunding materials. Upon completion of our review, we will either declare the offering exempt or send a comment letter if there are any outstanding issues to be addressed before the offering is declared exempt. In the event the Securities Division issues a comment letter, the offering will not be declared exempt until the issuer has satisfactorily addressed those comments. Depending on the nature and amount of the comments, and especially the length of time the issuer takes to respond, it may be anywhere from a few weeks to several months before the offering is declared exempt.

What restrictions am I required to follow in order to use the crowdfunding exemption under federal law?

The crowdfunding exemption is designed to be used in conjunction with the intrastate offering exemption under federal Rule 147, which strictly requires the issuer, its business activity, and the securities offering itself, to all be contained within the boundaries of a single state.

To conduct a crowdfunding offering under the rules set forth in WAC 460-99C and the federal intrastate offering exemption, federal Rule 147(c) requires, among other things, that:
The issuer is organized under Washington law;
The principal office of the issuer is located in Washington;
80% of the issuer’s gross revenues are derived from business activity in Washington;
80% of the issuer’s assets are located in Washington;
80% of the proceeds of the securities offering are used in Washington; and
All offers and sales of securities are made only to Washington residents

The Securities and Exchange Commission interprets this exemption narrowly. Any deviation from the requirements of the exemption may cause the issuer to be disqualified from relying on the exemption and subject the company and its affiliated persons to liability under federal securities law.

What is considered a “real estate program” subject to disqualification from using the crowdfunding exemption?

The crowdfunding rules are intended to allow start-up companies and other small businesses to raise capital in small securities offerings. The crowdfunding rules therefore provide for the use of a simplified offering document, which is generally unsuitable for issuers such as real estate programs and those with complex capital structures. The Securities Division invites issuers with questions about terms such as “complex capital structures” and “real estate programs” and that want to do a crowdfunding offering to contact the Securities Division. As specified in WAC 460-99C-030 (link is external), these issuers may still use the crowdfunding exemption if they demonstrate to the Securities Division that they can provide appropriate disclosure using the Washington Crowdfunding Form.

Advertising Requirements

Do advertisements for crowdfunding offerings have to be submitted to and reviewed by the Securities Division?

Yes, pursuant to WAC 460-99C-250 (link is external), all advertisements that do not otherwise meet the exception criteria set forth in WAC 460-99C-250(2) must be submitted to the Securities Division for review prior to dissemination.

Are there any exceptions from the requirement to file advertising with the Securities Division?

WAC 460-99C-250 (link is external)(2) sets forth limited forms of advertising that do not need to be filed prior to use, including:

- Tombstone advertisements containing the limited information provided for in WAC 460-99C-250(2)(a)(1)-(vi);
- Dividend notices, proxy statements and reports to shareholders, including periodic financial reports; and
Can portals advertise crowdfunding offerings using the internet?

Some requirements must be satisfied in order for a portal to advertise a crowdfunding offering. The crowdfunding exemption contained in RCW 21.20.880 through RCW 21.20.883 is intended to be exempt from registration at the federal level under Section 3(a)(11) of the federal Securities Act of 1933 and Securities and Exchange Commission Rule 147 (link is external). Among the requirements of Rule 147 (link is external) is the requirement that the offering be offered and sold only to residents of a single state. The staff of the Securities and Exchange Commission (“SEC”) have indicated that use of the Internet is not incompatible with the requirements of Rule 147 (link is external), if the portal implements adequate measures so that offers of securities are made only to persons resident in the relevant State. Specifically, in the context of a state crowdfunding offering, the SEC provides that adequate measures would include, at a minimum, disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law, and limiting access to information about specific investment opportunities to persons who first confirm they are residents of the relevant state (for example, by providing a representation as to residency or in-state residency information, such as a zip code or residential address). Please note, however, that these measures pertain only to the requirement that the offering be made solely to residents of a single state. The issuer must meet all other requirements of Rule 147 (link is external).

For further guidance, please see SEC Compliance and Disclosure Interpretation (“C&DI”) Question 141.04, as well as all other related C&DIs, available at: http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (link is external).

Can issuers advertise their crowdfunding offering using the internet?

An issuer’s ability to advertise its offering using the internet is limited. As stated above, issuers seeking to rely on the state crowdfunding exemption must also comply with the requirements of federal Rule 147 (link is external). Although Rule 147 does not prohibit general advertising or general solicitation, the use of websites or social media to advertise an offering typically occurs in a broad, indiscriminate manner. SEC staff have stated that using an issuer’s established Internet presence to convey information about specific investment opportunities would likely involve offers to residents outside of the relevant state, which may negate the issuer’s ability to rely on the exemption provided for in federal Rule 147, and may subject the issuer and affiliated persons to liability under federal securities law.

SEC staff has also stated, however, that issuers could implement technological measures to limit internet communications about an offering to those persons whose Internet Protocol (“IP”) address originates from a particular state or territory and thereby prevent any offers
to be made to persons whose IP address originates in other states or territories. Such offers should include disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law. Please note that issuers must comply with all other conditions of Rule 147.

For further guidance, please see SEC Compliance and Disclosure Interpretation (C&DI) Question 141.05, as well as all related C&DIs, available at: http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (link is external).

**Can I use Facebook, Twitter, and other social media platforms to advertise my crowdfunding offering?**

No. Given an issuer’s inability to implement technological measures to limit communications on social media platforms, any advertising on these platforms will likely communicate offers to residents outside of Washington. Accordingly, the use of social media platforms would most likely violate the limits of the federal Rule 147 intrastate offering exemption. As discussed in the prior FAQs, advertising on a portal or the issuer’s own website may be allowed with certain restrictions.

**Can my company use the Washington Crowdfunding Form without having to comply with all the intrastate restrictions of federal Rule 147?**

An issuer may not want to conduct a crowdfunding offering under federal Rule 147 for a number of reasons, including the restrictions that Rule 147 (link is external) places on internet advertising and the use of proceeds. To accommodate issuers that would like to conduct a crowdfunding offering that is not subject to the restrictions of Rule 147, the Division will allow an issuer to use the Washington Crowdfunding Form as the disclosure document for an offering of up to $1 million that is registered under RCW 21.20.210 (link is external). As such an offering would be registered at the state level, the offering could qualify for an exemption under federal Rule 504 instead of Rule 147. In an offering that is registered in one or more states, federal Rule 504 does not impose the restrictions on internet advertising that apply in intrastate offerings conducted under Rule 147. In addition, none of the other intrastate restrictions of federal Rule 147 apply in a Rule 504 (link is external) offering.

An issuer that wishes to use the Washington Crowdfunding Form in order to conduct an offering registered under RCW 21.20.210 will need to submit the completed form, an Application for Registration by Qualification, and the required fee. Please note that with respect to the majority of the required exhibits to the Application for Registration by Qualification, the issuer may simply include a cross reference to the location in the Washington Crowdfunding Form where this information is available. Further, the financial statements specified in the Washington Crowdfunding Form will satisfy the financial statement requirements under RCW 21.20.210 (thus an issuer may disregard the financial statement instructions in the application form). The fee is calculated as $100 for the first $100,000 of securities to be offered in this state plus 0.0005 times the amount of securities
to be offered in excess of $100,000. For example, an offering of $1 million would require the submission of a fee in the amount of $550.

It should be noted that if the issuer wishes to make the offering in additional states, the issuer will likely need to register the offering in the other states where the offering will be made. If an issuer is planning to make a multi-state offering using the internet and other forms of general solicitation, the issuer should consider conducting a SCOR offering instead as most states will accept the SCOR Form to conduct a registered offering and multi-state coordinated review is available. For more information, please see our Small Company Offering Registration (SCOR) page.

The staff in the Small Business Assistance Section of the Securities Division would be happy to answer your questions regarding the use of the Washington Crowdfunding Form and/or SCOR registration. Please call us at 360-902-8760 and ask to speak to a staff member regarding your offering options.

**What is the procedure for filing advertising with the Securities Division?**

Advertising material must be submitted to the Securities Division with the initial filing of the crowdfunding form. After the initial filing, any new advertising material must be sent to the Securities Division for review prior to use. To expedite review, please send the advertising materials to the attention of the Securities Division, and include a cover letter containing the issuer's name, DFI-issued file number, and statement that the issuer is submitting the enclosed advertising for proposed use in connection with its crowdfunding offering.

**What is the waiting period to use the advertising after submission to the Securities Division?**

The proposed advertising material must be submitted to the Securities Division for review at least seven days prior to first use. Issuers may disseminate their advertisements after seven days have passed, unless the Securities Division provides the issuer with written notice otherwise.

**May I advertise prior to distributing the Crowdfunding Form to prospective investors?**

Yes. Once the crowdfunding exemption has been declared effective, the issuer may begin advertising the offering, provided that all advertising is first filed with the Securities Division or otherwise meets one of the exceptions from filing in WAC 460-99C-250(2). The issuer may not advertise prior to the offering being declared exempt by the Securities Division, and the issuer must provide prospective investors the most recent Crowdfunding Form a reasonable period of time prior to accepting an investment commitment or funds.
What is considered “advertising?”

Advertising is construed broadly to include any communication, written, broadcast or otherwise disseminated, in connection with the offer or sale of the securities at issue. The Securities Act of Washington defines "offer" or "offer to sell" to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value. "Sale" or "sell" includes every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value. This includes providing information about the offering, soliciting purchases of the issuer’s securities, or otherwise intending to generate publicity for the offering or otherwise condition the market for the securities offered.

Advertising may include, for example, newspaper advertisements, internet advertisements, social media posts, informational seminars, radio and television advertisements, informational flyers and pamphlets, press releases, etc. If issuers are not sure whether something constitutes advertising that must be filed with the Securities Division, they should err on the side of caution and file it with the Securities Division.

Use of Portals

What is a portal?

WAC 460-99C-020 defines a portal as a local associate development organization as defined in RCW 43.330.010, a port district formed under chapter 53.04 RCW, or a broker-dealer registered with the Securities Division. Portals may provide limited assistance to issuers seeking to prepare and make a crowdfunding exemption filing. These activities are defined in WAC 460-99C-210(2), and include matters such as providing assistance with business plan development, providing ministerial assistance to the issuer regarding the exemption filing, providing referrals to attorneys, accountants, or other professional service providers, and submitting the exemption filing to the Division on behalf of the issuer.

Are issuers limited to receiving assistance from a portal in conducting a securities offering in reliance on the crowdfunding exemption?

No. Although the Securities Act and rules limit the definition of “portal” to include only local associate development organizations, port districts, and registered broker dealers, this does not prohibit other individuals or professional service providers, such as attorneys, accountants, and business consultants from assisting issuers with a crowdfunding offering, including offering the services that portals are permitted to provide, such as filing the Crowdfunding Form with the Securities Division on behalf of an issuer.

Are Local Associate Development Organizations, Port Districts, or registered broker-dealers required to act as portals?

No. While these organizations may act as portals, they are not required to do so.
May an entity acting as a crowdfunding portal charge a fee for its services?

Yes, an entity acting as a portal in connection with the crowdfunding exemption may charge a fee for its services. However, portals should take care to note that if any fees for services are directly or indirectly connected with the size or dollar amount of the offering, contingent on the success of the offering, constitute commissions related to sale of the securities, or reflect some other arrangement that constitutes “transaction-related” compensation, the portal may be engaging in conduct that may trigger broker-dealer registration requirements under state and federal securities laws. Portals seeking to charge fees for services may wish to consult the Securities and Exchange Commission’s Compliance Guide to Broker-Dealer Registration (link is external) for further information regarding fee structure.

Are issuers relying on the crowdfunding exemption required to use the services of a portal?

No. Portals are optional; issuers are not required to use the services of a crowdfunding portal to rely on the crowdfunding exemption. An issuer may prepare the crowdfunding filing and conduct a securities offering on its own once declared effective by the Securities Division, without any assistance from a portal.

Investor Limits

Can I have an unlimited number of investors?

There is no restriction under Washington law as to the number of investors that may invest in a crowdfunding offering. Issuers, however, should be aware of federal securities law requirements. In particular, Section 12(g) of the federal Securities Exchange Act of 1934 (“Exchange Act”) provides that an issuer will become subject to public reporting requirements if the issuer has a class of equity securities held of record by either 2,000 persons or 500 persons who are not accredited investors and total assets in excess of $10 million. Exchange Act reporting requirements include, for example, Form 10-K annual reports, Form 10-Q quarterly reports, and Form 8-K current reports.

How much money can I raise from each investor?

The following individual investment limitations apply in crowdfunding offerings under Title 460-99C (link is external):

- If either the annual income or net worth of an investor is less than $100,000, the aggregate amount of securities sold to that investor shall not exceed $2,000 or 5% of the investor’s annual income or net worth.
- If either the annual income or net worth is equal to or exceeds $100,000, the aggregate amount of securities sold to that investor may be as much as 10% of the investor’s annual income or net worth, up to a maximum of $100,000.
The “lesser of” these limits applies. For example, if an investor's annual income or net worth is under $100,000, then the investor may only invest up to $2,000 or 5% of his annual income or net worth, whichever is greater.

It is important to note that this maximum investment amount applies in the aggregate to all offerings conducted under the Washington crowdfunding exemption. In other words, the maximum amount an investor may invest in a year is fixed regardless of whether the investor invests in only your crowdfunding offering or in multiple crowdfunding offerings by other issuers. The issuer must have a reasonable belief that these individual investment limits have not been exceeded.

**Financial Statements**

What format is required for preparing and presenting an issuer's financial statements?

The financial statements required to be provided with the Washington Crowdfunding Form to prospective investors must be prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"), including footnote disclosure when appropriate. The financial statements do not need to be audited. If you do not, however, have experience preparing financial statements in accordance with U.S. GAAP, you may want to obtain a compilation or review of your financial statements from a certified public accountant. Compilations and reviews are generally less expensive services than a full audit.

**Offering Limits**

How much money can my company raise in a crowdfunding offering?

An issuer is permitted to raise up to $1 million in a crowdfunding offering during any 12 month period using the crowdfunding exemption. An issuer may elect to renew an offering for one additional 12-month period. There is no limit on the number of crowdfunding offerings an issuer may conduct, but the most that can be raised in crowdfunding offerings during any 12-month period is $1 million.

What if I decide to abandon my crowdfunding offering and raise money privately instead or otherwise pursue registration of an offering?

If an issuer that commences a crowdfunding offering instead decides it wants to raise money through a different exemption or in a registered offering, an issue that arises is whether the different offerings will be “integrated” and treated as a single offering. If the offerings are integrated, it can create compliance problems. For example, an exempt private offering of more than $1,000,000 that is integrated with a prior crowdfunding offering would create a compliance problem due to the $1,000,000 offering limit under the crowdfunding exemption.
To address this issue, the Securities Division adopted an integration safe harbor in WAC 460-99C-200. That rule lays out the factors that are considered in determining whether two or more offerings that are intended to be separate will be integrated into a single offering. This provision further provides that offers and sales that are made more than six months before the start of an offering, or that are made more than six months after completion of an offering, will not be considered part of that offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under these rules, other than those offers or sales of securities under an employee benefit plan.

Other

What is considered a material change that would require the amendment of an issuer’s Crowdfunding Form pursuant to WAC 460-99C-090?

Regardless of whether an issuer is relying on an exemption from registration, federal and state securities laws require an issuer to inform each potential investor of all material information regarding the issuer, its principals, and the investment opportunity. Generally, information is material if a reasonable investor would consider it important in evaluating whether to purchase the securities (or to continue his or her investment commitment). When there is a material change affecting the disclosure provided to prospective investors in the Crowdfunding Form, the issuer must amend the form and submit it to the Securities Division. A material change occurs when an event or other change in circumstances for the issuer renders the information in the Crowdfunding Form to be inaccurate or incomplete. For further guidance on this matter, issuers may wish to consult Regulation S-K (link is external) of the federal Securities Act, as well as the Securities Division’s “Role of Disclosure” publication.

As a broker-dealer representative, what information should I provide to a client if they wish to invest in a crowdfunding offering, or seek to liquidate assets in order to invest in a crowdfunding offering?

In making a recommendation to purchase or sell securities, broker-dealers and their representatives must have reasonable grounds for believing that the recommendation is suitable for the customer based upon the customer’s other security holdings and his or her financial situation and needs. Further, a broker-dealer or representative must ensure that any investment advice rendered is solely incidental to its conduct as a broker-dealer or representative and not compensated unless they are appropriately registered as an investment adviser or investment adviser representative. These requirements apply to all offerings, including securities offered under the crowdfunding exemption.

A broker-dealer or representative that effects transactions in a crowdfunding offering must furnish the investor a copy of the most recent Crowdfunding Form prior to making an investment commitment. Representatives must not engage in any sales of crowdfunded securities that have not been approved by their firm.
Broker-dealers and representatives may consider providing written information to clients regarding the risks of purchasing securities in a crowdfunded offering. They may also check on the status of an offering with the Securities Division in situations where the client is considering investing in crowdfunding securities outside of their relationship with the broker-dealer or representative. If an offering has not been filed or declared effective, the broker-dealer or representative may inform the client and encourage them to contact the Securities Division. Complaints regarding solicitations for unlawful crowdfunding offerings may be submitted online to the Securities Division using the [online complaint form](#). In addition, broker-dealers and other financial institutions may refuse transactions requiring disbursal of funds in the account of a vulnerable adult they believe is the subject of financial exploitation under RCW 74.34.215. Complaints regarding financial exploitation may also be referred to the Department of Social and Health Services, which has contact information for reporting abuse listed online at [www.dshs.wa.gov/altsa/home-and-community-services/reporting-abuse](http://www.dshs.wa.gov/altsa/home-and-community-services/reporting-abuse) (link is external).

**May the Securities Division revoke a crowdfunding exemption after the offering has been declared exempt?**

Yes, the Securities Division may revoke a crowdfunding exemption at any time if the Securities Division has concerns that a crowdfunding issuer or affiliated persons are committing fraud.

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Chapter 7A
The Impact of Trulia and Walgreen on Deal Litigation

JOHN CASEY
Stoel Rives LLP
Portland, Oregon

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John Casey

May 19, 2017

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Chapter 7A—The Impact of Trulia and Walgreen on Deal Litigation

129 A.3d 884

In re Trulia, Inc. Stockholder Litigation

CONSOLIDATED C.A. No. 10020-CB

Court of Chancery of Delaware.

Submitted: October 16, 2015
Decided: January 22, 2016


Rudolf Koch and Sarah A. Clark, Richards, Layton & Finger, P.A., Wilmington, Delaware; Deborah S. Birnbach, Goodwin Procter LLP, Boston, Massachusetts; Michael T. Jones, Goodwin Procter LLP, Menlo Park, California; Attorneys for Defendants Trulia, Inc., Pete Flint, Robert Moles, Theresia Gouw, Gregory Waldorf, Sami Inkinen, Erik Bardman and Steve Hafner.

William M. Lafferty, Morris, Nichols, Arsthi & Tunnell LLP, Wilmington, Delaware; Alan S. Goudiss, Shearman & Sterling, New York, New York; Attorneys for Defendants Zillow, Inc. and Zebra Holdco, Inc.

Joseph Christensen, Joseph Christensen P.A., Wilmington, Delaware; Counsel for Amicus Curiae Sean J. Griffith.

OPINION

BOUCHARD, C.

This opinion concerns the proposed settlement of a stockholder class action challenging Zillow, Inc.’s acquisition of Trulia, Inc. in a stock-for-stock merger that closed in February 2015. Shortly after the public announcement of the proposed transaction, four Trulia stockholders filed essentially identical complaints alleging that Trulia’s directors had breached their fiduciary duties in approving the proposed merger at an unfair exchange ratio. Less than four months later, after taking limited discovery, the parties reached an agreement-in-principle to settle.

The proposed settlement is of the type often referred to as a “disclosure settlement.” It has become the most common method for quickly resolving stockholder lawsuits that are filed routinely in response to the announcement of virtually every transaction involving the acquisition of a public corporation. In essence, Trulia agreed to supplement the proxy materials disseminated to its stockholders before they voted on the proposed transaction to include some additional information that theoretically would allow the stockholders to be better informed in exercising their franchise rights. In exchange, plaintiffs dropped their motion to preliminarily enjoin the transaction and agreed to provide a release of claims on behalf of a proposed class of Trulia’s stockholders. If approved, the settlement will not provide Trulia stockholders with any economic benefits. The only money that would change hands is the payment of a fee to plaintiffs’ counsel.

Because a class action impacts the legal rights of absent class members, it is the responsibility of the Court of Chancery to exercise independent judgment to determine whether a proposed class settlement is fair and reasonable to the affected class members. For the reasons explained in this opinion, I conclude that the terms of this proposed settlement are not fair or reasonable because none of the supplemental disclosures were material or even helpful to Trulia’s stockholders, and thus the proposed settlement does not afford them any meaningful consideration to warrant providing a release of claims to the defendants. Accordingly, I decline to approve the proposed settlement.

On a broader level, this opinion discusses some of the dynamics that have led to the proliferation of disclosure settlements, noting the concerns that scholars, practitioners and members of the judiciary have expressed that these settlements rarely yield genuine benefits for stockholders and threaten the loss of potentially valuable claims that have not been investigated with rigor. I also discuss some of the particular challenges the Court faces in evaluating disclosure settlements through a non-adversarial process.

Based on these considerations, this opinion offers the Court’s perspective that disclosure claims arising in deal litigation optimally should be adjudicated outside of the context of a proposed settlement so that the Court’s consideration of the merits of the disclosure claims can occur in an adversarial process without the defendants’ desire to obtain an often overly broad release hanging in the balance. The opinion further explains that, to the extent that litigants continue to pursue disclosure settlements, they can expect that the Court will be increasingly vigilant in scrutinizing the “give” and the “get” of such settlements to ensure that they are genuinely fair and reasonable to the absent class members.
I. BACKGROUND

The facts recited in this opinion are based on the allegations of the Verified Amended Class Action Complaint in C.A. No. 10022–CB, which was designated as the operative complaint in the consolidation action; the brief plaintiffs submitted in support of their motion for a preliminary injunction; and the briefs and affidavits submitted in connection with the proposed settlement. Because of the posture of the litigation, the recited facts do not represent factual findings, but rather the record as it was presented for the Court to evaluate the proposed settlement.

A. The Parties

Defendant Trulia, Inc., a Delaware corporation, is an online provider of information on homes for purchase or for rent in the United States. Individual defendants Pete Flint, Robert Moles, Theresia Gouw, Gregory Waldorf, Sami Inkinen, Erik Bardman, and Steve Hafner were members of Trulia’s board of directors when the merger was approved.

Defendant Zillow, Inc., a Washington corporation, is a real estate marketplace that helps home buyers, sellers, landlords and others find and share information about homes. Defendant Zebra Holdco, Inc. (“Holdco”), now known as Zillow Group, Inc., is a Washington corporation that was formed to facilitate the merger at issue and is now the parent company of Zillow and Trulia.

Plaintiffs Christopher Shue, Matthew Sciabacucci, Chaile Steinberg, and Robert Collier were Trulia stockholders at all times relevant to this action.

B. The Announcement of the Merger and the Litigation

On July 28, 2014, Trulia and Zillow announced that they had entered into a definitive merger agreement under which Zillow would acquire Trulia for approximately $3.5 billion in stock. The transaction was structured to include two successive stock-for-stock mergers whereby separate subsidiaries of Holdco would acquire both Trulia and Zillow. After these mergers, Trulia and Zillow would exist as wholly-owned subsidiaries of Holdco, and the former stockholders of Trulia and Zillow would receive, respectively, approximately 33% and 67% of the outstanding shares of Holdco.

After the merger was announced, the four plaintiffs filed class action complaints challenging the Trulia merger and seeking to enjoin it. Each of the complaints alleged essentially identical claims: that the individual defendants had breached their fiduciary duties, and that Zillow, Trulia, and Holdco aided and abetted those breaches.

On September 11, 2014, Holdco filed a registration statement containing Trulia and Zillow’s preliminary joint proxy statement with the United States Securities and Exchange Commission. On September 24, 2014, one of the four plaintiffs filed a motion for expedited proceedings and for a preliminary injunction.

On October 13, 2014, the Court granted an unopposed motion to consolidate the four cases into one action and to appoint lead counsel. On October 14, at 10:37 a.m., plaintiffs filed a motion to expedite the proceedings in the newly consolidated case. The Court never heard the motion, however, because the parties promptly agreed on an expedited schedule, which they documented in a stipulated case schedule filed on October 14 at 12:12 p.m., less than two hours after the motion to expedite was filed.

Over the next few weeks, plaintiffs reviewed documents produced by defendants and deposed one director of Trulia (Chairman, CEO, and co-founder Pete Flint) and a banker from J.P. Morgan Securities LLC, Trulia’s financial advisor in the transaction.

On November 14, 2014, plaintiffs filed a brief in support of their motion for a preliminary injunction. In that brief, plaintiffs asserted that the individual defendants had breached their fiduciary duties by “failing to obtain the highest exchange ratio available for the Company’s stockholders in a single-bidder process, failing to properly value the Company, agreeing to preclusive provisions in the Merger Agreement that impede the Board’s ability to consider and accept superior proposals, and disseminating materially false and misleading disclosures to the Company’s stockholders...” The discussion of the merits in that brief, however, focused only on disclosure issues. Plaintiffs provided no argument in support of any other aspect of their claims.

On November 17, Trulia and Zillow filed a definitive joint proxy statement regarding the transaction on Schedule 14A (the “Proxy”).

C. The Parties Reach a Settlement

On November 19, 2014, the parties entered into a Memorandum of Understanding detailing an agreement-in-principle to settle the litigation for certain disclosures to supplement those contained in the Proxy, subject to confirmatory discovery. The same day, Trulia filed a Form 8–K with the Securities and Exchange Commission containing the disclosures (the “Supplemental Disclosures”).
On December 18, 2014, Trulia and Zillow held special meetings of stockholders at which each company’s stockholders voted on and approved the transaction. Trulia’s stockholders overwhelmingly supported the transaction. Of the Trulia shares that voted, 99.15% voted in favor of the transaction. In absolute terms, 79.52% of Trulia’s outstanding shares voted in favor of the transaction.³

On February 10, 2015, plaintiffs conducted a confirmatory deposition of a second Trulia director, Gregory Waldorf. On February 17, 2015, the transaction closed.

On June 10, 2015, the parties executed a Stipulation and Agreement of Compromise, Settlement, and Release (the “Stipulation”) in support of a proposed settlement reiterating the terms of the Memorandum of Understanding. In the Stipulation, the parties agreed to seek certification of a class consisting of all Trulia stockholders from July 28, 2014 (when the transaction was announced) through February 17, 2015 (when the transaction closed). The Stipulation included an extremely broad release encompassing, among other things, “Unknown Claims”⁴ and claims “arising under federal, state, foreign, statutory, regulatory, common law or other law or rule” held by any member of the proposed class relating in any conceivable way to the transaction.⁵ The Stipulation further provided that plaintiffs’ counsel intended to seek an award of attorneys’ fees and expenses not to exceed $375,000, which defendants agreed not to oppose.

Beginning on July 17, 2015, Trulia disseminated notices to the proposed class members in accordance with a scheduling order the Court had entered.

D. Procedural Posture

On September 16, 2015, after receiving a brief and an affidavit from plaintiffs advocating for approval of the proposed settlement, I held a hearing to consider the fairness of the terms of the proposed settlement. Defendants made no submissions concerning the proposed settlement before the hearing, and no stockholder filed an objection to it. After the hearing, I took the request to approve the settlement under advisement and asked the parties for supplemental briefing on whether disclosures must meet the legal standard of materiality in order to constitute an adequate benefit to support a settlement, and on the rationale and justification for including “unknown claims” among the claims that would be released by the proposed settlement.

On September 22, 2015, Sean J. Griffith, a professor at Fordham University School of Law who has researched disclosure settlements and objected to them in the past,⁶ requested permission to appear as amicus curiae in order to submit a brief on the topics for which I requested supplemental briefing. I approved this request on September 23, and the parties submitted their supplemental briefing on October 16.

Along with their supplemental briefing, plaintiffs submitted an affidavit from Timothy J. Meinhart, a managing director of Willamette Management Associates, which provides business valuation and transaction financial advisory services. The affidavit addresses certain concerns about some (but not all) of the disclosures that I raised at the settlement hearing. Plaintiffs and defendants also informed the Court that, following the hearing, the parties had agreed to a revised stipulation with a narrower release.

Specifically, the parties removed “Unknown Claims” and “foreign” claims from the ambit of the release and added a carve-out so that the release would not cover “any claims that arise under the Hart–Scott–Rodino, Sherman, or Clayton Acts, or any other state or federal antitrust law.” As revised, the release still encompasses “any claims arising under federal, state, statutory, regulatory, common law, or other law or rule” held by any member of the proposed class relating in any conceivable way to the transaction, with the exception of the carve-out for claims arising under state and federal antitrust law.²

II. LEGAL ANALYSIS

A. Legal Standard

Under Court of Chancery Rule 23, the Court must approve the dismissal or settlement of a class action.⁷ Although Delaware has long favored the voluntary settlement of litigation,² the fiduciary character of a class action requires the Court to independently examine the fairness of a class action settlement before approving it.¹⁰ “Approval of a class action settlement requires more than a cursory scrutiny by the court of the issues presented.”¹¹ The Court must exercise its own judgment to determine whether the settlement is reasonable and intrinsically fair.¹² In doing so, the Court evaluates not only the claim, possible defenses, and obstacles to its successful prosecution,¹³ but also “the reasonableness of the ‘give’ and the ‘get,’ “¹⁴ or what the class members receive in deal litigation should be adjudicated in the future.
B. Considerations Involving Disclosure Claims in Deal Litigation

Over two decades ago, Chancellor Allen famously remarked in Solomon v. Pathe Communications Corporation that “[i]t is a fact evident to all of those who are familiar with shareholder litigation that surviving a motion to dismiss means, as a practical matter, that economical[ly] rational defendants ... will settle such claims, often for a peppercorn and a fee.” The Chancellor’s remarks were not made in the context of a settlement, but they touch upon some of the same dynamics that have fueled disclosure settlements of deal litigation.

Today, the public announcement of virtually every transaction involving the acquisition of a public corporation provokes a flurry of class action lawsuits alleging that the target’s directors breached their fiduciary duties by agreeing to sell the corporation for an unfair price. On occasion, although it is relatively infrequent, such litigation has generated meaningful economic benefits for stockholders when, for example, the integrity of a sales process has been corrupted by conflicts of interest on the part of corporate fiduciaries or their advisors. But far too often such litigation serves no useful purpose for stockholders. Instead, it serves only to generate fees for certain lawyers who are regular players in the enterprise of routinely filing hastily drafted complaints on behalf of stockholders on the heels of the public announcement of a deal and settling quickly on terms that yield no monetary compensation to the stockholders they represent.

In such lawsuits, plaintiffs’ leverage is the threat of an injunction to prevent a transaction from closing. Faced with that threat, defendants are incentivized to settle quickly in order to mitigate the considerable expense of litigation and the distraction it entails, to achieve closing certainty, and to obtain broad releases as a form of “deal insurance.” These incentives are so potent that many defendants self-expedite the litigation by volunteering to produce “core documents” to plaintiffs’ counsel, obviating the need for plaintiffs to seek the Court’s permission to expedite the proceedings in aid of a preliminary injunction application and thereby avoiding the only gating mechanism (albeit one friendly to plaintiffs) the Court has to screen out frivolous cases and to ensure that its limited resources are used wisely.

Once the litigation is on an expedited track and the prospect of an injunction hearing looms, the most common currency used to procure a settlement is the issuance of supplemental disclosures to the target’s stockholders before they are asked to vote on the proposed transaction. The theory behind making these disclosures is that, by having the additional information, stockholders will be better informed when exercising their franchise rights. Given the Court’s historical practice of approving disclosure settlements when the additional information is not material, and indeed may be of only minor value to the stockholders, providing supplemental disclosures is a particularly easy “give” for defendants to make in exchange for a release.

Once an agreement-in-principle is struck to settle for supplemental disclosures, the litigation takes on an entirely different, non-adversarial character. Both sides of the caption then share the same interest in obtaining the Court’s approval of the settlement. The next step, after notice has been provided to the stockholders, is a hearing in which the Court must evaluate the fairness of the proposed settlement. Significantly, in advance of such hearings, the Court receives briefs and affidavits from plaintiffs extolling the value of the supplemental disclosures and advocating for approval of the proposed settlement, but rarely receives any submissions expressing an opposing viewpoint.

Although the Court commonly evaluates the proposed settlement of stockholder class and derivative actions without the benefit of hearing opposing viewpoints, disclosure settlements present some unique challenges. It is one thing for the Court to judge the fairness of a settlement, even in a non-adversarial context, when there has been significant discovery or meaningful motion practice to inform the Court’s evaluation. It is quite another to do so when little or no motion practice has occurred and the discovery record is sparse, as is typically the case in an expedited deal litigation leading to an equally expedited resolution based on supplemental disclosures before the transaction closes. In this case, for example, no motions were decided (not even a motion to expedite), and discovery was limited to the production of less than 3,000 pages of documents and the taking of three depositions, two of which were taken before the parties agreed in principle to settle and one of which was a “confirmatory” deposition taken thereafter.

The lack of an adversarial process often requires that the Court become essentially a forensic examiner of proxy materials so that it can play devil’s advocate in probing the value of the “get” for stockholders in a proposed disclosure settlement. Consider the following example. During discovery, plaintiffs will typically receive copies of board presentations made by financial advisors who ultimately opine on the fairness of the transaction from a financial point of view. It is all too common for a plaintiff to identify and obtain supplemental disclosure of a laundry list of minutiae in a financial advisor’s board presentation that does not appear in the summary of the advisor’s analysis in the proxy materials—summaries that commonly run ten or more single-spaced pages in the first instance. Given that the newly added pieces of information were, by definition, missing from the original proxy, it is not difficult for an advocate to make a superficially persuasive argument that it is better for stockholders to have more information rather than less. In an adversarial process, defendants, armed with the help of their financial advisors, would be quick to contextualize the omissions and point out why the missing details are immaterial (and may even be unhelpful) given the summary of the advisor’s analysis already disclosed in the proxy. In the
It is beyond doubt in my view that the dynamics described above, in particular the Court’s willingness in the past to approve disclosure settlements of marginal value and to routinely grant broad releases to defendants and six-figure fees to plaintiffs’ counsel in the process, have caused deal litigation to explode in the United States beyond the realm of reason. In just the past decade, the percentage of transactions of $100 million or more that have triggered stockholder litigation in this country has more than doubled, from 39.3% in 2005 to a peak of 94.9% in 2014. Only recently has the percentage decreased, falling to 87.7% in 2015 due to a decline near the end of the year. In Delaware, the percentage of such cases settled solely on the basis of supplemental disclosures grew significantly from 45.4% in 2005 to a high of 76.0% in 2012, and only recently has some decline. The increased prevalence of deal litigation and disclosure settlements has drawn the attention of academics, practitioners, and the judiciary.

Scholars have criticized disclosure settlements, arguing that non-material supplemental disclosures provide no benefit to stockholders and amount to little more than deal “rents” or “taxes,” while the liability releases that accompany settlements threaten the loss of potentially valuable claims related to the transaction in question or other matters falling within the literal scope of overly broad releases. One recent study provides empirical data suggesting that supplemental disclosures make no difference in stockholder voting, and thus provide no benefit that could serve as consideration for a settlement. Another paper, written by a practitioner, provides examples of cases in which unexplored but valuable claims that almost were released through disclosure settlements later yielded significant recoveries for stockholders. A particularly vivid example is the recently concluded Rural/Metro case. In that case, the Court of Chancery initially considered it a “very close call” to reject a disclosure settlement that would have released claims which subsequently yielded stockholders over $100 million, mostly from a post-trial judgment, after new counsel took over the case.

Members of this Court also have voiced their concerns over the deal settlement process, expressing doubts about the value of relief obtained in disclosure settlements, and explaining their reservations over the breadth of the releases sought and the lack of any meaningful investigation of claims proposed to be released. Judges outside of Delaware have expressed similar concerns.

Given the rapid proliferation and current ubiquity of deal litigation, the mounting evidence that supplemental disclosures rarely yield genuine benefits for stockholders, the risk of stockholders losing potentially valuable claims that have not been investigated with rigor, and the challenges of assessing disclosure claims in a non-adversarial settlement process, the Court’s historical predisposition toward approving disclosure settlements needs to be reexamined. In the Court’s opinion, the optimal means by which disclosure claims in deal litigation should be adjudicated is outside the context of a proposed settlement so that the Court’s consideration of the merits of the disclosure claims can occur in an adversarial process where the defendants’ desire to obtain a release does not hang in the balance.

Outside the settlement context, disclosure claims may be subjected to judicial review in at least two ways. One is in the context of a preliminary injunction motion, in which case the adversarial process would remain intact and plaintiffs would have the burden to demonstrate on the merits a reasonable likelihood of proving that “the alleged omission or misrepresentation is material.” In other words, plaintiffs would bear the burden of showing “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

A second way is when plaintiffs’ counsel apply to the Court for an award of attorneys’ fees after defendants voluntarily decide to supplement their proxy materials by making one or more of the disclosures sought by plaintiffs, thereby mooting some or all of their claims. In that scenario, where securing a release is not at issue, defendants are incentivized to oppose fee requests they view as excessive. Hence, the adversarial process would remain in place and assist the Court in its evaluation of the nature of the benefit conferred (i.e., the value of the supplemental disclosures) for purposes of determining the reasonableness of the requested fee.

In either of these scenarios, to the extent fiduciary duty claims challenging the sales process remain in the case, they may be amenable to dismissal. Harkening back to Chancellor Allen’s words in Soloman, the Court would be cognizant of the need to “apply the pleading test under Rule 12 with special care” in stockholder litigation because “the risk of strike suits means that too much turns on the mere survival of the complaint.” In that regard, both the litigants and the Court are aided today by thirty years of jurisprudence that now exists interpreting the principles enunciated in Unocal and Revlon that often are central to reviewing fiduciary conduct in deal litigation.

The preferred scenario of a mootness dismissal appears to be catching on. In the wake of the Court’s increasing scrutiny of disclosure settlements, the Court has observed an increase in the filing of stipulations in which, after disclosure claims have been mooted by defendants electing to supplement their proxy materials, plaintiffs dismiss their actions without prejudice to the other members of the putative class (which has not yet been certified) and the Court reserves jurisdiction solely to hear a mootness fee application. From the Court’s perspective, this arrangement provides a logical and sensible framework for
concluding the litigation. After being afforded some discovery to probe the merits of a fiduciary challenge to the substance of the board’s decision to approve the transaction in question, plaintiffs can exit the litigation without needing to expend additional resources (or causing the Court and other parties to expend further resources) on dismissal motion practice after the transaction has closed. Although defendants will not have obtained a formal release, the filing of a stipulation of dismissal likely represents the end of fiduciary challenges over the transaction as a practical matter.

In the mootness fee scenario, the parties also have the option to resolve the fee application privately without obtaining Court approval. Twenty years ago, Chancellor Allen acknowledged the right of a corporation’s directors to exercise business judgment to expend corporate funds (typically funds of the acquirer, who assumes the expense of defending the litigation after the transaction closes) to resolve an application for attorneys’ fees when the litigation has become moot, with the caveat that notice must be provided to the stockholders to protect against “the risk of buy off” of plaintiffs’ counsel. As the Court recently stated, “notice is appropriate because it provides the information necessary for an interested person to object to the use of corporate funds, such as by ‘challeng[ing] the fee payment as waste in a separate litigation,’ if the circumstances warrant.” In other words, notice to stockholders is designed to guard against potential abuses in the private resolution of fee demands for mooted representative actions. With that protection in place, the Court has accommodated the use of the private resolution procedure on several recent occasions and reiterates here the propriety of proceeding in that fashion.

Returning to the historically trodden but suboptimal path of seeking to resolve disclosure claims in deal litigation through a Court-approved settlement, practitioners should expect that the Court will continue to be increasingly vigilant in applying its independent judgment to its case-by-case assessment of the reasonableness of the “give” and “get” of such settlements in light of the concerns discussed above. To be more specific, practitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently. In using the term “plainly material,” I mean that it should not be a close call that the supplemental information is material if that term is defined under Delaware law. Where the supplemental information is not plainly material, it may be appropriate for the Court to appoint an amicus curiae to assist the Court in its evaluation of the alleged benefits of the supplemental disclosures, given the challenges posed by the non-adversarial nature of the typical disclosure settlement hearing.

Finally, some have expressed concern that enhanced judicial scrutiny of disclosure settlements could lead plaintiffs to sue fiduciaries of Delaware corporations in other jurisdictions in the hope of finding a forum more hospitable to signing off on settlements of no genuine value. It is within the power of a Delaware corporation to enact a forum selection bylaw to address this concern. In any event, it is the Court’s opinion, based on its extensive experience in adjudicating cases of this nature, that the historical predisposition that has been shown towards approving disclosure settlements must evolve for the reasons explained above. We hope and trust that our sister courts will reach the same conclusion if confronted with the issue.

With the foregoing considerations in mind, I consider next the “give” and the “get” of the proposed settlement in this case.

C. The Supplemental Disclosures Are not Material and Provided no Meaningful Benefit to Stockholders

Under Delaware law, when directors solicit stockholder action, they must “disclose fully and fairly all material information within the board’s control.” Delaware has adopted the standard of materiality used under the federal securities laws. Information is material “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” In other words, information is material if, from the perspective of a reasonable stockholder, there is a substantial likelihood that it “significantly alter[s] the ‘total mix’ of information made available.”

Here, the joint Proxy that Trulia and Zillow stockholders received in advance of their respective stockholders’ meetings to consider whether to approve the proposed transaction ran 224 pages in length, excluding annexes. It contained extensive discussion concerning, among other things, the background of the mergers, each board’s reasons for recommending approval of the proposed transaction, prospective financial information concerning the companies that had been reviewed by their respective boards and financial advisors, and explanations of the opinions of each company’s financial advisor. In the case of Trulia, the opinion of J.P. Morgan was summarized in ten single-spaced pages.

The Supplemental Disclosures plaintiffs obtained in this case solely concern the section of the Proxy summarizing J.P. Morgan’s financial analysis, which the Trulia board cited as one of the factors it considered in deciding to recommend approval of the proposed merger. Specifically, these disclosures provided additional details concerning: (1) certain synergy numbers in J.P. Morgan’s value creation analysis; (2) selected comparable transaction multiples; (3) selected public trading multiples; and (4) implied terminal EBITDA multiples for a relative discounted cash flow analysis.

Relevant to considering the materiality of information disclosed in this section of the Proxy, then-Vice Chancellor Strine observed in In re Pure Resources, Inc. Shareholders Litigation that there were “conflicting impulses” in Delaware case law about whether, when seeking stockholder action, directors must disclose “investment banker analyses in circumstances in
which the bankers’ views about value have been cited as justifying the recommendation of the board.\textsuperscript{52} The Court held that, under Delaware law, when the board relies on the advice of a financial advisor in making a decision that requires stockholder action, those stockholders are entitled to receive in the proxy statement “a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely.”\textsuperscript{53} This “fair summary” standard has been a guiding principle for this Court in considering proxy disclosures concerning the work of financial advisors for more than a decade.\textsuperscript{54}

A fair summary, however, is a summary. By definition, it need not contain all information underlying the financial advisor’s opinion or contained in its report to the board.\textsuperscript{55} Indeed, this Court has held that the summary does not need to provide sufficient data to allow the stockholders to perform their own independent valuation.\textsuperscript{56} The essence of a fair summary is not a cornucopia of financial data, but rather an accurate description of the advisor’s methodology and key assumptions.\textsuperscript{57} In my view, disclosures that provide extraneous details do not contribute to a fair summary and do not add value for stockholders.\textsuperscript{58}

With the foregoing principles in mind, I consider next whether any of the four specific Supplemental Disclosures that plaintiffs obtained here were material or whether they provided any benefit to Trulia’s stockholders at all.

1. Synergy Numbers in the Value Creation Analysis

The Supplemental Disclosures provided some additional details in the sections of J.P. Morgan’s analysis entitled “Value Creation Analysis—Intrinsic Value Approach” and “Value Creation Analysis—Market–Based Approach.” In the “Intrinsic Value Approach” analysis, J.P. Morgan compared the implied equity value derived from its discounted cash flow analysis of Trulia on a standalone basis to Trulia stockholders’ pro forma ownership of the implied equity value of the combined company. In the “Market–Based Approach,” J.P. Morgan compared the public market equity value of Trulia on a standalone basis to Trulia stockholders’ pro forma ownership of the implied equity value of the combined company.

As supplemented, the disclosure concerning the Intrinsic Value Approach reads in relevant part as follows, with the information that was added to the original disclosure in the Proxy appearing in bolded text:

The pro forma combined company equity value was equal to: (1) the Trulia standalone discounted cash flow value of $2.9 billion, plus (2) the Zillow standalone discounted cash flow value of $6.2 billion, plus (3) $2.2 billion, representing the present value of (a) Trulia’s management expected after-tax synergies of $2.4 billion, less (b) Trulia’s management estimates of (i) the one-time costs to achieve such synergies of $65.0 million and (ii) transaction expenses of $85 million. The present value of after-tax synergies was based on an estimate of $175.0 million in synergies to be fully realized starting in 2016, extrapolated through 2029 based on assumptions provided by Trulia’s management.\textsuperscript{60}

Plaintiffs argue that the disclosure of the $175 million synergies figure in the quote above was important because it is substantially different from the $100 million in synergies that J.P. Morgan used in the Market–Based Approach, which figure already was disclosed in the Proxy.\textsuperscript{61} According to plaintiffs, “[h]ad [stockholders] initially known that the market-based approach analysis was skewed downward by using lower synergies numbers, their view as to the resulting implied value and reliability of [J.P. Morgan’s] analysis may have changed appreciably.”\textsuperscript{62} There are three fundamental problems with this argument.

First, although plaintiffs question why J.P. Morgan used different synergies figures in two different analyses, they provide no explanation as to why doing so would be inappropriate. To the contrary, it seems logical that an intrinsic value approach (which is based on a comparison derived from a discounted cash flow analysis) would use synergies based on long-term management projections, while a market-based approach (which is based on a comparison to the public market equity value of Trulia) would use synergies based on what would be publicly announced to investors. Regardless, the Proxy accurately disclosed which synergies assumptions the financial advisor deemed appropriate to use in each analysis.\textsuperscript{63}

Second, the $175 million synergies figure that plaintiffs consider so important was not new information. It already was disclosed in the Proxy, which contained the following table providing information about management’s synergies expectations:\textsuperscript{64}

The following table presents summary estimated synergies that Trulia’s management also prepared in respect of the combined company following the completion of the mergers for the calendar years ending 2014 through 2024 in connection with Trulia’s evaluation of the mergers.

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(1) “Total Operating Synergies” means the expected EBIT effect of revenue synergies plus the EBIT effect of cost savings/cost avoidance less one-time costs to achieve and retain such synergies. “EBIT” means earnings before interest and
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An assumed tax rate of 40% was applied to Total Operating Synergies to determine estimated after-tax synergies. Projected synergies (including costs to achieve synergies) were prepared by Trulia’s management through fiscal year 2016 after discussion with Zillow’s management. The management of Trulia provided J.P. Morgan with assumptions relating to projected synergies for fiscal years 2017 through 2024 deemed appropriate by Trulia’s management. The management of Trulia then directed J.P. Morgan to use these assumptions in extrapolating such estimated synergies for fiscal years extending beyond those for which the management of Trulia had provided projections. The management of Trulia then reviewed and approved such extrapolation of the synergies.

Because the $175 million figure for 2016 synergies already appeared in this table, inserting it into a methodological paragraph a few pages later is of no benefit to stockholders. In my view, the supplemental disclosure may have added confusion more than anything else, because it lacks explanatory context and does not clearly describe the nature of management’s estimate of synergies that was disclosed in the original Proxy.

Third, plaintiffs exaggerate the significance of juxtaposing the synergy figures used in the Intrinsic Value Approach with those used in the Market–Based Approach. In contrast to the Intrinsic Value Approach, the Market–Based Approach was placed in the end of the summary of the financial advisor’s analysis in the “Other Information” section, was termed an “illustrative value creation analysis,” and “was presented merely for informational purposes.” As plaintiffs concede, a “fair reading” of the Proxy indicates that the Market–Based Approach analysis was less important than the Intrinsic Value Approach analysis. Thus, the notion that the disclosure of the $175 million synergies figure used in one analysis (which already was disclosed in the Proxy) was significant because it was higher than the $100 million figure used in a second, different analysis is based on a false equivalence of the relative importance of the two analyses.

In sum, the disclosures in the original Proxy already provided a fair summary of J.P. Morgan’s methodology and assumptions in its two “Value Creation” analyses. Inserting additional minutiae underlying some of the assumptions could not reasonably have been expected to significantly alter the total mix of information and thus was not material. Indeed, in my view, the supplemental information was not even helpful to stockholders.

2. Individual Company Multiples in the Selected Transaction Analysis

The Proxy disclosed that J.P. Morgan used publicly available information to analyze certain selected precedent transactions involving companies engaged in businesses that J.P. Morgan considered analogous to Trulia’s businesses. The Proxy listed the date, the target, and the acquirer for each of 32 transactions that were considered. It also disclosed the low and high forward EBITDA multiples for the group of transactions. Using a narrower range of multiples falling between the low and the high for the group, J.P. Morgan created an estimated range of equity values per share for Trulia common stock. This methodology was summarized in the Proxy as follows:

J.P. Morgan reviewed the implied firm value for each of the transactions as a multiple of the target company’s two-year forward EBITDA immediately preceding the announcement of the transaction. The analysis indicated a range of EBITDA multiples of 8.0x to 69.1x. Based on the result of this analysis and other factors that J.P. Morgan considered appropriate, J.P. Morgan applied an EBITDA multiple range of 10.0x to 23.0x to Trulia’s fiscal 2015 Adjusted EBITDA and arrived at an estimated range of equity values per share for Trulia common stock of $17.25–$38.50.

Plaintiffs’ grievance is that the Proxy did not provide the relevant multiples for each of the 32 individual transactions. The individual multiples were added in the Supplemental Disclosures for those transactions for which the information was publicly available. The addition of this information made evident that multiples were not publicly available for 15 of the 32 transactions. Plaintiffs argue that, without the Supplemental Disclosures, stockholders would not have realized that J.P. Morgan’s analysis did not consider multiples for half of the precedent transactions it listed and was therefore less robust than the Proxy portrayed it to be.

The addition of the individual multiples and the revelation that some were not publicly available could not reasonably have been expected to significantly alter the total mix of information. No argument is made, for example, that having 16 similar transactions was not sufficient to perform the analysis that J.P. Morgan conducted. The discussion in the Proxy, moreover, including the portion quoted above, fairly summarized the methodology and assumptions J.P. Morgan used in conducting that analysis to extrapolate a range of per share values for Trulia stock. A fair summary does not require disclosure of sufficient data to allow stockholders to perform their own valuation.

This conclusion is supported by the Court’s decision in In re MONY Group Shareholder Litigation. There, the Court rejected a similar argument that the disclosure of transaction multiples was important because it showed that 25% of the multiples in a set of 71 transactions were unavailable. After noting that the plaintiffs had not argued that the financial advisor did not have sufficient data to perform its analysis, the Court held that the additional information was “immaterial, as a matter of law,” and a “triviality [that] could not reasonably be expected to affect the total mix of information.” In my view, the addition of similar trivialities was not helpful to Trulia’s stockholders here.
3. Individual Company Multiples in the Selected Public Trading Analysis

The Proxy disclosed the names of sixteen publicly traded companies that J.P. Morgan used to construct ranges of forward EBITDA and revenue multiples for Trulia and Zillow. The Proxy provided these multiples for Trulia and Zillow based on their last unaffected trading day before the announcement of the merger, and provided the median multiples for the three groups into which J.P. Morgan categorized the sixteen comparable companies: “Real Estate,” “Software as a Service,” and “Other.” The Proxy did not include individual multiples for the peer companies.

The Supplemental Disclosures added the revenue and EBITDA multiples for each of the sixteen companies. Citing *Celera Corporation Shareholder Litigation*, plaintiffs argue, in essence, that individual company multiples are material per se. That is not a fair reading of the case. In *Celera*, the Court commented that “as a matter of best practices, a fair summary of a comparable companies or transactions analysis probably should disclose the market multiples derived for the comparable companies or transactions.” Although the decision reluctantly concluded that a multiples disclosure was compensable, it found it “questionable whether [the multiples] altered the ‘total mix’ of available information” because that information “already was publicly available.” The individual company multiples in the Supplemental Disclosures here also were already publicly available.

More importantly, the original disclosures in *Celera* simply listed the comparable companies with no summary multiple data at all. Although the supplemental disclosures in that case added summary data for each of three categories of companies, they did not provide any individual company multiples. In other words, the disclosures in Trulia’s Proxy, which provided the median multiples for three different categories of companies that J.P. Morgan considered in its judgment to be similar to Trulia, essentially started at the point where *Celera* ended.

Plaintiffs next argue that the individual multiples are important here because they allow stockholders to compare the selected companies’ EBITDA growth rates and EBITDA multiples to Trulia’s. This argument is unpersuasive for two reasons. First, basic valuation principles already would suggest to stockholders that higher growth rates should correspond to higher multiples. Second, the Supplemental Disclosures do not contain EBITDA growth rates, so the figures necessary to make that comparison are not present in any event. Thus, plaintiffs have not persuaded me that individual company multiples are material or were even helpful in this case.

4. Implied Terminal EBITDA Multiples in the DCF Analysis

J.P. Morgan performed a relative discounted cash flow analysis to determine the per-share equity values of Trulia and Zillow, using expected cash flows from 2014 through 2028 based on management’s projections for each company and the perpetuity growth method to calculate the companies’ respective terminal values. The Proxy explained this methodology and provided the assumptions J.P. Morgan used in its analysis. Specifically, the Proxy disclosed management’s projections of unlevered free cash flows, the ranges of discount rates (11.0% to 15.0%) and perpetuity growth rates (2.5% to 3.5%) that were used, the terminal period projected cash flows, and other details. In my view, these disclosures already provided a more-than-fair summary of the relative discounted cash flow analysis that J.P. Morgan performed.

The Supplemental Disclosures added to this summary the EBITDA exit multiple ranges for Trulia and Zillow that were implied by the range of terminal values calculated based on J.P. Morgan’s chosen inputs. Plaintiffs argue that, although J.P. Morgan used the perpetuity growth method and only derived the implied EBITDA exit multiples to check the strength of its methodology, the implied multiples were important to stockholders, who would be concerned that the exit multiples for Trulia and Zillow are nearly identical despite differences in their current EBITDA growth rates, and that the exit multiples are much lower than the current EBITDA multiples of Trulia and its peers.

The logic of plaintiffs’ argument is flawed in two respects. First, because the same range of perpetuity growth rates (2.5% to 3.5%) was used to calculate the terminal values for both companies, it should not have been surprising that the implied exit EBITDA multiples would be similar for both companies: 4.0x to 6.7x for Trulia and 4.1x to 6.8x for Zillow. Second, although Trulia’s then-current EBITDA growth rate was high, the exit EBITDA multiples are based on growth assumptions as of 2028, not 2015, and the 2015 growth rate cannot realistically continue through the projection period. Basic principles of valuation suggest that it would be more reasonable to forecast that the growth of both Trulia and Zillow eventually would fall to a market-based rate, making plaintiffs’ comparison to the current growth rates of Trulia and its peers inappropriate. Thus, not only is the supplemental disclosure immaterial, it also serves none of the purposes that plaintiffs allege.

* * * * *

For the reasons explained above, none of plaintiffs’ Supplemental Disclosures were material or even helpful to Trulia’s stockholders. The Proxy already provided a more-than-fair summary of J.P. Morgan’s financial analysis in each of the four respects criticized by the plaintiffs. As such, from the perspective of Trulia’s stockholders, the “give” in the form of the Supplemental Disclosures does not provide adequate consideration to warrant the “give” of providing a release of claims to defendants and their affiliates, in the form submitted or otherwise. Accordingly, I find that the proposed settlement is not fair or reasonable to Trulia’s stockholders.
III. CONCLUSION

For the foregoing reasons, approval of the proposed settlement is DENIED.

IT IS SO ORDERED.

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Notes:


4 “Unknown Claims” were defined as “any claim that a releasing person does not know or suspect exists in his, her or its favor at the time of the release of the Released Claims as against the Released Persons, and at the time of Defendants’ release of Plaintiffs, each and all Class Members, and all Plaintiffs’ counsel from all claims as set forth in Paragraph 9, including without limitation those claims which, if known, might have affected the decision to enter into the Settlement.” Stipulation ¶ 10.

5 Stipulation ¶ 8.


8 See Ct. Ch. R. 23(e). Court of Chancery Rule 23.1(c) similarly requires Court approval of the dismissal or settlement of derivative actions.


11 Rome v. Archer, 197 A.2d at 53.

12 Id.

13 See id.


15 In this Opinion, I use the term “disclosure settlement” to refer to settlements in which the sole or predominant consideration provided to stockholders in exchange for releasing their claims is the dissemination of one or more disclosures to supplement the proxy materials distributed for the purpose of soliciting stockholder approval for a proposed transaction. An example of a disclosure settlement in which the supplemental disclosures would be the predominant but not sole consideration is one that, in addition to supplemental disclosures, includes an insubstantial component of other non-monetary consideration, such as a minor modification to a deal protection measure.


17 Some examples of adjudicated cases of this type arising from acquisitions of public corporations include: In re Rural/Metro Corp. S’holders Litig., 102 A.3d 205, 263 (Del. Ch.2014) (finding after trial that class suffered damages of $91 million, of which the board’s financial advisor was liable for 83%, based on aiding and abetting fiduciary breaches in sale of corporation), aff’d sub nom. RBC Capital Mkts., LLC v. Jervis, 129 A.3d 816, 2015 WL 7721882 (Del. Nov. 30, 2015); In re Dole Food Co., Inc. S’holder Litig., 2015 WL 5052214, at *47 (Del. Ch. Aug. 27, 2015) (finding after trial that certain directors were liable for $148 million in damages, based on fiduciary breaches in going-private transaction); In re Emerging Commc’ns, Inc. S’holders Litig., 2004 WL 1305745, at *43 (Del. Ch. May 3, 2004) (finding after trial that certain defendants were liable to stockholders for damages of $27.80 per share for fiduciary breaches in going-private transaction). See also In re Jeffries Grp., Inc. S’holders Litig., 2015 WL 1414350 (Del. Ch. Mar. 26, 2015) (ORDER) (approving settlement for $70 million (net of attorneys’ fees) to resolve allegations involving conflicts of interest in the sale of Jeffries Group to Leucadia National Corporation); In re Del Monte Foods Co. S’holder Litig., Cons.C.A. No. 6027–VCL, 2011 WL 6008590 (Del. Ch. Dec. 1, 2011) (ORDER) (approving $89 million settlement of stockholder suit alleging fiduciary duty violations in connection with leveraged buy-out).
Stockholder plaintiffs who seek expedition benefit from the most favorable standard available under our law for assessing the merits of a claim—“colorability”—and from the sensible policy of this Court to attempt to resolve disclosure claims before stockholders are asked to vote. See Ortsman v. Green, 2007 WL 702475, at *2 (Del. Ch. Feb. 28, 2007) (granting expedited proceedings because disclosure claims were “colorable” and “[o]nly by remedying proxy deficiencies in advance of a vote can irreparable harm be avoided”); Morton v. Am. Mktg. Indus. Holdgs., Inc., 1995 WL 1791090, at *2–4 (Del. Ch. Oct. 5, 1995) (granting expedition because colorability finding did not require a determination of merits or even legal sufficiency of pleadings, and disclosures must be made before stockholder vote rather than after the fact).


See, e.g., id. at *5 (finding that “a positive result of small therapeutic value to the Class ... can support ... a settlement, but only where what is given up is of minimal value”); In re Dr. Pepper/Seven Up Cos., Inc. ’S’holders Litig., 1996 WL 74214, at *4 (Del. Ch. Feb. 9, 1996) (“[E]ven a meager settlement that affords some benefit for stockholders is adequate to support its approval.”), aff’d, 683 A.2d 58 (Del.1996) (TABLE).

See Ginsburg v. Phila. Stock Exch., Inc., 2007 WL 2982238, at *1 (Del. Ch. Oct. 9, 2007) (“When parties have reached a negotiated settlement, the litigation enters a new and unusual phase where former adversaries join forces to convince the court that their settlement is fair and appropriate.”).

See In re Caremark Int’l Inc. Deriv. Litig., 698 A.2d 959, 961 (Del.Ch.1996) (Allen, C.) (“[I]n most instances, the court is constrained by the absence of a truly adversarial process, since inevitably both sides support the settlement and legally assisted objectors are rare.”); Browning Jeffries, The Plaintiffs’ Lawyer’s Transaction Tax: The New Cost of Doing Business in Public Company Deals, 11 Berkeley Bus. L.J. 55, 59, 89 (2014) (“[D]ue to the agency costs involved in class action litigation and the lack of motivation of any one plaintiff shareholder to monitor class counsel, these fee awards are rarely objected to...”). In the rare case in which objectors are present, the question necessarily becomes whether the objectors represent the interests of the class or instead represent yet another set of interests. See Sean J. Griffith & Alexandra D. Lahav, The Market for Preclusion in Merger Litigation, 66 Vand. L.Rev. 1053, 1084 n.142, 1122 (2013) (noting that in some cases objectors may also be hold-outs demanding a piece of the settlement value).

“Confirmatory” discovery is discovery taken after an agreement-in-principle to settle a case has been reached. Theoretically, it is an opportunity for plaintiffs’ counsel to “confirm” that the settlement terms are reasonable—that is, to probe further the strengths and weaknesses of the claims relative to the consideration for the proposed settlement. In reality, given that plaintiffs’ counsel already have resigned themselves to settle on certain terms, confirmatory discovery rarely leads to a renunciation of the proposed settlement and, instead, engenders activity more reflective of “going through the motions.” See Brinckerhoff v. Tex. E. Prods. Pipeline Co., LLC, 986 A.2d 370, 385 (Del.Ch.2010) (questioning quality of confirmatory discovery process) (“Confirmatory discovery performances ranging from the deferent to the reckless impair, rather than inspire, judicial confidence.”); In re Coleman Co., Inc. ’S’holders Litig., 750 A.2d 1202, 1212 (Del.Ch.1999) (“[C]onfirmatory discovery in settlement situations is hardly the equivalent of adversarial pre-trial discovery.”).

See In re Sauer–Danfoss Inc. ’S’holders Litig., 65 A.3d 1116, 1135–43 (Del.Ch.2011) (discussing disclosure settlements and compiling fee awards in various disclosure-only cases).


See id. at 2–3.

See id. at 6. The percentage of settlements in Delaware based solely on supplemental disclosures was 63.6% in 2013 and 70.6% in 2014. Figures for 2015 appear to be too preliminary to be meaningful.

See generally Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform, 93 Tex. L.Rev. 557 (2015) (proposing that state courts reject disclosure settlements and shift disclosure policing to the federal securities laws). See also J. Travis Laster, A Milder Prescription for the Peppercorn Settlement Problem in Merger Litigation, 93 Tex. L.Rev. See Also 129 (2015) (responding to the Fisch, Griffith & Solomon article, acknowledging similar concerns regarding disclosure settlements, and proposing solutions involving greater judicial scrutiny of claims at motion to expedite stage); Matthew D. Cain & Steven Davidoff
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Solomon, A Great Game: The Dynamics of State Competition and Litigation, 100 Iowa L.Rev. 465 (2015) (examining merger litigation data and theorizing that states seeking to attract corporate litigation award higher fees and dismiss fewer cases); Jeffries, supra note 23 (criticizing disclosure-only settlements and suggesting legislative responses); Griffith & Lahav, supra note 23 (discussing the value for defendants of receiving release through disclosure-only settlements and the potential usefulness of multi-jurisdiction litigation). But see Phillip R. Sumpter, Adjusting Attorneys’ Fee Awards: The Delaware Court of Chancery’s Answer to Incentivizing Meritorious Disclosure–Only Settlements, 15 U. Pa. J. Bus. L. 669 (2013) (arguing that disclosure-only settlements can have value and discussing the concept of awarding of varying levels of fees to encourage or discourage different types of disclosure settlements).

30 Fisch, Griffith & Solomon, supra note 29, at 582–87.


34 See Friedlander, supra note 31, at 16–22. The paper also examines litigation over the sale of Prime Hospitality Corporation, which settled for $25 million after a disclosure settlement was rejected and new counsel was appointed to litigate the case. See id. at 11–14.

35 See, e.g., Acevedo v. Aeroflex Hldg. Corp., C.A. No. 9730–VCL, at 60–79, 2015 WL 4127547 (Del. Ch. July 8, 2015) (TRANSCRIPT) (rejecting settlement because relief obtained was insufficient to support a broad release, and giving the option to reapply with a release tailored only to the Delaware disclosure and fiduciary claims investigated by plaintiffs); In re Riverbed Tech., 2015 WL 5458041, at *3–6 (approving settlement, but expressing concerns over agency problems, lack of adversarial presentation, limited benefit conferred by disclosures, and noting that broad releases may not be approved going forward); In re InterMune, Inc. S’holder Litig., C.A. No. 10086–VCN (Del. Ch. July 8, 2015) (TRANSCRIPT) (deferring decision on a disclosure settlement and questioning whether the releases should be limited only to disclosure claims) (settlement later approved in C.A. No. 10086–VCN, 2015 WL 9481182 (Del. Ch. Dec. 29, 2015) (TRANSCRIPT)); In re TW Telecom, Inc. S’holders Litig., C.A. No. 9845–CB (Del. Ch. Aug. 20, 2015) (TRANSCRIPT) (approving a settlement “somewhat reluctantly” while opining that settlements going forward will receive more scrutiny and that all but one disclosure obtained had “no consequential value”).

36 See, e.g., In re Allied Healthcare S’holder Litig., 49 Misc.3d 1210(A), 2015 WL 6499467, at *2 (N.Y.Sup.Ct. Oct. 23, 2015) (rejecting a settlement and expressing concern that “in the area of derivative litigation, a culture has developed that results in cases of relatively worthless settlements (derivative actions are rarely tried to a verdict) that discontinue the action (with releases) resulting in the corporate defendants not opposing an agreed upon legal fee to class counsel”); City Trading Fund v. Nye, 46 Misc.3d 1206(A), 2015 WL 93894 (N.Y.Sup.Ct. Jan. 7, 2015) (rejecting a settlement the court regarded as exceptionally frivolous and noting that the nature of “merger tax suits” incentivizes settlement regardless of a case’s frivolity).


38 Id. (quoting Arnold v. Soc’y for Sav. Bancorp, Inc., 650 A.2d 1270, 1277 (Del.1994)).

39 If defendants do not oppose a mootness fee application, then the Court presumably would not have the benefit of any opposing position when considering the application unless an objector appeared. But, in that case, the Court would have some indication of the reasonableness of the fee request.


41 That jurisprudence includes the Delaware Supreme Court’s recent express confirmation that “the business judgment rule is invoked as the appropriate standard of review for a post-closing damages action when a merger that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders.” Corwin v. KKR Fin. Hldgs. LLC, 125 A.3d 304, 305–06 (Del.2015).

In this case, because the disputed transaction involved a stock-for-stock merger of widely held, publicly traded corporations, plaintiffs’ claims presumably would not benefit from the enhanced scrutiny of Revlon and instead would need to overcome the business judgment presumption. Paramount Commc’ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 46–47 (Del.1994) (quoting Paramount Commc’ns Inc. v. Time Inc., 1989 WL 79880, at *23 (Del. Ch. July 14, 1989), aff’d, 571 A.2d 1140 (Del.1989)).

42 See, e.g., In re Family Dollar Stores, Inc. S’holder Litig., C.A. No. 9985–CB, 2015 WL 4642210 (Del. Ch. Aug. 4, 2015) (ORDER) (dismissing case with prejudice to plaintiffs and without prejudice to class, where supplemental disclosures had
mooted certain claims, and setting schedule for mootness fee application); *In re Zalicus, Inc. S’holder Litig.*, C.A. No. 9602–CB (Del. Ch. Nov. 12, 2014) (ORDER) (dismissing action without prejudice after defendants had mooted certain disclosure claims, and setting schedule for mootness fee application).


43 See, e.g., *Swomley v. Schlecht*, 2015 WL 1186126, at *1–2 (Del. Ch. Mar. 12, 2015) (setting forth class notice procedure for mootness fee, after defendants mooted certain disclosure claims and successfully moved to dismiss rest of case); *In re Zalicus*, 2015 WL 226109, at *1–2 (supporting private mootness fee resolution procedure while requiring that adequate notice be provided to stockholders); *Astex Pharm., Inc. S’holders Litig.*, 2014 WL 4180342, at *1–2 (Del. Ch. Aug. 25, 2014) (same).

44 In contrast to the settlement context, the Court does not need to weigh the “give” of the supplemental disclosures against the “take” of a release when determining whether to grant an award of fees in the mootness fee scenario discussed above. Accordingly, an award of fees in the mootness fee scenario may be appropriate for supplemental disclosures of less significance than would be necessary to sustain approval of a settlement. The amount of the fee in the mootness scenario, however, would be commensurate with the value of the benefit conferred. Thus, for example, a supplemental disclosure of nominal value would warrant only a nominal fee award.

45 See *Hoffman v. Dann*, 205 A.2d 343, 345 (Del.1964) (noting that “the Chancellor appointed an amicus curiae to report to him on the relevant issues to be tendered at the hearing on the proposed settlement, and as to proof which would be of assistance to him in passing on the fairness of the settlement.”). The costs of the *amicus curiae* may be taxed to the parties, as appropriate, in the Court’s discretion. See 3B C.J.S. Amicus Curiae § 6 (“Where the court appoints an amicus curiae who renders services which prove beneficial to the solution of the question presented, the court may properly award compensation and direct it to be paid by the party responsible for the situation that prompted the court to make the appointment.”). Cf. *Chapin v. Benwood Found., Inc.*, 1977 WL 2583, at *1 (Del. Ch. June 28, 1977) (describing appointment of individual trustee defendant as *amicus curiae* with costs paid by defendant corporation, as agreed by the parties). Scholars have proposed a similar solution in which the Court may “appoint an objector as a kind of guardian ad litem for the class.” See *Griffith & Lahav, supra* note 23, at 1122 n.309 (compiling sources for proposal).


50 Proxy at 118.


52 Id.

53 See, e.g., *In re Netsmart Techs., Inc. S’holders Litig.*, 924 A.2d 171, 203–04 (Del. Ch.2007) (“[W]hen a banker’s endorsement of the fairness of a transaction is touted to shareholders, the valuation methods used to arrive at that opinion as well as the key inputs and range of ultimate values generated by those analyses must also be fairly disclosed.”).

54 See, e.g., *In re Micromet, Inc. S’holders Litig.*, 2012 WL 681785, at *11 (Del. Ch. Feb. 29, 2012) (rejecting claim that the board failed to disclose underlying assumptions and bases for probabilities of success of clinical trial drugs) (“Stockholders are entitled to a fair summary of the substantive work performed by the investment bankers, but Delaware courts have repeatedly held that a board need not disclose specific details of the analysis underlying a financial advisor’s opinion.”) (internal quotation marks omitted); *In re Cogent, Inc. S’holder Litig.*, 7 A.3d 487, 511 (Del. Ch.2010) (holding stockholders are entitled to fair summary, but not to minutiae, and rejecting requests for additional disclosures); *Ryan v. Lyondell Chem. Co.*, 2008 WL 2923427, at *20 & n. 120 (Del. Ch. July 29, 2008) (finding that fair summary did not require disclosure of all projections, as long as it disclosed description of valuation exercises, key assumptions, and range of values generated; but noting that the failure to disclose that the financial advisor used a significantly higher WACC in its calculation than management’s WACC estimate, even when it was using management’s other financial projections, could constitute a disclosure violation), rev’d on other grounds, 970 A.2d 235 (Del.2009). See also *David P. Simonetti Rollover IRA v.*
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Margolis, 2008 WL 5048692, at *9–10 (Del. Ch. June 27, 2008) (distinguishing Pure Resources as a case in which a proxy statement was deficient because it did not disclose “any substantive portions of the bankers’ work”) (internal quotation marks omitted); In re MONY Grp. Inc. S’holder Litig., 852 A.2d 9, 28 (Del. Ch.2004) (“The plain meaning of ‘summary’ belies the Stockholders’ interpretation.”).

57 See Globis P’rs, L.P. v. Plumtree Software, Inc., 2007 WL 4292024, at *12–13 (Del. Ch. Nov. 30, 2007) (rejecting disclosure claims for various details that may have been helpful in determining accuracy of analysis) (“Delaware law does not require disclosure of all the data underlying a fairness opinion such that a shareholder can make an independent determination of value.”); In re Gen. Motors (Hughes) S’holder Litig., 2005 WL 1089021, at *16 (Del. Ch. May 4, 2005) (rejecting claim for information that would amount to “the raw data behind the advisors’ updated summaries”) (“A disclosure that does not include all financial data needed to make an independent determination of fair value is not, however, per se misleading or omitting a material fact. The fact that the financial advisors may have considered certain non-disclosed information does not alter this analysis.”), aff’d, 897 A.2d 162 (Del.2006).

One important qualification bears mention. Although management projections and internal forecasts are not per se necessary for a fair summary, this Court has placed special importance on this information because it may contain unique insights into the value of the company that cannot be obtained elsewhere. See In re Netsmart Techs., 924 A.2d at 203 (noting that management projections can be important because management can have “meaningful insight into their firms’ futures that the market [does] not”).

58 See In re 3Com S’holders Litig., 2009 WL 5173804, at *2–3 (Del. Ch. Dec. 18, 2009) (rejecting claim for omission of financial projections because “an adequate and fair summary of the work performed by [the advisor] [was] included in the proxy”); In re CheckFree Corp. S’holders Litig., 2007 WL 3262188, at *3 (Del. Ch. Nov. 1, 2007) (distinguishing Netsmart and rejecting disclosure claim based on omission of management financial projections, because proxy statement fairly summarized financial advisor’s methods and conclusions); In re Pure Res., 808 A.2d at 449 (noting in fair summary discussion that stockholders would find it material to know the advisor’s basic valuation exercises, key assumptions of those exercises, and range of values produced).


60 Supplemental Disclosures at 5–6.

61 Pls.’ Br. Supp. Proposed Settlement at 23 (citing Proxy at 103 (noting that the synergies “are expected to be at least $100 million in annualized cost savings by 2016”)).

62 Id. at 23–24.

63 Proxy at 130, 132.

64 Plaintiffs’ counsel was not aware that this information already was disclosed in the Proxy until the Court pointed it out at the settlement hearing. See Hr’g Tr. 12–15, Sept. 16, 2015. If the proposed settlement had been opposed, this fact presumably would have been brought to the attention of plaintiffs and the Court.

65 Proxy at 123.

66 For instance, the Supplemental Disclosures refer to the expected synergies after 2016 as extrapolations through 2029 based on management’s assumptions. But the table in the Proxy, produced above, notes that management provided assumptions regarding synergies through 2024. Plaintiffs do not address this ambiguity.

67 Proxy at 131–32.

68 Hr’g Tr. 15, Sept. 16, 2015.

69 Proxy at 129–30.

70 Id. at 130.

71 In one case, the publicly available multiple was not included because it exceeded 100x and thus was not considered meaningful. Supplemental Disclosures at 5.

72 In re Gen. Motors (Hughes), 2005 WL 1089021, at *16.

73 852 A.2d 9 (Del. Ch.2004).

74 Id. at 28.

75 Proxy at 125–26.
Meinhart, plaintiffs’ expert, points out that not all stockholders can access all of this information because some of the forward-looking data are available only from proprietary fee-based services. It may be correct that not all of these data would be freely or easily obtainable. A fair summary, however, does not require disclosure of sufficient data to allow stockholders to perform their own valuation. And it certainly does not require disclosure of underlying data that stockholders could obtain on their own, even if doing so would involve some cost or investment of time. Meinhart also opines that the multiples show a high level of dispersion, but he fails to explain how that information undermines J.P. Morgan’s analysis or is otherwise informative considering that J.P. Morgan explicitly stated that its analysis was not strictly quantitative in nature. See Proxy at 126–27 (“J.P. Morgan did not rely solely on the quantitative results.... Based on various judgments concerning relative comparability of each of the selected companies to Trulia, as well its experience with the industry ... J.P. Morgan selected a range of revenue and Adjusted EBITDA multiples that it believed reflected an appropriate range of multiples applicable to Trulia.”).

80 See In re Celera Corp., 2012 WL 1020471, at *32.

81 See id. The supplemental disclosure in Celera added more categories of summary data, namely the high, low, median, and mean multiples. This distinction is immaterial. The point of a fair summary is to summarize the methodologies and assumptions the financial advisor used in its analysis. Here, the Proxy fairly summarizes J.P. Morgan’s use of multiples in its trading multiples analysis.

82 Plaintiffs also rely on a transcript ruling in Turberg v. ArcSight, C.A. No. 5821–VCL, 2011 WL 9535204 (Del. Ch. Sept. 20, 2011) (TRANSCRIPT). As in Celera, the initial description in ArcSight did not have any multiples at all. The plaintiff obtained a full description of the analysis comparable to the depiction that would appear in a board book. The Court praised that disclosure in the context of a non-adversarial presentation regarding settlement approval. The case is distinguishable because, unlike here, no summary multiples were initially provided to stockholders.

83 Joshua Rosenbaum & Joshua Pearl, Investment Banking: Valuation, Leveraged Buyouts, and Mergers & Acquisitions 19 (2009) (“A company’s growth profile, as determined by its historical and estimated future financial performance, is an important driver of valuation. Equity investors reward high growth companies with higher trading multiples than slower growing peers.”).

84 See Proxy at 127.

85 See id. at 108, 122, 127.


87 Id. at 26 (noting Trulia’s expected EBITDA growth rate of 148% and the “decided correlation between higher growth rates and higher valuation multiples”). Were Trulia able to retain this impressive EBITDA growth rate for the entire forecast period, its 2028 EBITDA would amount to nearly $10 trillion, more than half the current GDP of the United States.

88 See Rosenbaum & Pearl, supra note 83, at 132 (“The perpetuity growth rate is typically chosen on the basis of the company’s expected long-term industry growth rate, which generally tends to be within a range of 2% to 4% (i.e., nominal GDP growth).”).

89 As noted above, after the settlement hearing, the parties commendably agreed to narrow the release to exclude “Unknown Claims,” foreign claims, and claims arising under state or federal antitrust law. Nevertheless, even if the Supplemental Disclosures had provided sufficient consideration to warrant the “give” of a release of claims, which they did not, the scope of the revised release still would have been too broad to support a fair and reasonable settlement because the revised release was not limited to disclosure claims and fiduciary duty claims concerning the decision to enter the merger.

90 Because I reject the proposed settlement, I do not address the issue of class certification, although stockholder classes in cases such as this are typically certified.
In merger litigation the terms “strike suit” and “deal litigation” refer disapprovingly to cases in which a large public company announces an agreement that requires shareholder approval to acquire another large company, and a suit, often a class action, is filed on behalf of shareholders of one of the companies for the sole purpose of obtaining fees for the plaintiffs’ counsel. Often the suit asks primarily or even exclusively for disclosure of details of the proposed transaction that could, in principle at least, affect shareholder approval of the transaction. But almost all such suits are designed to end—and very quickly too—in a settlement in which class counsel receive fees and the shareholders receive additional disclosures concerning the proposed transaction. The disclosures may be largely or even entirely worthless to the shareholders, in which event even a modest award of attorneys’ fees ($370,000 in this case) is excessive and the settlement should therefore be disapproved by the district judge. In this case, however, the district judge approved the settlement, including a narrow release of claims and the fee for the plaintiff’s lawyers that the company had agreed not to oppose. A shareholder named Berlau, having objected unsuccessfully to the settlement in the district court, has appealed.

In 2012 Walgreen Co. (usually referred to as “Walgreens”) acquired a 45 percent equity stake in a Swiss company named Alliance Boots GmbH, plus an option to acquire the rest of Alliance’s equity, beginning in February 2015, for a mixture of cash and Walgreens stock. In 2014 the two companies altered the deal to allow the option to be exercised earlier. Walgreens announced its intent to purchase the remainder of Alliance Boots and then engineer a reorganization whereby Walgreens (having swallowed Alliance Boots) would become a wholly owned subsidiary of a new Delaware corporation to be called Walgreens Boots Alliance, Inc. Within two weeks after Walgreens filed a proxy statement seeking shareholder approval of the reorganization, the inevitable class action was filed, and 18 days later—less than a week before the shareholder vote—the parties agreed to settle the suit.

The suit sought additional disclosures to the shareholders, disclosures alleged to be likely to affect the shareholder vote. The settlement required Walgreens to issue several of the disclosures to the shareholders—that was the entire benefit of the settlement to the class—and released the company from liability for the other disclosure-related claims made in the suit. It also authorized class counsel to ask the district judge to award them $370,000 in attorneys’ fees, without opposition from Walgreens.

The disclosures agreed to in the settlement (the parties call these the supplemental disclosures, as shall we) represented only a trivial addition to the extensive disclosures already made in the proxy statement: fewer than 800 new words—resulting in less than a 1 percent increase—spread over six disclosures.

The supplemental disclosure deemed most significant by class counsel concerned the nomination to the board of directors of Walgreens of Barry Rosenstein, who was involved in a hedge fund that had a 1.5 percent interest in Walgreens stock. The disclosure states that before his nomination he had “engaged in...”

1 Of the Southern District of Illinois, sitting by designation. Judge Yandle dissents from the panel’s decision. Her dissent will be issued separately in due course.
preliminary discussions [with Walgreens] during which [he had] expressed his views regarding Walgreens and its strategic direction and prospects,” that Walgreens had entered into a confidentiality agreement with Rosenstein’s firm, and that there had been further consultations ending in Walgreens’ concluding “that Mr. Rosenstein would be a valuable addition to the Board” of Walgreens Boots Alliance.

The new disclosure was worthless because it was and is obvious that Walgreens would not nominate a person for election to its board of directors without discussing with the prospective nominee the company’s strategic direction and prospects. The only new thing to be gleaned from the disclosure related to the timing of the conversations. Rosenstein had been nominated on September 5, 2014, and the disclosure indicated that there had been conversations stretching back at least a month. But even without that revelation, the shareholders would have assumed that Rosenstein’s appointment to the board had not happened overnight, and the disclosure revealed no further details about the period or content of the pre-nomination consultations.

A second supplemental disclosure concerned the allocation of stock in Walgreens Boots Alliance to two investment groups, SP Investors and KKR Investors, after the merger. The disclosure estimated that SP Investors would have about 11.3 percent of the shares and KKR Investors about 4.6 percent. But as these estimates could be derived by simple arithmetic from data in the proxy statement, the disclosure added nothing. See, e.g., Werner v. Werner, 267 F.3d 288, 299–300 (3d Cir. 2001).

Supplemental disclosure number three: in 2014, shortly before Walgreens and Alliance decided to merge, Walgreens’ executive vice president and chief financial officer and president of its international division, Wade D. Miquelon, had resigned from the company and sued it for defamation. The proxy statement did not mention Miquelon’s resignation or his suit; the supplemental disclosure listed the claims made in his suit and said that Walgreens had denied them. There was no suggestion that the suit (seven of the nine counts of which were dismissed in 2015) could have had a significant impact on the formation or operation of Walgreens Boots Alliance, or that it was even related to the formation of the new company.

Supplemental disclosure number four: The proxy statement included a bullet-point list of risk factors that the Walgreens board had considered in deciding whether to merge with Alliance Boots. The supplemental disclosure added four to the list—but all were based on language found in the proxy statement. The additional disclosure provided no new information to shareholders.

Supplemental disclosure five: The proxy statement noted that Stefano Pessina, who was designated to become CEO of Walgreens Boots Alliance and had interests in Alliance Boots resulting from his affiliation with SP Investors had, along with one other member of Walgreens’ board, not voted on whether to approve the merger. The supplemental disclosure explained that “as a result of their interest in the proposed transaction” the two had recused themselves from the Board’s decision to exercise Walgreens’ option to buy the rest of Alliance Boots. The supplemental disclosure merely stated the reason they’d not voted, and there is nothing to suggest that the disclosure of that reason could have upended the merger. And their recusal from voting on the reorganization because of their financial interest in it had been highlighted elsewhere in the proxy statement. Class counsel argues that the disclosure revealed that the two board members also had not participated in discussions leading up to the shareholder vote, but the disclosure does not say that.

Supplemental disclosure number six, the last supplemental disclosure, also concerns Pessina. According to a public filing, he had been appointed acting CEO of the new entity because of his “extensive leadership experience and knowledge of Walgreens and Alliance Boots.” The statement went on to list previous positions he’d held, and boards he’d sat on. The supplemental disclosure embroidered the enumeration of Pessina’s qualifications by remarking that among the “factors” that the board had considered were his “considerable knowledge of the industries in which both Walgreens and Alliance Boots operate, his familiarity with both . . . businesses and leadership teams and his international experience and background in managing global businesses.” This was frosting on the cake—the cake consisting of the detailed enumeration in the public filing of his business history. And to be told that the board considered “a number of factors” was to be told nothing.

The reorganization that ratified Walgreens Boots Alliance was approved by 97 percent of the Walgreens shareholders who voted. It is inconceivable that the six disclosures added by the settlement agreement either reduced support for the merger by frightening the shareholders or increased that support by giving the shareholders a sense that now they knew everything. This conclusion is supported by recent empirical work which shows that there is little reason to believe that disclosure-only settlements ever affect shareholder voting. Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, “Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform,” 93 Tex. L. Rev. 557, 561, 582–91 (2015). The value of the disclosures in this case appears to have been nil. The $370,000 paid class counsel—pennies to Walgreens, amounting to 0.039 cents per share at the time of the merger—bought
nothing of value for the shareholders, though it spared the new company having to defend itself against a meritless suit to void the shareholder vote.

In deciding whether to approve a class settlement, a court must consider whether the agreement benefits class members. See Crawford v. Equifax Payment Services, Inc., 201 F.3d 877, 882 (7th Cir. 2000). Disclosures are meaningful only if they can be expected to affect the votes of a nontrivial fraction of the shareholders, implying that shareholders found the disclosures informative. As explained by the Supreme Court in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976), “an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . What th[is] standard . . . contemplate[s] is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.” Id. (emphasis added). Cf. Thomas Hazen, 2 Law of Securities Regulation § 9:19 (7th ed. 2016). The supplemental disclosures in this case did not do that; they contained no new information that a reasonable investor would have found significant. It is not to be believed that had it not been for those disclosures, not 97 percent of the shareholders would have voted for the reorganization but 100 percent or 99 percent or 98 percent.

In Eubank v. Pella Corp., 753 F.3d 718, 720 (7th Cir. 2014), we “remarked the incentive of class counsel, in complicity with the defendant’s counsel, to sell out the class by agreeing with the defendant to recommend that the judge approve a settlement involving a meager recovery for the class but generous compensation for the lawyers—the deal that promotes the self-interest of both class counsel and the defendant and is therefore optimal from the standpoint of their private interests.” Except that in this case the benefit for the class was not meager; it was nonexistent. The type of class action illustrated by this case—the class action that yields fees for class counsel and nothing for the class—is no better than a racket. It must end. No class action settlement that yields zero benefits for the class should be approved, and a class action that seeks only worthless benefits for the class should be dismissed out of hand. See, e.g., Robert F. Booth Trust v. Crowley, 687 F.3d 314, 319 (7th Cir. 2012).

The district judge approved the settlement agreement—but with misgivings. She remarked that “in the future, especially if there are issues like this [financial issues concerning a $15 billion transaction], hearing from someone who’s not a lawyer who could explain to me that it [she meant the supplemental disclosures] mattered would have been very, very helpful.” She could of course have appointed her own expert to explain the significance (or rather lack thereof) of the supplemental disclosures, see Fed. R. Evid. 706, and she should have done that given her doubts about the lawyers’ explanations.

She went on to say that she’d “been persuaded that at least the following supplemental disclosures may have mattered to a reasonable investor” (emphasis added). “May have” is not good enough. Possibility is not actuality or even probability. The question the judge had to answer was not whether the disclosures may have mattered, but whether they would be likely to matter to a reasonable investor. She did list the supplemental disclosures that she thought “may have mattered,” but it was a bare list, devoid of meaningful explanation of why they may have mattered (let alone why they did matter)—with just one exception. Regarding the supplemental disclosure concerning Miquelon’s lawsuit, the judge said that although “somewhat skeptical” of its importance she had been convinced by class counsel that “it isn’t a frivolous point and may well have alerted investors to issues they would have otherwise ignored about turmoil in the company.” But keeping in mind the size of the transaction to which the disclosures were supposed to pertain, a bare assumption that Miquelon’s lawsuit would cause or signal “turmoil” that would deter the stockholders from voting for the creation of Walgreens Boots Alliance was too farfetched to be credited on the basis of the lawyers’ self-interested say so, with no inquiry into the likely effect of the suit on the transaction.

The district judge was handicapped by lack of guidance for judging the significance of the disclosures to which the parties had agreed in order to settle the class action at nominal cost to the defendant (because class counsel’s fees were small potatoes to the giant new company and the disclosures irrelevant to the shareholders and thus incapable of preventing the reorganization) and sweet fees for class counsel, who devoted less than a month to the litigation, a month’s activity that produced no value.

Delaware’s Court of Chancery sees many more cases involving large transactions by public companies than the federal courts of our circuit do, and so we should heed the recent retraction by a judge of that court of the court’s “willingness in the past to approve disclosure settlements of marginal value and to routinely grant broad releases to defendants and six-figure fees to plaintiffs’ counsel in the process.” The result has been to “cause[ ] deal litigation to explode in the United States beyond the realm of reason. In just the past decade, the percentage of transactions of $100 million or more that have triggered stockholder litigation in this country has more than doubled, from 39.3% in 2005 to a peak of 94.9% in 2014.” In re Trulia, Inc. Stockholder Litigation, 129 A.3d 884, 894 (Del. Ch. 2016).

And so Trulia adopted a clearer standard for the approval of such settlements, id. at 898–99 (footnotes omitted, emphasis added), which we endorse, and apply in this case:
Returning to the historically trodden but suboptimal path of seeking to resolve disclosure claims in deal litigation through a Court-approved settlement, practitioners should expect that the Court will continue to be increasingly vigilant in applying its independent judgment to its case-by-case assessment of the reasonableness of the “give” and “get” of such settlements in light of the concerns discussed above. To be more specific, practitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently. In using the term “plainly material,” I mean that it should not be a close call that the supplemental information is material as that term is defined under Delaware law. Where the supplemental information is not plainly material, it may be appropriate for the Court to appoint an amicus curiae to assist the Court in its evaluation of the alleged benefits of the supplemental disclosures, given the challenges posed by the non-adversarial nature of the typical disclosure settlement hearing.

We’ve italicized the key term in the quoted passage: the misrepresentation or omission that the supplemental disclosures correct must be “plainly material,” cf. Appert v. Morgan Stanley Dean Witter, Inc., 673 F.3d 609, 616–17 (7th Cir. 2012), as they were not in this case. If immaterial their correction does nothing for the shareholders. And we add that it’s not enough that the disclosures address the misrepresentation or omissions: they must correct them. Neither requirement was satisfied in this case.

A class “representative who proposes that high transaction costs (notice and attorneys’ fees) be incurred at the class members’ expense to obtain [no benefit] . . . is not adequately protecting the class members’ interests.” In re Aqua Dots Products Liability Litigation, 654 F.3d 748, 752 (7th Cir. 2011). Courts also have “a continuing duty in a class action case to scrutinize the class attorney to see that he or she is adequately protecting the interests of the class, and if at any time the trial court realizes that class counsel should be disqualified, the court is required to take appropriate action.” In re Revlon, Inc. Shareholders Litigation, 990 A.2d 940, 955 (Del. Ch. 2010) (quoting 4 Newberg on Class Actions § 13:22, at 417 (2002)).

The oddity of this case is the absence of any indication that members of the class have an interest in challenging the reorganization that has created Walgreens Boots Alliance. The only concrete interest suggested by this litigation is an interest in attorneys’ fees, which of course accrue solely to class counsel and not to any class members. Certainly class counsel, if one may judge from their performance in this litigation, can’t be trusted to represent the interests of the class. Because the settlement can’t be approved, we reverse the district court’s judgment. And since class counsel has failed to represent the class fairly and adequately, as required by Federal Rule of Civil Procedure 23(g)(1)(B) and (g)(4), the district court on remand should give serious consideration to either appointing new class counsel, cf. Fed. R. Civ. P. 23(g)(1), or dismissing the suit. Cf. Robert F. Booth Trust v. Crowley, supra, 687 F.3d at 319.

Reversed and Remanded, with Directions.
Chapter 7B

Participation Claims—ORS 59.115(3)

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Keith Ketterling
Stoll Berne
NWSI – May 19, 2017

Berjac Class Action/Aequitas Class Action

- Elements of 59.115(3) Participation Claims
- Cox v Holcomb Decision – Oregon State Court
- Aequitas Class Action F&Rs – Oregon Federal Court
- Comparison of Scope of Cox/Aequitas
ORS 59.115(3) Claim Elements - Participation

In order to assert a valid claim under ORS 59.115(3), must allege the following elements to prove the claim:

1. Seller sold a security to the plaintiff, AND
2. The sale by Seller to the plaintiff was made:
   a. In violation of ORS 59.135(1)
   b. In violation of ORS 59.135(3); OR
   c. By means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, the plaintiff not knowing of the untruth or omission; AND
3. Defendant (Non-Seller) participated or materially aided in the sale to the plaintiffs.

Oregon Participation Cases

- **Gonia v. EI Hagen Co**
  - Non-seller visited prospective purchasers with a rep of the seller re sale

- **Adamson v. Lang**
  - Non-seller’s loan specifically to facilitate the sale/offerer

- **Black & Co. v. Nova-Tech, Inc.**
  - Lawyer prepared legal papers to complete sale/offerer

- **Adams v. American Western Securities, Inc.**
  - Lawyer prepared docs for sale/offerer and filed documents to register securities
Oregon Participation Cases

- **Ainslie v. First Interstate Bank**
  - Non-seller participated in **sale/offering** by holding and distributing proceeds in escrow

- **Prince v. Brydon**
  - Lawyer prepared offering statement for **sale/offering** of securities and legal documents necessary to create the entity for which the securities were sold

- **McDonough v. Jones**
  - Defendant authorized seller, in connection with **sale/offering** of securities, to make specific reps re financial condition, validity and safety of notes

- **Ainslie v. Spoylar**
  - Lawyer prepared docs and was deeply involved in **sale/offering**

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Cox v Holcomb Opinion

- Banks provided LOCs to Berjac entities

- Umpqua and PCB – Participants for roles in facilitating on going business of Berjac through lines of credit

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STOLL BERNE
Plaintiffs’ Berjac Argument

- Plaintiffs’ Argument:
  - No requirement of participation or material aid in a SALE
  - Only need participation in the MEANS or SCHEME
  - “The important thing is to evaluate the means . . . [leading to sales], and then evaluate . . . participation or material aid in those means [or scheme].” Ps’Brief, p 46

- 59.115(3): “Every person who participates or materially aids in the SALE is also liable.”

- Plaintiffs: “Every person who participates or materially aids in the MEANS OR SCHEME is also liable.”

Scheme Liability Addressed Elsewhere

- Control Persons
  - Liability under 59.115(3): Every person who directly or indirectly CONTROLS a seller is liable
  - Participation in SALE not required
  - Control persons face SCHEME liability

- Participants/Material Aiders
  - No scheme liability under 59.115(3)
  - Scheme liability under common law for aiding and abetting a fraud or fraudulent scheme
  - There is liability for participation in a scheme—just not under 59.115(3)
Aequitas Class Action F&Rs

- Judge Acosta – on appeal to Judge Mosman
- Summary of ruling – Participation in sale or facilitating offerings
- Lawyers – Sidley and Tonkon – Participants for roles in PPMs, Investment Adviser advice
- Accountants – Deloitte and Eisner – Participants for roles in audits and allowing names in PPMs
- Integrity Bank – Participant for role in marketing AEQ to customers
- TD Ameritrade – Participant for role in referral network and hosting meetings

Berjac – Aequitas Comparison

- **Berjac** – Arguably a broader reach
- Liability as Participant for participation in a SCHEME

- **Aequitas** – Arguably a more narrow reach
- Follows Oregon State Court law decisions
- Participation in the SALE/OFFERING not the SCHEME
IN THE CIRCUIT COURT OF THE STATE OF OREGON
FOR THE COUNTY OF MULTNOMAH

CHARLENE SUE COX, TRUSTEE OF CHARLENE SUE COX REVOCABLE TRUST DATED 10-9-08. et al. Case No. 1308-12201

v.

HOLCOMB FAMILY LIMITED PARTNERSHIP, et al.
ORDER ON DEFENDANTS’ MOTIONS TO DISMISS OR MAKE MORE DEFINITE AND CERTAIN

Defendants Umpqua Bank, Pacific Continental Bank, Jones & Roth, and Fred “Jack” Holcomb have filed motions to dismiss and, alternatively, motions to make the complaint more definite and certain. After considering the arguments of the parties, the court rules as set forth below.

I. STANDARD FOR MOTIONS TO DISMISS UNDER ORCP 21 A(8) AND (9)

Defendants move to dismiss under ORCP 21 A(8), which permits a motion to dismiss a complaint for “failure to state ultimate facts sufficient to constitute a claim.” Defendants also move to dismiss under ORCP 21 A(9) on the ground that the complaint “shows that the action has not been commenced within the time limited by statute” “In determining the sufficiency of plaintiff’s complaint, [the court] accept[s] as true all well-pled allegations in the complaint and give[s] plaintiff the benefit of all favorable inferences that may be drawn from the facts alleged.” Granewich v. Harding, 329 Or 47, 51, 985 P2d 788, 791 (1999).
II. **CLAIM ONE – ORS 59.115(1)(b)**

In Claim One, plaintiffs allege an Oregon securities law violation under ORS 59.115(l)(b). That statute provides as follows:

(1) A person is liable as provided in subsection (2) of this section to a purchaser of a security if the person:

* * *

(b) Sells or successfully solicits the sale of a security in violation of ORS 59.135 (1) or (3) or by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

Plaintiffs concede that they also rely on ORS 59.115(3), although they don’t specifically allege it in the complaint. That statute provides:

(3) Every person who directly or indirectly controls a seller liable under subsection (1) of this section, every partner, limited liability company manager, including a member who is a manager, officer or director of such seller, every person occupying a similar status or performing similar functions, and every person who participates or materially aids in the sale is also liable jointly and severally with and to the same extent as the seller, unless the nonseller sustains the burden of proof that the nonseller did not know, and, in the exercise of reasonable care, could not have known, of the existence of facts on which the liability is based. Any person held liable under this section shall be entitled to contribution from those jointly and severally liable with that person.

A. **Participates or Materially Aids Under ORS 59.115(3)**

The Oregon Supreme Court has repeatedly held that Oregon’s Blue Sky Law, “including ORS 59.115, is to be ‘liberally construed to afford the greatest possible protection to the public.’” *Adams v. American Western Securities*, 265 Or 514, 524, 510 P2d 838 (1973); see also *Adamson v. Lang*, 236 Or 511, 516, 389 P2d 39 (1964)); *Spears v. Lawrence Sec., Inc.*, 239 Or 583, 587, 399 P2d 348 (1965); *Gonia v. E.I. Hagen Co.*, 251 Or 1, 3, 443 P2d 634 (1968).
Under ORS 59.115(3), “the liability of the nonseller participant * * * is predicated on the violation of the seller.” *Anderson v. Carden,* 146 Or App 675, 683, 934 P2d 562, 566 (1997) (citing *Computer Concepts, Inc. v. Brandt,* 137 Or App 572, 905 P2d 1177 (1995)). “The nonseller participant becomes liable under ORS 59.115(3) because it has participated or materially aided “in the sale,¹ not because it has violated any law.” *Id; see also Houston v. Seward & Kissel, LLP,* No. 07CV6305HB, 2008 WL 818745, at *7 (SDNY Mar 27, 2008) (“ORS § 59.115(3) does not establish a standard of conduct; it merely expands the class of potentially liable persons from whom damages may be obtained for a seller’s violation of the securities laws). Thus, “it is incorrect to say that one may be sued for a “violation” of ORS 59.115(3); one may be sued under ORS 59.115(3) for participating in a sale of securities that occurred in violation of one of the substantive provisions of the Oregon Securities Laws * * *[.]” *Anderson,* 146 Or App at 683. “Therefore, if a complaint sufficiently pleads primary liability, it need only allege sufficient facts to establish that the nonseller defendant participated or materially aided in the sale or controlled the seller.” *Alcantar v. MML Investors Servs., Inc.,* No. CIV 08-041-MO, 2008 WL 2570938, at *5 (D Or June 25, 2008).

As used in ORS 59.115(3), “‘[p]articipate’ and ‘materially aids’ are separate concepts, not synonyms.” *Prince v. Brydon,* 307 Or 146, 149, 764 P.2d 1370 (1988). “A person may participate without materially aiding or materially aid without participating.” *Id.*

Whether a defendant participated or materially aided in the sale “depends on the importance of one’s personal contribution to the transaction.” *Id.* “The cases have emphasized that liability as a participant or a provider of material aid depends on the extent and importance

¹ A “sale” is defined in ORS 59.015(17)(a) to “include[] every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value.”

“[S]omething more than mere preparation and execution of documents is required to find liability for “participating” or “materially aiding” under the statute. *Fakhrdai v. Mason*, 72 Or App 681, 684, 696 P.2d 1164, 1166 (1985). “Typing, reproducing, and delivering sales documents may all be essential to a sale, but they could be performed by anyone[.]” *Prince*, 307 Or at 149.

However, the preparation of documents without which the “sale would and could not have been completed or consummated” constitute evidence from which a jury could find that the defendant “participated or materially aided” in the illegal sale of a security. *Fakhrdai*, 72 Or App at 686. “[I]t is a drafter’s knowledge, judgment, and assertions reflected in the contents of the documents that are ‘material’ to the sale.” *Prince*, 307 Or at 149.

“A person need not have actual knowledge of an illegal securities transaction in order to become a ‘participant’ in such sale.” *Black & Co. v. Nova-Tech, Inc.*, 333 FSupp 468, 472 (D Or 1971). Otherwise stated, whether one’s assistance in the sale is ‘material’ does not depend on one’s knowledge of the facts that make it unlawful[.]” *Prince*, 307 Or at 149; see also *Ainslie*, 148 Or App at 184 (liability under the applicable part of ORS 59.115(3) requires no showing by plaintiffs that [the defendant] knew of the illegality that inhered in the transaction[.])

Lack of knowledge, however, is an affirmative defense under ORS 59.115(3). A nonseller may avoid liability by “sustain[ing] the burden of proof that the nonseller did not know, and, in the exercise of reasonable care, could not have known, of the existence of facts on which the liability is based.” ORS 59.115(3). “‘The drafters took pains to make clear that the relevant knowledge is of “the existence of the facts,’ not of the unlawfulness of a sale.” *Prince*, 148 Or App 184 (liability under the applicable part of ORS 59.115(3) requires no showing by plaintiffs that [the defendant] knew of the illegality that inhered in the transaction[.]’”
307 Or at 150. That imposes what the Supreme Court has recognized as “a substantial burden” on nonseller participants, but, as the court also has observed, “this legislative choice was deliberate.” Id.

A handful of Oregon cases have analyzed circumstances in which a third-party participated or materially aided in the sale of securities:

In Adams, the court held that there was evidence from which a jury could find that the attorney who represented the securities salesperson and the corporation licensed to sell the securities participated or materially aided in the sale of securities under ORS 59.115(3).

Specifically, the court held:

“[W]hen an attorney prepares, attends to the execution of, and personally delivers and files documents required for the registration of a security with the knowledge that solicitation and sales of such a security have already been made, such conduct goes beyond what plaintiff describes as the ‘preparation of documents and other services normally performed by a lawyer for a client’ so as to constitute ‘participat(ion)’ or ‘materially aid(ing)’ in the sale of such a security.”

265 Or at 528.

In Prince, the defendant, an attorney, “drafted the limited partnership agreement and major portions of the offering circular. He also gave an opinion on the tax status of the partnership, which [the partnership] included in the information that it provided prospective investors.” 307 Or at 148. On these facts, the court reversed the trial court’s decision to grant summary judgment on an ORS 59.115(3) claim.

In Ainslie, the defendant, a subordinate attorney, prepared the offering memorandum and other documents, including the registration application for the Oregon Corporate Division. He also was involved in the use of investor money to prevent the foreclosure of a separate business that would have seriously impeded the offering. The court found sufficient evidence that the
defendant participated in or materially aided the sale of the underlying securities. 144 Or App at 145.

In Anderson, the defendants prepared the offering memorandum and supporting documentation, a tax opinion letter, projections and appraisals in connection with the sale of securities. The court held “[t]here is no question that a person who prepares documentation in connection with a sale of securities is a person who ‘participates or materially aids’ in the sale under ORS 59.115(3).” 146 Or App at 684.

Finally, in Black & Co., the defendant, an attorney, “prepared the legal papers necessary for Nova-Tech to complete the sale of its securities.” 333 FSupp at 472. The court held that, “[e]ven if [the attorney did not know and could not have known of Nova-Tech’s failure to register the securities, he was a participant in the sale because, without his assistance, the sale would not have been accomplished.” Id.

B. Motions to Dismiss

With the above framework in mind, the court examines the allegations against each defendant:

1. Umpqua Bank

Plaintiffs allege that Umpqua participated and materially aided in the sales of the Berjac securities. Plaintiffs’ factual allegations are voluminous. In essence, plaintiffs allege the following:

1) From 1995 to 2009, Umpqua (and one of its predecessors, Centennial Bank) repeatedly loaned money to Berjac to fund Berjac’s securities business. Specifically, Umpqua provided a credit line to Berjac that it used to pay investors when investors “withdrew” money
“on demand.” Umpqua knew that Berjac was drawing on its lines of credit to repay investors. Investors were unaware that their money was being used to repay Loans from banks.

2) These loans gave Berjac the illusion of credibility. They created the illusion of a track record that Berjac was able to keep and perform its obligations, that investments in Berjac were safe and secure, and that Berjac was solvent. The loans covered up the fact that Berjac’s statements to purchasers were untrue or misleading and covered up undisclosed risks, including significant credit and default risks associated with real estate and construction loans that Berjac had made with money raised by investors. The other risks Berjac failed to disclose included that the sum of its debts was greater than its assets, it was insolvent, and it would not be able to pay its debts as they became due.

Plaintiffs have alleged facts showing that Umpqua’s actions go beyond tasks such as mere preparation and execution of documents. Fakhrdai, 72 Or App at 684. Umpqua’s actions

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2 Plaintiffs also allege additional facts that arguably pertain to Umpqua’s alleged knowledge of the existence of facts on which the liability is based. Specifically, plaintiffs allege that Umpqua downgraded Berjac of Portland to “Watch” status in 2006. An Umpqua Senior Vice President noted that Berjac’s real estate lending was “risky” and something Umpqua had “no control and limited understanding of.” In 2008, Umpqua vice presidents stated that the real estate notes were “worrisome,” “ugly,” and had “great potential for trouble,” and that they should “start setting up and exit strategy.” Umpqua officials did not think “the investors know much about what their money is invested in” and that “most of them still think it is all or mostly insurance premium financing.” They recognized that the companies had very little equity so the “notes are financed by short term investor money which is due on demand and causes reason for alarming concern[.].” They further recognized that, if the investors ever figured out “the poor quality of the investments,” the company would “have a run on cash” that it “probably cannot meet.” When Umpqua closed the lines of credit in 2009, employees greeted that event with “Nice,” “Sweetness!!,” “Yay!,” “Horray!,” and “excellent news.” Umpqua’s executive vice president and chief lending officer said, “A nice, polite and quiet exit of a credit we perceived to have an extremely high degree of risk of implosion.” Another vice president responded, “thank God! With all the Ponzi schemes coming to light these days, we are so lucky they didn’t have a panic and run on the money from their investors.” An Umpqua officer later noted, “Bottom line this is a big (by Eugene standards) Ponzi scheme and many folks in Eugene have lost substantial amounts of money.”
were an important contribution to the transaction. *Prince*, 307 Or at 149. Umpqua’s loans, which were used to create the illusion of stability and credibility, were made “in connection” with the sale of Berjac securities. *Anderson*, 146 Or App at 684. As alleged by plaintiffs, the sales “could not have been completed or consummated” without the loans from Umpqua. *Fakhrdai*, 72 Or App at 686. Defendant Umpqua’s motion to dismiss is therefore denied.

However, Umpqua’s motion to make more definite and certain is granted. First, as requested by Umpqua, plaintiffs must clarify that their theory of liability on Claim One includes 59.115(3). Second, Umpqua must provide more specifics regarding the underlying sales that are at issue in this case. As it stands, the current lack of specificity will be logistically problematic at trial. For example, thinking ahead to a trial, the court wonders:

1) What underlying sales will be specifically presented to the jury in support of plaintiffs’ claims against Umpqua? If the underlying sales are not identified in the complaint, how will defendants be on notice regarding the underlying sales that will be at issue during trial?

2) If the underlying sales are not identified, how will the same nine jurors agree if evidence regarding more than one sale is presented?

3) In the same respect, if the underlying sales are not identified, how will a jury decide the question of damages?

For these reasons, plaintiffs shall make the complaint more definite and certain regarding the underlying sales in which Umpqua allegedly participated or materially aided. Specific information about the sales can be either incorporated into the complaint or attached as an addendum in the form of a spreadsheet or whatever other document would be most helpful and
convenient to the parties. In the same regard, plaintiffs shall also provide more specificity regarding the damages they are seeking against Umpqua for these sales.

2. **Century Bank/Pacific Continental Bank**

   Plaintiffs’ allegations against Century Bank and its successor, Pacific Continental Bank, are similar to its allegations against Umpqua. Plaintiffs claim that these banks also provided loans to Berjac to fund its securities business, which created false expectations, created the illusion of prosperity, and provided Berjac with credibility. Under the same analysis set forth above, the motion to dismiss against Century Bank and Pacific Continental Bank is denied. However, defendants’ motion to make more definite and certain is granted, as discussed above.

3. **Jones & Roth, P.C.**

   As Jones & Roth contends, the allegations against it are “scant.” They are essentially articulated in one sentence: “Beginning in 2002, Jones & Roth provided reviewed financial statements for Berjac that the banks making the loans required of Berjac and its related borrowers.”

   The one sentence allegation against Jones & Roth is vague. It is unclear what the scope of the “reviewed financial statement” was, to whom it was provided, etc. Otherwise stated, the complaint does not provide ultimate facts regarding the extent and importance of Jones & Roth’s involvement or its connection to the underlying sales. Accordingly, Jones & Roth’s motion to dismiss is granted.

C. **Fred “Jack” Holcomb’s Motion to Make More Definite and Certain**

   Defendant Jack Holcomb has filed a motion to make the complaint more definite and certain. First, he contends that, instead of generally referring to “Berjac,” plaintiffs should be required to specify whether they are alleging conduct by Berjac of Portland or Berjac of Oregon.
or both. As plaintiffs explain, “there is no reason to do that” because “[b]oth Berjacs were
general partnerships with the same partners.” The court accepts that argument and denies this
motion.

Defendant Holcomb next moves for greater specificity regarding the underlying sales and
damages. These motions are granted for the reasons discussed above (see p. 8).

Defendant Holcomb also moves for clarification of the allegations in paragraph 12
regarding his control of Berjac entities. The court agrees that the allegations in paragraph 12 are
too general and conclusory. The motion is therefore granted. Paragraph 23 is likewise
conclusory with respect to Defendant Holcomb and must be made more definite and certain. As
Defendant Holcomb notes, “timing is important.”

Finally, Defendant Holcomb moves for clarification of paragraph 11. Specifically, he
asks for more details regarding the time periods during which Berjac allegedly made untrue or
misleading statements or failed to make certain disclosures. As plaintiffs contend, however,
“there is no time when an omitted statement is made.” Moreover, other details can be obtained
during discovery. Accordingly, this motion is denied.

III. CLAim two – ORS 59.135

In Claim Two, plaintiffs allege that “Berjac sold securities in violation of ORS 59.135(1)
through (3)” and that [d]efendants participated and materially aided in those sales.”

ORS 59.135(1) through (3) provide as follows:

It is unlawful for any person, directly or indirectly, in connection with the
purchase or sale of any security or the conduct of a securities business or for any
person who receives any consideration from another person primarily for advising
the other person as to the value of securities or their purchase or sale, whether
through the issuance of analyses or reports or otherwise:

(1) To employ any device, scheme or artifice to defraud;
(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; [or]

(3) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person[.]

A. Pacific Continental Bank’s Motions

1. ORS 59.135(2)

Pacific Continental Bank (PCB) argues that ORS 59.115(3) does not provide a remedy for violations of ORS 59.135(2). Specifically, PCB contends that “ORS 59.115(1) is explicit that it provides a remedy for violations of ORS 59.135(1) and (3) but not ORS 59.135(2).” Indeed, ORS 59.115(1) expressly mentions subsections (1) and (3) of ORS 59.135 and excludes subsection (2):

(1) A person is liable as provided in subsection (2) of this section to a purchaser of a security if the person:
   (a) Sells or successfully solicits the sale of a security, other than a federal covered security, in violation of the Oregon Securities Law or of any condition, limitation or restriction imposed upon a registration or license under the Oregon Securities Law; or
   (b) Sells or successfully solicits the sale of a security in violation of ORS 59.135 (1) or (3) or by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

(Emphasis added.) PCB argues that the only remedy for violations of ORS 59.135(2) is found in ORS 59.137, and plaintiffs concede that they are not asserting a claim pursuant to ORS 59.137.

Plaintiffs contend that ORS 59.115(1)(a) can and should be read as providing that “[a] person is liable as provided in subsection (2) of this section to a purchaser of a security if the person: (a) Sells...a security...in violation of [ORS 59.135(1), (2), and (3)].” Plaintiffs contend that subsections (a) and (b) are not in conflict but are “simply redundant.” They argue that “[t]he
fact that as a consequence of the legislature’s amendments ORS 59.115(1) ended up with two subsections that redundantly provide liability for the same conduct is something that happens all the time.”

In construing a statute, the “first step” consists of “an examination of text and context.” State v. Gaines, 346 Or 160, 171, 206 P3d 1042, 1050 (2009). Whether or not there is an ambiguity in the statute, the court may also consider legislative history “where that legislative history appears useful to the court’s analysis.” Id. at 172. “[T]he extent of the court’s consideration of that history, and the evaluative weight that the court gives it is for the court to determine.” Id. Otherwise stated, the court is obligated “to consider proffered legislative history only for whatever it is worth—and what it is worth is for the court to decide.” Id. at 173. “If the legislature’s intent remains unclear after examining text, context, and legislative history, the court may resort to general maxims of statutory construction to aid in resolving the remaining uncertainty.” Id. at 172.

ORS 59.115(1) was amended twice in 2003, as the parties have explained. The first amendment was accomplished through Senate Bill 509 and the second amendment was accomplished through House Bill 3666. The court has examined the minutes for (1) the April 28, 2003 meeting of the Senate Committee on Business and Labor at which Senate Bill 509 was discussed and (2) the August 14, 2003 meeting of the House Committee on Rules and Public Affairs at which HB 3666 was discussed.3 In addition to testimony, several exhibits were received at these hearings. The court could not easily locate those exhibits and believe they may

3 These minutes can be found at these links: http://arcweb.sos.state.or.us/pages/records/legislative/legislativeminutes/2003/senate/business_labor/SBL04282003.htm http://arcweb.sos.state.or.us/pages/records/legislative/legislativeminutes/2003/house/rules_public_affairs/HRULES08142003.htm
be helpful in understanding the legislative history. The court would like to know if the parties have those exhibits and whether they can provide copies to the court. The court will continue to keep this motion under advisement, pending an examination of the exhibits.

2. **Scienter**

PCB moves to dismiss Claim Two on the ground that plaintiffs have not adequately alleged scienter. Plaintiffs concede that they must prove scienter for ORS 59.135(1), but claim that there is no scienter requirement for subsections (2) and (3).


All claims under ORS 59.135 require scienter. *Marsh*, 269 Or App at 49 (“we are persuaded that the legislature understood the phrase ‘violation of ORS 59.135(1), (2) or (3)’ to refer to acts that are committed with scienter”). Plaintiffs contend that *Marsh* is distinguishable because, in that case, the court analyzed ORS 59.137 and not ORS 59.115, which is the statute at issue in this case. However, as defendants contend, although *Marsh* concerned a different remedial provision, its reasoning applies with equal force to claims made pursuant to ORS 59.115. Accordingly, defendant’s motion is granted in this regard.

The next question is whether plaintiffs have adequately alleged that Berjac acted with scienter. The court finds that the complaint is sufficient in this regard. *See* Second Amended Complaint, 8-11. Therefore, the motion to dismiss or to make more definite and certain is denied.
B. **Umpqua’s Motions**

1. **Cause of Action Under ORS 59.135**

Citing *Marsh*, Umpqua contends that ORS 59.135 does not provide for a private right of action. In *Marsh*, the court held that “ORS 59.135 merely sets out a standard of conduct that applies to causes of action that may be pursued under ORS 59.115, ORS 59.137, and ORS 59.255.” 353 Or at 8. The “elements of the causes of action under ORS 59.137 and ORS 59.115...are found in those statutes – not in ORS 59.135.” *Id.* at 9. Otherwise stated, while ORS 59.135 “makes it illegal for ‘any person’ to defraud another person ‘in connection with the purchase or sale of any security,’ ORS 59.115 provided a civil remedy for this illegal activity.” *Anderson*, 146 Or App at 681 (quoting *Held v. Product Manufacturing Company*, 286 Or 67, 69, 592 P2d 1005 (1979)). Because ORS 59.135 does not provide a cause of action, plaintiffs shall amend their complaint to include that it is premised on ORS 59.115.

2. **Reliance Under ORS 59.137**

Umpqua next contends that, to the extent plaintiffs have alleged a claim under ORS 59.137, they have failed to allege ultimate facts supporting the element of reliance. Plaintiffs respond that their claims are not premised on ORS 58.137, that their claims are instead based on ORS 59.115, and that they therefore do not have to prove reliance. With that clarification, this motion is denied.

IV. **CLAIM 3 – ORS 59.055**

Umpqua contends that there is no cause of action under ORS 59.055. Plaintiffs concedes that “Umpqua is correct that ORS 59.055, which provides generally that it is unlawful to sell securities that are not registered, does not provide a remedy for its violation.” Instead, plaintiffs contend that they are stating a claim for relief against Umpqua under ORS 59.115(3).
The motion to make more definite and certain is granted and plaintiff shall amend the complaint to make it clearer that they are seeking relief against defendants pursuant to ORS 59.115(3).

V. STATUTE OF LIMITATIONS

Defendants move to dismiss claims that are barred by the three-year statute of limitations set forth in ORS 59.115(6), which provides:

Except as otherwise provided in this subsection, no action or suit may be commenced under this section more than three years after the sale. An action under this section for a violation of subsection (1)(b) of this section or ORS 59.135 may be commenced within three years after the sale or two years after the person bringing the action discovered or should have discovered the facts on which the action is based, whichever is later. Failure to commence an action on a timely basis is an affirmative defense.

Plaintiffs commenced this action on August 23, 2013.

A. Claim Three

With respect to Claim Three, plaintiffs concede that they are not stating a claim for sale of unregistered securities with respect to sales that occurred more than three years before August 23, 2013.

B. Claims One and Two

With respect to Claims One and Two, defendants contend that plaintiffs “do not allege that they did not discover the facts on which their actions are based, or plead any facts to explain plaintiffs contend that, under ORS 59.115(6), statute of limitations is an affirmative defense and that plaintiffs do not have to allege further facts in the complaint.” Plaintiffs respond that, under ORS 59.115(6), which makes statute of limitations an affirmative defense, the burden is on defendants to plead and prove their affirmative defense.
The situation presented here is not unique. Statute of limitations is generally an affirmative defense. See ORCP 19 B.\(^4\) However, ORCP 21 A(9), upon which defendants rely, permits a motion to dismiss the complaint for failure to show “that the action has not been commenced within the time limited by statute.” Under ORCP 21 A(9), a defendant may validly move to dismiss the complaint based on a plaintiff’s failure to adequately assert that its claims fall within the statute of limitations. Therefore, in this case, to the extent that plaintiffs are relying on the discovery rule, they must amend the complaint to allege that they “discovered or should have discovered the facts on which the action is based” within two years of the filing of the complaint.

Umpqua contends that there is no discovery rule with respect to non-sellers because ORS 59.115(6) refers only to ORS 59.115(l)(b) and ORS 59.135 and not to ORS 59.115(3). However, as plaintiff correctly notes, “ORS 59.115(3) is not a statute that may be violated.” Anderson, 146 Or App at 684. “It simply describes a class of persons who may be found liable for the violations of the securities laws.” Id. One “may be sued under ORS 59.115(3) for participating in a sale of securities that occurred in violation of one of the substantive provisions of the Oregon Securities law, such as ORS 59. 135.” Id. As in Anderson, “[i]n this case, plaintiffs have brought an action for violations of ORS 59.135, and they have alleged that

\(^4\) ORCP 19 B provides:

**Affirmative defenses.** In pleading to a preceding pleading, a party shall set forth affirmatively: accord and satisfaction; arbitration and award; assumption of risk; claim preclusion; comparative or contributory negligence; discharge in bankruptcy; duress; estoppel; failure of consideration; fraud; illegality; injury by fellow servant; issue preclusion; laches; license; payment; release; statute of frauds; **statute of limitations**; unconstitutionality; waiver; and any other matter constituting an avoidance or affirmative defense.

(Emphasis added.)
defendants are liable for those violations of ORS 59.135.” Id. “That falls squarely within the provisions of the exception to the general three-year limitation described in ORS 59.115(6).” Id.

The same holds true for plaintiffs’ claims under ORS 59.115(l)(b). Construing ORS 59.115(6) in this manner comports with the Oregon Supreme Court’s ruling that Oregon’s Blue Sky Law, “including ORS 59.115, is to be ‘liberally construed to afford the greatest possible protection to the public.’” Adams, 265 Or at 524. Accordingly, Umpqua’s motion to dismiss on this ground is denied.

Finally, with respect to PCB’s motion that claims against it are limited to the time period beginning in 2009, it appears that plaintiff does not oppose that motion. It is therefore granted.

IT IS SO ORDERED.

Dated this 14th day of December.

Youlee Yim You, Circuit Court Judge
UNITED STATES DISTRICT COURT
DISTRICT OF OREGON
PORTLAND DIVISION

LAWRENCE P. CIUFFITELLI, for himself and as Trustee of CIUFFITELLI REVOCABLE TRUST; GREG and ANGELA JULIEN; JAMES and SUSAN MACDONALD, as Co-Trustees of the MACDONALD FAMILY TRUST; R.F. MACDONALD CO.; ANDREW NOWAK, for himself and as Trustee of the ANDREW NOWAK REVOCABLE LIVING TRUST U/A 2/20/2002; WILLIAM RAMSTEIN; and GREG WARRICK, for himself and, with SUSAN WARRICK, as Co-Trustees of the WARRICK FAMILY TRUST, individually and on behalf of all others similarly situated,

Plaintiffs,

v.

DELOITTE & TOUCHE LLP, EISNERAMPER LLP; SIDLEY AUSTIN LLP; TONKON TORP LLP; TD AMERITRADE, INC.; and INTEGRITY BANK & TRUST,

Case No. 3:16-cv-580-AC

AMENDED FINDINGS AND RECOMMENDATION

1 The Amended Findings and Recommendation addresses two additional issues raised in the motions but inadvertently omitted from the original Findings and Recommendation (ECF No. 232). The additional discussion appears at pages 37–42 and 68–70, infra.
ACOSTA, Magistrate Judge:

Introduction


Presently before the court is a joint motion to dismiss Plaintiffs’ First Amended Complaint (“FAC”), filed by Deloitte, EisnerAmper, Sidley, and Tonkon. Also before the court are motions to dismiss the FAC filed individually by Deloitte, EisnerAmper, Sidley, Tonkon, Ameritrade, and Integrity. Joint Movants additionally move for judicial notice of some offering documents for the securities at issue, engagement letters between Aequitas companies and Deloitte, and some regulatory filings made by Aequitas companies.

Summary of Decision

The court should grant in part and deny in part Defendants’ Motions to Dismiss. Plaintiffs insufficiently allege the Aequitas entities’ primary violations of the Oregon Securities Law. Rule 9(b) requires Plaintiffs to allege the Aequitas entities’ misrepresentations and
material omissions with particularity. Plaintiffs’ remaining allegations against the Aequitas entities and the Defendants are subject to Rule 8. Accordingly, the court should grant the motions to dismiss as follows: The court should dismiss the allegations in the FAC that do not differentiate between the Aequitas entities and the securities they sold. The court should also dismiss the allegations of misrepresentations and material omissions that do not state when and where the misleading statements occurred, or that misrepresentations were false when made. Additionally, the court should dismiss alleged material omissions where Plaintiffs do not identify an affirmative statement made false by the omission.

The court should deny Defendants’ motions to dismiss based on construction of the Oregon Securities Law. Plaintiffs need not plead receipt of misleading communications if the security purchased was part of a series or group of transactions effected by means of misleading communications. The Oregon Securities Law creates “participation and material aid” liability for non-sellers whose interactions with a seller have a causal, material relationship with an unlawful securities transaction. Plaintiffs adequately allege that Deloitte, EisnerAmper, Tonkon, Sidley, Integrity, and Ameritrade participated in or materially aided some securities transactions by Aequitas entities.

The court should grant Plaintiffs leave to file another amended complaint because the defects of the FAC could be cured by additional factual allegations.

Factual Background

The 51-page FAC lays out a complex series of allegations, centered on the securities business of the Aequitas group of companies. Not all of the allegations are relevant to the pending motions. Still, significant background facts are necessary to resolve the pending motions. The following facts are alleged in the complaint and, for the purposes of the pending
motions to dismiss, the allegations in the complaint are taken as true and construed in the light most favorable to Plaintiffs.  *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 989 (9th Cir. 2009).

**I. Parties.**

The complaint contains allegations relating to three principal groups: the Aequitas group, Plaintiffs, and Defendants.

* A. The Aequitas Group.

The Aequitas group of entities is a group of approximately 75 affiliated limited liability companies, partnerships, and corporations.  (First Am. Compl. (“FAC”) (ECF No. 57), ¶ 21.) The complaint refers to the group of companies collectively as “Aequitas.”  (*E.g.*, id. ¶¶ 1–4.) This Findings and Recommendation will refer to the entire group of affiliated entities as “the Aequitas group,” and to unspecified groups of affiliated entities as “the Aequitas entities.”  A complex series of loans, ownership interests, management agreements, and other relationships connected the Aequitas group.  (*E.g.*, *id.* ¶¶ 21–25, 29, 169–75.)

Aequitas Management, LLC (“Management”) is the parent entity of the Aequitas group.  (*Id.* ¶ 22.) Management holds an 84% ownership stake in Aequitas Holdings, LLC (“Holdings”).  (*Id.*) Holdings is the sole owner and member of Aequitas Commercial Finance, LLC (“ACF”) and sole shareholder of Aequitas Capital Management, Inc. (“ACM”).  *Id.* ACM wholly owns Aequitas Investment Management, LLC (“AIM”).  (*Id.* ¶ 25.) Management, Holdings, ACM, and AIM (“the Control Entities”) owned and managed the subordinate Aequitas entities.  (*Id.* ¶¶ 21–25.)

Principally, the Aequitas group raised funds by selling securities through ACF.  (*FAC ¶ 27.*) Additional Aequitas subordinate entities sold securities mentioned in the complaint:
MotoLease Financial, LLC ("MotoLease"); Aequitas Income Protection Fund, LLC ("AIPF"); Aequitas Income Opportunity Fund, LLC ("AIOF"); Aequitas Income Opportunity Fund II, LLC ("AIOF II"); Aequitas Capital Opportunities Fund, LP ("ACOF"); and Aequitas Enhanced Income Fund, LLC ("AEIF") (collectively, "the Funds"). (Id. ¶ 28.) ACF owned all or part of the Funds. (Id. ¶ 23.)

**B. Plaintiffs.**

Plaintiffs are investors who purchased securities from ACF or the Funds. (FAC ¶¶ 8–14; 64–70.) With the exception of AEIF, ACF and the funds each sold securities to at least one named plaintiff. (Id. ¶¶ 64–70.) Which plaintiff purchased which securities is not relevant to the pending motions because Plaintiffs sue in a representative capacity. In some cases, the issuing entities induced Plaintiffs to extend the maturity date of a purchased security or reinvest the proceeds of a security after redemption. (E.g. id. ¶¶ 67(c), 68(a).) Plaintiffs seek to represent a class of all investors who purchased securities from the Aequitas group on or after June 29, 2011. (Id. ¶ 181.)

**C. Defendants.**

Deloitte, an accounting firm, performed accounting and auditing services for Aequitas entities in 2013 and 2014. (FAC ¶ 15.) EisnerAmper, an accounting firm, performed accounting and auditing services for Aequitas entities in 2011 and 2012. (Id. ¶ 16.) Sidley is an international business law firm. (Id. ¶ 17.) Sidley provided legal advice to Aequitas entities regarding sales of securities and prepared legal documents necessary to sell securities through ACOF and other Aequitas entities. (Id. ¶¶ 17; 30(d).) Tonkon, an Oregon law firm, prepared legal documents necessary to sell securities through multiple Aequitas entities. (Id. ¶ 18.) Ameritrade, a corporation, served as custodian for unspecified Aequitas securities and referred
investors to financial advisors to buy unspecified Aequitas securities. (Id. ¶ 19.) Integrity, a commercial bank, served as custodian for unspecified Aequitas securities and solicited sales of unspecified Aequitas securities. (Id. ¶ 20.) The specific interactions of each defendant with specific Aequitas entities are detailed below.

A. Structure and Organization.

The Aequitas group used a complex system of ownership interests, financial transactions, management agreements, and other relationships to connect the myriad Aequitas entities. (FAC ¶¶ 21–25.) Plaintiffs, giving some examples, allege that there were minimal operational distinctions between the nominally separate entities. (Id. ¶¶ 29, 103–08.) The intra-Aequitas transactions meant the proceeds of securities sold by individual entities were used to fund the operations of the Aequitas group, regardless of the individual entity’s stated purpose. (Id. ¶ 29.) Conversely, the success or failure of ACF and the Funds depended on the financial wellbeing of the Aequitas group. (Id.)

B. Business Activities.

The Aequitas group engaged in diverse business activities, including purchasing consumer debt from multiple industries. (FAC ¶¶ 2, 104, 110, 117, 126.) A group of Aequitas subsidiaries, owned by ACF, purchased student loans from Corinthian Colleges, Inc. (“Corinthian”). (Id. ¶¶ 146–60.) Another group of Aequitas subsidiaries purchased vehicle leases, through ACF and Motolease. (Id. ¶¶ 125–29.) Other Aequitas subsidiaries purchased healthcare receivables and debt-consolidation loans. (Id. ¶¶ 104, 117.)

C. Finances.

The Aequitas group raised capital in part by selling securities. (FAC ¶ 26.) The group also obtained third-party financing from lenders. (Id. ¶¶ 107, 119, 130.) ACF, the Funds, and
subsidiary Aequitas affiliates often paid management fees to ACM, which ran some of the day-to-day operations of other Aequitas entities. (E.g. id. ¶¶ 103, 108.) ACF also loaned tens of millions of dollars to Holdings and other Aequitas entities. (Id. ¶ 170.)

D. Securities.

The Aequitas entities sold securities — promissory notes and interests in Aequitas entities — as a fundraising method. (FAC ¶ 26.) The securities at issue in this case were not registered under Oregon or Federal law. (Id.) The primary fundraising mechanism for the Aequitas entities was ACF’s sale of Secured Subordinated Promissory Notes (“ACF Notes”). (Id. ¶ 27.) Other Aequitas entities sold separate securities, including: Limited Liability Company Interests, sold by AIPF (“AIPF Interests”); Senior Secured Promissory Notes, sold by AIOF (“AIOF Notes”); Senior Secured Promissory Notes, sold by AIOF-II (“AIOF-II Notes”); Senior Secured Promissory Notes, sold by MotoLease (“MotoLease Notes”); LLC Interests, sold by AEIF (“AEIF Interests”); and Capital Commitments, sold by ACOF (“ACOF Interests”) (collectively with the ACF Notes, “the Disputed Securities”). (Id. ¶ 28.) The Funds represented that the other Disputed Securities were distinct from the ACF Notes, concealing the complex financial interdependence between the ACF, the Funds, and other Aequitas entities. (Id. ¶ 29.) The FAC alleges the Disputed Securities were essentially the same security because of the intra-Aequitas financial dealings. (Id.)

The Funds sold the Securities using Private Placement Memoranda (“PPM”), where the seller described to potential investors its business operations, assets, and risks. (FAC ¶¶ 32, 39, 51, 45, 57, 61.) Each of the PPMs contained a directory, listing the manager, auditor, legal counsel, and other partners of the issuing entities. Investors purchased securities by completing subscription agreements. (Id. ¶¶ 32, 39, 45, 51, 57, 61.)
III. Defendants’ Involvement with the Aequitas Group.

Plaintiffs’ claims against Defendants arise from Defendants’ transactions with the Aequitas group. Each defendant interacted with one or more Aequitas entity. Plaintiffs allege Defendants provided services or engaged in transactions that enabled the Aequitas entities to sell the Disputed Securities to investors. (FAC ¶ 30.) The services each defendant provided were necessary to the sale of the securities or the Aequitas group’s ongoing securities business. (Id. ¶¶ 15–20, 30.) In several PPMs, the Aequitas entities identified EisnerAmper, Deloitte, Tonkon, and/or Sidley as auditor or counsel to the entities, depending on the time of issue. (Id. ¶¶ 15, 33, 34, 41, 42, 47, 48, 53, 58, 63.) The “directory” section identifying EisnerAmper, Deloitte, Tonkon, and/or Sidley appeared in the first pages of each PPM, before any information about the issuing entity or the offered security. (Decl. of Gavin M. Masuda (“Masuda Decl.”) (ECF No. 79), Exs. 13 at v, 14 at vii, 15 at iv–v; Decl. of Philip Van Der Weele (“Van der Weele Decl.”) (ECF No. 76), Exs. 2 at v, 3 at v.)

A. EisnerAmper & Deloitte.

The allegations against EisnerAmper and Deloitte are similar, as the firms had comparable functions during different time periods. EisnerAmper was the auditor for ACF, AIPF, and AIOF in 2011 and 2012. (FAC ¶¶ 30(a), 33, 41, 47.) Deloitte was the auditor for ACF, AIPF, AIOF, AIOF II, AIEF, and ACOF in 2013 and 2014. (Id. ¶¶ 30(b), 34, 42, 48, 53, 58, 63.) During the years when each firm audited ACF, Deloitte and EisnerAmper audited the financial statements of myriad subordinate Aequitas entities as part of the consolidated statements of ACF. (Id. ¶ 30(a–b).) ACF, AIPF, and AIOF provided financial documents audited by EisnerAmper and Deloitte to prospective investors. (Id. ¶¶ 30(a), 33–34, 41–42, 47–48, 53, 58, 63.) With EisnerAmper’s knowledge and consent, ACF, AIPF, and AIOF issued
some PPMs identifying EisnerAmper as their auditor. \(\textit{Id. \S\S\ 15, 33, 41, 47.}\) With Deloitte’s knowledge and consent, ACF, AIPF, AIOF, AIOF II, AIEF, and ACOF issued PPMs identifying Deloitte as their auditor. \(\textit{Id. \S\S\ 15, 34, 42, 48, 53, 58, 63.}\) Other promotional materials sent to current and prospective investors in ACF, AIPF, and AIOF identified EisnerAmper as their auditor. \(\textit{Id. \S\S\ 35, 43, 49.}\) Similarly, promotional materials sent to current and prospective investors in ACF, AIPF, AIOF, AIOF II, and ACOF identified Deloitte as their auditor. \(\textit{Id. \S\S\ 35, 43, 49, 54, 59.}\)

The financial statements that EisnerAmper and Deloitte audited helped conceal the financial interdependence, the integrated nature of the Aequitas group, and the growing insolvency of the Aequitas group over time. \(\textit{Id. \S\S\ 15–16, 161–174.}\)

B. Tonkon.

Tonkon was legal counsel for multiple Aequitas entities, including ACF, AIOF, AIOF-II, AIPF, AEIF, ACOF, Motolease, and AIM. \(\textit{FAC \S\S\ 15, 30(c).}\) Tonkon prepared documents necessary for ACF and the Funds to sell securities. \(\textit{Id. \S\S\ 15, 30(c), 32, 39, 45, 51, 61.}\) Tonkon drafted or helped draft the PPMs and subscription agreements for all of the Disputed Securities, except for ACOF Interests. \(\textit{Id.}\) As with the accounting firms, promotional materials sent to current and prospective investors in ACF, AIPF, AIOF, and AIOF II identified Tonkon as counsel to the issuers. \(\textit{Id. \S\S\ 35, 43, 49, 54.}\) Tonkon also advised AIM in its capacity as investment advisor and manager of multiple Aequitas entities. \(\textit{Id. \S\ 30(c).}\)

C. Sidley.

Sidley was legal counsel to ACOF, AIM, and other unspecified Aequitas entities. \(\textit{FAC \S\S\ 17, 30(d), 40, 46, 52, 57, 62.}\) Sidley prepared documents necessary for ACOF to sell securities, including drafting the PPM and subscription agreements for the ACOF Interests. \(\textit{Id.}\)
¶ 30(d), 57.) Some promotional materials sent to current and prospective investors in ACOF identified Sidley as counsel to ACOF. (Id. ¶ 59.) As counsel to AIM, Sidley had indirect involvement with the operations of AIM-managed Aequitas subsidiaries, including AIPF, AIOF, AIOF-II, ACOF, and AEIF. (Id. ¶¶ 30(d), 40, 46, 52, 62.) Sidley enabled an unspecified Aequitas entity to pledge its healthcare receivables as collateral to secure $100 million in financing, removing those assets from investors. (Id. ¶ 30(d).)

D. Integrity.

Integrity offered and solicited sales of ACF Notes and AIOF-II Notes to prospective investors. (FAC ¶¶ 30(f), 36, 55.) Integrity prepared subscription agreements and other documents necessary to complete sales of ACF Notes and AIOF-II Notes. (Id.) Integrity is the custodian of some Disputed Securities. (Id.)

E. Ameritrade.

Ameritrade referred investors to third-party financial advisors to purchase unspecified securities from Aequitas subsidiaries. (FAC ¶ 30(e).) Ameritrade was also the custodian for some unspecified Aequitas Securities. (Id.)

III. Misrepresentations and Material Omissions.

The allegations of the Aequitas group’s misconduct spans over 100 paragraphs of the FAC. (FAC ¶¶ 71–175.) Accordingly, the facts restated here will not repeat every allegation against the Aequitas group. Instead, the following allegations reflect the general actions and events giving rise to the lawsuit. The FAC refers generally to “Aequitas” in many allegations, without specifying which Aequitas entity engaged in specific conduct. The following facts refer to specific Aequitas entities, where possible.
A. Problems with Specific Aequitas Investments.

An ACF subsidiary, ASFG, LLC (“ASFG”), had a lucrative student-loan origination agreement with Corinthian. (FAC ¶ 146.) ASFG purchased student loans from Corinthian at a net discount, with a recourse agreement requiring Corinthian to buy back any loans in default. (Id.) So long as Corinthian met its obligations under the recourse agreement, ASFG collected on loans at a profit and sold any past-due loans back to Corinthian. (Id. ¶ 147.) Corinthian began to face increasing public relations problems and regulatory scrutiny, beginning in 2010 and increasing afterwards. (Id. ¶ 115.) Corinthian’s demise became increasingly apparent in late 2013. (Id. ¶¶ 115(h), 155.) ASFG terminated its relationship with Corinthian in early 2014. (Id. ¶ 155.) Corinthian ceased its operations in 2014, while facing a civil-enforcement action from the Consumer Financial Protection Bureau. (Id. ¶ 116.) Corinthian declared bankruptcy in 2015, increasing default rates on the loans and eliminating any remedy ASFG might have had against Corinthian. (Id. ¶ 160.) The Aequitas group did not disclose any of the preceding information about the investment in Corinthian, including Corinthian’s identity, the Aequitas group’s exposure to financial harm as Corinthian declined, and the adverse events occurring to Corinthian. (Id. ¶¶ 109–16.)

Besides the Corinthian portfolio, other Aequitas investments faced challenges. ACF and other Aequitas entities invested in consumer-credit receivables (“the Consumer Receivables”), claiming the receivables as valuable assets. (FAC ¶¶ 117, 123–24.) ACF and other Aequitas entities pledged all or most of the Consumer Receivables as collateral for third-party loans. (Id. ¶ 120.) The Consumer Receivables portfolio consisted of sub-prime consumer loans, and had a high failure rate. (Id. ¶¶ 117, 121.) The failure rate of the Consumer Receivables portfolio exceeded the assumptions of the third-party lenders, making the portfolio a futile investment.
ACF and other Aequitas entities defaulted on the third-party financing obligations underlying the Consumer Receivables in 2015. The Aequitas group did not disclose any of the preceding information about the Consumer Receivables to investors.

B. Financial Engineering and Use of Invested Assets.

The Aequitas group used complex financial engineering to embellish its financial well-being to investors. Intra-Aequitas loans eliminated the functional distinctions between nominally separate entities. The intra-Aequitas transactions funneled money from the Funds to ACF, rendering the Funds wholly dependent on the fate of ACF and the Aequitas group. Functionally, there was no difference between investing in ACF and the Funds. ACF also loaned substantial amounts to Holdings, to fund the operational expenses of the Control Group.

In communications to investors regarding the ACF Notes, ACF represented that the collateral supporting the ACF Notes exceeded the total owed on the ACF Notes. But ACF’s statements regarding its collateral overstated the value of its assets, particularly assets derived from intra-Aequitas transactions. ACF reported its loan to Holdings as a valuable asset, without reflecting Holding’s lack of collateral and inability to repay the loan. ACF and the Funds also claimed ownership interests in fellow Aequitas entities as valuable assets, regardless of the actual value of the ownership interests. ACF and the Funds did not disclose the intra-Aequitas transactions and misrepresented the intra-Aequitas transactions to investors. The Aequitas group also reported some illusory ownership interests in Aequitas subordinates as valuable assets in 2013 and 2014.
C. Use of Invested Assets.

The promotional materials for the Funds misrepresented the use of invested assets, describing varied investment strategies unique to each Fund and omitting the use of the Funds’ assets as a source of cash for ACF. (FAC ¶¶ 136–42.) ACF and the Funds also used assets to fund bonuses, large salaries, private aircraft, and company parties for the Aequitas group and its employees, a use not disclosed to investors. (Id. ¶¶ 144, 171.) ACF and the Funds paid millions of dollars annually to ACM and other Aequitas entities in management fees, without disclosing the amount or recipient of the management fees to investors. (Id. ¶ 175.) As the Aequitas group’s financial health deteriorated, ACF and the Funds began to use newly invested money to repay earlier investors. (Id. ¶¶ 136, 141.) The materials distributed to prospective investors either did not disclose the use of new investments to repay previous investors or described such uses as infrequent. (Id. ¶¶ 137–142.) Only in December 2015 did ACF disclose its use of newly invested assets to repay prior investors. (Id. ¶ 143.)

D. Insolvency.

The Aequitas group became insolvent, although the complaint does not specify when insolvency occurred. (FAC ¶ 169.) The Aequitas group used intra-Aequitas loans to conceal its insolvency, using new investments to fund through ACM the operating expenses of the Aequitas group. (Id. ¶¶ 169, 171.) The outstanding balance of the largest intra-Aequitas loan — from ACF to Holdings — grew from $62.7 million in 2012 to $180.3 million at the end of 2015. (Id. ¶ 170.) The Aequitas group received collateral analyses indicating the balance of the ACF–Holdings loan exceeded Holding’s ability to collateralize the debt, as early as 2014. (Id. ¶ 173.) The Aequitas group did not disclose these collateral analyses to investors. (Id.)
Throughout the period of insolvency, the Aequitas group continued to sell securities, increasingly using the proceeds of the sales to repay previous investors. (Id. ¶¶ 136, 141.)

In February 2016, the Aequitas entities publically declared their insolvency to investors and turned operations over to an outside consultant. (FAC ¶¶ 176–78.) The Securities and Exchange Commission (“SEC”) filed suit in March 2016 against Management, Holdings, ACF, ACM, and several top executives. (Id. ¶ 179.) The SEC and Aequitas entities asked the court to appoint a receiver in the course of the SEC Lawsuit against the Aequitas entities. (Id. ¶ 180.)


Federal Rule of Civil Procedure (“Rule”) 8 requires that complaints in federal court consist of “a short and plain statement of the claim showing that the pleader is entitled to relief.” Pleadings need not contain detailed factual allegations, but “labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do[.]” Bell Atl. Corp. v. Twombly, 550 U.S. 544, 555 (2007). However, a claim “may proceed even if it strikes a savvy judge that actual proof of [necessary] facts is improbable,” and the plaintiff is unlikely to succeed on the merits. Id. at 556.

On a motion to dismiss for failure to state a claim, the court may consider only the pleadings themselves, exhibits that are physically attached to the complaint, and matters of which the court may take judicial notice. Swartz v. KPMG LLP, 476 F.3d 756, 763 (9th Cir. 2007) (per curiam). The court generally must “accept all allegations in the complaint are true and draw all reasonable inferences in favor of the nonmoving party.” Dahlia v. Rodriguez, 753 F.3d 1060, 1066 (9th Cir. 2013) (quoting TwoRivers v. Lewis, 174 F.3d 987, 991 (9th Cir. 1999)). The court is not bound to accept as true allegations contradicted by “matters properly
subject to judicial notice or by exhibit[s]” attached to the complaint.  *Sprewell v. Golden State Warriors*, 266 F.3d 979, 988 (9th Cir. 2001), amended on denial of reh’g 275 F.3d 1187. Legal conclusions in a complaint are not entitled to a presumption of truth.  *Ashcroft v. Iqbal*, 556 U.S. 662, 679 (2009).

II. Federal Rule of Civil Procedure 9(b).

Under Rule 9(b), parties must plead fraud, claims sounding in fraud, and allegations of fraudulent conduct with specificity, alleging the “who, what, when, where, and how of the misconduct charged.”  *Cafasso v. Gen. Dynamics C4 Sys., Inc.*, 637 F.3d 1047, 1055 (9th Cir. 2011). Where a claim sounds in fraud, plaintiffs must plead the entire claim with particularity.  *Vess v. Ciba-Geigy Corp., USA*, 317 F.3d 1097, 1104–05 (9th Cir. 2003). A claim sounds in fraud where a plaintiff “allege[s] a unified course of fraudulent conduct and rel[ies] entirely on that course of conduct as the basis of a claim.”  *Id.*  In a claim based on fraudulent and non-fraudulent conduct, Rule 9(b) applies only to the allegations of fraudulent conduct.  *Id.*  at 1104.

Rule 9(b) also furthers three policy interests:

(1) to provide defendants with adequate notice to allow them to defend the charge and deter plaintiffs from the filing of complaints “as a pretext for the discovery of unknown wrongs”; (2) to protect those whose reputation would be harmed as a result of being subject to fraud charges; and (3) to “prohibit [ ] plaintiff[s] from unilaterally imposing upon the court, the parties and society enormous social and economic costs absent some factual basis.”

*Kearns v. Ford Motor Co.*, 567 F.3d 1120, 1125 (9th Cir. 2009) (quoting *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1405 (9th Cir. 1996)).

III. Motion for Judicial Notice.

Federal Rule of Evidence 201 allows the court to take judicial notice of facts (1) that are generally known within the court's jurisdiction; or “(2) can be accurately and readily determined
from sources whose accuracy cannot reasonably be questioned.” FED. R. EVID. 201(b). Courts “may take judicial notice of undisputed matters of public record . . . including documents on file in federal or state courts.” Harris v. County of Orange, 682 F.3d 1126, 1131 (9th Cir. 2012).

Analysis

No Aequitas entity is a party to this lawsuit. Nonetheless, the conduct of Aequitas entities is at the core of the allegations in the complaint. Plaintiffs claim the Aequitas entities sold securities in violation of the Oregon Securities Law, ORS §§ 59.005–59.451. Defendants’ alleged liability depends on the Aequitas group’s predicate violations of the Oregon Securities Law. See OR. REV. STAT. § 59.115(3) (creating derivative liability for third-parties based on participation or material aid in unlawful securities transactions). Defendants contest the legal and factual sufficiency of the allegations of primary violations of the Oregon Securities Law by the Aequitas entities, as well as the allegations of participation or material aid by Defendants.

I. The Oregon Securities Law.

Plaintiffs’ claims all arise under the Oregon Securities Law, ORS 59.005 et seq. Some initial discussion of the structure of the Oregon Securities Law is therefore necessary. Oregon courts interpret the Oregon Securities Law liberally “to afford the greatest possible protection to the public.” Foelker v. Kwalke, 279 Or. 379, 385 (1977) (internal quotation marks and citation omitted). The Oregon Securities Law allows private actions for direct buyer-to-seller transactions under ORS 59.115. State v. Marsh & McLennan Cos., 353 Or. 1, 8–9 (2012). Both sellers and non-sellers of securities may be liable to purchasers under section 115 for the purchase price of unlawfully sold securities. The relevant portion of the statute provides:

(1) A person who sells a security is liable . . . to a purchaser of the security if the person:
(a) Sells a security in violation of the Oregon Securities Law or of any condition, limitat
ion or restriction imposed upon a registration or license under the Oregon Securities Law; or

(b) Sells a security in violation of ORS 59.135 (1) or (3) by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

... 

(3) . . . every person who participates or materially aids in the sale is also liable jointly and severally with and to the same extent as the seller, unless the nonseller sustains the burden of proof that the nonseller did not know, and, in the exercise of reasonable care, could not have known, of the existence of facts on which the liability is based. Any person held liable under this section shall be entitled to contribution from those jointly and severally liable with that person.

OR. REV. STAT. § 59.115.

Plaintiffs allege the Aequitas entities violated three provisions of Oregon securities law in selling the Disputed Securities. First, Plaintiffs claim the Disputed Securities were sold without registration, in violation of ORS § 59.055. Plaintiffs also allege the Aequitas entities made material misrepresentations and omissions in selling the Disputed Securities, violating both ORS § 59.115(1)(b) and ORS § 59.135(2). Plaintiffs assert causes of action for violations of ORS § 59.055 and § 59.135(2) under ORS § 59.115(1)(a), which creates a cause of action for any sale made “in violation of the Oregon Securities Law.” Plaintiffs then allege Defendants bear secondary liability for “participat[ing] or materially aid[ing] in” the Aequitas group’s unlawful sales of securities. OR. REV. STAT. § 59.115(3).

A. ORS § 59.055.

Courts often describe ORS § 59.055 as a prohibition on the sale of unregistered securities. See, e.g., State v. Ghim, 360 Or. 425, 441 (2016) (“[T]he legislature has prohibited
the sale of unregistered securities in Oregon, ORS 59.055”). Textually, ORS § 59.055 forbids sale or offering of any security in Oregon unless one of three conditions exists. First, a security may be sold if it is registered. OR. REV. STAT. § 59.055(1). The second condition depends on specific exempt transactions identified in ORS § 59.025 and § 59.035. OR. REV. STAT. § 59.055(2). Third, sales are allowed if the security is a “federal covered security,” defined by reference to the federal Securities Act. OR. REV. STAT. § 59.055(3). Under federal law, federal covered securities include “transactions by an issuer not involving any public offering.” 15 U.S.C. §§ 77d(2)(a), 77r(b). The U.S. Securities and Exchange Commission (“SEC”) further defines “transactions by an issuer not involved in any public offering” by regulation. SEC Regulation D, 17 C.F.R. §§ 230.500–230.508, defines specific non-public offerings that qualify as federal covered securities.

B. ORS §§ 59.115(1)(b), 59.135(2).

Two provisions of the Oregon Securities Law forbid similar conduct in selling securities: making an “untrue statement of material fact or an omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading.” OR. REV. STAT. §§ 59.115(1)(b); 59.135(2). The statutes differ in the required connection between the misstatement or omission and the sale of securities. Under ORS § 59.115(1)(b), a violation occurs when “a person sells or successfully solicits the sale of a security . . . by means of” a material false statement or omission. Id. § 59.115(1)(b). ORS § 59.135(2) applies more broadly, applying to material misstatements or omissions made “directly or indirectly, in connection with the purchase or sale of any security or the conduct of a securities business.” Id. § 59.135(2).
C. ORS § 59.115(3).

Non-sellers who participate or materially aid in an unlawful securities sale are jointly and severally liable to the purchasers. Or. Rev. Stat. § 59.115(3). A purchaser seeking recovery from a non-seller must first allege a primary violation by a seller. Comp. Concepts, Inc. v. Brandt, 137 Or. App. 572, 587 (1995) (“[L]iability under ORS 59.115(3) is dependent on and derivative from the liability of a seller.”). Under ORS § 59.115(3), “[p]articipate’ and ‘materially aid’ are separate concepts, not synonyms.” Prince v. Brydon, 307 Or. 146, 149 (1988). Generally, participation addresses direct involvement in the sale, while material aid involves indirect support for the seller in making the sale. Id. at 150 (drafting partnership documents and providing legal advice regarding private securities offering was material aid); Adams v. Am. W. Secs., Inc., 265 Or. 514, 527 (1973) (preparing sales documents for use in transaction was participation); Ainslie v. Spolyar, 144 Or. App. 134, 145 (1996) (“Ainslie I”) (preventing a foreclosure and providing legal services prior to an offering was material aid). Still, other decisions use the terms together (“participate or materially aid”), without distinction. See, e.g., Fakhrdai v. Mason, 72 Or. App. 681, 684 (1985); Ainslie v. First Interstate Bank of Or., N.A., 148 Or. App. 162, 184–85 (1997) (“Ainslie II”).

II. Applicable Pleading Standards.

The parties dispute whether Rule 9(b) requires Plaintiffs to plead with specificity allegations of primary violations of the Oregon Securities Law and participation or material aid in an unlawful sale of securities. Defendants argue all of Plaintiffs’ claims sound in fraud and thus must be pleaded with particularity. Plaintiffs concede claims under ORS 59.135(2) sound in fraud, but otherwise contend their claims are subject only to Rule 8. (Opp. To Jt. Mot. (ECF No. 119), at 11.)
As a threshold matter, Defendants argue Rule 9(b) applies to the entire case because actions under ORS § 59.115 are statutory fraud actions. See *Karsun v. Kelley*, 258 Or. 155, 167 (1971) (“the basis for [an action under ORS 59.115] is fraud”). Plaintiffs contend Rule 9(b) applies only to allegations of fraudulent conduct because the FAC alleges both fraudulent and non-fraudulent conduct. See *Vess*, 317 F.3d at 1104. The specificity requirements of Rule 9(b) may apply to entire claims for relief, or to individual factual allegations. *Id.* at 1104–05. Here, Plaintiffs allege three claims for relief: one for sales of unregistered securities and two for sales of securities through misrepresentation or material omission. (FAC ¶¶ 191–93.) All claims assert Defendants’ secondary liability based on primary violations of the Oregon Securities Law by the Aequitas group. (*Id.* ¶ 190.) Accordingly, the court must first determine whether any or all of the claims sound in fraud, such that allegations against both the Aequitas group and Defendants must be pleaded with particularity.

A. All Allegations and Claims.

Defendants first argue the entirety of the complaint sounds in fraud because Plaintiffs’ claims arise under ORS § 59.115. Courts have characterized actions under ORS § 59.115 and ORS § 59.135 as “statutory ‘fraud’ actions.” E.g., *Aero Marine Engine, Inc. v. Transporter, Inc.*, No. 05-1469, 2006 WL 3128500, at *3 n.2 (D. Or. Oct. 23, 2007) (quotation marks omitted). Because Plaintiffs bring claims under ORS § 59.115, Defendants conclude Rule 9(b) applies to all of Plaintiffs’ allegations. Plaintiffs respond that cases referring to actions under ORS § 59.115 as “fraud” actions did not address pleading standards, and they identify multiple aspects of their claims that do not allege fraudulent conduct. Instead, Plaintiffs suggest the court should apply Rule 9(b) to this case on an allegation-by-allegation basis. See *Vess*, 317 F.3d at
1104 (where a plaintiff alleges “some fraudulent and some non-fraudulent conduct . . . only the allegations of fraud are subject to Rule 9(b)’s heightened pleading requirements.”).

Two Ninth Circuit cases are instructive on this issue. In *Vess*, the court analyzed a series of allegations against a pharmaceutical company, the American Psychological Association, and an advocacy group, arising out of each defendant’s role in promoting sales of Ritalin, a prescription drug. *Vess*, 317 F.3d at 1100–01. In that case, the complaint alleged some allegations of a fraudulent conspiracy among all defendants, and other allegations of non-conspiratorial, non-fraudulent failures to disclose information and warn consumers. *Id.* at 1105–06. The court held that the complaint alleged a combination of fraudulent and non-fraudulent conduct, and applied Rule 9(b) only to the allegations of fraudulent conduct. *Id.* The court also held that Rule 9(b) applied to all of the allegations of a fraudulent conspiracy because they asserted “a unified course of fraudulent conduct.” *Id.* at 1107–08. In contrast, *Kearns* addressed claims against a single car manufacturer, alleging misrepresentations regarding a used-car certification program. *Kearns*, 567 F.3d at 1125–26. The court concluded all of the claims were state-law fraud claims under California law, and applied Rule 9(b) to the complaint as a whole. *Id.* at 1126–27.

Thus, the entirety of a complaint is subject to Rule 9(b) if it exclusively alleges claims sounding in fraud or a uniform course of fraudulent conduct by all defendants. *Kearns*, 567 F.3d at 1126–27. Rule 9(b) does not apply categorically where a complaint asserts some claims that do not sound in fraud or alleges a mixture of fraudulent and non-fraudulent conduct by at least one defendant. *Vess*, 317 F.3d at 1105–06. For Defendants’ pleading argument to prevail, then, the FAC must either allege entirely claims sounding in fraud or allege a unified course of fraudulent conduct against all defendants. It is therefore necessary to determine the
requirements for pleading a cause of action against a non-seller under the Oregon Securities Law.

Pleading a claim against a non-seller requires two groups of allegations: a primary violation by the seller, and requisite acts of participation or material aid by the non-seller. Anderson v. Carden, 146 Or. App. 675, 684 (1997). A prima facie case of participant or material aider liability does not require any allegation of wrongdoing by the non-seller, let alone allegations of fraud. Id. at 683 ("[T]he remedy against nonseller participants is not contingent on the nonsellers’ violation of any law."). Even where the allegedly unlawful securities sale involves fraud, participation and material aid merely entails a connection to the unlawful transaction. Prince, 307 Or. at 149–50. In this case, Plaintiffs do not allege any defendant engaged in fraudulent or independently wrongful conduct.

The claims against Defendants do not sound in fraud because they do not “rely entirely” on allegations of fraud. Vess, 317 F.3d at 1104. Plaintiffs allege the Aequitas group engaged in a complex series of violations of the Oregon Securities Law, while the allegations against Defendants describe their connection to ACF and the Funds. The allegations of Defendants’ participation and material aid in the Aequitas group’s sales of securities stand separate from the wrongdoing alleged against the Aequitas group. See id. at 1103; cf. Kearns, 567 F.3d at 1125. Moreover, the FAC does not rely on a “uniform course of fraudulent conduct” by all Defendants — Plaintiffs allege only that Defendants participated or materially aided in the sale of securities. Whether a non-seller knew of the facts making the transaction unlawful arises as an affirmative defense, not as an element of the cause of action. Adams, 265 Or. at 528–29. Accordingly, the specificity requirements of Rule 9(b) do not apply to the entirety of the complaint. The
appropriate approach is to analyze the FAC’s allegations categorically, by subject of the allegations.

B. Primary Violations through Non-Registration.

Allegations of selling securities without registration are not subject to Rule 9(b). As non-registration claims do not require any showing of fraudulent conduct or even intentional wrongdoing, Rule 9(b) could apply only to claims under ORS § 59.055 through the “claims sounding in fraud” doctrine. See Vess, 317 F.3d at 1104. But Vess delimits the pleading requirements of Rule 9(b) by claim. Id. A claim for violation of ORS § 59.055 is a strict liability claim, requiring no allegations of fraud or other intentional wrongdoing. The claims for non-registration therefore do not allege fraud, and are subject only to Rule 8. Walling v. Beverly Enters., 476 F.2d 393, 397 (9th Cir. 1973). Accordingly, Rule 9(b) does not apply to the allegations supporting Plaintiffs’ claim for selling unregistered securities, except for the extent to which the same allegations support a separate allegation of fraud.

C. Primary Violations through Misrepresentation and Omission.

Plaintiffs’ claims alleging Aequitas committed primary violations of the Oregon Securities Law through misrepresentation and omission sound in fraud, and must be pleaded with particularity. Of the two misrepresentation or omission statutes, the parties contest the applicability of Rule 9(b) only to claims under ORS § 59.115(1)(b); Plaintiffs agree that Rule 9(b) applies to claims under ORS § 59.135(2). Thus, Plaintiffs must plead all allegations of misrepresentation and omission with particularity whether or not Rule 9(b) applies to the claims of misrepresentation or omission. Still, Defendants seek to dismiss all claims arising under ORS § 59.115(1)(b) for failure to comply with the pleading requirements of Rule 9(b). The court therefore must determine whether Rule 9(b) applies to claims under ORS 59.115(1)(b).
The allegations against the Aequitas entities, under both ORS § 59.115(1)(b) and § 59.135(2), allege a broad fraudulent scheme to conceal the financial infirmities of the Aequitas enterprise. (FAC ¶¶ 71–175.) Regardless of whether all claims under ORS § 59.115(1)(b) are subject to Rule 9(b), Plaintiffs’ claim of a substantial pattern of misrepresentation, omission, and other deception sounds in fraud. Vess, 317 F.3d at 1101–05 (complaint alleging a course of willful misrepresentations and omissions regarding pharmaceuticals was a “unified course of fraudulent conduct” subject to Rule 9(b)); see also Aero Marine Engine, Inc. v. Transporter, Inc., 3:05-cv-1469-HA, 2007 WL 3128500, at *3 n.2 (D. Or. Oct. 23, 2007) (concluding both statutes create statutory fraud actions). Accordingly, the court holds that Rule 9(b) requires pleading with particularity all of Plaintiffs’ claims of misrepresentation and omission.

D. Secondary Liability.

Defendants, and Tonkon in particular, argue claims of participant and material aid liability are also securities fraud claims that must be pleaded with particularity. Defendants rely on cases describing non-seller liability under ORS § 59.115(3) as a “securities fraud” claim. Jost v. Locke, 65 Or. App. 704, 709 n.4 (1983); Paulsell v. Cohen, No. Civ. 00-1175-ST, 2002 WL 31496397, at *27 (D. Or. May 22, 2002). Neither Jost nor Paulsell applied Rule 9(b) to claims for non-seller liability. Jost, 65 Or. App. at 709 n.4; Paulsell, 2002 WL 31496397, at *27. As previously noted, participant and material aid liability does not require allegations of wrongdoing, let alone fraud, by the non-seller. Anderson, 146 Or. App. at 683. Claims for non-registration which do not allege fraud are not made subject to Rule 9(b) by the presence of separate claims alleging fraud. Vess, 317 F.3d at 1104 (“The rule does not require allegations supporting a claim to be stated with particularity when those allegations describe non-fraudulent conduct.”).

III. Collective References to the Aequitas Entities.

Throughout the FAC, Plaintiffs refer generally to “Aequitas” and the “Aequitas Securities.” Defendants oppose Plaintiffs’ use of collective references to the Aequitas group and to the securities sold by the Aequitas group. Under both Rules 8 and 9(b), Defendants contend Plaintiffs must distinguish between legally distinct Aequitas entities and securities. Plaintiffs disagree. Plaintiffs argue the court may, as a matter of law, disregard the separateness of the Aequitas entities and the securities they sold. As to the entities, Plaintiffs contend the piercing the corporate veil doctrine allows the court to disregard the nominal separateness of the Aequitas entities. Plaintiffs also argue that the group-pleading doctrine allows Plaintiffs to refer generally to the Aequitas group because of the close organizational and functional ties between the entities. Regarding the securities, Plaintiffs ask the court to consider all securities issued by the Aequitas group as an integrated offering — essentially, to disregard the separateness of the securities.
A. Piercing the Corporate Veil.

The court first considers whether the doctrine of piercing the corporate veil supports treating the Aequitas group as one entity for the purposes of the Oregon Securities Law. Plaintiffs argue the Aequitas group’s use of subsidiary and affiliate business entities helped conceal the true financial health and structure of the Aequitas group. Therefore, Plaintiffs conclude, the court may disregard the corporate separateness of the individual Aequitas entities in this case. Oregon law does not support Plaintiffs’ conclusion. Even if Plaintiffs could pierce the corporate veils between one or more Aequitas entities in a case against the Aequitas group, Oregon law provides no basis for using veil-piercing to extend non-seller liability under ORS 59.115(3).

Plaintiffs do not cite, nor can the court find, any decision by an Oregon appellate court considering whether the veil-piercing doctrine extends to secondary liability. This court’s task is to “reasonably determine the result that the [Oregon Supreme Court] would reach if it were deciding the case.” Gonzales v. CarMax Auto Superstores, LLC, 840 F.3d 644, 649 (9th Cir. 2016). Where Oregon appellate decisions do not provide direct guidance, the court may still provide a remedy based on the methods of interpretation used by state courts. Id.

Oregon law allows courts to disregard corporate separateness to allow an injured party to recover from a corporate parent based on an injury inflicted by a subsidiary or affiliate. State ex rel. Neidig v. Superior Nat’l Ins. Co., 343 Or. 434, 454–55 (2007) (citing Amfac Foods v. Int’l Sys. & Controls Corp., 294 Or. 94, 108–09 (1982)). Control and ownership alone is not enough to support veil-piercing; the corporate separateness must be used to achieve some injustice or perpetrate a fraud. Id. at 108. The underlying rationale is to keep wrongdoers from using corporate forms to avoid responsibility. Id.
In *Amfac*, the court undertook a survey of past veil-piercing cases, to determine the underlying rationale of the doctrine. *Amfac*, 294 Or. at 103–08. The court described the limited liability inherent in corporate forms, and focused the exception on “conduct of the [parent or affiliate] sought to be charged, and the relationship between the improper conduct and the creditor’s claim.” *Id.* at 108. The “extraordinary remedy” of disregarding the separateness of legal entities rests on the defendant’s misconduct. *Id.* at 103, 108–09. Here, Defendants’ liability is purely derivative of alleged violations by the Aequitas entities. *Anderson*, 146 Or. App. at 683. Piercing the corporate veil to expand Defendants’ liability would disadvantage parties who face no allegations of unlawful conduct, much less alleged use of corporate forms to evade liability. Imposing expanded liability against parties who have not engaged in culpable wrongdoing is inconsistent with the purpose of Oregon’s veil-piercing doctrine because the veil-piercing doctrine turns on culpable conduct by the defendant. Accordingly, even if piercing the corporate veil would apply in a direct lawsuit by Plaintiffs against the Aequitas entities, the rationale behind the doctrine does not support expanding the liability of third-party non-sellers under the Oregon Securities Law. Therefore the court declines to apply the veil-piercing doctrine to derivative liability actions under ORS § 59.115(3).

**B. Group Pleading.**

Plaintiffs contend the group pleading doctrine allows a general reference to an affiliated group of business entities acting jointly. The group pleading doctrine allows a plaintiff to allege wrongdoing against a group of individuals or entities jointly engaging in fraudulent or conspiratorial conduct. *Wool v. Tandem Computers*, 818 F.2d 1433, 1440 (9th Cir. 1987) (allowing group pleading where a group of corporate officers jointly published fraudulent financial statements), *overruled on other grounds by Hollinger v. Titan Capital Corp.*, 914 F.2d
1564, 1575 (9th Cir.1990) (en banc). Defendants argue group pleading is inappropriate in this case.

Here, Plaintiffs seek to use group pleading to plead the primary liability of the Aequitas entities, which are not parties to this action. Group pleading arose as a mechanism for alleging a defendant’s liability when the specifics of a defendant’s participation in a common scheme or fraudulent action are unknown to a plaintiff. See, e.g., DiVittorio v. Equidyne Extractive Indus., Inc., 822 F.2d 1242, 1248 (2d Cir. 1987) (allowing group pleading against a partnership where the allegations dealt with internal operations). Group pleading remains a way to allege joint participation in a venture where a plaintiff cannot know the specifics of individual involvement. In re TFT-LCD (Flat Panel) Antitrust Litig., 599 F. Supp. 2d 1179, 1184–85 (N.D. Cal. 2009) (allowing group pleading against corporate families as to a price-fixing conspiracy); see also Wool, 818 F.2d at 1440 (noting that “where possible, Wool has extended such particularity to the individual defendants.”).

Defendants object to Plaintiffs’ use of group pleading in this lawsuit as impermissibly lumping together all of the Funds and Control Entities. See Swartz v. KPMG LLP, 476 F.3d 756, 764–65 (9th Cir. 2007) (“Rule 9(b) does not allow a complaint to merely lump multiple defendants together but ‘require[s] plaintiffs to differentiate their allegations when suing more than one defendant . . . .’”) (internal quotation marks and citation omitted). Because each defendant had varying involvement with different entities or groups of entities, Defendants argue the FAC does not provide sufficient notice of their alleged involvement with the Aequitas group, and thus the scope of the claims against them. Thus, Defendants conclude any use of group pleading must also provide each defendant with sufficient notice of the allegations against that defendant.
Group pleading is appropriate where Plaintiffs allege fraud in the inner workings of Aequitas. For example, Plaintiffs allege the Aequitas entities concealed the true operations and financial health of the Aequitas entities through complex financial engineering and use of “shell” entities. (FAC ¶¶ 163–67.) This allegation addresses conduct Plaintiffs could not know when filing their lawsuit, and therefore is properly pleaded using group pleading. But most of the allegations in the complaint relate to misrepresentations and omissions by individual Aequitas entities. Here, Defendants’ objection to Plaintiffs’ use of group pleading has merit.

Plaintiffs fail to satisfy the requirements of either Rule 9(b) or Rule 8 by referring generally to “Aequitas” making misrepresentations and omissions. Defendants’ secondary liability is contingent upon transactions they participated in or materially aided through working relationships with ACF and the Funds. Defendants did not work with “Aequitas” — Defendants worked with individual Aequitas entities. (FAC ¶ 30.) Defendants cannot defend against Plaintiffs’ claim without knowing who sold the securities at issue. Plaintiffs argue Defendants have sufficient information to know which “Aequitas” each allegation refers to, but this argument does not address the requirements of Rules 8 and 9(b). Particularity, not presumption, is the standard in federal courts. To provide notice to Defendants — and certainly to allege fraud with particularity — Plaintiffs must, where possible, identify the entity that allegedly made each misrepresentation or omission.

The court should grant Defendants’ motions to dismiss as to all allegations of actions by or interactions with “Aequitas” instead of a specific Aequitas entity. The allegations of misrepresentations and omissions in paragraphs 72–135, 141–45, 148–50, 153, 159, 161, 166, 168, and 173 all improperly refer to “Aequitas” without identifying a specific Aequitas entity. Additionally, the allegations of Defendants’ participation in or material aid for the Aequitas
group’s securities business in paragraphs 30, 32, 35, 39, 43, 45, 49, 51, 54, 57, 59, and 61 all improperly refer to a defendant’s interactions with “Aequitas.”

C. Integrated Offering.

Plaintiffs also refer to the securities sold by all Aequitas entities, without distinction among the various securities. Defendants argue that by referring to the Disputed Securities and other securities sold by Aequitas entities without distinction, Plaintiffs improperly ignore differences including type of security, seller, and offering documents. In response, Plaintiffs contend the court should view any security sold by an Aequitas entity as an “integrated offering,” disregarding the separateness of the securities when determining whether the securities were sold in violation of the Oregon Securities Law. The court rejects Plaintiff’s integrated offering theory. First, Plaintiffs do not establish that an integrated offering theory exists under the Oregon Securities Law. Second, just as Plaintiffs cannot use a unitary reference for the Aequitas group, Rule 9(b) does not allow them to make unitary reference to the securities sold by the Aequitas group.

Under Plaintiffs’ integrated offering theory, the Aequitas group was the “issuer” of all securities sold by individual entities and, thus, the court may disregard the distinction between the individual securities. The only authority Plaintiffs offer are cases interpreting the term “issuer” in the federal Securities Act, defined in 15 U.S.C. § 77b(4). See, e.g., S.E.C. v. Murphy, 626 F.2d 633, 643 (9th Cir. 1980) (construing § 77b(4) to determine the availability of a private offering exemption under § 77d). Plaintiffs conclude that “Aequitas” is the issuer of all securities sold by any Aequitas entity, and therefore that the Disputed Securities and any other securities sold by an Aequitas entity are part of an integrated offering. The court disagrees. Even if the Aequitas group is the issuer of all of the securities its subsidiaries and affiliates sold,
it does not follow that the securities are all part of an integrated offering for purposes of
determining secondary liability for misrepresentations, omissions, and selling unregistered securities.

First, “issuer,” as applied in § 77d and construed in Murphy, relates to the availability of
a private-offering exemption from registration. Murphy, 626 F.2d at 641–42. The question presented there was whether, to qualify for an exemption from registration, a subsidiary had to provide information to prospective investors about its parent company. Id. at 637–38. Murphy did not address secondary liability or claims of misrepresentation. Id. The term “issuer” does not appear in the federal analogue to ORS § 59.115. 15 U.S.C. § 77l; see Karsun v. Kelley, 258 Or. 155, 161 (1971) (ORS § 59.115 was modeled on 15 U.S.C. § 77l). Nor does “issuer” appear in ORS §§ 59.115 or 59.135, even though “issuer” is defined and used elsewhere in the Oregon Securities Law. See OR. REV. STAT. §§ 59.015 (9) (definition); 59.035 (use). Accordingly, Murphy and similar cases do not support an integrated offering theory under the Oregon Securities Law because they address construe a defined term that does not appear in the statutes. Plaintiffs offer no other authority for their integrated offering theory or any other basis for disregarding the differences between the Disputed Securities as a matter of law.

Second, for the same reasons Plaintiffs cannot refer to the many Aequitas entities as “Aequitas,” Rules 8 and 9(b) do not allow Plaintiffs to refer to securities sold at different times, by different entities, and using different offering documents as “Aequitas Securities.” Defendants have varying relationships to different Aequitas entities and their securities offerings, and thus lack sufficient notice of the claims against them where Plaintiffs use “Aequitas Securities.”
In sum, Plaintiffs’ allegations fail to distinguish between the securities sold by different Aequitas entities. Plaintiffs’ integrated offering theory is unsupported by the Oregon Securities Law, and does not allow consideration of all of the “Aequitas Securities” as a single securities offering. The unitary reference to “Aequitas Securities” is also insufficient under Rules 8 and 9(b).

D. Dismissal with Leave to Amend.

The court should dismiss the FAC for failure to comply with Rule 9(b) insofar as the FAC refers to “Aequitas” or the “Aequitas securities.” Oregon law does not support disregarding the legal separateness of the Aequitas entities or the Aequitas securities for the purposes of non-seller liability under the Oregon Securities Law. Moreover, the group-pleading doctrine does not support allegations of conduct by “Aequitas,” except where the allegations are of internal operations where Plaintiffs could not reasonably know which Aequitas entity or entities engaged in specific conduct.

The FAC is premised on Plaintiffs’ legal theory that the Aequitas group and all securities sold by Aequitas entities are legally indistinguishable in the secondary-liability context. Because this theory is not legally viable, all allegations regarding “Aequitas” and “Aequitas securities” are insufficiently pleaded. The court should therefore dismiss the FAC, with leave to amend, and Plaintiffs should be required to allege actions by specific Aequitas entities and differentiate between the securities sold by Aequitas entities.

IV. Consideration of Documents.

Defendants, and Deloitte in particular, ask the court to take judicial notice of several documents in support of their motions to dismiss. Plaintiffs do not object to judicial notice of some documents, specifically: (1) certain Generally Accepted Auditing Standards (“GAAS”)
(Masuda Decl., Exs. 1–4); (2) SEC filings by the Funds (Id. Exs. 6–10); and (3) the complaint filed in the SEC lawsuit. (Id. Ex. 25). Plaintiffs condition their position on the purpose of the notice: they do not object to judicial notice of the documents, if limited to the existence of the documents and not the facts therein. (Pls.’ Partial Objs. To Defs.’ Req. for Judicial Notice (ECF No. 117), at 1.) Plaintiffs contest judicial notice of the facts asserted in the SEC filings and application of the incorporation by reference doctrine to the PPMs. (Id.)

A. SEC Filings and Court Documents.

Courts may take judicial notice of information “not subject to reasonable dispute in that it is either (1) generally known within the territorial jurisdiction of the trial court or (2) capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned.” Fed. R. Evid. 201(b). Court filings are public records, whose authenticity is not subject to reasonable dispute. Lee v. City of Los Angeles, 250 F.3d 668, 688–89 (9th Cir. 2001). SEC filings are also public records subject to judicial notice. Vesta Corp. v. Amdocs Mgmt. Ltd., 129 F. Supp. 3d 1012, 1020–21 (D. Or. 2015). When taking judicial notice of public records, courts take notice of the existence of the records rather than the information contained in the records. Id.; Lee, 250 F.3d at 690. Courts may not take judicial notice of reasonably disputed facts, nor may courts draw inferences from documents subject to judicial notice “that contradict the reasonable inferences drawn from the facts alleged in Plaintiff[s’] complaint.” Lee, 250 F.3d at 1022. Accordingly, the court takes judicial notice of the existence SEC Complaint and SEC Filings, but only as to the existence of the documents.

B. GAAS Documents.

The court should take judicial notice of the GAAS document, to establish the terms of the GAAS themselves. See In re Medicis Pharm. Corp. Sec. Lit., 689 F. Supp. 2d 1192, 1202 n.6
But at this stage in the litigation, courts cannot infer from the terms of the GAAS that an auditor complied or did not comply with the GAAS in their auditing activities because the court must accept Plaintiffs’ allegations as true. 

Whether EisnerAmper and Deloitte actually complied with GAAS in auditing the Aequitas entities is an issue of fact inappropriate for resolution on a motion to dismiss.

C. Documents Incorporated by Reference.

The most contentious issue regarding extraneous documents is consideration of engagement letters between Deloitte and some Aequitas entities (Masuda Decl. Exs. 12–13), certain PPMs (Id. Exs. 14–16; Van der Weele Decl. Exs. 1–3), and Deloitte-audited financial documents for some Aequitas entities (Masuda Decl. Exs. 16–24). While the motion for judicial notice is submitted by all Defendants, Deloitte is the proponent of the documents at issue. (Def. Deloitte & Touche LLP’s Reply in Supp. of Req. for Judicial Notice (ECF No. 133).) Deloitte seeks judicial notice of these documents under the incorporation-by-reference doctrine. See Knievel v. ESPN, 393 F.3d 1069, 1076 (9th Cir. 2005) (applying the doctrine). Incorporation by reference allows the court to consider documents outside of the complaint when ruling on a motion to dismiss, but only under a narrow set of circumstances. Id. A document is incorporated by reference when its “contents are alleged in a complaint,” the document’s authenticity is undisputed, and the document is not attached to the complaint. Id. (quoting In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 986 (9th Cir. 1999)). The doctrine also applies when “the plaintiff's claim depends on the contents of a document, the defendant attaches the
document to its motion to dismiss, and the parties do not dispute the authenticity of the document, even though the plaintiff does not explicitly allege the contents of that document in the complaint.” *Id.* (citing *Parrino v. FHP, Inc.*, 146 F.3d 699, 706 (9th Cir. 1988)).

Deloitte argues the engagement letters, PPMs, and audited financial documents are incorporated by reference in the FAC because the allegations against Deloitte explicitly mention or implicitly rely on the documents. Plaintiffs do not dispute the authenticity of any of the proffered documents, but, plaintiffs disagree that the FAC incorporates the documents by reference. Alternatively, Plaintiffs argue the court should not use the documents to draw inferences adverse to Plaintiffs at this stage in the litigation. *See Vesta*, 129 F. Supp. 3d at 1022 (refusing to draw inferences adverse to the nonmoving party from documents subject to judicial notice in ruling on a motion to dismiss).

The court does not consider the engagement letters under the incorporation by reference doctrine. The distinction between the engagement letter and the scope of work done by Deloitte is important. Deloitte argues the engagement letters are subject to judicial notice, based on the following premise: “Deloitte’s engagement as independent auditors depends on the contents of the engagement letters which define the engagement.” (Req. for Judicial Notice at 11.) Deloitte’s argument for considering the engagement letters conflates the terms of the engagement letter with the scope of work Deloitte actually performed for the Aequitas group, as alleged in the FAC. Plaintiffs do not allege the contents of or otherwise rely on the engagement letter between Deloitte and the Aequitas entities. Thus, while Deloitte’s work for the Aequitas group is central to the FAC, the terms of its engagement letter are not.

The court does consider the PPMs, but not the other documents, under the incorporation by reference doctrine. The FAC references the PPMs repeatedly (FAC ¶¶ 32, 39, 45, 51, 57, 61),
and relies on the alleged misrepresentations and omissions in the PPMs as a basis for the Aequitas entities’ primary violations of the Oregon Securities Law (see, e.g., id. ¶¶ 137–40). Because Plaintiffs allege the contents of the PPMs, but did not attach the PPMs to the complaint, the PPMs are subject to judicial notice.

The parties also contest the extent to which the court may disregard Plaintiffs’ allegations based on the PPMs. Deloitte argues the court may disregard allegations in the FAC when contradicted by the PPMs. See Sprewell, 266 F.3d at 988 (“The court need not, however, accept as true allegations that contradict matters properly subject to judicial notice or by exhibit.”). Plaintiffs reply that the court cannot use inferences drawn from extrinsic documents to contradict the allegations in the FAC. Vesta, 129 F. Supp. 3d at 1021–22 (citing Lee v. City of Los Angeles, 250 F.3d 668, 688 (9th Cir. 2001). Deloitte argues Vesta is inapplicable to this case because it dealt with judicially noticed documents, not documents incorporated by reference. See id. at 1020.

The court considers the PPMs as though they were attached to the complaint, and construe the contents of the PPMs in the light most favorable to Plaintiffs. The court may “treat [documents incorporated by reference] as part of the complaint.” United States v. Ritchie, 342 F.3d 903, 908 (9th Cir. 2003). The court must also construe the complaint in the light most favorable to Plaintiffs when ruling on a motion to dismiss. See Zucco Partners, LLC v. Digimarc Corp., 552 F.3d 981, 989 (9th Cir. 2009). Accordingly, whether under the analysis articulated in Vesta and Lee or by treating the documents as part of the complaint, the court must construe the contents of the documents in the light most favorable to the plaintiff when ruling on a motion to dismiss. Id.
V. Sale of Securities Without Proper Registration.

Plaintiffs allege the Aequitas Entities sold securities without registration, in violation of the Oregon Securities Law. Defendants move to dismiss Plaintiffs’ non-registration claims, both as a matter of law and as insufficiently pleaded. Plaintiffs’ claims are legally viable, but are insufficiently pleaded. Accordingly, the court should grant Plaintiffs’ motions to dismiss as to the non-registration claims, with leave to amend.

A. Status as Federal Covered Securities.

Defendants first argue the non-registration claims fail as a matter of law. Defendants contend the Disputed Securities were exempt from registration under Oregon law because the Disputed Securities were federal covered securities. Oregon's Blue Sky law defines a federal covered security by reference to the federal Securities Act. OR. REV. STAT. § 59.015(5) (referring to 15 U.S.C. § 77r(b)). Defendants argue the Disputed Securities were sold pursuant to the private-offering exception of Securities and Exchange Commission Regulation D ("Regulation D"), 17 C.F.R. §§ 230.500-.508. In support of this argument, Defendants ask the court to take judicial notice of Form D filings for the Disputed Securities, notifying the SEC that the Securities would be sold without registration, under one of the Regulation D exceptions. (Masuda Decl., Exs. 5-10.)

Securities meeting the requirements of Regulation D are federal covered securities. 15 U.S.C. § 77r(b)(4) ("A security is a covered security with respect to a transaction that is exempt from registration under [federal statutes and regulations, including Regulation D]"). A security is exempt from registration under Regulation D, and therefore a covered security, only if the security actually meets the requirements of Regulation D. See, e.g., 17 C.F.R. § 230.506(a) (exempting from registration"[o]ffers and securities by an issuer that satisfy the conditions in
paragraph (b) or (c) of this section"; see also Brown v. Earthbound Sports USA, Inc., 481 F.3d 901, 912 (6th Cir. 2007) (“[F]ar from defining ‘covered securities’ in a manner that generally incorporates all securities, the SEC has promulgated specific requirements that must be met in order for a security to be ‘covered.’”). The plain text of section 77r(b)(4) does not reach securities that do not actually qualify for an exemption. 15 U.S.C. § 77r(b)(4).

Defendants argue that the Form D filings establish the Disputed Securities’ status as a matter of law, but a Form D filing alone does not establish a security's status under Regulation D. 17 C.F.R. § 230.503 (requiring a Form D filing for all offerings "in reliance on" Regulation D); see also Chanana's Corp. v. Gilmore, 539 F. Supp. 2d 1299, 1303-04 (W.D. Wash. 2003) (a security may still qualify as a covered security under Regulation D even if the Form D filing is deficient). Moreover, the court can take judicial notice only of the fact of an SEC filing, not the assertions made therein. Vesta, 129 F. Supp. 3d at 1021. The Form D filings establish the Aequitas Entities claimed Regulation D exemptions for the Disputed Securities, id., but to show the Disputed Securities are federal covered securities, the Defendants must prove the Securities actually fall under Regulation D. See 15 U.S.C. § 77r(b)(4). The Form D filings do not prove the Disputed Securities actually qualify for a Regulation D exemption, and thus do not establish as a matter of law that the Disputed Securities are federal covered securities.

B. NSMIA Preemption.


Defendants argue that the Form D filings establish the Disputed Securities’ status as a matter of law, but a Form D filing alone does not establish a security's status under Regulation D. 17 C.F.R. § 230.503 (requiring a Form D filing for all offerings "in reliance on" Regulation D); see also Chanana's Corp. v. Gilmore, 539 F. Supp. 2d 1299, 1303-04 (W.D. Wash. 2003) (a security may still qualify as a covered security under Regulation D even if the Form D filing is deficient). Moreover, the court can take judicial notice only of the fact of an SEC filing, not the assertions made therein. Vesta, 129 F. Supp. 3d at 1021. The Form D filings establish the Aequitas Entities claimed Regulation D exemptions for the Disputed Securities, id., but to show the Disputed Securities are federal covered securities, the Defendants must prove the Securities actually fall under Regulation D. See 15 U.S.C. § 77r(b)(4). The Form D filings do not prove the Disputed Securities actually qualify for a Regulation D exemption, and thus do not establish as a matter of law that the Disputed Securities are federal covered securities.

B. NSMIA Preemption.

exemption, but neither the Ninth Circuit nor courts in this district have considered the issue. Some courts have found that NSMIA preempts state regulation of securities sold "pursuant to [federal regulations] regardless of whether the private placement actually complied with the substantive requirements of" the regulations. See, e.g., Temple v. Gorman, 201 F. Supp. 2d 1238, 1243-44 (S.D. Fla. 2002). Other courts, including the only federal court of appeals to consider the issue, held that NMSIA preempts only state regulation of those securities that actually qualify for a federal exemption. See, e.g., Brown, 481 F.3d at 910-12. The court concludes NSMIA preemption is limited to securities that actually qualify as covered securities under federal law.

NSMIA expressly preempts state laws from requiring registration of federal covered securities. 15 U.S.C. § 77r(a)(1). The statute is silent as to securities that are not covered securities but are sold as though they were. Id. As the court concluded previously, a security is only a covered security under federal law if it actually meets the requirements of federal law — here, compliance with Regulation D. The broader scope of preemption found in Temple and similar cases derives from the legislative history of NSMIA instead of the text. Temple, 201 F. Supp. 2d at 1242-44. Temple found a broader scope of preemption because of the legislative gloss accompanying NSMIA, which states "securities sold in private transactions under section 4(2) of the Securities Act would be 'covered securities,' and thus preempted, if offered or sold pursuant to a[n SEC] rule or regulation adopted under such section 4(2)." Id. at 1243 (quoting H.R. Rep. No. 104-622, at 32(1996)).

In light of the unambiguous text of the statute, the legislative history of NSMIA will require a contrary result only if "the legislative history clearly indicates that Congress meant something other than what it said." Close v. Thomas, 653 F.3d 970, 975 (9th Cir. 2011) (internal
quotation marks omitted) (citation omitted). The legislative history of NSMIA does not clearly indicate Congress intended "covered securities" to include securities sold under a putative exemption from registration. H.R. Rep. No. 104-622, at 16, 32, reprinted in 1996 U.S.C.C.A.N 3877; see also Brown, 481 F.3d at 911-12. The language the Temple court relied on was a reference to “securities offered or sold pursuant to a Commission rule or regulation” as covered securities. H.R. Rep. No. 104-622, at 32. Without more explicit language that being sold “pursuant to” a regulation included telling investors that a regulation applied when the regulation did not apply, the court cannot find that NSMIA preemption applies beyond the plain language of the statute. Close, 653 F.3d at 975; see also Brown, 481 F.3d at 911-12 ("[T]he statute plainly restricts its preemptive scope to 'covered securities,' and it neither defines, nor requires the SEC to define, 'covered securities' in a fashion that would actually include all securities."). Accordingly, NSMIA does not preempt ORS 59.055, which by its terms does not apply to federal covered securities.

C. Sufficiency of Non-Registration Allegations.

Defendants’ final argument is that even if NSMIA does not preempt ORS § 59.055, Plaintiffs' non-registration claim is insufficiently pleaded. Rule 8’s plausibility requirement applies to Plaintiffs’ non-registration claims. Plaintiffs allege in the FAC that under ORS § 59.055 the Disputed Securities were not registered (FAC ¶¶ 31, 38, 44, 50, 56, 60) and were required to be registered (id. ¶¶ 72–78). Under ORS § 59.055, a security must be registered unless it is a federal covered security or satisfies a statutory exemption. Under ORS § 59.055: "It is unlawful for any person to offer or sell any security in this state, unless: (1) The security is registered . . . (2) The security is exempt under ORS 59.025 or the sale is exempt under ORS 59.035; or (3) The security is a federal covered security . . . ." Defendants argue the non-
registration allegations are insufficient because they do not plead facts showing that the Disputed Securities were not federal covered securities. Plaintiffs contend a separate provision of the Oregon Securities Law, ORS § 59.275, allows them to assert a claim for violation of ORS § 59.055 without pleading facts showing the conditions of subsections (2) or (3) of section 055 were not present. Under ORS § 59.275, Plaintiffs content they do not have the burden of pleading “any of the exemptions or classifications provided in the Oregon Securities Law.” OR. REV. STAT. § 59.275.

Plaintiffs must plead facts showing the Disputed Securities were not federal covered securities. As an initial matter, this dispute is rendered moot by Plaintiffs’ allegations that the Aequitas entities violated ORS §§ 59.115(1)(b) and 59.135(2) by failing to disclose that the Disputed Securities were required to be registered. (FAC ¶¶ 72–78.) These allegations are subject to the particularity requirements of Rule 9(b), for the reasons discussed previously. Even if Plaintiffs did not implicate the registration status of the Disputed Securities in their misrepresentation/material omission allegations, Rule 8 requires Plaintiffs to allege facts showing the Disputed Securities were not federal covered securities.

A federal court exercising diversity jurisdiction applies state substantive law and federal procedural law. *Erie R. Co. v. Tompkins*, 304 U.S 64, 78 (1938). Where a Federal Rule of Civil Procedure governs a question, the court applies the Rule, even where a state court would reach a different conclusion. *In re County of Orange*, 784 F.3d 520, 527 (9th Cir. 2015 (citing *Hanna v. Plumer*, 380 U.S. 460, 470–71 (1964)); *Vess*, 317 F.3d at 1103–04 (federal pleading standards apply to state-law causes of action in federal court). Here, Rule 8(a) governs the question of what facts must be pleaded to state a claim under ORS § 59.005. The more permissive pleading standard of ORS § 59.275 would allow Plaintiffs to plead a legal conclusion, unsupported by
facts.  *Cf. Twombly*, 550 U.S. at 555 (Rule 8 “requires more than labels and conclusions, and a
formulaic recitation of the elements of a cause of action will not do.”)

Under ORS § 59.055, that a security is not a federal covered security or statutorily
exempt from registration are elements of a violation, not affirmative defenses to a violation.
Accordingly, Rule 8(a) requires Plaintiffs to plead facts showing all three elements of a violation
*9-10 (S.D.N.Y. Mar. 27, 2008) (dismissing a claim under ORS § 59.055 for failing to allege
facts showing the securities at issue were federal covered securities or exempt from registration
under state law).  The court should dismiss Plaintiffs’ claim under ORS § 59.055 for failure to
state a claim, with leave to amend.

VI. Misrepresentations and Omissions.

Defendants also assert six grounds for challenging Plaintiffs’ allegations of
misrepresentations and omissions regarding the Securities, arising under the elements of primary
violations of the Oregon Securities Law and the particularity requirement of Rule 9(b).  First,
Defendants argue Plaintiffs fail to connect the majority of Aequitas’ alleged misrepresentations
and omissions with specific representations to purchasers.  Second, Defendants seek to dismiss
all of Plaintiffs’ misrepresentation claims for failing to allege a causal connection between the
misrepresentations and Plaintiffs’ purchases.  Third, Defendants contend Plaintiffs’
misrepresentation claims are improper because Plaintiffs do not allege that specific affirmative
representations were false when made.  Fourth, Defendants argue Plaintiffs’ omissions claims
fail because Plaintiffs do not connect the alleged omissions with any affirmative statement.
Fifth, Defendants seek dismissal of some misrepresentation and omission claims because the

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misleading communications appeared to occur after the sale. Sixth, and finally, Defendants claim Plaintiffs did not sufficiently allege the Aequitas entities acted with scienter.

A. Structure and Purpose of ORS § 59.115(1)(b).

Initially determining the proper construction of ORS § 59.115(1)(b) is necessary here, as multiple arguments depend on the terms of the statute. Plaintiffs’ claims against Defendants are derivative of the Aequitas entities’ primary violations of Oregon securities laws. Specifically, ORS § 59.115(3) provides for secondary liability for material aid or participation in sales violating ORS § 59.115(1). One does not violate ORS § 59.115(3); secondary liability attaches because of the seller’s violation and the non-seller’s involvement in the sale. Ainslie v. First Interstate Bank of Or., N.A., 148 Or. App. 162, 184 (1997). Plaintiffs allege the Aequitas entities violated ORS § 59.115(1)(b) by misrepresentations and omissions regarding the operations and financial health of the Aequitas entities. Accordingly, to resolve Defendants’ arguments that Plaintiffs insufficiently pleaded the Aequitas entities’ primary violations of Oregon securities law, the court first must determine the requirements of a claim under ORS § 59.115(1).

The Oregon Legislature adopted ORS § 59.115(1)(b) in 1967. The subsection remains substantially unchanged. The Legislature intended ORS § 59.115(1)(b) to mirror a provision of the Federal Security Act of 1933, 15 U.S.C. § 77l(2). Karsun, 258 Or. at 161. Thus, decisions construing the parallel federal statute are instructive in interpreting ORS § 59.115(1)(b). Id. The provisions of ORS § 59.115 and the remainder of the Oregon Securities Law are “to be liberally construed to afford the greatest possible protection to the public. Adamson v. Lang, 236 Or. 511, 516 (1964).
Plaintiffs allege Aequitas’ primary violation occurred under the following provision: “A person is liable . . . if the person sells or successfully solicits the sale of a security . . . by means of an untrue statement of a material fact or omission.” OR. REV. STAT. § 59.115(1)(b). A substantial disagreement exists regarding the scope of two components of the provision: what is the scope of “selling a security,” and what nexus does “by means of” require. First, Defendants argue the “sale” of a security is limited to individual purchases, i.e., each purchase is an independent sale for purposes of Section 115. Plaintiffs construe “sale” to reach the entire offering of related securities. Second, Defendants contend Section 115 requires Plaintiffs to plead a causal connection between the misrepresentation and the sale. Plaintiffs contend Section 115 allows an action based on sales of a security merely if the seller made a material misrepresentation or omission regarding that security, without need of causation.

B. Connection Between Misleading Information and Sale.

Defendants argue the FAC fails to allege sufficient connections between the alleged misrepresentations and omissions and individual purchases. Defendants first contend Plaintiffs must plead that individual purchasers purchased Disputed Securities based on misleading information. This contention is incorrect. A primary violation of ORS § 59.115(1)(b) does not require reliance on a misrepresentation or omission. *Everts v. Holman*, 64 Or. App. 145, 152 (1983) (“ORS 59.115(1)(b) imposes liability without regard to whether a buyer relies on the omission or misrepresentation.”). Moreover, a case interpreting the federal analogue to ORS § 59.115(1)(b) rejected any requirement that a buyer receive the misleading communication, if the seller sold a group of securities by means of a material misstatement or omission. *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1226–27 (7th Cir. 1980), cited in *Everts*, 64 Or. App. at 152.
Defendants also argue Plaintiffs must plead individual receipt of offering documents containing misrepresentations or omissions. In support, Defendants cite cases describing ORS 59.115 as covering “face-to-face transactions.” See, e.g., State v. Marsh & McLennan Cos., Inc., 353 Or. 1, 12 (2012). Defendants interpret “face-to-face” as limiting the scope of an ORS § 59.115(1)(b) violation to an individual transaction between one buyer and one seller. Defendants also rely on an Oregon Circuit Court case, Loewen v. Galligan, No. A9005-02822, 1992 WL 12582753 (Or. Cir. Ct. Aug. 19, 1992), aff’d 130 Or. App. 222 (1994). Loewen held that a securities transaction is not unlawful because of a subsequent misleading statement, as the prior sale was not “by means of” a misleading statement. Id. at *8. Defendants rely on other statements in Loewen, suggesting the misleading statement must cause the transaction. Id. In that respect, Loewen conflicts with Marsh and Everts by requiring transaction causation for a claim under ORS 59.115(1)(b). Compare id. at *8–9 with Marsh, 323 Or. at 17 (reliance and transaction causation are the same thing in securities fraud context) (quoting Dura Pharm., Inc. v. Broudo, 511 U.S. 164, 180 (2005)) and Everts, 64 Or. App. at 152 (no reliance requirement under ORS 59.115(1)(b)). Plaintiffs contend ORS 59.115(1)(b) requires only a nexus between communicated misrepresentation or omission and a group of securities.

Defendants argue ORS 59.115(1)(b) requires a plaintiff to plead receipt of a misleading communication. While Defendants correctly note that Oregon cases interpreting ORS § 59.115(1)(b) all involve receipt of a misleading communication, nothing in those decisions suggests receipt was a requirement. Instead, Everts expressly rejected a reliance requirement for claims under ORS 59 § 59.115(1)(b). Everts, 64 Or. App. at 152 (citing Sanders, 619 F.2d at 2

2 The appellate decision in Loewen did not discuss the aspects of the trial court’s decision upon which Defendants rely. See Loewen, 130 Or. App. at 239 (deciding the ORS 59.115 claim based on timeliness).
1225). The holding in *Everts* does not require receipt of a misleading communication simply because the plaintiff in that case received a misleading prospectus. *Id.*

Plaintiffs may plead sale of a security by means of a misleading statement where the seller made a misleading statement in the offering documents or other promotional materials for a security. *Sanders* contains an instructive fact pattern. There, a class of securities purchasers sued under the federal analogue to Section 115(1)(b) (15 U.S.C. § 77l(2)), alleging that the offering documents for a series of unsecured promissory notes contained misleading financial information. *Sanders*, 619 F.2d at 1224. The defendants claimed not all class members received the misleading offering documents, and thus could not state a claim because there was no causal relationship between the misleading documents and purchases. *Id.* at 1225. The court rejected the defendants’ argument, concluding requiring receipt of an offering document improperly imposes a reliance requirement and ignores the effect of misleading communications on the market price and reputation of a security. *Id.* at 1225–27. The court held that issuing securities using misleading documents makes all sales of that security “by means of” the misleading document, regardless of whether every purchaser received or relied on the documents. *Id.* at 1227 (“[I]t is enough that the seller sold by means of a misleading prospectus securities of which those purchased by the plaintiff were a part.”).

*Sanders* controls because it furthers the remedial purpose of Oregon’s Blue Sky law. Although *Sanders* is a non-binding aid to interpreting ORS 59.115, it interpreted the federal statute (15 U.S.C. § 77l(2)) upon which ORS § 59.115 was modeled. *Badger v. Paulson Inv. Co., Inc.*, 311 Or. 14, 21 (1991). *Sanders* makes clear that § 77l(2) was intended to reach all securities sold in an offering where the seller employed misleading communications to promote sales. *Sanders*, 619 F.2d at 1227. Further, the same statutory language at issue in *Sanders* —

*Sanders* also is consistent with *Everts* because requiring receipt of misleading communications serves no purpose other than implicitly requiring reliance. *Sanders*, 619 F.2d at 1225, *Everts*, 64 Or. App. at 152. Misleading communications have a broad effect on the reputation of a seller in the market, even when the securities are sold in private offerings. *Id.* at 1227 (“[P]ublication of [defendant’s] true financial condition would have caused a total collapse of the market for its notes.”). When the Funds sold securities using allegedly misleading offering documents and financial statements, all buyers of a security experienced the market effect of the Funds’ misrepresentations and material omissions. The Funds would not have been able to find buyers for the Disputed Securities had they represented the true condition and nature of the Aequitas entities as a whole. *See id.* Accordingly, the court addresses as “sales” each group of sales the Funds effected through the allegedly misleading PPMs and other communications.

The court also adopts the same approach for Plaintiffs’ claim under ORS § 59.115(1)(a) for violating ORS § 59.135(2). The provisions of ORS § 59.135 do not create an independent cause of action, but are actionable only through ORS §§ 59.115 and 59.137. *Marsh*, 353 Or. at 8. Plaintiffs bring their ORS § 59.135(2) claim under ORS § 59.115(1)(a). Both OR § 59.115(1)(a) and (1)(b) apply when a person “[s]ells or successfully solicits the sale of a security.” The connecting language between the misleading communication and sale is similar: “by means of” in ORS § 59.115(1)(b); “in connection with” in ORS § 59.135(2). Just a misleading offering documents and promotional materials render a group of sales “by means of” that misleading statement, the broad remedial purpose of the Oregon Securities Law also
supports finding those statements “in connection with” a group of sales, whether or not the purchaser received the statements.

In sum, ORS § 59.115(1)(b) requires Plaintiffs to plead actionable misrepresentations and omissions connected to a sale or group of sales of a security. Plaintiffs need not plead individual receipt of or reliance upon the misleading communications.

C. Where and When Misrepresentations and Omissions Occurred.

Defendants next argue Plaintiffs must allege that misstatements and omissions appeared in specific documents. Particularly, Defendants challenge the lack of specific connections between the alleged misrepresentations and omissions and the Disputed Securities. Put differently, Defendants argue it is unclear when the Funds made the alleged misleading statements, and in connection with which Disputed Securities. Defendants advance two specific arguments regarding to Plaintiffs’ lack of specificity in when and where misleading statements appeared. First, Defendants argue Plaintiffs must allege they received misleading information prior to the sale. Second, Defendants argue Rule 9(b) requires Plaintiffs to plead when and where the misleading statements occurred with particularity, including that the statements were false when made. Plaintiffs contend that, under Everts, they need not plead any connection between the misleading statements and a purchase of securities.

First, Plaintiffs must plead facts sufficient to show that allegedly misleading communications preceded Plaintiffs’ purchases of the Disputed Securities. As discussed above, the Oregon Securities Law does not require a plaintiff to allege or prove receipt of a misleading communication if the seller uses misleading communications to sell a group of securities of which the plaintiff’s purchase was a part. Everts, 64 Or. App. at 152. But the misleading communication must precede the sale. Loewen, 1992 WL 12582753, at *8–9.
Second, Plaintiffs must allege when and where misrepresentations and omissions appeared. Rule 9(b) applies to the primary-liability allegations against the Aequitas entities, for the reasons previously discussed. Under Rule 9(b), a plaintiff alleging misrepresentations or omissions must allege when and where the misleading statement was made, “what is misleading about [the] statement, and why it is false.” In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1548 (9th Cir. 1994), superseded by statute on other grounds by 15 U.S.C. § 78u–4(b)(2). Defendants also note that some of Plaintiffs’ allegations hinge on changing circumstances. For example, the Aequitas group’s investment in Corinthian and the ACF–Holdings loan both became much more problematic over time. (FAC ¶¶ 115, 155, 170–71.) Where, as here, whether a statement was misleading when made depends on changing circumstances, the plaintiff must allege that the statement was false when made. GlenFed, 42 F.3d at 1549.

Accordingly, the court should grant the motions to dismiss as to Plaintiffs’ allegations of misrepresentations and omissions by the Aequitas group, with leave to amend. The allegations in paragraphs 72–135, 149–50, 160–61, 163, 168, and 173 do not identify where and when the allegedly misleading statement appeared. The allegations in paragraphs 137–40 state when and where misleading statements about uses of funds appeared, but lack allegations showing why the statements were false when made. Similarly, the allegations in paragraphs 86–102, 115–16, 121, 132–33, 136, 144, 158, 160, 169, and 173 all concern misrepresentation or omissions about circumstances that changed over time, without alleging facts showing affirmative statements were false when made. Any amended complaint must comply with Rule 9(b) by alleging which Aequitas entity made a misrepresentation or material omission, when and where the statement was made, and what was misleading about the statement when made.
D. Material Omissions.

Defendants argue most of Plaintiffs’ omission claims fail to identify an affirmative statement made false by an omission. Under ORS § 59.115(1)(b), a violation occurs when a seller makes an “omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading.” Plaintiffs contend the broad remedial purpose of the Oregon Securities Law mandates full disclosure of material facts in promotional or offering materials.

No Oregon cases substantially discuss the contested provision, but two cases are instructive. In Foelker v. Kwake, 279 Or 379, 386 (1977), the court found allegations of material omissions sufficient when statements of account values were not accompanied by disclosure regarding problems with the accounts. Plaintiffs cite Foelker as support for their method of pleading, but Foelker identifies affirmative statements made false by omissions. Id. (seller told buyer that it “had ‘at least’ $10,000 in accounts receivable, and named some of such accounts, but did not disclose that there were any problems in collecting such accounts”). Plaintiffs here have not made that connection.

Plaintiffs’ reliance on Everts, where the court stated “ORS 59.115(1)(b) mandates a full and truthful disclosure of material information,” is similarly inapposite. Everts, 64 Or. App. at 152. The relevant portion of Everts dealt with the impact of disclaimers, concluding boilerplate disclaimers did not cure omission of material information regarding the seller’s financial condition. Id. The court in Everts identified specific and general affirmative statements made false by the seller’s material omissions. Id. at 149–50 (seller provided financial statements and prospectus with information about the issue). Thus, Everts does not stand for the proposition that the material omission provision of ORS § 59.115(1)(b) does not require an affirmative
statement made false by the omission. Accordingly, the court should grant the motions to dismiss as to the material omissions alleged that do not identify an affirmative statement made false by the particular material omission – specifically, paragraphs 71–135, 149–50, 153, 158, 160, 163, and 173.

E. Scienter.

Scienter — “a guilty state of mind” in making misleading statements — is a required element of a violation of ORS § 59.135(2). *State v. Marsh & McClellan Co.*, 269 Or. App. 31, 47 (2015); *Cox*, slip op. at 13. Plaintiffs argue that they may allege scienter generally, and that their allegations sufficiently allege scienter. *Odom v. Microsoft Corp.*, 486 F.3d 541, 554 (9th Cir. 2007) (“While the factual circumstances of the fraud itself must be alleged with particularity, the state of mind — or scienter — of the defendants may be alleged generally.”). Defendants argue the plausibility requirement of *Twombly* and *Iqbal* applies to allegations of scienter. See *United States ex rel. Lee v. Corinthian Coll.*, 655 F.3d 984, 1000 (9th Cir. 2011) (applying plausibility standard to scienter). Defendants then contend Plaintiffs do not allege facts supporting a plausible allegation of scienter.

Plaintiffs must allege facts supporting a plausible inference of scienter, and scienter must be adequately specified. The particularity requirement of Rule 9(b) did not apply to allegations of scienter — consequently, Rule 8 applies to allegations of scienter just as it applies to all other allegations. *Lee*, 655 F.3d at 1000; *Odom*, 486 F.3d at 554. *Twombly* and *Iqbal*’s plausibility requirement derives from Rule 8. *Iqbal*, 556 U.S. at 677–79; *Twombly*, 550 U.S. at 553–56. Accordingly, Plaintiffs must plead facts supporting a plausible inference of scienter. They have done so here.
The FAC generally alleges facts supporting a plausible inference of scienter as to the Aequitas entities. Plaintiffs claim Aequitas deceived investors, maintained a façade of financial stability, and repaid prior investors with newly invested funds to conceal insolvency. Plaintiffs do not specifically allege that every misleading statement was intended to mislead investors, but the overall course of conduct alleged against the Aequitas group is sufficient to create the necessary inference. Accordingly, the FAC sufficiently alleges scienter.

VII. Participant Liability.

Defendants challenge the allegations of their participation and material aid in the allegedly unlawful sales. Plaintiffs’ failure to allege when and where misrepresentations occurred, the falsity of statements when made, and which Aequitas entity made what statements regarding which securities eliminates Defendants’ secondary liability, for purposes of the FAC. Defendants also contend that even if the Aequitas entities’ primary liability was sufficiently pleaded, the allegations of participation in and material aid for the securities transactions are also insufficient. Accordingly, the court considers these arguments to determine whether the court should deny Plaintiffs leave to amend because their theory of liability fails as a matter of law.

The parties’ disagreement about the participation and material aid allegations centers around two issues. First, relevant to all Defendants, the parties advocate divergent interpretations of the required connection between participation or material aid, and unlawful sales. Second, each defendant contests the sufficiency of the specific allegations Plaintiffs levy against the individual defendant. Accordingly, the court first constructs the standard for participation or material aid liability under ORS 59.115(3). The court next addresses the sufficiency of the allegations against each individual defendant.

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A. Standard for Non-Seller Liability.

Under ORS 59.115(3), “‘participate’ and ‘materially aid’ are separate concepts, not synonyms.” Prince, 307 Or. at 149. Whether aid in a sale is material “depends on the importance of one’s personal contribution to the transaction.” Id. Generally, participation addresses direct involvement in the sale, while material aid involves indirect support for the seller in making the sale. Id. at 150 (drafting partnership documents and providing legal advice regarding private securities offering was material aid); Adams, 265 Or. at 527 (1973) (preparing sales documents for use in transaction was participation); Ainslie v. Spolyar, 144 Or. App. 134, 145 (1996) (“Ainslie I”) (preventing a foreclosure and providing legal services prior to an offering was material aid). Other Oregon decisions use the terms together, “participate or materially aid,” without distinction. See, e.g., Fakhrdai v. Mason, 72 Or. App. 681, 684 (1985); Ainslie v. First Interstate Bank of Or., N.A., 148 Or. App. 162, 184–85 (1997) (“Ainslie II”).

Plaintiffs, citing the liberal construction of Oregon’s securities laws mandated by Adamson v. Lang, 236 Or. at 516, advocate for a broad scope of secondary liability.

The parties primarily disagree regarding the required nexus between acts supporting a securities business and the sale of securities. This dispute arises because Plaintiffs assert participation and material aid liability against EisnerAmper, Deloitte, Tonkon, and Sidley based on their alleged material aid in large groups of securities transactions. Defendants argue ORS § 59.115(3) and Prince limit non-seller liability to acts where the purchaser of securities received documents reflecting the non-seller’s “knowledge, judgment, or assertions.” Defendants therefore conclude the allegations of participation or material aid are insufficient because they do not allege involvement in each named plaintiff’s purchases. Plaintiffs contend ORS § 59.115(3)

Ainslie I

Ainslie II

Adamson v. Lang
encompasses any acts in support of the securities business of a seller, whether or not the acts
directly supported specific sales of securities.

A non-seller’s liability depends on the importance of their conduct — whether
participation or aid — to the sale. For the reasons discussed below, the court concludes non-
seller liability depends on a causal relationship between unlawful securities transactions and the
nature of the non-seller’s support for the transactions. First, the non-seller’s interactions with the
seller must have a causal relationship with the transaction. Adams, 265 Or. at 529 (finding
liability where a “sale would and could not have been completed or consummated without” the
non-seller’s actions). Second, the non-seller’s conduct must reflect some “knowledge,
judgment” or other specialized skills particular to the non-seller. Prince, 307 Or. at 149. If
persons materially aid an unlawful sale of securities, their professional roles are not a defense to
liability. Id. at 151.

1. Causal Relationship with Securities Sales.

Secondary liability under ORS 59.115(3) first requires interactions with a seller that have
a causal relationship to an unlawful sale of securities. Adams, 265 Or. at 529. For example, in
Adams a lawyer participated in a transaction when he prepared, oversaw the execution of, and
filed registration documents for a security. Id. at 528–30. The court held that the lawyer
“contributed to the completion and consummation” of the transaction, which “would not and
could not have been completed or consummated without” various documents prepared by the
lawyer. Id. at 529–30. The Prince court also found liability based on conduct with a causal
relationship with a sale. There, an attorney provided legal advice to a seller, drafted necessary
legal documents and substantial parts of the offering documents, and provided a tax opinion
which investors received. Prince, 307 Or. at 148; see also Prince v. Brydon, 89 Or. App. 203,
206 (1988) (summarizing facts). The court held that sale of the securities could not have occurred without the lawyer’s services. *Prince*, 307 Or. at 149 (quoting *Prince*, 89 Or. App. at 206). Further, the court held that the lawyer’s conduct was not immune from liability because the services were “routine parts of a securities practice.” *Id.*

Building on *Adams* and *Prince*, the court in *Ainslie I* found non-seller liability based on conduct more attenuated from the transaction in that case. *Ainslie I*, 144 Or. App. at 145. In *Ainslie I*, the seller issued an offering memorandum for a Christmas-tree business, proposing to purchase cutting rights on a tree farm. *Id.* at 138–39. The cutting-rights purchase was contingent on receiving sufficient subscriptions from prospective investors. *Id.* Prior to receiving sufficient subscriptions, the tree farm was about to undergo foreclosure. *Id.* The seller’s attorney and a bank manipulated transactions to release funds from an escrow account set up for the purchase, despite the lack of sufficient investors. *Id.* The court concluded that the attorney had materially aided in the transaction, in part by “prevent[ing a] foreclosure that would at the least have seriously impeded the offering.” *Id.* at 145. *Ainslie I* demonstrates that interactions enabling a seller to continue its securities business constitutes material aid for any subsequent enabled transactions.

Plaintiffs also rely on *Black & Co v. Nova-Tech, Inc.*, 333 F. Supp. 468 (D. Or. 1971), a decision of this court interpreting ORS 59.115(3). *Black* applied ORS 59.115(3) expansively, holding that designation of a law firm as corporate counsel in published reports made “the firm’s partners ‘participants’ in any unlawful securities transactions in which the annual reports were used for promotional purposes.” *Id.* at 472. Defendants contend *Black* should not guide this court’s analysis, in part because *Adams* criticized *Black* as overbroad. See *Adams*, 265 Or. at 527–28 (“The decision[] in *Black & Company v. Nova-Tech, Inc.* . . . [is] not binding on us and
some of the statements in that opinion may be overly broad, if literally applied.”) *Prince* clarified the criticism of *Black* in *Adams* as “stat[ing] a possible question, not a conclusion.” *Prince*, 307 Or. at 149–50. Accordingly, the court considers *Black* as persuasive authority, but does not adopt any statement from *Black* unless supported by other authority.


The *Prince* court also defined materiality under ORS 59.115(3), distinguishing essential but ministerial tasks, which do not create secondary liability (“typing, reproducing, and delivering sales documents”), from materially aiding acts such as drafting documents requiring “knowledge [and] judgment.” 307 Or. at 149. A non-seller’s acts of participation or aid are only material when the interactions require some judgment, skill, expertise, or ability particular to the non-seller. *Id.* Put differently, an interaction is material if “could [not] have been performed by anyone.” *Id.*

Defendants contend the materiality criteria announced in *Prince* protects non-sellers from liability where a non-seller’s involvement with the sale was confined to their professional role as auditor or attorney, or where no offering documents reflected the knowledge or judgment of the non-seller. Neither contention is correct. First, *Prince* expressly rejected limitations on liability based on professional roles. *Id.* at 151. (“The defense against strict liability, in short, was to be a showing of ignorance, not the professional role of the person who renders material aid in the unlawful sale.”) Defendants’ reliance on *Prince* is further undercut because the reversed opinion of the court of appeals held an attorney bore no liability because the attorney “only rendered routine legal services to the partnership.” *Prince v. Brydon*, 89 Or. App. 203, 207 (1988), *rev’d*, 307 Or. at 149, 151. Thus, whether any defendant’s conduct was more or less than the ordinary professional role of that defendant is immaterial to the question of participation or material aid.
Defendants also argue *Prince* limited non-seller liability to involvement where the buyer receives some document reflecting the knowledge, judgment, or other expertise of the non-seller. In *Prince*, the court stated: “Typing, reproducing, and delivering sales documents may all be essential to a sale, but they could be performed by anyone; it is a drafter's knowledge, judgment, and assertions reflected in the contents of the documents that are ‘material’ to the sale.” *Prince*, 307 Or. at 149. Defendants read this sentence as limiting material aid to instances where a buyer receives documents reflecting a non-seller’s “knowledge, judgment, or assertions.” But the quoted sentence from *Prince* does not reflect the outer bounds of non-seller liability. Instead, the court was defining the concept of materiality by contrasting varying roles in preparation and execution of sales documents. Other interactions with a seller may create secondary liability for material aid, subject to the causation and materiality requirements. *Id.* at 149–50. While this construction of ORS 59.115(3) imposes a broad scope of potential secondary liability, the *Prince* court noted that the legislative history of ORS 59.115(3) shows the legislature intended to place such a “substantial burden” on non-sellers who participate in or materially aid an unlawful sale of securities. *Id.* at 150.

Plaintiffs and Defendants both rely on *Cox v. Holcomb Family Limited Partnership*, an Oregon Circuit Court decision regarding the issue of attenuation. In *Cox*, investors in an allegedly fraudulent securities business brought a lawsuit under ORS 59.115(3) against two banks and an accounting firm, alleging participation and material aid in the unlawful sale of securities. *Cox v. Holcomb Family Ltd. P'ship*, No. 1308-12201, slip op. at 6-9 (Or. Cir. Ct., Dec. 14, 2010). The court found the allegations against the banks were sufficient, but the allegations against the accounting firm did not state a claim for non-seller liability. *Id.* The banks provided loans to the seller, giving the seller credibility and creating an illusion of
financial strength. *Id.* at 7. The court dismissed the claims against the accounting-firm defendant, because the one-line allegation of “review[ing] financial statements for” the issuer necessary for the loans was insufficient to establish “the extent or importance of [the accounting firm]’s involvement or its connection to the underlying sales.” *Id.* at 9. The *Cox* analysis is instructive here and, as appropriate, will be applied to individual defendants below.

Finally, Deloitte provided the court with supplemental authority on the scope of non-seller liability, in the form of a case decided after oral argument on the motions to dismiss. In a decision construing the non-seller liability provision of Ohio securities law, a federal district court in Ohio concluded a bank had not participated or aided in unlawful securities sales because the bank only engaged in “normal commercial activities.” *Cruz v. PNC Bank, Nat’l Ass’n*, Case No 3:16-cv-0292, 2017 WL 86327, at *2–3 (S.D. Ohio Jan. 10, 2017), *appeal filed* Jan. 31, 2017. *Cruz* does not inform the court’s analysis. The Ohio statute at issue in *Cruz* includes language similar to that used in ORS § 59.115(3), *see* OHIO REV. CODE § 1707.43(A) (“every person that has participated in or aided the seller in any way in making such sale or contract for sale”), but Ohio courts recognize an exception for banks engaged in “normal commercial banking activities.” *See Wells Fargo v. Smith*, 2013-Ohio-855, ¶¶ 28–29 (Ct. App.) (collecting cases). Oregon courts do not recognize such a distinction. The holding in *Cruz* turned on Ohio-specific principles, and thus has minimal persuasive weight on this case. *See Cruz*, 2017 WL 86327, at *3.

In sum, ORS § 59.115(3) imposes secondary liability on non-sellers when a non-seller’s interactions with a seller have a causal relationship with an unlawful securities transaction. *Adams*, 265 Or. at 529–30. The causal relationship may exist even if the interaction is a routine part of a professional’s work with sellers of securities. *Prince*, 307 Or. at 149, 151. The
interaction must enable an unlawful securities transaction, that it may be attenuated from the transaction is not determinative. Adams, 265 Or. at 529–30; Ainslie I, 144 Or. App. at 145. The interaction also must be material, in that it reflects the professional skill, judgment, or abilities of the non-seller. Prince, 307 Or. at 149.

The participation-and-material-aid allegations against Defendants fall into three broad categories. First, the law-firm defendants allegedly prepared documents necessary for the consummation of transactions, materially aiding the sale itself. (FAC ¶ 30(c–d).) Second, Integrity and Ameritrade allegedly facilitated some transactions with specific investors. (FAC ¶ 30(e–f).) Finally, the law-firm and accounting-firm defendants allegedly provided professional services necessary for the success of the Aequitas group’s securities business as a whole. (FAC ¶ 30(a–d).)

B. Deloitte.

Plaintiffs allege Deloitte participated and materially aided in the sale of multiple Disputed Securities in its role as auditor for ACF, AIOF, AIOF-II, AEIF, ACOF, AIPF, and other Aequitas subsidiaries. Deloitte argues the allegations against it do not state a plausible claim for non-seller liability.

First, Deloitte argues the allegations against it have an insufficient connection to any of Plaintiffs’ securities purchases. Relying on Prince, Deloitte contends an auditor can incur participation or material aid liability only if a purchaser receives the auditor’s work product —

3 Plaintiffs also allege some additional acts of participation or material aid in their responses to the motions to dismiss, but the court does not consider allegations not included in the complaint, Schneider v. Cal. Dep’t of Corr., 151 F.3d 1194, 1197 n.1 (9th Cir. 1998), except to allow leave to amend. Orion Tire Corp. v. Goodyear Tire & Rubber Corp., 268 F.3d 1133, 1137 (9th Cir. 2001). Accordingly, the discussion that follows analyzes the sufficiency only of the allegations in the FAC. Plaintiffs may include any additional bases for participation or material aid in any amended complaint. Id.
audited financial statements and the auditor’s report — with the auditor’s consent. (Deloitte Mot. at 14.) Plaintiffs disagree — and based on the previous analysis, so does the court. Deloitte’s position depends on its professional role as an auditor, but nothing in ORS 59.115(3), or the cases interpreting it limit non-seller liability to actions with a non-seller’s professional role. To the contrary, a non-seller’s professional role is irrelevant. See Prince, 307 Or. at 151 (a non-seller’s professional role was not intended to be a defense). Nor does Deloitte’s citation to the GAAS definitions of an auditor’s role limit its potential liability under ORS 59.115(3). Deloitte implicitly asks the court to assume Deloitte’s interactions with the Aequitas entities were strictly limited by the GAAS, an assumption the court cannot make in ruling on a motion to dismiss. Cotton, 2006 WL 6382128, at *6. Accordingly, the court rejects Deloitte’s proposed auditor-specific scope of non-seller liability, and examines whether Deloitte’s interactions with ACF and the Funds had a material, causal relationship with ACF and the Funds’ sales of securities.

Plaintiffs allege Deloitte’s connection with and work for the Aequitas group was a necessary component of the Aequitas group’s fundraising model. The Aequitas group allegedly built the trust of prospective investors in part by prominently describing Deloitte as auditor of multiple Aequitas entities engaged in securities sales, and by providing Deloitte-audited financial statements to current and prospective investors. First, ACF and the Funds identified Deloitte as the auditor in its promotional materials. (FAC ¶¶ 15, 34, 42, 48, 53, 58, 63.) Plaintiffs claim Deloitte’s association with the Aequitas entities provided credibility for their securities sales, because of Deloitte’s reputation with investors. (Id. ¶ 15.) The “clout” Deloitte provided to the Aequitas entities attracted and supported the retention of investors. (Id.)
Additionally, prospective investors received Deloitte-audited financial statements as promotional materials. (Id. ¶¶ 30(a), 33–34, 41–42, 47–48, 53, 58, 63.)

The court should deny Deloitte’s motion to dismiss as to its participation or material aid. Plaintiffs plausibly allege Deloitte’s participation or material aid in at least some securities transactions by ACF, AIOF, AIOF-II, ACOF, AEIF, and Motolease. Because the complaint insufficiently differentiates between the Aequitas entities, the securities they sold, and the groups of securities sold by means of misleading securities, the court should defer a determination of the sufficiency of Deloitte’s alleged acts of participation or material aided to an amended complaint.

Second, Deloitte objects to finding participation and material aid based on an auditing relationship because such liability would extend to most, if not all auditors. Accepting the truth of this premise arguendo, Oregon courts have considered and rejected similar arguments. In Prince, the court considered the possible scope of liability for attorneys who prepare prospectuses, a common task for attorneys with a securities practice. Prince, 307 Or. at 150–51. The Prince court found that the legislative history for ORS 59.115(3) shows intent to reach the routine activities of professionals who work with sellers of securities, placing the burden on those professionals to “exonerate themselves from liability.” Id. The broad scope of non-seller liability reflects a deliberate choice by the legislature. Id. Accordingly, even if auditors of sellers of securities face broad potential liability, limiting such liability is beyond the purview of this court. Routine auditing services may incur liability when the auditing has a material, causal relationship with securities transactions.

Third, Deloitte argues extensively that the PPMs did not contain Deloitte-audited financial documents, and that most of the PPMs for Disputed Securities were issued before Deloitte completed audits of financial statements. (Deloitte Mot. at 17–18.) Even if Deloitte is
correct, Plaintiffs do not allege the PPMs were the only promotional materials ACF and the Funds used. (See, e.g., FAC ¶ 35 (alleging the existence of other promotional materials for the ACF Notes highlighting Deloitte’s involvement), ¶ 43 (alleging the existence of other promotional materials for the AIPF notes highlighting Deloitte’s involvement), ¶ 49 (alleging the existence of other promotional materials for the AIOF notes highlighting Deloitte’s involvement).) Plaintiffs also allege Deloitte consented to the Aequitas entities’ advertising their association with Deloitte, at least in the PPMs. (FAC ¶¶ 15, 34, 42, 48, 53, 58, 63.) Accepting the allegations in the complaint as true, and construing the complaint and all other materials in favor of Plaintiff, the record supports a plausible claim for relief. See Zucco Partners, 552 F.3d at 989.

The FAC plausibly alleges that the Aequitas entities used their affiliation with Deloitte to attract potential investors. Deloitte is a well-known and respected professional services firm, and its association with the Aequitas entities plausibly could cause investors to make a speculative investment in a company with limited transparency as to assets, valuation, and operations. See Cox, slip op. at 8 (finding liability based on loans giving “the illusion of credibility”). By associating itself with the Aequitas entities as auditor, Deloitte plausibly materially aided in any transactions conducted by means of PPMs and promotional materials advertising Deloitte as the auditor. Deloitte’s contribution to the transaction is not interchangeable with any other professional services firm, as not every accounting firm has the same reputation as Deloitte. See Prince, 307 Or. at 149 (aid to the transaction is not material if services “could be performed by anyone”). Accordingly, Plaintiffs state a plausible claim for non-seller liability against Deloitte based on the prominent mention of Deloitte as auditor in
several PPMs and on the importance of Deloitte’s reputation to the Aequitas entities’ securities business.

Similarly, Plaintiffs’ allegation that various Aequitas entities used Deloitte-audited financial statements in selling securities plausibly alleges material aid in any transaction involving such financial statements. Plaintiffs plausibly allege prospective investors received financial information audited by Deloitte. (FAC ¶¶ 15, 34, 42, 48, 53, 58, 63.) Any transaction or group of transactions effected using the Deloitte-audited financial statements was “by means of” such financial statements. *Sanders*, 619 F.2d at 1226–27. The credibility Deloitte’s involvement lends to such financial statements plausibly could have a causal effect on any sales made by means of Deloitte-audited financial statements. *Cox*, slip op. at 7–8; *see also Black*, 333 F. Supp. at 472 (finding non-seller liability based on designation as corporate counsel in annual reports).

Plaintiffs’ final theory of non-seller liability is that Deloitte’s auditing services enabled the Aequitas group to conduct its securities business as a whole. The facts alleged in the complaint do not plausibly support this claim — Plaintiffs rely on facts not alleged in the complaint to support the importance of Deloitte’s services to the particular business structure the Aequitas group employed. (Resp. to Deloitte’s Mot. (ECF No. 122), at 5–7.) Plaintiffs cannot add new facts to the complaint in their response to a motion to dismiss. *Schneider*, 151 F.3d at 1197 n.1. The court should grant Deloitte’s motion as to Plaintiffs’ claim against Deloitte based on alleged material aid for the Aequitas entities based on auditing activities alone, with leave to amend. *Orion Tire Corp.*, 268 F.3d at 1137.

In sum, the court should deny in part and grant in part Deloitte’s motion to dismiss. Plaintiffs plausibly allege Deloitte’s participation and material aid in securities transactions
conducted by means of PPMs and promotional materials identifying Deloitte as auditor, and use of Deloitte-audited financial statements as promotional materials. Plaintiffs do not allege sufficient facts to support their claim that Deloitte’s auditing services materially aided all of the Aequitas group’s securities sales.

C. EisnerAmper.

First, EisnerAmper claims its connections with the Aequitas group were insufficient to participate or materially aid in any sales of securities, even if the claims of the Aequitas group’s primary liability were sufficiently pleaded. Plaintiffs’ allegations of material aid by EisnerAmper follow a similar theory as the allegations against Deloitte. For the reasons discussed above regarding the claims against Deloitte, the court rejects EisnerAmper’s interpretation of Prince and ORS § 59.115(3). EisnerAmper’s advertised association with the Aequitas entities, together with the use of EisnerAmper-audited financial statements as promotional materials in at least some Aequitas securities transactions, support a plausible claim for participation or material aid under ORS § 59.115(3). Cox, slip op. at 7–8; Black, 333 F. Supp. at 472. Plaintiffs also state a plausible claim for relief based on any sales made by means of EisnerAmper-audited financial statements. Sanders, 619 F.2d at 1226–27.

Second, EisnerAmper seeks dismissal of the claims against it based on the timing of its involvement with the Aequitas group. EisnerAmper’s auditing relationship with the Aequitas group allegedly ended in 2012. (FAC ¶¶ 16, 30(a).) EisnerAmper contends the alleged misrepresentations, and thus unlawful sales, occurred after EisnerAmper ended its relationship with the Aequitas entities. Most of this disagreement revolves around the issue of when and where the Aequitas entities made misleading statements, an issue analyzed in depth above. The
precise scope of Plaintiffs’ claims against EisnerAmper is unclear because Plaintiffs pleaded their allegations under a “unified offering” theory.

But Plaintiffs also contend EisnerAmper’s initial involvement with the Aequitas entities constitutes material aid for all subsequent sales of securities by helping “Aequitas in building its façade, behind which it operated for many years.” (Resp. to EisnerAmper’s Mot. to Dismiss (ECF No. 121), at 15–16.) Put differently, Plaintiffs argue the Aequitas group could continue selling securities only because its structure concealed its true financial condition from investors. EisnerAmper’s services as auditor allegedly helped Aequitas maintain an illusion of success and stability. Accordingly, EisnerAmper materially aided in every security transaction an Aequitas entity made during and after EisnerAmper was auditor to some Aequitas entities. This theory may be viable, at least in some form. Ainslie I, 144 Or. App. at 145 (finding material aid where lawyer and banks enabled a group of securities transactions through an escrow transaction). But the FAC does not contain even conclusory allegations that EisnerAmper’s auditing services were necessary for the ongoing securities business of the Aequitas entities, let alone the facts showing a plausible basis for such a theory. Twombly, 550 U.S. at 555.

Accordingly, the court should grant EisnerAmper’s motion to dismiss as to the claim for non-seller liability for sales of securities beyond those made by means of promotional materials highlighting EisnerAmper or financial documents audited by EisnerAmper. Leave to amend is appropriate, as the record does not indicate Plaintiffs cannot allege additionally facts showing the plausibility of Plaintiffs’ theory. Cf. Kendall v. Visa U.S.A., Inc., 518 F.3d 1042, 1051–52 (9th Cir. 2008) (“Dismissal without leave to amend is proper if it is clear the complaint could not be saved by amendment.”).
D. Tonkon.

Tonkon seeks its dismissal because the allegations against it fail to adequately plead Tonkon’s participation or material aid in the Aequitas group’s securities transactions. Apart from arguments analyzed previously in this Findings and Recommendation, Tonkon makes three principal arguments. First, Tonkon challenges the allegations of participation and material aid for failing to connect Tonkon’s drafting of PPMs, subscription agreements, and other promotional documents with the misleading portions of such documents. Second, Tonkon argues its “preparation and execution of documents” cannot constitute participation or material aid, as a matter of law. Finally, Tonkon contends the claims based on its provision of “legal services” to AIM and other Aequitas entities does not state a plausible claim for non-seller liability because the allegations do not specify the legal services provided or what relationship the legal services had to any unlawful securities transactions. For the reasons that follow, the court should dismiss the allegations based on unspecified legal services, but otherwise deny Tonkon’s motion to dismiss.

Tonkon argues the document-drafting-based allegations of participation and material aid are insufficiently pleaded because they do not connect Tonkon’s services with the misleading portions of the Aequitas entities’ promotional materials. Here, Tonkon conflates material aid in a sale with material aid in the unlawful portion of the sale. ORS § 59.115(3) imposes non-seller liability based on participation or material aid in the sale itself, regardless of whether the participation or material aid has any connection with the unlawfulness of the sale. Comp. Concepts, 137 Or App. at 581; see also Anderson, 146 Or. App. at 683. Plaintiffs need allege only the unlawfulness of the sale and Tonkon’s involvement in the sale. Anderson, 146 Or. App. at 683.
Next, Tonkon contends Oregon decisions establish that a defendant has no liability for “mere preparation and execution of documents.” See Fakhrdai, 72 Or. App. at 684. Oregon decisions consistently reflect liability for attorneys and others who prepare documents with a material, causal relationship to the sale. See id. at 686 (liability for “preparation and execution of a contract”); Prince, 307 Or. at 149 (liability for drafting an offering circular and other documents necessary for the transaction); Adams, 265 Or. at 529 (liability for preparation of documents necessary to consummate securities transaction); Anderson, 146 Or. App. at 648 (“There is no question that a person who prepares documentation in connection with a sale of securities is a person who ‘participates or materially aids’ in the sale under ORS 59.115(3).”).

Thus, whether a non-seller was involved in document preparation or other conduct is irrelevant; the proper inquiry is whether the non-seller’s involvement had a causal, material relationship with the transaction. Prince, 307 Or. at 149–51. Plaintiffs allege that Tonkon drafted all or part of several Aequitas entities’ offering documents and subscription agreements. The PPMs and subscription agreements were necessary to consummate the sales of securities. Plaintiffs’ allegations regarding Tonkon’s participation and material aid by drafting offering documents and subscription agreements therefore state a plausible claim for relief under ORS § 59.115(3).

Tonkon also challenges the sufficiency of allegations that it participated or materially aided by providing unspecified legal services directly to Aequitas entities selling securities, and indirectly by serving as counsel to AIM. The provision of legal services to a seller may constitute material aid if the legal services have a causal, material relationship with a transaction. Ainslie I, 144 Or. App. at 145. But Plaintiffs’ allegations are little more than a legal conclusion, and thus do not render their legal-services-based theory plausible. Iqbal, 556 U.S. at 678–79. Plaintiffs do not specify what these legal services were and how the legal services had a causal,
material relationship with any securities transactions. (FAC ¶ 30(c).) Accordingly, the court should dismiss any claims against Tonkon for non-seller liability based on legal services other than preparation of documents necessary for sales of securities, with leave to amend.

E. Sidley.

Sidley’s motion to dismiss advances two arguments. First, Sidley correctly observes its only alleged direct involvement in a sales transaction is in drafting a PPM for ACOF. Sidley then argues there is no plausible allegation that any sale of ACOF violated the Oregon Securities Law. Second, Sidley contends that Plaintiffs’ allegations of material aid in securities other than ACOF do not state a plausible claim for relief. Plaintiffs dispute both contentions.

Sidley does not contest the possibility of participation or material aid in a sale through preparing offering documents for ACOF. Instead, Sidley argues the allegations of a primary violation by ACOF are insufficient. Without a primary violation by ACOF, Sidley would have no derivative liability. Anderson, 146 Or. App. at 683. The sole allegation of a misleading statement by ACOF is an alleged omission in a 2014 PPM (Masuda Decl. Ex. 14) regarding the use of investor funds. Sidley argues the allegation is insufficient because it does not identify an affirmative statement made false by the omission, and it fails to allege scienter. For the reasons discussed earlier in this Findings and Recommendation, the court should dismiss the allegation against ACOF, with leave to amend, because it does not identify an affirmative statement made false by the omission. OR. REV. STAT. §§ 59.115(1)(b); 59.135(2).

Second, Sidley seeks dismissal of the claims against it based on its role as legal counsel to AIM and other unspecified Aequitas entities. Sidley argues these allegations fail to specify how Sidley’s legal services constituted participation or material aid in any transaction or group of transactions, and thus are insufficient to show participation or material aid in any transaction.
or group of transactions. The court agrees. Secondary liability under ORS § 59.115(3) requires a material, causal relationship between Sidley’s conduct and the Aequitas entities’ sale of securities. *See Prince*, 307 Or. at 149. The FAC does not identify with any detail the majority of Sidley’s alleged interactions with the Aequitas Entities. While providing legal services can have a material, causal relationship with the sale of securities, a plausible claim of participation or material aid requires identifying the services provided and how they related to the Aequitas entities’ sale of securities. For example, the FAC does not identify what legal services Sidley provided for AIM, which is Sidley’s primary alleged connection to the Disputed Securities other than the ACOF Interests. (FAC ¶¶ 40, 46, 52.) Plaintiffs also do not allege facts showing how AIM’s role as investment manager related to ACF and the Funds’ sales of securities. The remainder of Plaintiffs’ allegations against Sidley based on unspecified legal services or a relationship as legal counsel are similarly deficient.

Plaintiffs specifically allege one service Sidley provided to an unspecified Aequitas entity: legal opinions and other services that enabled the entity to “isolate its healthcare receivables from investors and pledge those assets as collateral” to secure a bank loan. (FAC ¶ 30(d).) Plaintiffs additionally allege the bank loan enabled further securities sales by promoting an image of financial success. (*Id.*) The alleged connection between Sidley’s action and ongoing sales of securities is plausible, *see Ainslie I*, 144 Or. App. at 145; *Cox*, slip op. at 7–8 (similar loans were material aid for an ongoing securities business), but the lack of details regarding the specific seller and timing of this transaction is fatal. Plaintiffs must specify when Sidley enabled this transaction, which security or securities the transaction related to, and which sales the transaction enabled.
Accordingly, the allegations of secondary liability against Sidley are factually insufficient, both as to ACOF and the Aequitas group as a whole. The court should grant Sidley’s motion to dismiss, with leave to amend.

F. Integrity.

Plaintiffs allege Integrity participated and materially aided in sales of ACF Notes and AIOF-II Notes by soliciting sales and preparing subscription agreements necessary to consummate the transactions. Integrity argues these allegations are insufficiently pleaded because Integrity’s involvement is within the exemption from liability in § ORS 59.115(4), and because the complaint does not specifically allege which sales Integrity participated in. ORS 59.115(4) provides a qualified exemption from liability under ORS § 59.115(3) for “a person whose sole function in connection with the sale of a security is to provide ministerial functions of escrow, custody or deposit services.” Integrity served as custodian for some Disputed Securities. (FAC ¶ 30(f).)

The court finds Integrity is not shielded from liability because of its status as a custodian. The plain text of ORS § 59.115(4) only exempts a custodian from liability when serving as a custodian is the person’s “sole function in connection with the sale of a security.” Plaintiffs do not rely solely on Integrity’s role as a custodian to support their claims; they also allege Integrity solicited sales of some Disputed Securities, and drafted subscription agreements to complete some transactions. (FAC ¶¶ 30(f), 36, 55.) The allegations against Integrity go beyond serving as custodian and fall outside of ORS § 59.115(4). Accordingly, the court should deny Ameritrade and Integrity’s motions to dismiss based on ORS § 59.115(4).

Integrity’s remaining argument for dismissal is a lack of specificity in the allegations of its involvement the Aequitas group’s securities transactions. In part, this argument depends on
applying Rule 9(b) to allegations of participation or material aid. Because Rule 9(b) does not apply to allegations of non-seller liability, the FAC instead is subject to the Rule 8(a) plausibility standard. Plaintiffs allege Integrity’s solicitation of some sales and preparation of documents in support of other transactions. In both cases, Integrity’s alleged conduct plausibly has a causal, material relationship with consummation of the transactions. Plaintiffs do not need to identify every transaction Integrity allegedly participated in or materially aided at this stage of the lawsuit. The court should therefore conclude that the allegations of Integrity’s participation and material aid are sufficient under Rule 8(a).

G. Ameritrade.

Similarly to Integrity, Ameritrade seeks to dismiss the claims against it because of its status as a custodian and the sufficiency of the allegations against it. Plaintiffs allege Ameritrade steered customers to third-party financial advisors to purchase Disputed Securities. As with Integrity, ORS § 59.115(4) does not shield Ameritrade from liability because Plaintiffs allege acts of participation and material aid other than custodial services. (FAC ¶ 30(e).)

The court also concludes that the allegations of participation or material aid against Ameritrade are sufficient under Rule 8(a). Plaintiffs allege Ameritrade referred customers to third-part financial advisors to buy ACF Notes. (FAC ¶ 37.) Construed in the light most favorable to Plaintiffs, these factual allegations support a plausible inference that the referrals had a material, causal relationship with any resulting purchases of ACF Notes.

VIII. Statute of Limitations.

Defendants seek dismissal of all of Plaintiffs’ claims based on conduct before April 4, 2013, based on the three-year statute of limitations for actions under ORS § 59.115. The FAC asserts liability for sales beginning in 2011. The default statute of limitations for actions under
Section 115 is three years from the date of sale. Or. Rev. Stat. § 59.115(6). A two-year discovery rule applies, starting from the point at which when the plaintiff “discovered or should have discovered the facts on which the action is based.” Id. The court may consider a statute of limitations defense on a motion to dismiss where the “defense is obvious on the face of a complaint.” Rivera v. Peri & Sons Farms, Inc., 735 F.3d 892, 902 (9th Cir. 2013). Plaintiffs concede their non-registration claim is subject to the three-year statute of limitations, but they argue their claims based on material misrepresentations and omissions are timely under the discovery rule. Defendants concede the discovery rule is available, but contend Plaintiffs do not plead facts showing the discovery rule applies.

In the complaint, Plaintiffs allege they “did not know of the untruths or omissions and, in the exercise of reasonable care, could not have known of the untruths or omissions.” (FAC ¶ 190(c).) Plaintiffs rely on the preceding statement to invoke the discovery rule. Defendants argue Plaintiffs must allege facts supporting application of the discovery rule to this case. Indeed, even before the heightened pleading standards announced in Twombly and Iqbal, a plaintiff had to allege facts supporting invocation of the discovery rule. Mitchell v. Greenough, 100 F.2d 184, 186 (9th Cir. 1938); TRM Corp v. Paulsell, No. CV-02-215-ST, 2002 WL 51349112, at *2 (D. Or. June 4, 2002) (citing Mitchell). Oregon law also requires a plaintiff to plead facts showing the date of discovery. Frohs v. Greene, 253 Or. 1, 7 (1969). Here, Plaintiffs do not plead the date or dates when they discovered the alleged violations. The court should dismiss all of Plaintiffs’ claims based on sales prior to April 4, 2013, with leave to amend.

Plaintiffs also contend language limiting their claim for relief in paragraph 190(b) to the three years prior to filing was a typographical error, and that they intended the claim in paragraph 190(b) to also invoke the discovery rule. Defendants argue Plaintiffs cannot add
language to the complaint by claiming a typographical error. On a motion to dismiss, the court considers the language in the complaint, and cannot rely on clarifications and elaborations in responsive pleadings. *Schneider*, 151 F.3d at 1197 & n.1 (9th Cir. 1998). The existing language in paragraph 190(b) controls, and limits Plaintiffs’ claims to three years prior to filing. Plaintiffs may, on filing another amended complaint, allege a specific discovery date and supporting facts, and an alleged discovery date to the claims in paragraph 190(b).

**IX. Standing.**

Lastly, Defendants seek to excise many claims from the complaint based on standing. Defendants argue Plaintiffs do not have standing to assert claims regarding securities they did not purchase. Plaintiffs respond they have standing to pursue claims regarding all Disputed Securities because Plaintiffs and all members of the putative class share a common injury, traceable to shared statutory violations. Plaintiffs cite multiple cases finding investor standing as class representatives for securities-law violations for types of securities the investors had not purchased, where the same alleged misconduct caused common injuries. *E.g. Facciola v. Greenberg Traurig LLP*, 281 F.R.D. 363, 367 (D. Ariz. 2012); *In re Juniper Networks, Inc. Sec. Litig.*, 264 F.R.D. 584, 594 (N.D. Cal. 2009). Here, Plaintiffs allege the Funds sold the Disputed Securities pursuant to a unitary course of misconduct, concealing and manipulating the financial wellbeing of the Funds. (FAC ¶ 28–30.)

The court should defer any ruling on standing until its ruling on class certification. The standing arguments Defendants raise would not remove any party from this action. Each named plaintiff asserts a cognizable claim against at least one defendant, and each defendant allegedly participated or materially aided in at least one allegedly unlawful sale of securities. Accordingly, each plaintiff asserts, and each defendant faces, at least one claim creating Article

Defendants’ concerns are better addressed in the context of class certification. Plaintiffs’ claims are for the purchase price of the securities they purchased, with interest. OR. REV. STAT. § 59.115(2). The FAC clearly identifies which securities Plaintiffs purchased. (FAC § 64–70.) The FAC make allegations about securities Plaintiffs did not purchase only in seeking to represent purchasers of those unpurchased securities in a class action. (*Id.* ¶ 181.) The question of whether Plaintiffs may assert claims based on securities they did not purchase is therefore inextricable from the issue of whether this case may proceed as a class action. Accordingly, the court should address the standing issues when and if this case reaches the class certification stage. *See Facciola*, 281 F.R.D. at 367 (addressing standing during a motion for class certification); *In re Juniper*, 264 F.R.D. at 594 (same); *In re Sepracor Inc.*, 233 F.R.D. 52, 56 (D. Mass. 2005) (same).

**Conclusion**

The court should GRANT in part and DENY in part the Joint Motion to Dismiss (ECF No. 74), Deloitte’s Motion to Dismiss (ECF No. 85); EisnerAmper’s Motion to Dismiss (ECF No. 78); Sidley’s Motion to Dismiss (ECF No. 81); Tonkon’s Motion to Dismiss (ECF No. 80); Integrity’s Motion to Dismiss (ECF No. 95); and Ameritrade’s Motion to Dismiss (ECF No. 113). The court GRANTS in part and DENIES in part Deloitte’s Motion for Judicial Notice (ECF No. 77).
The Findings and Recommendation will be referred to a district judge for review. Objections, if any, are due April 24, 2017. If no objections are filed, then the Findings and Recommendation will go under advisement on that date.

If objections are filed, then a response is due within 14 days after being served with a copy of the objections. When the response is due or filed, whichever date is earlier, the Findings and Recommendation will go under advisement.

DATED this 10th day of April, 2017.

/s John V. Acosta
JOHN V. ACOSTA
United States Magistrate Judge
Chapter 7C

Washington Case Law Review

DOUGLAS SIDDOWAY
Randall | Danskin PS
Spokane, Washington

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1The author sincerely acknowledges the significant contributions of Faith Anderson and the other attorneys at the Washington Securities Division who prepared the following materials for use in other presentations and graciously consented to his using them.
I. 2016 WASHINGTON CASES

The following cases arose under or were decided with reference to the Securities Act of Washington (Chapter 21.20 RCW) in 2016:

**Norton v. Graham & Dunn, P.C.**


The facts are unremarkable. In 2006, Jose Luis Nino de Guzman, Jr., a Peruvian national, established NDG Investment Group, LLC (“NDG”) to engage in commercial and residential real estate development in Peru. In 2007, de Guzman and NDG retained the law firm of Graham & Dunn to form limited liability companies that would house these real estate projects. In 2008, Norton, both individually and through his investment company, invested in NDG and purchased membership interests in several of the limited liability companies that Graham & Dunn, P.C. helped organize.

In January 2009, Norton met with de Guzman in Peru to discuss the status of the investments. During this meeting, de Guzman admitted that he had sold one of the properties in which Norton had invested, and used the sale proceeds to buy other properties, without consulting Norton.

After returning to the U.S., Norton reviewed information about the limited liability companies and their investments, and “continued to discover…the inappropriate nature” of de Guzman’s business dealings. On March 11, 2009, Norton’s business partner sent him an e-mail stating that de Guzman had admitted to an employee that he was “running a financial house of cards” and that “[de Guzman] has proven himself to be a very accomplished liar and con man.”

Other investors soon became aware of NDG’s fraud and formed a “steering committee,” to recover funds. Norton agreed to become a part of the steering committee, and in 2009 sent an email to his attorney expressing concerns about the steering committee’s proposed allocation of any recovered assets. His email identified a claim against Graham & Dunn as a possible avenue of recovery.

In October 2010, Norton filed a lawsuit against de Guzman and NDG for breach of fiduciary duty and violations of the Washington Securities Act. In July 2012, more than 80 NDG investors, many of whom were members of the steering committee, filed a lawsuit against Graham & Dunn (*Angela Aggen, et al. v. Graham & Dunn*) alleging that Graham & Dunn had violated the Securities Act of Washington and aided and abetted NDG and de Guzman in the commission of a fraud. Specifically, the complaint alleged that the private placement memorandum provided to NDG’s investors stated that, on advice of counsel, NDG planned to rely on the Rule 506 exemption from registration. The complaint also alleged that Graham & Dunn knew that NDG’s offerings were not in compliance with Regulation D, but that Graham &
Dunn nonetheless continued to form new limited liability companies to facilitate NDG’s capital raising and development activities despite the firm’s knowledge that NDG was violating the securities laws. Norton did not participate in this lawsuit.

In April 2013, Norton filed his own lawsuit against Graham & Dunn, asserting essentially the same claims as those of the Aggen complaint. In October 2014, Graham & Dunn filed a motion for summary judgment, arguing that Norton was barred by the three-year statute of limitation in RCW 21.20.430(4)(b). Graham & Dunn argued that evidence established that Norton knew in 2009 that de Guzman was engaged in a Ponzi scheme and had identified a potential claim against Graham & Dunn. Norton countered by arguing that fraud and violations of the Securities Act of Washington did not accrue until the Aggen complaint was filed in 2012.

The trial court ruled that Norton’s claims against Graham & Dunn were barred by the statute of limitation. The court found that Norton had identified Graham & Dunn “as a possible source of recovery” and did not act with diligence to pursue his claims against the firm. The trial court noted that Norton had “ample evidence” to base a claim against Graham & Dunn before July 2012, when the Aggen complaint was filed.

Division I affirmed the summary judgment dismissal on appeal. The appellate court was not persuaded by the argument that the discovery rule tolled the statute of limitation because Norton had not actually seen the documents produced to the steering committee that supported his claim against Graham & Dunn. The court opined that the discovery rule requires due diligence to discover the basis for a cause of action, and that Norton had identified a potential claim against Graham & Dunn, but opted to pursue other avenues of recovery rather than bring a timely lawsuit.

**Burdick v. Rosenthal Collins Grp., LLC**


From 1996 to 2009, Enrique Villalba perpetrated a Ponzi scheme. After receiving investor funds, Villalba paid himself large management fees, funded a lavish lifestyle, and made $3 million in Ponzi-type payments to other investors. Investors were apparently unaware of the scheme since Villalba lied to them throughout and provided false account statements that reflected steady gains.

In 1998, Some 18 months after he accepted his first investments, Villalba opened a nondiscretionary futures trading account with Rosenthal Collins Group (“RCG”). Villalba retained complete control over the account and had full responsibility and liability for all trading decisions.

Shortly after Villalba’s fraud was uncovered, the Commodities Futures Trading Commission (“CFTC”) investigated RCG’s role in Villalba’s fraud. The CFTC found that RCG ignored
many “red flags” regarding Villalba’s account and that it should have acted in light of “the lack of regard for trading losses, commissions, and fees in [Villalba’s] account.” RCG neither admitted or denied these findings in the CFTC’s consent order.

On the strength of the CFTC order, Burdick alleged that RCG was secondarily liable as a “seller” or “broker-dealer” under RCW 21.20.430(1) and (3). He argued that RCG’s involvement was that of a “seller” in Villalba’s scheme because RCG’s actions were “a substantial contributive factor” of his decision to invest. Burdick also argued that RCG could be held liable because RCG “materially aid[ed]” Villalba as a broker-dealer.

The trial court thought otherwise, however, and granted RCG’s motion for summary judgment.

On appeal, Division I noted that the Washington Supreme Court has held that service providers such as RCG can be held liable as a “seller” under RCW 21.20.430(1) if they are a “substantial contributive factor” in a securities offering. However, the appellate court also noted that the service provider must have some level of “active participation” in the sales transaction itself, citing *Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127 (1990). The court further noted while no Washington appellate court had opined on the “materially aids” standard for holding a broker-dealer liable under RCW 21.20.430(3), case law from other jurisdictions established that, at a minimum, the material aid must be given “in the course of the sales transaction” to establish secondary liability of a broker-dealer.

The court affirmed the trial court’s order granting summary judgment, holding that RCG could not be liable under the Securities Act of Washington because RCG did not participate “at all” in Villalba’s sale of securities to investors, and that the investors all admitted that RCG did not factor into their decision to invest with Villalba.

**State v. Young**

The question before the court in *State v. Young*, noted at 194 Wn. App. 1054, 2016 WL 3800909 (2016), *review denied*, 187 Wn.2d 1004, 386 P.3d 1095 (2017) (unpublished), was whether the trial court erred in imposing an exceptional sentence below the standard range for an individual who had plead guilty to ten counts of criminal securities fraud.

The facts are these: In 2006, Young solicited investment from sixteen people for a feeder fund, Safeguard Capital, LLC (“Safeguard”), telling his potential investors that they would earn “a guaranteed return of between 18 and 24 percent with no risk.” Young then invested $1.6 million of the $2.2 million he raised in his Safeguard solicitation in a hedge fund, Gemstar Capital Group, Inc. (“Gemstar”), and used the remaining $600,000 to repay a line of credit for his other business, Amigo Vino, which supplied wine grapes to hobbyists and small wineries. Over the next two years, Gemstar paid over $5 million in distributions to Safeguard, a profit of $3.4 million. Unsurprisingly, Young put this money into Amigo Vino instead of distributing it to the Safeguard investors.
The SEC investigated the matter and sued Gemstar for operating a Ponzi scheme. During the investigation into the Gemstar’s fraud, Young testified that he was the sole investor in Safeguard. Young continued to tell his investors that Safeguard was successful and failed to tell them about the SEC action against Gemstar.

In 2011, the Washington Department of Financial Institutions received a complaint regarding Young, and the Securities Division launched an investigation. In January 2013, DFI entered charges against Young for securities fraud, acting as an unregistered salesperson, acting as an unregistered investment advisor, and for anti-fraud violations. In May 2013, DFI entered into a consent order with Young which required him to cease and desist in engaging in investments on behalf of others.

In June 2014, Young was charged with multiple counts of criminal securities fraud and pleaded guilty to ten counts. The standard sentence range was 51 to 60 months of incarceration, however, the trial court determined that multiple factors were present and that these factors warranted a departure from the sentencing guidelines. The court imposed an exceptional sentence of six months of work release and six months home detention. The trial court based its decision on Young’s age, his medical condition, his lack of criminal history, the cost of incarceration, and the fact that it was more likely he could continue to make restitution payments if he was not incarcerated.

The State appealed Young’s sentence. The Court of Appeals noted that one of the statutory mitigating factors established by the Sentencing Reform Act was whether the defendant had compensated or made a good effort to compensate the victim of criminal conduct for any damage or injury sustained before detection. After reviewing the record, the court determined that the trial court had failed to conclude that the mitigating factor had been established, noting that Young made restitution payments only prior to entering his plea, not before his fraud was detected. The appellate court also noted that the trial court never made any finding as to when Young’s criminal conduct was detected. Finally, the appellate court noted that there was no evidence before the trial court that Young had communicated to his investors that the funds he repaid them was intended to compensate them for his wrongdoing.

Finally, the appellate court noted that many of the other mitigating factors cited by the trial court were personal in nature and should not have been taken into account, since the Sentencing Reform Act prohibits exceptional sentences based on factors that are personal in nature to a particular defendant. The appellate court remanded the case for resentencing within the standard range.

**Bastida v. Nat’l Holdings Corp.**

Here are the facts: In the mid-1990s, Bastida and others became customers of William Gillis, a securities broker. In 2008, Gillis began working at National Securities Corporation (“NSC”). In 2016, Bastida filed a lawsuit alleging that Gillis and NSC violated the Washington Securities Act by recommending large investments in high-risk companies that were unsuitable considering the financial needs of retired persons. In the complaint, Bastida alleged that National Holding Corporation was the complete owner of NSC and had “control” over the actions of NSC and Gillis.

National Holding Corporation argued that Bastida’s complaint failed to adequately plead that the National Holding Corporation was liable as a “control person” under RCW 21.20.430. The court noted that the Washington Supreme Court has applied a two-part federal test for control liability, “requiring that the plaintiff show that the defendant exercised control over the operations of the corporation allegedly in violation of the law, and that the defendant had actual power to control the relevant transactions,” citing Hines v. Data Lines Sys., 114 Wn.2d 127 (1990).

Although the defendant had argued that “complete ownership is not sufficient to establish that a corporate parent has control over a subsidiary within the meaning of RCW 21.20.430,” the court concluded that ownership of shares is a “relevant indicia of control.” Accepting Bastida’s allegation that National Holding Corporation owned all shares in NSC as true, the court concluded that National Holding Corporation owned a sufficient percentage of voting securities to have achieved the required level of control to support a theory of control person liability. As a result, the court denied National Holding Corporation’s motion of dismiss with respect to the claim.

II. 2015 WASHINGTON CASES

The following cases arose under or were decided with reference to the Securities Act of Washington in 2015:

State v. Reeder

In State v. Reeder, 184 Wn.2d 805, 365 P.3d 1243 (2015), the Washington Supreme Court considered whether a special inquiry judge subpoena gave sufficient authority to obtain private bank records, and whether multiple counts of securities fraud based on a series of transactions violates constitutional double jeopardy principles.

Between March 2006 and June 2007, in reliance on representations made by Michael J. Reeder, William McAllister made a series of payments to Reeder, totaling approximately $1.7 million, in two real estate investments. Reeder never purchased or developed the properties, and never returned McAllister’s money. After receiving a complaint, the Securities Division of the Washington Department of Financial Institutions investigated and ultimately referred the matter to the King County Prosecuting Attorney’s Office.

Suspecting Reeder of securities fraud and theft, the state obtained Reeder’s private bank records using subpoenas issued by a special inquiry judge. The records revealed that Reeder had used
McAllister’s funds to supporting his gambling habit, and for other personal expenses. The state charged him with 14 counts of securities fraud under the Securities Act of Washington, each count being a separate payment that McAllister made to Reeder.

Reeder moved to suppress his bank records at trial, arguing they were obtained in violation of his constitutional rights because the state did not have a valid warrant or judicially-issued subpoena as required by State v. Miles, 160 Wn.2d 236, 256 P.3d 864 (2007). (In Miles, the court held that an administrative subpoena issued under the Securities Act of Washington was insufficient authority of law to obtain private bank records. Rather, the subpoena must have justification beyond the statute authorizing a subpoena and must be subject to judicial review.)

The trial court denied Reeder’s motion to suppress and Reeder was found guilty on all 14 counts. The Court of Appeals affirmed. Reeder appealed, and the Washington Supreme Court granted review of two issues: whether the state violated Reeder’s right to privacy by obtaining his bank records through a special inquiry judge proceeding; and whether Reeder’s sentence violated constitutional double jeopardy principles.

With respect to the first issue, the court examined the nature of the special inquiry judge proceeding to determine whether the state violated Reeder’s rights under article I, section 7 of the Washington Constitution, which provides that no person shall be disturbed in his private affairs without authority of law. The court rejected Reeder’s argument, noting that it has previously held that “authority of law” to collect private records encompasses more than probable cause warrants and includes judicially-reviewed subpoenas. Unlike the subpoena issued in Miles, the subpoena in this case was issued pursuant to a special inquiry judge’s power under a presumably constitutional statute, which requires a subpoena to be issued only when there is “reason to suspect crime or corruption.”

The court then examined whether “reason to suspect crime or corruption” is sufficient justification for the subpoena. Because Washington courts had not squarely addressed this matter, the court looked to the federal grand jury subpoena process for guidance.

The court noted that the Supreme Court of the United States has held that federal grand jury subpoenas need not be justified by probable cause, and then went on to identify the ways in which special inquiry judge proceedings were similar to federal grand juries in purpose and structure—namely, that both served the purpose of gathering evidence about suspected crimes in order to determine whether probable cause for an indictment exists; that both ensured the confidentiality of reports and testimony; that the power of special inquiry judges was not unlimited and was subject to judicial review; and that the power of the prosecuting attorney to obtain evidence through the subpoena process was also subject to judicial review. The court concluded that a special inquiry judge subpoena, like a federal grand jury subpoena, can be justified by less than probable cause, and “reason to suspect crime or corruption” is sufficient justification, and that the subpoena for Reeder’s bank account records was issued pursuant to sufficient “authority of law”.

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With respect to the second issue, whether Reeder’s multiple convictions violated double jeopardy principles, the court considered, in part, what the proper “unit of prosecution” is under the Securities Act of Washington. The double jeopardy clause of the Washington Constitution protects a defendant from being convicted twice under the same statute for committing one “unit of prosecution.”

To determine what the proper unit of prosecution is, the court reviewed RCW 21.20.010, the “anti-fraud” statute under which Reeder was convicted. RCW 21.20.010 prohibits misleading actions in connection with the offer, sale or purchase of any security. “Sale” is defined to include every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value. Because the definition of “sale” includes every sale of a security, the court determined this indicated the legislature’s intent for each transaction or sale to constitute the unit of prosecution. Thus, the unit of prosecution in the anti-fraud statute is every separate sale of a security, rather than the underlying security. Since the state presented evidence that 14 different misleading sales took place on several different dates, Reeder’s sentence did not violate double jeopardy principles.

**Garrison v. SagePoint Financial, Inc. (f/k/a AIG Financial Advisors, Inc.)**


Mark M. Garrison, a federally-registered investment adviser, was co-owner of a financial investment advice firm, Acumen Financial Group, Inc. (“Acumen”). In 1999, Garrison entered into an agreement with AIG Financial Advisors, Inc. (“AIG”) to act as a registered representative. As part of this agreement, Garrison agreed to notify AIG in writing of any outside business activity prior to engaging in such activity.

In 2006, Garrison was appointed manager of the Garrison Family LLC and trustee of the Jack M. Garrison and Charlotte L. Garrison Revocable Trust, the assets of which were held in two brokerage accounts at Wells Fargo Investments LLC (“Wells Fargo”). AIG approved Garrison’s acting in these roles for the Wells Fargo accounts, provided in part that he annually disclosed this and other outside business activities, and was monitored by AIG’s “First Line Supervisor.” AIG also required receipt of duplicate account statements and confirmation slips for the Wells Fargo accounts.

In 2006, Garrison submitted an outside business activity questionnaire to AIG. The questionnaire disclosed his status as owner of Acumen and his status as the trustee, owner and manager of the Wells Fargo accounts. The questionnaire also disclosed that Garrison was spending up to 25 percent of his time conducting these activities, for which he received compensation of less than $10,000.
In 2007, Garrison emailed the brokers for the Wells Fargo accounts, stating he planned to hire Acumen to provide investment advice to the accounts, but that Wells Fargo would continue to execute trades. In his 2007 questionnaire concerning outside business activities, Garrison reported that he was “actively engaged” as the trustee, owner and manager of the Wells Fargo accounts and that it was an “investment related activity” conducted by Acumen.

In late 2007, AIG approved Garrison’s request to open personal brokerage accounts at TD Ameritrade, instructing him to provide duplicate copies of account information.

In 2011, plaintiffs sued Garrison and AIG, among others, alleging that Garrison converted $9.6 million from the Wells Fargo accounts to his personal TD Ameritrade accounts and paid himself over $550,000 in investment advisory fees. The complaint also alleged that Garrison’s speculative and high-risk investments caused plaintiffs’ to lose over $20 million.

Plaintiffs further asserted claims against AIG for negligent supervision, violations of the Securities Act of Washington, and respondeat superior liability. AIG moved for summary judgment to dismiss the claims that had been asserted against it, the trial court granted the motion, and plaintiffs appealed.

The appellate court affirmed summary judgment dismissal of the respondeat superior claim, holding that Garrison’s investment adviser activities were outside the scope of his employment with AIG. However, the appellate court reversed the trial court’s dismissal of the negligent supervision and control person claims, and remanded them for trial.

Examining the negligent supervision claim—i.e., AIG’s duty to supervise Garrison’s outside business activities—the court looked, in part, to rules promulgated by the National Association of Securities Dealers (“NASD”), now known as the Financial Industry Regulatory Authority, as well as NASD Notice to Members publications, specifically whether it had a duty to supervise Garrison’s outside business activities under NASD Rule 3040. The court concluded that NASD Rule 3040 did apply, and that the dispositive question was whether AIG knew or should have known that Garrison’s role had changed to that of an investment adviser, triggering the duty to supervise. In answering this question, the court first looked to Garrison’s 2007 questionnaire, which did not comply with NASD Rule 3040’s written notice requirements, and concluded that this alone may not have provided AIG with notice. However, the court also examined the directive from AIG and its company manual, which requires registered representatives to disclose outside business activities prior to engaging in them, via the questionnaire. The court concluded there was a genuine issue of material fact as to whether AIG knew or should have known that Garrison was also acting as an investment adviser.

The court also determined that there were material issues of fact as to whether suspicious activity required AIG to investigate and monitor Garrison’s activities in the Wells Fargo accounts. AIG was receiving monthly account statements and confirmation slips on both the Wells Fargo and TD Ameritrade accounts, and required its first line supervisors to not only review the outside business activity questionnaires, but to question registered representatives regarding their outside business activities. The court noted in passing that there was also evidence that Garrison had
changed the nature of the Wells Fargo investments and had transferred more than $9.6 million to his TD Ameritrade accounts—activities that should have put AIG on notice that further monitoring may have been needed.

The appellate court next examined whether AIG could be held liable as a “control person” under the Securities Act of Washington and reversed the trial court’s summary judgment dismissal of the claim. The court reasoned that, because there were material issues of fact as to whether AIG knew or should have known that Garrison was also acting as an investment adviser, there were similar material issues of fact concerning the extent to which AIG could or should have exercised control over the Wells Fargo account transactions.

**Hara v. Kunath, Karren, Rinne & Atkins LLC**


In 1996, Kunath, Karren, Rinne, & Atkin LLC (“KKRA”), a federally-registered investment adviser, hired Lloyd Hara. The parties did not execute a written employment agreement. Pursuant to their oral agreement, however, KKRA allegedly paid Hara a salary and commissions for any new clients Hara brought in. Hara introduced two new clients to the firm prior to September 1997, when he resigned due to a disagreement over his role with the firm.

Hara and KKRA began negotiating a severance agreement when he announced his resignation. The agreement included a provision that KKRA would pay Hara his share of collected management fees on the two client accounts for as long as KKRA retained the clients. In exchange for this and other promises, Hara agreed not to accept employment with a competing firm.

KKRA paid Hara under the severance agreement until January 2010, when it attempted to pay Hara $17,000 in exchange for voiding the agreement. Hara sought to continue collecting on the agreement, and ultimately filed a complaint.

At trial, KKRA argued that the severance agreement was unlawful and unenforceable Hara was not a licensed investment adviser representative (and was not exempt from a federal regulation), and that forbade KKRA from paying him anything for what were, essentially, his solicitation activities regarding the two client accounts. The trial court entered judgment in favor of KKRA and dismissed Hara’s claims.

Hara appealed, challenging the trial court’s findings that Hara’s work at KKRA was that of an investment adviser representative, and that Hara was paid both a salary and a commission for clients that Hara procured for KKRA. The trial court had determined there was substantial evidence on the record to support these findings where, among other evidence introduced, Hara testified he sent letters to his contacts informing them KKRA had an investment arm and KKRA
produced copies of checks marked as “commissions” that matched the agreed-upon percentage of client fees. Moreover, the severance agreement provided that KKRA would pay Hara a percentage commission of new investment management business at a rate he had been paid in past periods, implying that he had previously been paid commissions for generating investment management business. Hara also alleged that the trial court erred when it found the severance agreement unlawful under both federal and state law.

The appellate court rejected Hara’s argument that, because the agreement did not require him to engage in unlawful solicitation, there was no violation of federal law. The court concluded that it was enough that payments were made on the severance agreement with respect to solicitations that were unlawful when they were made. The court also rejected Hara’s argument that the “employee exemption” to the federal rule applied, since there was no evidence that Hara’s solicitor status was disclosed to either client at the time of solicitation. Because the severance agreement required KKRA to compensate Hara for solicitation activities, and there was no evidence an exemption applied, the court held that the trial court properly concluded it was unlawful under federal law.

Turning to state law, the court determined that Hara’s suit was barred by RCW 21.20.430(5) because Hara’s work soliciting new clients for KKRA made him an investment advisor representative, and absent licensing by the Securities Division (which Hara did not have), he could not lawfully engage in such work nor be compensated for it pursuant to the terms of his oral agreement.

The court then considered whether the unlawfulness of the oral agreement affected the lawfulness of the severance agreement, or whether the two were even severable, ultimately determining that the severance agreement was not separate and distinct, was not supported by independent consideration, and did not implicate provisions that were sufficiently remote from the precedent oral agreement. The court held that the parties to both agreements—the oral agreement and the later severance agreement—were identical, the funds Hara was promised were in part tied to the illegal solicitation activities, and the severance agreement essentially perpetuated the illegal employment agreement. The court affirmed the trial court’s conclusion that the severance agreement was not severable from the original oral employment agreement and was thus unenforceable.

**Somerset Communications Group, LLC v. Wall to Wall Advertising, Inc.**


In 2009, Donald MacCord and Shannon Doyle approached William Moore with an offer to purchase shares in Fourpoints Holding, LLC (“Fourpoints”), then held by Wall to Wall Advertising, Inc. (“W2W”). Fourpoints was formed by W2W, Lubin Outdoor, LLC (“Lubin”) and Fourpoints Investors (“FP Investors”) for the purpose of holding and operating Fourpoints
Communications, LLC (“FC”). FC built and operated digital signs. MacCord was W2W’s sole shareholder and President, and Fourpoints’ Chief Executive Officer. Doyle was Fourpoints’ Chief Financial Officer.

Over the next six months, MacCord and Doyle made numerous statements and provided Moore with documents detailing Fourpoints’ business plans, existing signs, its 2009 operating results and projections, and year-end actual operating results. Each allegedly indicated that Fourpoints had significant and ongoing revenue from two signs in California (“Pala signs”). In addition, MacCord and Doyle allegedly represented that the managing partners of Fourpoints had consented to W2W’s sale of shares, a requirement under Fourpoints’ operating agreement.

Based on these representations, Moore formed Somerset Communications Group, Inc. (“Somerset”) as the entity that would purchase W2W’s shares in Fourpoints, and then made multiple purchases of the shares. MacCord and Doyle then allegedly used the investment money not to fund new ventures as represented, but rather to keep Fourpoints financially afloat.

Somerset allegedly did not learn of Fourpoints’ financial troubles until it was informed that MacCord had been dismissed by Fourpoints’ other shareholders. Around this time, Somerset was also informed that FP Investors had not consented to any of W2W’s sales, that the consent forms had been forged, and that Fourpoints believed Somerset had no interest in the company. Somerset sued W2W, MacCord, Doyle, and others for securities fraud under Section 10b of the Securities Exchange Act of 1934 and federal Rule 10b-5 thereunder, and the Securities Act of Washington. W2W, MacCord and Doyle soon moved for summary judgment.

In its first cause of action, Somerset alleged that the W2W, MacCord and Doyle falsely represented Fourpoints’ assets and revenues by, among other things, claiming non-existent revenue from the Pala signs. The court determined that Somerset had established disputes of material fact on this cause of action where, among other things, Somerset presented evidence the Pala sign revenues were included in actual and projected revenues after the signs had been turned off. Somerset presented evidence of genuine issues as to reasonable reliance where, although it had full access to Fourpoints’ books and records, its own private placement memorandum reflected revenue numbers supplied by Doyle, and there was no evidence of reckless lack of due diligence. The court also found that Somerset established genuine issues of scienter, where it alleged that, before Doyle provided documents to Somerset falsely representing Fourpoints’ profitability, he had produced a truthful internal version that showed the company’s true financial picture.

In its second cause of action, Somerset alleged that W2W, MacCord and Doyle failed to disclose that Fourpoints did not have sufficient revenue to meet its liabilities and was essentially insolvent. The court found Somerset had presented issues of material fact as to Fourpoints’ insolvency. And even if Somerset independently evaluated Fourpoints’ financial condition prior to investing, the court opined that the omission might still be fraudulent. Somerset asserted that because federal Rule 10b-5 obligates a person to disclose information when necessary to make the statements made, in light of the circumstances under which they were made, not misleading,
the W2W, MacCord and Doyle had a duty to disclose that it could not pay its debts. The court found this argument sufficient to preclude summary judgment.

In a third cause of action, Somerset alleged that W2W, MacCord and Doyle omitted the fact that, at the time Somerset was purchasing shares, Lubin was selling its own Fourpoints shares to W2W and MacCord at a valuation 40% lower than that offered to Somerset. The court found that Somerset had established genuine issues of fact when it alleged that a duty to speak existed when it provided documents identifying Lubin as one of only three owners. Moreover, the fact that one owner was divesting its interest at a time when Fourpoints was supposedly profitable raised questions about the reliability of the financial statements that W2W, MacCord and Doyle had provided to Somerset.

In a fourth cause of action, Somerset alleged that W2W, MacCord and Doyle failed to disclose that Fourpoints was operating under a forbearance agreement deferring its interest and distribution payments to FP Investors. In part, the court accepted Somerset’s argument that when W2W, MacCord and Doyle provided financial statements representing that Fourpoints was profitable, it had a duty to disclose that Fourpoints could not make its debt payments and had entered into forbearance agreements. Thus summary judgment was also inappropriate on this claim.

Lastly, Somerset alleged W2W, MacCord and/or Doyle forged the signatures on the consents to sales of shares to Somerset in violation of federal and state laws. Somerset had presented sufficient evidence to call into question whether the requisite consents had been obtained—this being evidence that FP Investors never had knowledge of or consented to the sales. The court also rejected the W2W’s, MacCord’s and Doyle’s argument that Somerset lacked standing because Somerset would have received valid Fourpoints units in exchange for its investments. The motion for summary judgment was denied.

In a subsequent motion for partial summary judgment, Case No. C13-2084-JCC, 2015 WL 5007680 (W.D. Wash. Aug. 20, 2015) (unpublished), the court considered a motion, this time brought by Somerset. In particular, Somerset brought a partial summary judgment motion on two of its claims: that MacCord and Doyle falsely represented Fourpoints’ assets and revenues; and that MacCord or Doyle, or both, forged signatures on the consents in violation of state and federal securities laws.

On the first claim, the court determined summary judgment was inappropriate under both the Securities Act of Washington and federal securities law. Under state law, while Somerset arguably prevailed on its claim that a material misrepresentation was made, there was an issue of material fact as to reliance, because there was evidence that Somerset did not include the Pala signs as “operational” in one of its PPMs. Additionally, under federal law, W2W, MacCord and Doyle presented sufficient evidence to establish a dispute as to whether W2W knew no revenue would be forthcoming at the time of the transactions. W2W also alleged that discussion of future Pala sign revenue merely represented forward-looking projections that contained cautionary language.
The court further determined that summary judgment was inappropriate for Somerset’s second claim under both the Securities Act of Washington and federal securities laws. W2W presented contrary testimony that MacCord received approval for its first sales to Somerset and reused the same form under the impression that FP Investors would continue to approve the sales.

Therefore, there was a genuine issue of material fact under the Securities Act of Washington as to whether MacCord had the authority to sell shares to Somerset. Additionally, under federal securities law there was a genuine dispute of material fact as to whether the alleged forgery caused loss. W2W presented evidence that Somerset declared to its own investors that even if the sale had been invalid as to Fourpoints, Somerset still had shares in W2W.

The court denied Somerset’s motion.
Chapter 8

Where’s Your Data? Privacy, Security, and Your Ethical Obligations

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Why do we care?

» **Ethical Obligations**
  - Competence
  - Confidentiality
  - Safekeeping client property
  - Supervising subordinate lawyers and non-lawyer staff

» **Statutory Obligations**
  - State and Federal Law (Data Breach Notification, SEC Guidance and Enforcement)

» **Remaining Competitive in the Marketplace**
  - Engagement requirements (public company concerns)
  - Client audits
It happens to the best of us...

What does a data breach look like?
Remember this story?

Holland & Knight
Your data is exposed

- Insider theft: 14%
- Hacking: 17%
- Accidental exposure or negligence: 42%
- Subcontractor: 27%

Holland & Knight

Cybersecurity and data breach law

State statutes
Federal statutes
Other laws

Holland & Knight
Not a surprise: lawyers must be competent

Cmt [8]: Lawyer must “maintain” competence by keeping abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education.
Duty of confidentiality – RPC 1.6(c)

A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

What are “reasonable efforts”? 
Do you need a zombie house? Consider:

• Sensitivity of the information;
• Is disclosure likely if add’l safeguards not employed;
• Cost of employing add’l safeguards;
• Difficulty of implementing the safeguards; and
• Extent to which safeguards adversely affect the lawyer’s ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use).

Clients can control their data

• A client may require the lawyer to implement special security measures
• A client may give informed consent to forgo security measures that would otherwise be required
Everyone is an expert after the fact – be an expert beforehand

Lawyer’s Duties of Supervision

Everyone in the firm shares in the responsibility:

- **RPC 5.1:** Partners, managers and supervisory lawyers

- **RPC 5.2:** Subordinate Lawyers remain responsible even if acting at direction of another

- **RPC 5.3:** Nonlawyers employed, retained, supervised or directed by lawyer
Be prepared for a breach

Conduct a systems assessment – what do you have, what do you need and where are your holes?

Hire an IT Expert and respect their expertise

Identify a firm IT policy/crisis/document response team
- Include IT, lawyers, staff
- Consider legal & ethical obligations and business objectives

Create polices and conduct training – and TEST!

Evaluate third-party vendors (including the cloud)

Consider cyber-insurance and compare to LPL

Respond to a breach appropriately

1. Assemble your team
2. Secure your network, investigate and identify compromised data
3. Make necessary notifications
4. Remedy breach / respond to client complaints and consumer issues
5. Follow up including lessons learned
2 primary risks of using mobile devices

- Physical access to lost or stolen device by unauthorized user
- Hackers accessing confidential information
  - Unencrypted data over an unsecured wireless network
Chapter 8—Where’s Your Data? Privacy, Security, and Your Ethical Obligations

10 ways to minimize risk

• Use secure networks, where possible
• Use encrypting technology
• Inactivity timer
• Location services
• Remote wipe
• URLs and QRs
• Update your device
• Don’t jailbreak or root
• Terms of Service
• Use strong passwords and change them regularly
Talk to your clients

- Talk to your client about passwords, mobile devices & shared-access accounts

Mobile / Computer Access – Change Account Passwords

Please think about who has access to your confidential, financial, or otherwise personal information. This type of information can be kept on your smartphones, emails, files, thumb drives, in the cloud and on other electronic storage devices. It is essential that you, and only you, control who has access to this information and that you take steps to secure it from others, including the opposing party and their lawyer.

As a result, I recommend that you change your password on all accounts and devices on which another person may have access, including your smartphone, computer, websites (such as banks and cloud services), and email. You should use two-factor authorization and a strong password.

Cloud Computing

- External friendly threats
- External unfriendly threats
- Internal threats
- Business model threats

Holland & Knight
“Data farms”

A look inside one of the data centers operated by 1&1 Internet, which is among the companies with the most web servers.

Holland & Knight


- **Confidentiality:** lawyer must take reasonable steps to ensure that the storage company will reliably secure client data and keep information confidential

- May be enough to comply with industry standards

- As technology advances, the third-party vendor’s protective measures may become less secure or obsolete over time. Lawyer may be required to reevaluate the protective measures.

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Factors to consider in choosing cloud provider

• Financial stability
• Limits on staff access
• Protection of third parties
• Reasonable assurances of protection
• Compatible technology
• Server locations
• Considering your behavior

Thank you!

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RULE 1.1 COMPETENCE

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.
RPC 1.1

COMPETENCE

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

[Originally effective September 1, 1985; amended effective September 1, 2006.]

Comment

Legal Knowledge and Skill

[1] In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances.

[2] A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

[3] In an emergency a lawyer may give advice or assistance in a matter in which the lawyer does not have the skill ordinarily required where referral to or consultation or association with another lawyer would be impractical. Even in an emergency, however, assistance should be limited to that reasonably necessary in the circumstances, for ill-considered action under emergency conditions can jeopardize the client's interest.

[4] A lawyer may accept representation where the requisite level of competence can be achieved by reasonable preparation. This applies as well to a lawyer who is appointed as counsel for an unrepresented person. See also Rule 6.2.

Thoroughness and Preparation

[5] Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners. It also includes adequate preparation. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence. An agreement between the lawyer and the client regarding the scope of the representation may limit the matters for which the lawyer is responsible. See Rule 1.2(c).

Retaining or Contracting With Other Lawyers

[6] Before a lawyer retains or contracts with other lawyers outside the lawyer's own firm to provide or assist in the provision of legal services to a client, the lawyer should ordinarily obtain informed consent from the client and the provision of legal services to a client, the lawyer should ordinarily obtain informed consent from the client and must reasonably believe that the other lawyers' services will contribute to the competent and ethical representation of the client. See also, RPC 1.2 (allocation of authority), 1.4 (communication with client), 1.5(e) (fee sharing), 1.6 (confidentiality), and 5.5(a) (unauthorized practice of law). The reasonableness of the decision to retain or contract with other lawyers outside the lawyer's own firm will depend upon the circumstances, including the education, experience and reputation of the nonfirm lawyers; the nature of the services assigned to the nonfirm lawyers; and the legal protections, professional conduct rules, and ethical environments of the jurisdictions in which the services will be performed, particularly relating to confidential information.

[Comment 6 adopted September 1, 2016.]

[7] [Washington revision] When lawyers or LLLTs from more than one law firm are providing legal services to a client on a particular matter, the lawyers and/or LLLTs ordinarily should consult with each other and the client about the scope of their respective representations and the allocation of responsibility among them. See RPC 1.2. When making allocations of responsibility in a matter pending before a tribunal, lawyers, LLLTs, and parties may have additional obligations that are a matter of law beyond the scope of these Rules.

[Comment 7 adopted September 1, 2016.]

Maintaining Competence

[8] To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject.

[Comment 6 adopted effective September 1, 2006; renumbered to 8 and amended effective September 1, 2016.]

Additional Washington Comments (9-10)

[9] This rule applies to lawyers only when they are providing legal services. Where a lawyer is providing nonlawyer services ("supporting lawyer") in support of a lawyer who is providing legal services ("supported lawyer"), the supported lawyer should treat the supporting lawyer as a nonlawyer assistant for purposes of this rule and RPC 5.3. (Responsibilities Regarding Nonlawyer Assistants).

[Comment 9 adopted September 1, 2016.]

[10] In some circumstances, a lawyer can also provide adequate representation by enlisting the assistance of an LLLT of established competence, within the scope of the LLLT’s license and consistent with the provisions of the LLLT RPC. However, a lawyer may not enter into an arrangement for the division of the fee with an LLLT who is not in the same firm as the lawyer. See Comment [7] to Rule 1.5(e); LLLT RPC 1.5(e). Therefore, a lawyer may enlist the assistance of an LLLT who is not in the same firm only (1) after consultation with the client in accordance with Rules 1.2 and 1.4 and (2) by referring the client directly to the LLLT.

[Comment 7 adopted effective April 14, 2015; renumbered to 10 effective September 1, 2016.]
RULE 1.6 CONFIDENTIALITY OF INFORMATION

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to disclose the intention of the lawyer's client to commit a crime and the information necessary to prevent the crime;

(2) to prevent reasonably certain death or substantial bodily harm;

(3) to secure legal advice about the lawyer's compliance with these Rules;

(4) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;

(5) to comply with other law, court order, or as permitted by these Rules; or

(6) in connection with the sale of a law practice under Rule 1.17 or to detect and resolve conflicts of interest arising from the lawyer’s change of employment or from changes in the composition or ownership of a firm. In those circumstances, a lawyer may disclose with respect to each affected client the client's identity, the identities of any adverse parties, the nature and extent of the legal services involved, and fee and payment information, but only if the information revealed would not compromise the attorney-client privilege or otherwise prejudice any of the clients. The lawyer or lawyers receiving the information shall have the same responsibilities as the disclosing lawyer to preserve the information regardless of the outcome of the contemplated transaction.

(7) to comply with the terms of a diversion agreement, probation, conditional reinstatement or conditional admission pursuant to BR 2.10, BR 6.2, BR 8.7or Rule for Admission Rule 6.15. A lawyer serving as a monitor of another lawyer on diversion, probation, conditional reinstatement or conditional admission shall have the same responsibilities as the monitored lawyer to preserve information relating to the representation of the monitored lawyer’s clients, except to the extent reasonably necessary to carry out the monitoring lawyer’s responsibilities under the terms of the diversion, probation, conditional reinstatement or conditional admission and in any proceeding relating thereto.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.
RPC 1.6
CONFIDENTIALITY OF INFORMATION
(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
(b) A lawyer to the extent the lawyer reasonably believes necessary:
(1) shall reveal information relating to the representation of a client to prevent reasonably certain death or substantial bodily harm;
(2) may reveal information relating to the representation of a client to prevent the client from committing a crime;
(3) may reveal information relating to the representation of a client to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
(4) may reveal information relating to the representation of a client to secure legal advice about the lawyer's compliance with these Rules;
(5) may reveal information relating to the representation of a client to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer, or to prevent the client from committing a crime; or
(6) may reveal information relating to the representation to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client;
(7) may reveal information relating to the representation of a client to inform a tribunal about any client's breach of fiduciary responsibility when the client is serving as a court appointed fiduciary such as a guardian, personal representative, or receiver.
(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.
[Originally effective September 1, 1985; amended effective September 1, 1990; September 1, 2006; September 1, 2016.]
Comment
See also Washington Comment [19].
[1] [Washington revision] This Rule governs the disclosure by a lawyer of information relating to the representation of a client. See Rule 1.18 for the lawyer's duties with respect to information provided to the lawyer by a prospective client, Rule 1.9(c)(2) for the lawyer's duty not to reveal information relating to the lawyer's prior representation of a former client and Rules 1.8(b) and 1.9(c)(1) for the lawyer's duties with respect to the use of such information to the disadvantage of clients and former clients.
[2] [Washington revision] A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, the lawyer must not reveal information relating to the representation. See Rule 1.0(a)(e) for the definition of informed consent. This contributes to the trust that is the hallmark of the client-lawyer relationship. The client is thereby encouraged to seek legal assistance and to communicate fully and frankly with the lawyer even as to embarrassing or legally damaging subject matter. The lawyer needs this information to represent the client effectively and, if necessary, to advise the client to refrain from wrongful conduct. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. Based upon experience, lawyers know that almost all clients follow the advice given, and the law is upheld.
[3] The principle of client-lawyer confidentiality is given effect by related bodies of law: the attorney-client privilege, the work product doctrine and the rule of confidentiality established in professional ethics. The attorney-client privilege and work-product doctrine apply in judicial and other proceedings in which a lawyer may be called as a witness or otherwise required to produce evidence concerning a client. The rule of client-lawyer confidentiality applies in situations other than those where evidence is sought from the lawyer through compulsion of law. The confidentiality rule, for example, applies not only to matters communicated in confidence by the client but also to all information relating to the representation, whatever its source. A lawyer may not disclose such information except as authorized or required by the Rules of Professional Conduct. See also Scope.
[4] Paragraph (a) prohibits a lawyer from revealing information relating to the representation of a client. This prohibition also applies to disclosures by a lawyer that do not in themselves reveal protected information but could reasonably lead to the discovery of such information by a third person. A lawyer's use of a hypothetical to discuss issues relating to the representation is permissible so long as there is no reasonable likelihood that the listener will be able to ascertain the identity of the client or the situation involved.
Authorized Disclosure
[5] [Washington revision] Except to the extent that the client's instructions or special circumstances limit that authority, a lawyer is impliedly authorized to make disclosures about a client when appropriate in carrying out the representation. In some situations, for example, a lawyer may be impliedly authorized to admit a fact that cannot properly be disputed or to make a disclosure that facilitates a satisfactory conclusion to a matter. Lawyers in a firm may, in the course of the firm's practice, disclose information relating to a client of the firm to other lawyers or LLLTs within the firm, unless the client has instructed that particular information be confined to specified lawyers or LLLTs.
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Disclosure Adverse to Client
Paragraph (b) recognizes that a lawyer may be ordered to disclose information relating to the representation of their clients, the confidentiality rule is subject to limited exceptions. Paragraph (b)(1) recognizes that any disclosure reasonably necessary to prevent reasonably certain death or substantial bodily harm. Such harm is reasonably certain to occur if it will be suffered imminently or if there is a present and substantial threat that a person will suffer such harm at a later date if the lawyer fails to take action necessary to eliminate the threat. Thus, a lawyer who knows that a client has accidentally discharged toxic waste into a town’s water supply must reveal this information to the authorities if there is a present and substantial risk that a person who drinks the water will contract a life-threatening or debilitating disease and the lawyer’s disclosure is necessary to eliminate the threat or reduce the number of victims.
[7] [Reserved.]
[8] [Reserved.]
A lawyer’s confidentiality obligations do not preclude a lawyer from securing confidential legal advice about the lawyer’s personal responsibility to comply with these Rules. In most situations, disclosing information to secure such advice will be impliedly authorized for the lawyer to carry out the representation. Even when the disclosure is not impliedly authorized, paragraph (b)(4) permits such disclosure because of the importance of a lawyer’s compliance with the professional responsibilities of a fiduciary.

Where a legal claim or disciplinary charge alleges complicity of the lawyer in a client’s conduct or other misconduct of the lawyer involving representation of a former client, the lawyer may respond to the extent the lawyer reasonably believes necessary to establish a defense. The same is true with respect to a claim involving the conduct or representation of a former client. Such a charge can arise in a civil, criminal, disciplinary or other proceeding and can be based on a wrong allegedly committed by the lawyer against the client or on a wrong alleged by a third person, for example, a person claiming to have been defrauded by the lawyer and client acting together. The lawyer's right to respond arises when an assertion of such complicity has been made. Paragraph (b)(5) does not require the lawyer to await the commencement of an action or proceeding that charges such complicity, so that the defense may be established by responding directly to a third party who has made such an assertion. The right to defend also applies, of course, where a proceeding has been commenced.

A lawyer entitled to a fee is permitted by paragraph (b)(5) to prove the services rendered in an action to collect it. This aspect of the Rule expresses the principle that the beneficiary of a fiduciary relationship may not exploit it to the detriment of the fiduciary.

Detection of Conflicts of Interest
[Comment 13 adopted effective September 1, 2016.]
Paragraph (b)(7) recognizes that lawyers in different firms may need to disclose limited information to each other to detect and resolve conflicts of interest, such as when a lawyer is considering an association with another firm, two or more firms are considering a merger, or a lawyer is considering the purchase of a law practice. See RPC 1.17, Comment [7]. Under these circumstances, lawyers and law firms are permitted to disclose limited information, but only once substantive discussions regarding the new relationship have occurred. Any such disclosure Rule 6 ordinarily includes no more than the identity of the persons and entities involved in a matter, a brief summary of the general issues involved, and information about whether the matter has terminated. Even this limited information, however, should be disclosed only to the extent reasonably necessary to detect and resolve conflicts of interest that might arise from the possible new relationship. Moreover, the disclosure of any information is prohibited if it would compromise the attorney-client privilege or otherwise prejudice the client (e.g., the fact that a corporate client is seeking advice on a corporate takeover that has not been publicly announced, that a person has consulted a lawyer about the possibility of divorce before the person's intentions are known to the person's spouse, or that a person has consulted a lawyer about a criminal investigation that has not led to a public charge).

Under these circumstances, paragraph (a) prohibits disclosure unless the client or former client gives informed consent. A lawyer’s fiduciary duty to the lawyer's firm may also govern a lawyer's conduct when exploring an association with another firm and is beyond the scope of these rules. See also RPC 1.1, comment [6], [7], and [10] as to decisions to associate other lawyers or LLLTs.

[Comment 13 adopted effective September 1, 2016.]
Paragraph (b)(7) may be used or further disclosed only to the extent necessary to detect and resolve conflicts of interest. Paragraph (b)(7) does not restrict the use of information acquired by means independent of any disclosure pursuant to paragraph (b)(7). Paragraph (b)(7) also does not affect the disclosure of information within a law firm when the disclosure is otherwise authorized, see Comment [5], such as when a lawyer in a firm discloses information to another lawyer in the same firm to detect and resolve conflicts of interest that could arise in connection with undertaking a new representation.

[Comment 14 adopted effective September 1, 2016.]
Paragraph (b)(7) also applies when a lawyer is ordered to reveal information relating to the representation of a client by a court. Absent informed consent of the client to do otherwise, the lawyer should assert on behalf of the client all nonfrivolous claims that the information sought is protected against disclosure by the attorney-client privilege or other applicable law. In the event of an adverse ruling, the lawyer must consult with the client about the possibility of appeal to the extent required by Rule 1.4. Unless review is sought, however, paragraph (b)(6) permits the lawyer to comply with the court’s order.

See also Washington Comment [24].

[Paragraph (b) permits disclosure only to the extent the lawyer reasonably believes the disclosure is necessary to accomplish one of the purposes specified. Where practicable, the lawyer should first seek to persuade the client to take suitable action to obviate the need for disclosure. In any case, a disclosure adverse to the client's interest should be no greater than the lawyer reasonably believes necessary to accomplish the purpose. If
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the disclosure will be made in connection with a judicial proceeding, the disclosure should be made in a manner that limits access to the information to the tribunal or other persons having a need to know it and appropriate protective orders or other arrangements should be sought by the lawyer to the fullest extent practicable.

[17] [Washington revision] Paragraphs (b)(2) through (b)(7) permit but do not require the disclosure of information relating to a client's representation to accomplish the purposes specified in those paragraphs. In exercising the discretion conferred by those paragraphs, the lawyer may consider such factors as the nature of the lawyer's relationship with the client and with those who might be injured by the client, the lawyer's own involvement in the transaction and factors that may extenuate the conduct in question. A lawyer's decision not to disclose as permitted by paragraph (b) does not violate this Rule. Disclosure may be required, however, by other Rules. Some Rules require disclosure only if such disclosure would be permitted by paragraph (b). See Rules 1.2(d), 3.3, 4.1(b), and 8.1. See also Rule 1.13(c), which permits disclosure in some circumstances whether or not Rule 1.6 permits the disclosure.

See also Washington Comment [23].

Acting Competently to Preserve Confidentiality

[18] Paragraph (c) requires a lawyer to act competently to safeguard information relating to the representation of a client against unauthorized access by third parties and against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer's supervision. See RPC 1.1, 5.1 and 5.3. The unauthorized access to, or the inadvertent or unauthorized disclosure of, information protected by the attorney-client privilege or other applicable law constitutes a violation of the lawyer's duties to the extent the lawyer has made reasonable efforts to prevent the access or disclosure. Factors to be considered in determining the reasonableness of the lawyer's efforts include, but are not limited to, the sensitivity of the information, the likelihood of disclosure if additional safeguards are not employed, the cost of employing additional safeguards, the difficulty of implementing the safeguards, and the extent to which the safeguards adversely affect the lawyer's ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use). A client may require the lawyer to implement special security measures not required by this rule or may give informed consent to forgo security measures that would otherwise be required by this rule. Whether a lawyer may be required to take additional steps to safeguard a client's information in order to comply with other law, such as state and federal laws that govern data privacy or that impose notification requirements upon the loss of, or unauthorized access to, electronic information, is beyond the scope of these rules. For a lawyer's duties when sharing information with nonlawyers outside the lawyer's own firm, see RPC 5.3, Comments [3]-[4].

[Comment 16 renumbered to 18 and amended effective September 1, 2016.]

[19] When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. This duty, however, does not require that the lawyer use special security measures if the method of communication affords a reasonable expectation of privacy. Special circumstances, however, may warrant special precautions. Factors to be considered in determining the reasonableness of the lawyer's expectation of confidentiality include the sensitivity of the information and the extent to which the privacy of the communication is protected by law or by a confidentiality agreement. A client may require the lawyer to implement special security measures not required by this Rule or may give informed consent to the use of a means of communication that would otherwise be prohibited by this Rule. Whether a lawyer may be required to take additional steps in order to comply with other law, such as state and federal laws that govern data privacy, is beyond the scope of these rules.

[Comment 17 renumbered to 19 and amended effective September 1, 2016.]

Former Client

[20] The duty of confidentiality continues after the client-lawyer relationship has terminated. See Rule 1.9(c)(2). See Rule 1.9(c)(1) for the prohibition against using such information to the disadvantage of the former client.

Additional Washington Comments (21-28)

[21] The phrase "information relating to the representation" should be interpreted broadly. The "information" protected by this Rule includes, but is not necessarily limited to, confidences and secrets. "Confidence" refers to information protected by the attorney client privilege under applicable law, and "secret" refers to other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.

Disclosure Adverse to Client

[22] Washington's Rule 1.6(b)(2), which authorizes disclosure to prevent a client from committing a crime, is significantly broader than the corresponding exception in the Model Rule. While the Model Rule permits a lawyer to reveal information relating to the representation to prevent the client from "committing a crime . . . that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used the lawyer's services," Washington's Rule permits the lawyer to reveal such information to prevent the commission of any crime.

[23] [Reserved.]

[24] [Reserved.]

[25] The exceptions to the general rule prohibiting unauthorized disclosure of information relating to the representation "should not be carelessly invoked." In re Boelter, 139 Wn.2d 81, 91, 985 P.2d 328 (1999). A lawyer must make every effort practicable to avoid unnecessary disclosure of information relating to a representation, to limit disclosure to those having the need to know it, and to obtain protective orders or make other arrangements minimizing the risk of avoidable disclosure.

[26] Washington has not adopted that portion of Model Rule 1.6(b)(6) permitting a lawyer to reveal information related to the representation to comply with "other law." Washington's omission of this phrase arises from a concern that it would authorize the lawyer to decide whether a disclosure is required by "other law," even though the right to confidentiality and the right to waive confidentiality belong to the client. The decision to waive confidentiality...
should only be made by a fully informed client after consultation with the client's lawyer or by a court of competent jurisdiction. Limiting the exception to compliance with a court order protects the client's interest in maintaining confidentiality while insuring that any determination about the legal necessity of revealing confidential information will be made by a court. It is the need for a judicial resolution of such issues that necessitates the omission of "other law" from this Rule.

Withdrawal
[27] After withdrawal the lawyer is required to refrain from disclosing the client's confidences, except as otherwise permitted by Rules 1.6 or 1.9. A lawyer is not prohibited from giving notice of the fact of withdrawal by this Rule, Rule 1.8(b), or Rule 1.9(c). If the lawyer's services will be used by the client in furthering a course of criminal or fraudulent conduct, the lawyer must withdraw. See Rule 1.16(a)(1). Upon withdrawal from the representation in such circumstances, the lawyer may also disaffirm or withdraw any opinion, document, affirmation, or the like. If the client is an organization, the lawyer may be in doubt about whether contemplated conduct will actually be carried out by the organization. When a lawyer requires guidance about compliance with this Rule in connection with an organizational client, the lawyer may proceed under the provisions of Rule 1.13(b).

Other
[28] This Rule does not relieve a lawyer of his or her obligations under Rule 5.4(b) of the Rules for Enforcement of Lawyer Conduct.
RULE 1.15-1 SAFEKEEPING PROPERTY

(a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession separate from the lawyer's own property. Funds, including advances for costs and expenses and escrow and other funds held for another, shall be kept in a separate "Lawyer Trust Account" maintained in the jurisdiction where the lawyer's office is situated. Each lawyer trust account shall be an interest bearing account in a financial institution selected by the lawyer or law firm in the exercise of reasonable care. Lawyer trust accounts shall conform to the rules in the jurisdictions in which the accounts are maintained. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of five years after termination of the representation.

(b) A lawyer may deposit the lawyer's own funds in a lawyer trust account for the sole purposes of paying bank service charges or meeting minimum balance requirements on that account, but only in amounts necessary for those purposes.

(c) A lawyer shall deposit into a lawyer trust account legal fees and expenses that have been paid in advance, to be withdrawn by the lawyer only as fees are earned or expenses incurred, unless the fee is denominated as “earned on receipt,” “nonrefundable” or similar terms and complies with Rule 1.5(c)(3).

(d) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this rule or otherwise permitted by law or by agreement with the client, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.

(e) When in the course of representation a lawyer is in possession of property in which two or more persons (one of whom may be the lawyer) claim interests, the property shall be kept separate by the lawyer until the dispute is resolved. The lawyer shall promptly distribute all portions of the property as to which the interests are not in dispute.

RULE 1.15-2 IOLTA ACCOUNTS AND TRUST ACCOUNT OVERDRAFT NOTIFICATION

(a) A lawyer trust account for client funds that cannot earn interest in excess of the costs of generating such interest (“net interest”) shall be referred to as an IOLTA (Interest on Lawyer Trust Accounts) account. IOLTA accounts shall be operated in accordance with this rule and with operating regulations and procedures as may be established by the Oregon State Bar with the approval of the Oregon Supreme Court.

(b) All client funds shall be deposited in the lawyer’s or law firm’s IOLTA account unless a particular client’s funds can earn net interest. All interest earned by funds held in the IOLTA account shall be paid to the Oregon Law Foundation as provided in this rule.
(c) Client funds that can earn net interest shall be deposited in an interest bearing trust account for the client’s benefit and the net interest earned by funds in such an account shall be held in trust as property of the client in the same manner as is provided in paragraphs (a) through (d) of Rule 1.15-1 for the principal funds of the client. The interest bearing account shall be either:

(1) a separate account for each particular client or client matter; or

(2) a pooled lawyer trust account with sub accounting which will provide for computation of interest earned by each client's funds and the payment thereof, net of any bank service charges, to each client.

(d) In determining whether client funds can or cannot earn net interest, the lawyer or law firm shall consider the following factors:

(1) the amount of the funds to be deposited;

(2) the expected duration of the deposit, including the likelihood of delay in the matter for which the funds are held;

(3) the rates of interest at financial institutions where the funds are to be deposited;

(4) the cost of establishing and administering a separate interest bearing lawyer trust account for the client’s benefit, including service charges imposed by financial institutions, the cost of the lawyer or law firm's services, and the cost of preparing any tax-related documents to report or account for income accruing to the client’s benefit;

(5) the capability of financial institutions, the lawyer or the law firm to calculate and pay income to individual clients; and

(6) any other circumstances that affect the ability of the client’s funds to earn a net return for the client.

(e) The lawyer or law firm shall review the IOLTA account at reasonable intervals to determine whether circumstances have changed that require further action with respect to the funds of a particular client.

(f) If a lawyer or law firm determines that a particular client’s funds in an IOLTA account either did or can earn net interest, the lawyer shall transfer the funds into an account specified in paragraph (c) of this rule and request a refund for the lesser of either: any interest earned by the client’s funds and remitted to the Oregon Law Foundation; or the interest the client’s funds would have earned had those funds been placed in an interest bearing account for the benefit of the client at the same bank.

(1) The request shall be made in writing to the Oregon Law Foundation within a reasonable period of time after the interest was remitted to the Foundation and shall be accompanied by written verification from the financial institution of the interest amount.
(2) The Oregon Law Foundation will not refund more than the amount of interest it received from the client’s funds in question. The refund shall be remitted to the financial institution for transmittal to the lawyer or law firm, after appropriate accounting and reporting.

(g) No earnings from a lawyer trust account shall be made available to a lawyer or the lawyer’s firm.

(h) A lawyer or law firm may maintain a lawyer trust account only at a financial institution that:

(1) is authorized by state or federal banking laws to transact banking business in the state where the account is maintained;

(2) is insured by the Federal Deposit Insurance Corporation or an analogous federal government agency;

(3) has entered into an agreement with the Oregon Law Foundation:

(i) to remit to the Oregon Law Foundation, at least quarterly, interest earned by the IOLTA account, computed in accordance with the institution’s standard accounting practices, less reasonable service charges, if any; and

(ii) to deliver to the Oregon Law Foundation a report with each remittance showing the name of the lawyer or law firm for whom the remittance is sent, the number of the IOLTA account as assigned by the financial institution, the average daily collected account balance or the balance on which the interest remitted was otherwise computed for each month for which the remittance is made, the rate of interest applied, the period for which the remittance is made, and the amount and description of any service charges deducted during the remittance period; and

(4) has entered into an overdraft notification agreement with the Oregon State Bar requiring the financial institution to report to the Oregon State Bar Disciplinary Counsel when any properly payable instrument is presented against such account containing insufficient funds, whether or not the instrument is honored.

(i) Overdraft notification agreements with financial institutions shall require that the following information be provided in writing to Disciplinary Counsel within ten banking days of the date the item was returned unpaid:

(1) the identity of the financial institution;

(2) the identity of the lawyer or law firm;

(3) the account number; and

(4) either (i) the amount of the overdraft and the date it was created; or (ii) the amount of the returned instrument and the date it was returned.
(j) Agreements between financial institutions and the Oregon State Bar or the Oregon Law Foundation shall apply to all branches of the financial institution. Such agreements shall not be canceled except upon a thirty-day notice in writing to OSB Disciplinary Counsel in the case of a trust account overdraft notification agreement or to the Oregon Law Foundation in the case of an IOLTA agreement.

(k) Nothing in this rule shall preclude financial institutions which participate in any trust account overdraft notification program from charging lawyers or law firms for the reasonable costs incurred by the financial institutions in participating in such program.

(l) Every lawyer who receives notification from a financial institution that any instrument presented against his or her lawyer trust account was presented against insufficient funds, whether or not the instrument was honored, shall promptly notify Disciplinary Counsel in writing of the same information required by paragraph (i). The lawyer shall include a full explanation of the cause of the overdraft.

(m) For the purposes of paragraph (h)(3), “service charges” are limited to the institution’s following customary check and deposit processing charges: monthly maintenance fees, per item check charges, items deposited charges and per deposit charges. Any other fees or transactions costs are not “service charges” for purposes of paragraph (h)(3) and must be paid by the lawyer or law firm.
**RPC 1.15A**

SAFEGUARDING PROPERTY

(a) This Rule applies to (1) property of clients or third persons in a lawyer's possession in connection with a representation and (2) escrow and other funds held by a lawyer incident to the closing of any real estate or personal property transaction.

(b) A lawyer must not use, convert, borrow or pledge client or third person property for the lawyer's own use.

(c) A lawyer must hold property of clients and third persons separate from the lawyer's own property.

(1) A lawyer must deposit and hold in a trust account funds subject to this Rule pursuant to paragraph (h) of this Rule.

(2) Except as provided in Rule 1.5(f), and subject to the requirements of paragraph (h) of this Rule, a lawyer shall deposit into a trust account legal fees and expenses that have been paid in advance, to be withdrawn by the lawyer only as fees are earned or expenses incurred.

(3) A lawyer must identify, label and appropriately safeguard any property of clients or third persons other than funds. The lawyer must keep records of such property that identify the property, the client or third person, the date of receipt and the location of safekeeping. The lawyer must preserve the records for seven years after return of the property.

(d) A lawyer must promptly notify a client or third person of receipt of the client or third person's property.

(e) A lawyer must promptly provide a written accounting to a client or third person after distribution of property or upon request. A lawyer must provide at least annually a written accounting to a client or third person for whom the lawyer is holding funds.

(f) Except as stated in this Rule, a lawyer must promptly pay or deliver to the client or third person the property which the client or third person is entitled to receive.

(g) If a lawyer possesses property in which two or more persons (one of which may be the lawyer) claim interests, the lawyer must maintain the property in trust until the dispute is resolved. The lawyer must promptly distribute all undisputed portions of the property. The lawyer must take reasonable action to resolve the dispute, including, when appropriate, interpleading the disputed funds.

(h) A lawyer must comply with the following for all trust accounts:

(1) No funds belonging to the lawyer may be deposited or retained in a trust account except as follows:

   (i) funds belonging in part to the lawyer and in part to the client or third person;

   (ii) funds belonging in part to a client or third person and in part presently or potentially to the lawyer must be deposited and retained in a trust account, but any portion belonging to the lawyer must be withdrawn at the earliest reasonable time; or

(2) funds necessary to restore appropriate balances.

(2) A lawyer must keep complete records as required by Rule 1.15B.

(3) A lawyer may withdraw funds when necessary to pay client costs. The lawyer may withdraw earned fees only after giving reasonable notice to the client of the intent to do so, through a billing statement or other document.

(4) Receipts must be deposited intact.

(5) All withdrawals must be made only to a named payee and not to cash. Withdrawals must be made by check or by electronic transfer.

(6) Trust account records must be reconciled as often as bank statements are generated or at least quarterly.

The lawyer must reconcile the check register balance to the bank statement balance and reconcile the check register balance to the combined total of all client ledger records required by Rule 1.15B(a)(2).

(7) A lawyer must not disburse funds from a trust account until deposits have cleared the banking process and been collected, unless the lawyer and the bank have a written agreement by which the lawyer personally guarantees all deposits to the account without recourse to the trust account.

(8) Disbursements on behalf of a client or third person may not exceed the funds of that person on deposit. The funds of a client or third person may not be used on behalf of anyone else.

(9) Only a lawyer admitted to practice law or an LLLT may be an authorized signatory on the account. If a lawyer is associated in a practice with one or more LLLTs, any check or other instrument requiring a signature must be signed by a signatory lawyer in the firm.

(i) Trust accounts must be interest-bearing and allow withdrawals or transfers without any delay other than notice periods that are required by law or regulation and meet the requirements of ELC 15.7(d) and ELC 15.7(e). In the exercise of ordinary prudence, a lawyer may select any financial institution authorized by the Legal Foundation of Washington (Legal Foundation) under ELC 15.7(c). In selecting the type of trust account for the purpose of depositing and holding funds subject to this Rule, a lawyer shall apply the following criteria:

(1) When client or third-person funds will not produce a positive net return to the client or third person

(1) When client or third-person funds will not produce a positive net return to the client or third person because the funds are nominal in amount or expected to be held for a short period of time the funds must be placed in a pooled interest-bearing trust account known as an Interest on Lawyer's Trust Account or IOLTA. The interest earned on IOLTA accounts shall be paid to, and the IOLTA program shall be administered by, the Legal Foundation of Washington in accordance with ELC 15.4 and ELC 15.7(e).

(2) Client or third-person funds that will produce a positive net return to the client or third person

must be placed in one of the following two types of non-IOLTA trust accounts unless the client or third person requests that the funds be deposited in an IOLTA account:

(i) a separate interest-bearing trust account for the particular client or third person with earned interest paid to the client or third person; or

(ii) a pooled interest-bearing trust account with sub-accounting that allows for computation of interest earned by each client or third person's funds with the interest paid to the appropriate client or third person.

(3) In determining whether to use the account specified in paragraph (i)(1) or an account specified in paragraph (i)(2), a lawyer must consider only whether the funds will produce a positive net return to the client.
or third person, as determined by the following factors:

(i) the amount of interest the funds would earn based on the current rate of interest and the expected period of deposit;
(ii) the cost of establishing and administering the account, including the cost of the lawyer's services and the cost of preparing any tax reports required for interest accruing to a client or third person's benefit; and
(iii) the capability of financial institutions to calculate and pay interest to individual clients or third persons if the account in paragraph (i)(2)(ii) is used.

(4) The provisions of paragraph (i) do not relieve a lawyer or law firm from any obligation imposed by these Rules or the Rules for Enforcement of Lawyer Conduct.

(j) In any transaction in which a lawyer has selected, prepared, or completed legal documents for use in the closing of any real estate or personal property transaction, where funds received or held in connection with the closing of the transaction, including advances for costs and expenses, are not being held in that lawyer's trust account, the lawyer must ensure that such funds, including funds being held by a closing firm, are held and maintained as set forth in this rule or LPORPC 1.12A. This duty shall not apply to a lawyer whose participation in a matter is incidental to the closing if (i) the lawyer or lawyer's law firm has a preexisting lawyer-client relationship with a buyer or seller in the transaction, and (ii) neither the lawyer nor the lawyer's law firm has an existing client-lawyer relationship with a closing firm or LPO participating in the closing.

[Former Rule 1.14 was amended effective July 1, 1988; July 14, 1989; March 1, 1991; October 1, 2002. Renumbered and amended effective September 1, 2006; amended effective September 1, 2007; November 18, 2008; January 1, 2009; December 1, 2009; September 1, 2011; December 10, 2013 April 14, 2015.]

Washington Comments

[1] A lawyer must also comply with the recordkeeping rule for trust accounts, Rule 1.15B.

[2] Client funds include, but are not limited to, the following: legal fees and costs that have been paid in advance other than retainers and flat fees complying with the requirements of Rule 1.5(f), funds received on behalf of a client, funds to be paid by a client to a third party through the lawyer, other funds subject to attorney and other liens, and payments received in excess of amounts billed for fees.

[3] This Rule applies to property held in any fiduciary capacity in connection with a representation, whether as trustee, agent, escrow agent, guardian, personal representative, executor, or otherwise.


[5] Property covered by this Rule includes original documents affecting legal rights such as wills or deeds.

[6] A lawyer has a duty to take reasonable steps to locate a client or third person for whom the lawyer is holding funds or property. If after taking reasonable steps, the lawyer is still unable to locate the client or third person, the lawyer should treat the funds as unclaimed property under the Uniform Unclaimed Property Act, RCW 63.29.

[7] A lawyer may not use as a trust account an account in which funds are periodically transferred by the financial institution between a trust account and an uninsured account or other account that would not qualify as a trust account under this Rule or ELC 15.7.

[8] If a lawyer accepts payment of an advanced fee deposit by credit card, the payment must be deposited directly into the trust account. It cannot be deposited into a general account and then transferred to the trust account. Similarly, credit card payments of earned fees, of retainers meeting the requirements of Rule 1.5(f)(1), and of flat fees meeting the requirements of Rule 1.5(f)(2) cannot be deposited into the trust account and then transferred to another account.

[9] Under paragraph (g), the extent of the efforts that a lawyer is obligated to take to resolve a dispute depend on the amount in dispute, the availability of methods for alternative dispute resolution, and the likelihood of informal resolution.

[10] The requirement in paragraph (h)(4) that receipts must be deposited intact means that a lawyer cannot deposit one check or negotiable instrument into two or more accounts at the same time, commonly known as a split deposit.

[11] Paragraph (h)(7) permits Washington lawyers to enter into written agreements with the trust account financial institution to provide for disbursement of trust deposits prior to formal notice of dishonor or collection. In essence the trust account bank is agreeing to or has guaranteed a loan to the lawyer and the client for the amount of the trust deposit pending collection of that deposit from the institution upon which the instrument was written. A Washington lawyer may only enter into such an arrangement if 1) there is a formal written agreement between the attorney and the trust account institution, and 2) the trust account financial institution provides the lawyer with written assurance that in the event of dishonor of the deposited instrument or other difficulty in collecting the deposited funds, the financial institution will not have recourse to the trust account to obtain the funds to reimburse the financial institution. A lawyer must never use one client's money to pay for withdrawals from the trust account on behalf of another client who is paid subject to the lawyer's guarantee. The trust account financial institution must agree that the institution will not seek to fund the guaranteed withdrawal from the trust account, but will instead look to the lawyer for payment of uncollectible funds. Any such agreement must ensure that the trust account funds or deposits of any other client's or third person's money into the trust account would not be affected by the guarantee.

[12] The Legal Foundation of Washington was established by Order of the Supreme Court of Washington.

[13] A lawyer may, but is not required to, notify the client of the intended use of funds paid to the Foundation.

[14] If the client or third person requests that funds that would be deposited in a non-IOLTA trust account under paragraph (i)(2) instead be held in the IOLTA account, the lawyer should document this request in the
lawyer’s trust account records and preferably should confirm the request in writing to the client or third person.

[15] A lawyer may not receive from financial institutions earnings credits or any other benefit from the financial institution based on the balance maintained in a trust account.

[16] The term “closing firm” as used in this rule has the same definition as in ELCPC 1.3(g).

[17] The lawyer may satisfy the requirement of paragraph (j), that the lawyer must ensure that all funds received or held by a closing firm in connection with the closing of the transaction are held and maintained as set forth in this rule or LPORPC 1.12A, by obtaining a certification or other reasonable assurance from the closing firm that the funds are being held in accordance with RPC 1.15A and/or LPORPC 1.12A. The lawyer is not required to personally inspect the books and records of the closing firm.

The last sentence of Paragraph (j) is intended to relieve a lawyer from the duties of the paragraph only if the lawyer or the lawyer’s law firm has a previous client-lawyer relationship with one of the parties to the transaction and that party is a buyer or seller. Lawyers may be called on by clients to review deeds prepared during the escrow process, or may be asked to prepare special deeds such as personal representative’s deeds for use in the closing. A lawyer may also be asked by a client to review documents such as settlement statements or tax affidavits that have been prepared for the closing. Such activities are limited in scope and are only incidental to the closing. This exception does not apply if the lawyer or the lawyer’s law firm has an existing client-lawyer relationship with the closing firm or with a limited practice officer who is participating in the closing.

[19] RPC 1.15A. Partners and lawyers who individually or together with other lawyers possess comparable managerial authority in a law firm that employ LLLTs, or in which LLLTs are members, should also be aware of their obligations under Rule 5.10. These obligations extend to making reasonable efforts to establish internal policies and procedures designed to provide reasonable assurance that an LLLT’s conduct in relation to the firm’s trust account(s) is compatible with these Rules of Professional Conduct. A lawyer with managerial or supervisory authority over an LLLT who is signatory to a trust account under paragraph (h)(9) is also ethically obligated to make reasonable efforts to ensure that the LLLT’s conduct is compatible with the LLLT’s professional-ethical obligations. When a lawyer is a joint signatory on a trust account with an LLLT, a lawyer should exercise direct supervisory authority over the activities of the LLLT with respect to the account.

[Comment [22] amended effective April 14, 2015.]

RPC 1.15A

REQUIRED TRUST ACCOUNT RECORDS

(a) A lawyer must maintain current trust account records. They may be in electronic or manual form and must be retained for at least seven years after the events they record. At minimum, the records must include the following:

(1) Checkbook register or equivalent for each trust account, including entries for all receipts, disbursements, and transfers, and containing at least:

(i) identification of the client matter for which trust funds were received, disbursed, or transferred;

(ii) the date on which trust funds were received, disbursed, or transferred;

(iii) the check number for each disbursement;

(iv) the payor or payee for or from which trust funds were received, disbursed, or transferred; and

(v) the new trust account balance after each receipt, disbursement, or transfer;

(2) Individual client ledger records containing either a separate page for each client or an equivalent electronic record showing all individual receipts, disbursements, or transfers, and also containing:

(i) identification of the purpose for which trust funds were received, disbursed, or transferred;
(ii) the date on which trust funds were received, disbursed or transferred;
(iii) the check number for each disbursement;
(iv) the payor or payee for or from which trust funds were received, disbursed, or transferred; and
(v) the new client fund balance after each receipt, disbursement, or transfer;
(3) Copies of any agreements pertaining to fees and costs;
(4) Copies of any statements or accountings to clients or third parties showing the disbursement of funds to them or on their behalf;
(5) Copies of bills for legal fees and expenses rendered to clients;
(6) Copies of invoices, bills or other documents supporting all disbursements or transfers from the trust account;
(7) Bank statements, copies of deposit slips, and cancelled checks or their equivalent;
(8) Copies of all trust account bank and client ledger reconciliations; and
(9) Copies of those portions of clients’ files that are reasonably necessary for a complete understanding of the financial transactions pertaining to them.
(b) Upon any change in the lawyer’s practice affecting the trust account, including dissolution or sale of a law firm or suspension or other change in membership status, the lawyer must make appropriate arrangements for the maintenance of the records specified in this Rule.
[Adopted effective September 1, 2006; amended effective December 10, 2013.]
Washington Comments
[1] Paragraph (a)(3) is not intended to require that fee agreements be in writing. That issue is governed by Rule 1.5.
[2] If trust records are computerized, a system of regular and frequent (preferably daily) back-up procedures is essential.
[3] Paragraph (a)(9) does not require a lawyer to retain the entire client file for a period of seven years, although many lawyers will choose to do so for other reasons. Rather, under this paragraph, the lawyer must retain only those portions of the file necessary for a complete understanding of the financial transactions. For example, if a lawyer received proceeds of a settlement on a client’s behalf, the lawyer would need to retain a copy of the settlement agreement. In many cases, there will be nothing in the client file that needs to be retained other than the specific documents listed in paragraphs (a)(2)-(8).
[Comment adopted effective September 1, 2006.]
RULE 5.1 RESPONSIBILITIES OF PARTNERS, MANAGERS, AND SUPERVISORY LAWYERS

A lawyer shall be responsible for another lawyer's violation of these Rules of Professional Conduct if:

( a) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or

( b) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.
RPC 5.1
RESPONSIBILITIES OF PARTNERS, MANAGERS, AND SUPERVISORY LAWYERS
(a) A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm confrom to the Rules of Professional Conduct.
(b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.
(c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:
(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or
(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

Comments
[1] [Washington revision] Paragraph (a) applies to lawyers who have managerial authority over the professional work of a firm. See Rule 1.0A (c). This includes members of a partnership, the shareholders in a law firm organized as a professional corporation, and members of other associations authorized to practice law; lawyers having comparable managerial authority in a legal services organization or a law department of an enterprise or government agency; and lawyers who have intermediate managerial responsibilities in a firm. Paragraph (b) applies to lawyers who have supervisory authority over the work of other lawyers in a firm. [Comment[1] amended effective April 14, 2015.]
[2] Paragraph (a) requires lawyers with managerial authority within a firm to make reasonable efforts to establish internal policies and procedures designed to provide reasonable assurance that all lawyers in the firm will conform to the Rules of Professional Conduct. Such policies and procedures include those designed to detect and resolve conflicts of interest, identify dates by which actions must be taken in pending matters, account for client funds and property and ensure that inexperienced lawyers are properly supervised.
[3] Other measures that may be required to fulfill the responsibility prescribed in paragraph (a) can depend on the firm's structure and the nature of its practice. In a small firm of experienced lawyers, informal supervision and periodic review of compliance with the required systems ordinarily will suffice. In a large firm, or in practice situations in which difficult ethical problems frequently arise, more elaborate measures may be necessary. Some firms, for example, have a procedure whereby junior lawyers can make confidential referral of ethical problems directly to a designated senior partner or special committee. See Rule 5.2. Firms, whether large or small, may also rely on continuing legal education in professional ethics. In any event, the ethical atmosphere of a firm can influence the conduct of all its members and the partners may not assume that all lawyers associated with the firm will inevitably conform to the Rules.
[4] Paragraph (c) expresses a general principle of personal responsibility for acts of another. See also Rule 8.4(a).
[5] Paragraph (c)(2) defines the duty of a partner or other lawyer having comparable managerial authority in a law firm, as well as a lawyer who has direct supervisory authority over performance of specific legal work by another lawyer. Whether a lawyer has supervisory authority in particular circumstances is a question of fact. Partners and lawyers with comparable authority have at least indirect responsibility for all work being done by the firm, while a partner or manager in charge of a particular matter ordinarily also has supervisory responsibility for the work of other firm lawyers engaged in the matter. Appropriate remedial action by a partner or managing lawyer would depend on the immediacy of that lawyer's involvement and the seriousness of the misconduct. A supervisor is required to intervene to prevent avoidable consequences of misconduct if the supervisor knows that the misconduct occurred. Thus, if a supervising lawyer knows that a subordinate misrepresented a matter to an opposing party in negotiation, the supervisor as well as the subordinate has a duty to correct the resulting misapprehension.
[6] Professional misconduct by a lawyer under supervision could reveal a violation of paragraph (b) on the part of the supervisory lawyer even though it does not entail a violation of paragraph (c) because there was no direction, ratification or knowledge of the violation.
[7] [Washington revision] Apart from this Rule and Rule 8.4(a), a lawyer does not have disciplinary liability for the conduct of a partner, associate or subordinate lawyer. Whether a lawyer may be liable civilly or criminally for another lawyer's conduct is a question of law beyond the scope of these Rules.
[8] The duties imposed by this Rule on managing and supervising lawyers do not alter the personal duty of each lawyer in a firm to abide by the Rules of Professional Conduct. See Rule 5.2(a).
[Comments adopted adopted effective September 1, 2006.]
RULE 5.2 RESPONSIBILITIES OF A SUBORDINATE LAWYER

(a) A lawyer is bound by the Rules of Professional Conduct notwithstanding that the lawyer acted at the direction of another person.

(b) A subordinate lawyer does not violate the Rules of Professional Conduct if that lawyer acts in accordance with a supervisory lawyer's reasonable resolution of an arguable question of professional duty.
RPC 5.2
RESPONSIBILITIES OF A SUBORDINATE LAWYER
(a) A lawyer is bound by the Rules of Professional Conduct notwithstanding that the lawyer acted at the
direction of another person.
(b) A subordinate lawyer does not violate the Rules of Professional Conduct if that lawyer acts in
accordance with a supervisory lawyer's reasonable resolution of an arguable question of professional duty.
[Originally effective September 1, 1985.]
Comment
[1] Although a lawyer is not relieved of responsibility for a violation by the fact that the lawyer acted at the
direction of a supervisor, that fact may be relevant in determining whether a lawyer had the knowledge required
to render conduct a violation of the Rules. For example, if a subordinate filed a frivolous pleading at the
direction of a supervisor, the subordinate would not be guilty of a professional violation unless the subordinate
knew of the document's frivolous character.
[2] When lawyers in a supervisor-subordinate relationship encounter a matter involving professional
judgment as to ethical duty, the supervisor may assume responsibility for making the judgment. Otherwise a
consistent course of action or position could not be taken. If the question can reasonably be answered only one
way, the duty of both lawyers is clear and they are equally responsible for fulfilling it. However, if the question
is reasonably arguable, someone has to decide upon the course of action. That authority ordinarily reposes in the
supervisor, and a subordinate may be guided accordingly. For example, if a question arises whether the interests
of two clients conflict under Rule 1.7, the supervisor's reasonable resolution of the question should protect the
subordinate professionally if the resolution is subsequently challenged.
[Comments adopted effective September 1, 2006.]
RULE 5.3 RESPONSIBILITIES REGARDING NONLAWYER ASSISTANCE

With respect to a nonlawyer employed or retained, supervised or directed by a lawyer:

(a) a lawyer having direct supervisory authority over the nonlawyer shall make reasonable efforts to ensure that the person's conduct is compatible with the professional obligations of the lawyer; and

(b) except as provided by Rule 8.4(b), a lawyer shall be responsible for conduct of such a person that would be a violation of the Rules of Professional Conduct if engaged in by a lawyer if:

(1) the lawyer orders or, with the knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the person is employed, or has direct supervisory authority over the person, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.
Chapter 8—Where’s Your Data? Privacy, Security, and Your Ethical Obligations

RPC 5.3
RESPONSIBILITIES REGARDING NONLAWYER ASSISTANTS

With respect to a nonlawyer employed or retained by or associated with a lawyer:

(a) a partner, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that the person’s conduct is compatible with the professional obligations of the lawyer;

(b) a lawyer having direct supervisory authority over the nonlawyer shall make reasonable efforts to ensure that the person’s conduct is compatible with the professional obligations of the lawyer; and

(c) a lawyer shall be responsible for conduct of such a person that would be a violation of the Rules of Professional Conduct if engaged in by a lawyer if:

(1) the lawyer orders or, with the knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the person is employed, or has direct supervisory authority over the person, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

[Originally effective September 1, 1985; amended effective September 1, 2006.]

Comment

[1] Paragraph (a) requires lawyers with managerial authority within a law firm to make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that nonlawyers in the firm and nonlawyers outside the firm act in a manner that is compatible with the professional obligations of the lawyer. See Comment [6] to RPC 1.1 (retaining lawyers outside the firm) and Comment [1] to RPC 5.1 (responsibilities with respect to lawyers within a firm). Paragraph (b) applies to lawyers who have supervisory authority over such nonlawyers within or outside the firm. Paragraph (c) specifies the circumstances in which a lawyer is responsible for conduct of such nonlawyers within or outside the firm that would be a violation of the Rules of Professional Conduct if engaged in by a lawyer.

[Comment [2] renumbered as [1] and amended effective September 1, 2016.]

Nonlawyers Within the Firm

[2] Lawyers generally employ assistants in their practice, including secretaries, investigators, law student interns, and paraprofessionals. Such assistants, whether employees or independent contractors, act for the lawyer in rendition of the lawyer’s professional services. A lawyer must give such assistants appropriate instruction and supervision concerning the ethical aspects of their employment, particularly regarding the obligation not to disclose information relating to representation of the client, and should be responsible for their work product. The measures employed in supervising nonlawyers should take account of the fact that they do not have legal training and are not subject to professional discipline.

[Comment [1] renumbered as [2] and amended effective September 1, 2016.]

Nonlawyers Outside the Firm

[3] [Washington revision] A lawyer may use nonlawyers outside the firm to assist the lawyer in rendering legal services to the client. Examples include the retention of an investigative or paraprofessional service, hiring a document management company to create and maintain a database for complex litigation, sending client documents to a third party for printing or scanning, and using an Internet-based service to store client information. When using such services outside the firm, a lawyer must make reasonable efforts to ensure that the services are provided in a manner that is compatible with the lawyer’s professional obligations. The extent of this obligation will depend upon the circumstances, including the education, experience and reputation of the nonlawyer; the nature of the services involved; the terms of any arrangements concerning the protection of client information; and the legal and ethical environments of the jurisdictions in which the services will be performed particularly with regard to confidentiality. See also RPC 1.1 (competence), 1.2 (allocation of authority), 1.4 (communication with client), 1.6 (confidentiality), 5.4(a) (professional independence of the lawyer), and 5.5(a) (unauthorized practice of law). When retaining or directing a nonlawyer outside the firm, a lawyer should communicate directions appropriate under the circumstances to give reasonable assurance that the nonlawyer’s conduct is compatible with the professional obligations of the lawyer. Where an outside lawyer is retained to provide nonlegal services, the lawyer should be treated like a nonlawyer assistant. See also Comment [9] to RPC 1.1.

[Comment [3] adopted effective September 1, 2016.]

[4] Where the client directs the selection of a particular nonlawyer service provider outside the firm, the lawyer ordinarily should agree with the client concerning the allocation of responsibility for monitoring as between the client and the lawyer. See RPC 1.2. When making such an allocation in a matter pending before a tribunal, lawyers and parties may have additional obligations that are a matter of law beyond the scope of these Rules.

[Comment [4] adopted effective September 1, 2016.]

Additional Washington Comment (5)

[5] A nonlawyer for purposes of this Rule denotes an individual other than a lawyer or an LLLT acting as such. For responsibilities regarding an LLLT associated with a lawyer, see Rule 5.10. If a lawyer or an LLLT in a firm is providing services that do not require use of the lawyer’s or the LLLT’s license, then lawyers at the firm should treat such a lawyer or LLLT as a nonlawyer assistant under this rule rather than as a subordinate lawyer under Rule 5.1 or as an LLLT under RPC 5.10. See also Additional Washington Comment [9] to Rule 1.1.

FORMAL OPINION NO 2011-188
[REVISED 2015]

Information Relating to the Representation of a Client:
Third-Party Electronic Storage of Client Materials

Facts:

Law Firm contracts with third-party vendor to store client files and documents online on remote server so that Lawyer and/or Client could access the documents over the Internet from any remote location.

Question:

May Lawyer do so?

Conclusion:

Yes, qualified.

Discussion:

With certain limited exceptions, the Oregon Rules of Professional Conduct require a lawyer to keep client information confidential. See Oregon RPC 1.6.¹ In addition, Oregon RPC 5.3 provides:

¹ Oregon RPC 1.6 provides:

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to disclose the intention of the lawyer’s client to commit a crime and the information necessary to prevent the crime;

(2) to prevent reasonably certain death or substantial bodily harm;

(3) to secure legal advice about the lawyer’s compliance with these Rules;
With respect to a nonlawyer employed or retained, supervised or directed by a lawyer:

(4) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer’s representation of the client;

(5) to comply with other law, court order, or as permitted by these Rules; or

(6) in connection with the sale of a law practice under Rule 1.17 or to detect and resolve conflicts of interest arising from the lawyer’s change of employment or from changes in the composition or ownership of a firm. In those circumstances, a lawyer may disclose with respect to each affected client the client’s identity, the identities of any adverse parties, the nature and extent of the legal services involved, and fee and payment information, but only if the information revealed would not compromise the attorney-client privilege or otherwise prejudice any of the clients. The lawyer or lawyers receiving the information shall have the same responsibilities as the disclosing lawyer to preserve the information regardless of the outcome of the contemplated transaction.

(7) to comply with the terms of a diversion agreement, probation, conditional reinstatement or conditional admission pursuant to BR 2.10, BR 6.2, BR 8.7 or Rule for Admission Rule 6.15. A lawyer serving as a monitor of another lawyer on diversion, probation, conditional reinstatement or conditional admission shall have the same responsibilities as the monitored lawyer to preserve information relating to the representation of the monitored lawyer’s clients, except to the extent reasonably necessary to carry out the monitoring lawyer’s responsibilities under the terms of the diversion, probation, conditional reinstatement or conditional admission and in any proceeding relating thereto.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.
(a) a lawyer having direct supervisory authority over the nonlawyer shall make reasonable efforts to ensure that the person’s conduct is compatible with the professional obligations of the lawyer; and

(b) except as provided by Rule 8.4(b), a lawyer shall be responsible for conduct of such a person that would be a violation of the Rules of Professional Conduct if engaged in by a nonlawyer if:

(1) the lawyer orders or, with the knowledge of the specific conduct, ratifies the conduct involved; or

(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the person is employed, or has direct supervisory authority over the person, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

Lawyer may store client materials on a third-party server as long as Lawyer complies with the duties of competence and confidentiality to reasonably keep the client’s information secure within a given situation. To do so, the lawyer must take reasonable steps to ensure that the storage company will reliably secure client data and keep information confidential. See Oregon RPC 1.6(c). Under certain circumstances, this may be satisfied through a third-party vendor’s compliance with industry standards.

2 Some call the factual scenario presented above “cloud computing.” See Richard Acello, Get Your Head in the Cloud, 96-Apr ABA Journal 28, 28–29 (April 2010) (providing that “cloud computing” is a “sophisticated form of remote electronic data storage on the Internet” and “[u]nlike traditional methods that maintain data on a computer or server at a law office or other place of business, data stored ‘in the cloud’ is kept on large servers located elsewhere and maintained by a vendor”).

3 In 2014, leaked documents indicated that several intelligence agencies had the capability of obtaining electronic data and monitoring electronic communications between, among others, attorneys and clients through highly sophisticated methods beyond the capabilities of the general public. Oregon RPC 1.6(c) would not require an attorney to protect a client’s data against this type of advanced interception, as it only requires an attorney to take reasonable steps to secure client data. Nevertheless, an attorney may want to take additional security precautions if he or she handles clients or matters that involve national security interests.
standards relating to confidentiality and security, provided that those industry standards meet the minimum requirements imposed on the Lawyer by the Oregon Rules of Professional Conduct. This may include, among other things, ensuring the service agreement requires the vendor to preserve the confidentiality and security of the materials. It may also require that vendor notify Lawyer of any nonauthorized third-party access to the materials. Lawyer should also investigate how the vendor backs up and stores its data and metadata to ensure compliance with the Lawyer’s duties.4

Although the third-party vendor may have reasonable protective measures in place to safeguard the client materials, the reasonableness of the steps taken will be measured against the technology “available at the time to secure data against unintentional disclosure.”5 As technology advances, the third-party vendor’s protective measures may become less secure or obsolete over time.6 Accordingly, Lawyer may be required to

4 See OSB Formal Ethics Op No 2005-141 (rev 2015), which provides:

As long as Law Firm makes reasonable efforts to ensure that the recycling company’s conduct is compatible with Law Firm’s obligation to protect client information, the proposed conduct is permissible. Reasonable efforts include, at least, instructing the recycling company about Law Firm’s duties pursuant to Oregon RPC 1.6 and obtaining its agreement to treat all materials appropriately.

See also OSB Formal Ethics Op No 2005-129 (rev 2014); OSB Formal Ethics Op No 2005-44.

5 See New Jersey Ethics Op No 701 (discussing electronic storage and access to files).

6 See Arizona Ethics Op No 09-04 (discussing confidentiality, maintaining client files, electronic storage, and the Internet).
reevaluate the protective measures used by the third-party vendor to safeguard the client materials.\(^7\)

**Approved by Board of Governors, April 2015.**

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\(^7\) A lawyer’s obligation in the event of a breach of security of confidential materials is outside the scope of this opinion.

**COMMENT:** For additional information on this general topic and other related subjects, see *The Ethical Oregon Lawyer* § 6.2-1 (confidentiality), § 13.3-3 (employment of nonlawyers), § 16.4-5(c) (third-party electronic storage of client materials) (OSB Legal Pubs 2015); and *Restatement (Third) of the Law Governing Lawyers* §§ 59–60 (2000) (supplemented periodically).
Advisory Opinion: 2215
Year Issued: 2012
RPC(s): RPC 1.1, 1.6, 1.15A
Subject: Cloud Computing

This opinion addresses certain ethical obligations related to the use of online data storage managed by third party vendors to store confidential client documents.

Illustrative Facts:

Law Firm contracts with third-party vendor to store client files and documents online on remote server so that Lawyer and Client could access the documents over the Internet from any remote location.

Rules of Professional Conduct Implicated:

RPC 1.1, 1.6, 1.15A

Analysis:

Various service providers are offering data storage systems on remote servers that can be accessed by subscribers from any location over the Internet. This is one aspect of so-called “cloud computing,” and lawyers may be interested in using these services to store confidential client documents and other data. Use of these third party storage systems, however, means that confidential client information is outside of the direct control of the lawyer and raises particular ethical questions.

Under RPC 1.6, a lawyer owes a client the duty to keep all client information confidential, unless the information falls within a specified exception. The duty of confidentiality extends beyond deliberate revelations of client information and requires a lawyer to protect client information against all disclosure. Comment 16 to RPC 1.6 states: “A lawyer must act competently to safeguard information relating to the representation of a client against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are subject to the lawyer’s supervision. See Rules 1.1, 5.1 and 5.3.” In order to use online data storage, a lawyer is under a duty to ensure that the confidentiality of all client data will be maintained.

In addition to client confidentiality, the lawyer is also under a duty to protect client property, under RPC 1.15A. A lawyer using online data storage of client documents is therefore under a duty to ensure that the documents will not be lost.
It is impossible to give specific guidelines as to what security measures should be in place with a third party service provider of online data storage in order to provide adequate protection of client material, because the technology is changing too rapidly and any such advice would be quickly out of date. It is also impractical to expect every lawyer who uses such services to be able to understand the technology sufficiently in order to evaluate a particular service provider’s security systems. A lawyer using such a service must, however, conduct a due diligence investigation of the provider and its services and cannot rely on lack of technological sophistication to excuse the failure to do so. While some lawyers may be able to do more thorough evaluations of the services available, best practices for a lawyer without advanced technological knowledge could include:

1. Familiarization with the potential risks of online data storage and review of available general audience literature and literature directed at the legal profession, on cloud computing industry standards and desirable features.

2. Evaluation of the provider’s practices, reputation and history.

3. Comparison of provisions in service provider agreements to the extent that the service provider recognizes the lawyer’s duty of confidentiality and agrees to handle the information accordingly.

4. Comparison of provisions in service provider agreements to the extent that the agreement gives the lawyer methods for retrieving the data if the agreement is terminated or the service provider goes out of business.

5. Confirming provisions in the agreement that will give the lawyer prompt notice of any nonauthorized access to the lawyer’s stored data.

6. Ensure secure and tightly controlled access to the storage system maintained by the service provider.

7. Ensure reasonable measures for secure backup of the data that is maintained by the service provider.

A lawyer has a general duty of competence under RPC 1.1, which includes the duty “to keep abreast of changes in the law and its practice.” RPC 1.1 Comment 6. To the extent that a lawyer uses technology in his or her practice, the lawyer has a duty to keep informed about the risks associated with that technology and to take reasonable precautions. The lawyer’s duties discussed in this opinion do not rise to the level of a guarantee by the lawyer that the information is secure from all unauthorized access. Security breaches are possible even in the physical world, and a lawyer has always been under a duty to make reasonable judgments when protecting client property and information. Specific practices regarding protection of client property and information have always been left up to individual lawyers’ judgment, and that same approach applies to the use of online data storage. The lawyer must take reasonable steps, however, to evaluate the risks involved with that practice and to ensure that steps taken to protect the information are up to a reasonable standard of care.

Because the technology changes rapidly, and the security threats evolve equally rapidly, a
lawyer using online data storage must not only perform initial due diligence when selecting a provider and entering into an agreement, but must also monitor and regularly review the security measures of the provider. Over time, a particular provider’s security may become obsolete or become substandard to systems developed by other providers.

Conclusion

A lawyer may use online data storage systems to store and back up client confidential information as long as the lawyer takes reasonable care to ensure that the information will remain confidential and that the information is secure against risk of loss.

Advisory Opinions are provided for the education of the Bar and reflect the opinion of the Committee on Professional Ethics (CPE) or its predecessor, the Rules of Professional Conduct Committee. Advisory Opinions issued by the CPE are distinguished from earlier RPC Committee opinions by a numbering format which includes the year followed by a sequential number. Advisory Opinions are provided pursuant to the authorization granted by the Board of Governors, but are not individually approved by the Board and do not reflect the official position of the Bar association. Laws other than the Washington State Rules of Professional Conduct may apply to the inquiry. The Committee's answer does not include or opine about any other applicable law other than the meaning of the Rules of Professional Conduct.