

**SECURITIES REGULATION**  
 Professor John Orcutt  
 Fall Semester 2008  
**FINAL EXAMINATION**

**Instructions:**

1. This is an open-book examination. You may bring any materials you wish to the examination with the exception of computers, telephones or other electronic devices. Calculators, however, are permitted. For those of you who are taking this exam on a laptop computer, you are of course allowed to use your laptop to take the exam.
2. This is a 3½-hour examination (or 210 minutes).
3. This examination consists of 9 essay questions and is worth 210 points (or 80% of your grade).

<b>Question 1 = 30 points</b>	<b>Question 4 = 15 points</b>	<b>Question 7 = 25 points</b>
<b>Question 2 = 5 points</b>	<b>Question 5 = 20 points</b>	<b>Question 8 = 45 points</b>
<b>Question 3 = 25 points</b>	<b>Question 6 = 25 points</b>	<b>Question 9 = 20 points</b>

*It is your responsibility to apportion your time appropriately amongst the questions.* If you base your time on the possible points per question, the time apportionment should be:

<b>Question 1 = 30 minutes</b>	<b>Question 4 = 15 minutes</b>	<b>Question 7 = 25 minutes</b>
<b>Question 2 = 5 minutes</b>	<b>Question 5 = 20 minutes</b>	<b>Question 8 = 45 minutes</b>
<b>Question 3 = 25 minutes</b>	<b>Question 6 = 25 minutes</b>	<b>Question 9 = 20 minutes</b>

4. Please write your answers in a blue book. The only answers that will be graded are the answers written into a blue book. While you are free to use scratch paper, answers written on scratch paper, or anything else other than a blue book, will not be read and will not be counted for any credit. Please write only on the front side of the pages in the blue book. Please remember that organization, persuasiveness, neatness and legibility all count in determining your grade on the essay answers. To improve the organization of an answer, you may wish to quickly outline the answer on a separate sheet of paper prior to writing your full answer in the blue book.
5. I have tried my best to write and proofread the exam so that there are no distracting typos or other errors – but, I may not have been totally successful. If you believe there is a typo or other error that makes it difficult to answer a particular question, please provide your best answer and explain any assumption you used to answer the question.
6. For those of you who are taking this exam on a laptop computer, the above rules are modified to permit usage of a laptop and are supplemented by the laptop exam rules that have are provided to you by the Registrar.

Good luck on the examination!

**DO NOT TURN TO PAGE 2 UNTIL THE PROCTOR TELLS YOU TO BEGIN**

**Question No. 1 (30 points possible - 30 minutes suggested):**

Burst Telecom, Inc. ("Burst") is a reporting company that develops and manufactures multi-mode radio transceivers for cell phones and other wireless devices. Burst sells its radio transceiver products primarily through a network of distributors. Specifically, Burst sells the products to the distributors, who turn around and sell the products to manufacturers of cell phones and wireless devices. In late February 2008, Burst filed its Form 10-K for the fiscal year ended December 31, 2007. In its Form 10-K, Burst reported the following summary numbers for the fiscal year ended December 31, 2007:

- 2007 Revenues = \$1.0 billion
- 2007 Profits = \$0.2 billion

Burst's public auditing firm is Arthur & Young ("A&Y"). At the time of the Form 10-K, A&Y issued a statement that it had audited Burst's 2007 financial statements and certified that they conformed to generally accepted accounting practices.

Earlier this week, A&Y discovered some problems with Burst's 2007 financial results and demanded that Burst restate its 2007 numbers. It turns out that during 2007, Burst provided some of its biggest distributors with secret side agreements allowing those distributors to return Burst's products purchased in 2007 if they remained unsold on March 31, 2008 (the problem was discovered when A&Y reviewed Burst's 1<sup>st</sup> quarter numbers for 2008). Burst booked its 2007 sales that were subject to these side agreements as final (despite the right of return), which violated generally accepted accounting principles and falsely inflated Burst's revenues and profits (among other financial results). The restated numbers will be:

- Restated 2007 Revenues = \$0.8 billion
- Restated 2007 Profits = \$0.0 billion

Yesterday, Burst issued a press release announcing the restatement. Burst's stock price immediately dropped from \$20/share pre-announcement to \$12/share post-announcement.

You are legal counsel to A&Y, and you expect that A&Y will be named as a defendant in a plaintiff's lawsuit under Rule 10b-5. You have investigated A&Y's involvement in reporting the incorrect financial numbers for 2007, and you have uncovered the following:

- Nobody at A&Y was aware of the side agreements;
- Tom, the lead partner from A&Y who handled the Burst audit, did not follow the industry-accepted practice of requiring the audit team to spot check contracts with customers; and
- If Tom had ordered the spot-checking of contracts, it is likely that the side agreements would have been uncovered during the audit.

Based on the facts presented in this question, please assess the likelihood that A&Y will be held liable under Rule 10b-5. In answering this question, please assume that the originally reported 2007 financial results constituted a material misstatement (I don't want to see a materiality analysis).

## **BACKGROUND INFORMATION FOR QUESTIONS 2 and 3:**

In November 2005, Bump Inc. ("Bump") offered to the public \$1.5 billion of debt securities (the "Public Offering") to fund construction of the Pantheon Casino in Atlantic City. Prior to the offering, Bump was a private company (i.e., it was not a "reporting" company under the Securities Exchange Act of 1934). The Public Offering was underwritten by Bull Stearns, a highly-respected Wall Street investment bank, and was registered through an S-1 Registration Statement. The Public Offering was an offering of high-yield securities (frequently referred to as "junk bonds"). Namely, the offering involved higher risk debt securities that pay a higher interest rate to help compensate investors for the increased risk they are assuming with such investments.

Unfortunately, construction and operation of the Pantheon Casino did not go as smoothly as Bump anticipated, and in 2007 Bump defaulted on the debt securities and sought protection under Chapter 11 of the U.S. Bankruptcy Code. The result was that the debt securities lost most of their value. A class of investors in the Public Offering sued Bump, as well as a number of other defendants, under sections 11 and 12(a)(2) of the Securities Act and Rule 10b-5 of the Exchange Act. Plaintiffs ground their lawsuits in the text of the prospectus. Their primary complaint focuses on the following forward-looking statement that was made in the prospectus for the offering:

"Bump believes that funds generated from the operation of the Pantheon Casino will be sufficient to cover all of Bump's debt service (interest and principal)."

Plaintiffs' primary contention is that this statement was materially misleading because the defendants possessed neither a genuine nor a reasonable belief in its truth.

The prospectus at issue contained an abundance of warnings and cautionary language that bore directly on the prospective financial success of the Pantheon Casino and on Bump's ability to repay the debt securities. For example, the prospectus contained an extensive "Risk Factors" section that included detailed risk factors such as the following:

- The Pantheon Casino has not been completed and, accordingly, has no operating history. Bump, therefore, has no history of earnings and its operations will be subject to all of the risks inherent in the establishment of a new business enterprise. Accordingly, the ability of Bump to service the debt is completely dependent upon the success of that operation and such success will depend upon financial, business, competitive, regulatory and other factors affecting the Pantheon Casino and the casino industry generally, as well as prevailing economic conditions.
- The Pantheon Casino will be the largest casino/hotel complex in Atlantic City, with approximately twice the room capacity and casino space of many of the existing casino/hotels in Atlantic City. No other casino/hotel has had experience operating a complex the size of the Pantheon Casino in Atlantic City. Consequently, no assurance can be given that, once opened, the Pantheon Casino will be profitable or that it will generate cash flow sufficient to provide for the payment of the debt service.

It turned out that the primary reason for Bump's default on the debt securities was a hurricane that hit the construction site during spring 2007. The hurricane hit at the worst possible moment for the hotel/casino construction, as the facility in a particularly vulnerable situation when the hurricane hit. If the hurricane had hit 3 months later, the

facility would likely have been able to weather the storm with little problem. The costs and delays that would result from the hurricane damage caused Bump to default on the debt securities. There was no mention of "hurricane risk" in the prospectus for the Public Offering.

**Question No. 2 (5 points possible - 5 minutes suggested):**

Prior to the Public Offering, Bump was not a reporting company. Following the Public Offering, Bump was required to be a reporting company. Please explain why Bump was required to be a reporting company following the Public Offering (and cite statutory/regulatory authority in your analysis).

**Question No. 3 (25 points possible - 25 minutes suggested):**

Please analyze the strength of plaintiffs' contention that the forward-looking sentence in the prospectus, "Bump believes that funds generated from the operation of the Pantheon Casino will be sufficient to cover all of Bump's debt service (interest and principal)," was a materially misleading statement.

**\*\*\*END OF BUMP QUESTIONS\*\*\***

**Question No. 4 (15 points possible - 15 minutes suggested):**

We considered the Chiarella case (*Chiarella v. United States* (US S.Ct. 1980)) in class. The basic facts were as follows: Chiarella was an employee for a financial printer. Related to this case, the financial printer "had been engaged to print corporate takeover bids."

**BACKGROUND INFO:**

- These corporate takeover bids were "hostile takeovers." In a typical hostile takeover, the acquirer will make a bid to the target's shareholders to acquire their shares at a substantial premium (e.g., a 30% to 70% premium) to the current share price. Knowing that a company will be a target is therefore very valuable information.
- The acquirer's "bid" is made through a tender offer document that will be printed by a financial printer.
- In order to protect the identity of the target, the tender offer documents will use code names (rather than the actual names) of the acquirer and target until the last minute – when the real names will be inserted.

Chiarella worked on five such corporate takeovers and was able to "break the code" and figure out who the five targets were. "Without disclosing his knowledge, [Chiarella] purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public." This strategy allowed Chiarella to realize a gain of approximately \$30,000 over 14 months.

Under current federal securities law, please analyze whether Chiarella would be guilty for illegal insider trading under Rule 10b-5 if the SEC or the Justice Department were to bring a case against him.

## **BACKGROUND INFORMATION FOR QUESTIONS 5 – 7:**

ABC Company ("ABC") is an international contractor serving the oil and gas industry. Specifically, ABC specializes in the design, fabrication and installation of offshore oil and gas platforms that are used by oil companies for offshore drilling. In September 2007, the board of directors of ABC decided to take the company public through an initial public offering (an "IPO") of its common stock. ABC intends to register the common stock for the IPO with an S-1 Registration Statement.

Mary is ABC's CEO.

### **Question No. 5 (20 points possible - 20 minutes suggested):**

Please assume that you are answering this question in November 2007: In November 2007, Mary was approached by Time magazine for an interview about the offshore drilling industry and how it has been impacted by rising oil prices. The interview would appear in Time's December 1, 2007 issue. Mary would like to give the interview, because she believes it will provide very beneficial marketing to ABC's customers (Mary believes that most of ABC's customers, and potential customers, read Time magazine). Under the current timeline for the IPO, the S-1 Registration Statement is currently scheduled to be filed on February 1, 2008. Please advise Mary on whether she can conduct the interview with Time magazine, including a detailed analysis of the potential section 5 impact of the interview.

### **Question No. 6 (25 points possible - 25 minutes suggested):**

Please assume that you are answering this question on February 1, 2008: ABC filed the S-1 Registration Statement as planned on February 1, 2008. At that time, ABC and Milkem Securities, the lead underwriter on the IPO, decided to issue a press release announcing the filing of the registration statement. The following is a proposed draft for the press release:

#### **FOR IMMEDIATE RELEASE**

Contact: Andrew Fastow  
Chief Financial Officer  
ABC Company  
2 White Street  
Concord, NH 03301  
(603) 228-1541

CONCORD, NH (February 1, 2008) – ABC Company announced today that it has filed a registration statement with the Securities and Exchange Commission covering the public offering by ABC of 10,000,000 shares of its common stock.

ABC has announced an indicated price range of \$20.00 to \$24.00 per share. ABC has applied for quotation of the new common stock on the Nasdaq Global Market under the symbol "ABCC". The net proceeds of the offering will be used to expand ABC's research and development efforts, increase its distribution network and general working capital.

Milkem Securities Co. is acting as lead underwriter of the initial public offering.

Please analyze whether the press release would violate section 5 during the "waiting period," including an analysis of whether the press release could be made permissible under section 5.

**Question No. 7 (25 points possible - 25 minutes suggested):**

The S-1 Registration Statement is scheduled to go effective later this month (May 2008). The S-1 Registration Statement will contain full-year financial data for the fiscal years ending December 31, 2005, 2006 and 2007 (the "Full-Year Financial Data"), as well as interim financial data for the three months ended March 31, 2007 and 2008 (the "Interim Financial Data").

The Full-Year Financial Data has been audited by Arthur & Young ("AY", ABC's public auditors), but the Interim Financial Data (as is custom) has not been audited. Instead, AY has agreed to provide a "comfort letter" with respect to the Interim Financial Data. The underwriters for the IPO have been conducting their due diligence for the IPO and have asked you to advise them on what standard of care must they follow to establish their due diligence defense under section 11 of the Securities Act with respect to the Full-Year Financial Data and the Interim Financial Data.

**\*\*\*END OF ABC QUESTIONS\*\*\***

**Question No. 8 (45 points possible – 45 minutes suggested):**

**May 8, 2008:** Neva Gonagetit, a successful entrepreneur, recently commenced her latest start-up company. This new company is called NanoKlean, Inc. ("NanoKlean"), and it is working on developing nanotechnology that can be used to clean up toxic waste. Neva has hired Milkem and Bilkem to assist NanoKlean with its planned financing transactions. You are the star associate at Milkem and Bilkem and you have been assigned to work on the NanoKlean account.

NanoKlean would like to conduct a substantial equity capital raise. Specifically, NanoKlean would like to raise approximately \$5 million of Series B Convertible Preferred Stock. It is imperative that the financing be exempt from the registration requirements of §5 of the Securities Act of 1933, as amended (the "Securities Act"). In addition, Jehosaphat has provided you with the following information regarding NanoKlean's recently completed financing and its projected financing:

<b>RECENTLY COMPLETED FINANCING</b>				
<b>Amount Raised</b>	<b>Type of Security Sold</b>	<b>Purchasers</b>	<b>Exemption Relied On</b>	<b>Date Deal Was Closed</b>
\$800,000	Series A Convertible Preferred Stock	10 purchasers	Rule 504 <sup>1</sup>	Nov. 27, 2007

<sup>1</sup> The offering was conducted in three states and was conducted in compliance with state regulations.

<b>PROJECTED SERIES B FINANCING</b>			
<b>Approximate Amount to be Raised</b>	<b>Type of Security to be Offered</b>	<b>Expected Investors</b>	<b>Approximate Date to Commence Offer</b>
\$5 million	Series B Convertible Preferred Stock	<ul style="list-style-type: none"> <li>● Venture Capital Funds</li> <li>● Certain key employees</li> </ul>	May 10, 2008

Neva has provided you with the following additional details on the Series B financing:

- The founders of NanoKlean have pre-existing relationships with a number of venture capital funds. Neva envisions that the financing will be to two venture capital funds that are located in two states.
- Regarding the “key employees” for the Series B offering, it is currently anticipated that 7 employees would purchase an aggregate of approximately \$1 million in the offering. A list of the key employees, and the amount that will be offered to each employee is set forth below:

<b>Name</b>	<b>Position</b>	<b>Annual Compensation</b>	<b>Amount to be Purchased</b>
Neva Gonagetit	CEO/Director	\$150,000	\$500,000
Katie	CFO/Director	\$100,000	\$450,000
Adam	Engineer	\$80,000	\$10,000
Carol	Engineer	\$80,000	\$10,000
Mary	Engineer	\$80,000	\$10,000
Nigel	Admin. Asst.	\$50,000	\$10,000
Roberta	Engineer	\$80,000	\$10,000

For purposes of this question, please assume that you are rendering your advice on May 8, 2008.

Your assignment is to advise NanoKlean on the following: What exemption (or exemptions) from section 5 should NanoCom use for the Series B financing that Neva wants to commence shortly? Provide an explanation as to why you think that exemption is (or those exemptions are) the best choice for the Series B financing and provide any information regarding the exemption (or exemptions) that NanoCom should know in structuring and carrying out the Series B financing.

**Question No. 9 (20 points possible - 20 minutes suggested):**

**May 8, 2008:** World B. Free is a director of Warriors, Inc. On June 1, 2007, Mr. Free purchased 200,000 shares of Warriors Series D Convertible Preferred Stock in a Rule 506 offering. He paid for the shares in full on June 1, 2007. On March 15, 2008, Warriors conducted an IPO and listed its common stock on the New York Stock Exchange. The Series D Convertible Preferred Stock automatically converted into common stock (on a 1:1 ratio) at the time of the IPO. Mr. Free would like to build his dream house and would like to sell the 200,000 shares of Warriors common stock as soon as possible to finance construction of the house. Warriors has 10,000,000 shares of common stock outstanding. The trading volume for Warriors common stock over the last 4 weeks has been:

**Week 1 = 40,000 shares**

**Week 2 = 60,000 shares**

**Week 3 = 60,000 shares**

**Week 4 = 40,000 shares**

For purposes of these questions, please assume that you are rendering your advice on May 8, 2008.

- (a) Are the 200,000 shares held by Mr. Free "restricted" securities and/or "control" securities? Please explain and cite your statutory authority.
- (b) When can Mr. Free begin to sell his 200,000 shares under Rule 144? How many shares can he sell at that time?

\* \* \* \* \*

**END OF EXAM**

**FOR THE 3Ls AND GRADUATING GRADUATE STUDENTS: Enjoy wonderful careers and please keep in touch.**

**FOR THE 2Ls AND RETURNING GRADUATE STUDENTS: I look forward to seeing you next year.**