

**SECURITIES REGULATION**

Professor John Orcutt

Spring Semester 2009

**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 examination consists of ten essay questions and is worth 420 points (or 70% of your grade).

<b>Q1 = 60 points</b>	<b>Q2 = 15 points</b>	<b>Q3 = 15 points</b>	<b>Q4 = 40 points</b>	<b>Q5 = 110 points</b>
<b>Q6 = 15 points</b>	<b>Q7 = 60 points</b>	<b>Q8 = 50 points</b>	<b>Q9 = 40 points</b>	<b>Q10 = 15 points</b>

I have written this examination to be a 3½ hour (210 minutes) examination. ***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>Q1 = 30 minutes</b>	<b>Q2 = 7½ minutes</b>	<b>Q3 = 7½ minutes</b>	<b>Q4 = 20 minutes</b>	<b>Q5 = 55 minutes</b>
<b>Q6 = 7½ minutes</b>	<b>Q7 = 30 minutes</b>	<b>Q8 = 25 minutes</b>	<b>Q9 = 20 minutes</b>	<b>Q10 = 7½ minutes</b>

To provide some cushion in your taking of the exam, however, I am giving you an extra 30 minutes, so you will in fact have 4 hours (240 minutes) for the exam.

3. The grading of examinations is anonymous. So, you must write your examination number on the examination and your blue book. **YOU MAY NOT WRITE YOUR NAME ON ANYTHING – YOU MAY ONLY USE YOUR EXAM NUMBER.**
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 (60 points possible – 30 minutes suggested):**

Scott Boras is a managing director at Milkem Securities Co. (“MS”), a leading investment bank. Specifically, Boras works in the mergers & acquisitions group for MS. On June 2, 2008, Boras received a phone call from Theo Epstein, who is the CEO for Acme, Inc. (“Acme”). Acme is a leading technology company that was listed on the NYSE at that time. Theo was calling Boras to inquire whether MS would be interested in providing a fairness opinion for Acme.

On June 2<sup>nd</sup>, Acme was in the process of being acquired by Cisco Systems, Inc. (“Cisco”). A few days earlier, Cisco had made an offer to Acme’s board of directors to acquire Acme. Acme’s board found Cisco’s offer to be intriguing and decided to explore its merits in more detail. As part of that exploration, Acme’s board wanted to hire a financial advisor to provide Acme with a “fairness opinion.” The financial advisor would be asked to examine the price that Cisco was offering in the acquisition and opine on whether that price was fair to Acme from a financial point of view. MS regularly gave such fairness opinions, and Theo called Boras to see if MS would be able to provide such an opinion to Acme. During the conversation, Theo provided Boras with the following basic details:

- Cisco would acquire Acme for \$50 per share;
- Acme’s current stock price on the NYSE was roughly \$25 per share;
- Theo felt that Cisco’s offer was “very” generous and he fully expected Acme’s board to approve Cisco’s current offer (or something fairly close to it); and
- The deal would be announced on June 6<sup>th</sup>, so MS would need to work very quickly.

Boras explained that his team was very busy and would not be able to meet Acme’s quick deadline. He thanked Theo for thinking about using MS, but explained that MS would not be able to accept the assignment. The phone conversation lasted roughly 5 minutes. Acme had never been a client of MS in the past, so no confidentiality agreement existed between Acme and MS.

Within 10 minutes of getting off the phone with Theo, Boras called his broker, Mark Teixeira, and relayed to Mark the conversation with Theo. Boras then placed an order to purchase 100,000 shares of Acme stock at \$25 per share. In addition to placing Boras’ order, Mark placed an order for himself to purchase 50,000 shares of Acme for \$25 per share.

On June 6<sup>th</sup>, Cisco announced that it was acquiring Acme for \$50 per share. Immediately after the announcement, Acme’s stock price shot up to \$48 per share.<sup>1</sup> Boras and Mark immediately sold all of their Acme shares and generated profits of \$2.3 million and \$1.15 million respectively (minus commissions and expenses).

The SEC recently uncovered the above facts and is considering filing insider trading charges against Boras and Mark under Rule 10b-5. Please analyze the strength of the SEC’s case against each individual.

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<sup>1</sup> The \$2 difference between the announced acquisition price of \$50/share and the trading price of \$48/share represents the risk that the deal will not go through for one reason or another.

## BACKGROUND INFORMATION FOR QUESTIONS 2 – 4:

Medical Corp. (“MedCo”), is a medical device company whose common stock trades on the NYSE. On January 4, 2009, MedCo issued a press release (the “January Press Release”) that set forth the company’s revenue and profit projections for 2009. MedCo reports on a calendar-year basis – i.e., its fiscal year ends on December 31<sup>st</sup> – so the projections were for full-year 2009. The projections called for revenue-per-share of \$8.21 and profit-per-share of \$1.21. MedCo filed the January Press Release with the SEC pursuant to Form 8-K prior to releasing it for general dissemination. As part of the January Press Release, MedCo included the following clause (the “Forward-Looking Statement Clause”):

*Statements about the Company's future expectations and all other statements in this press release other than historical facts are "forward-looking statements." Such forward-looking statements involve risks and uncertainties and are subject to change at any time, and the Company's actual results could differ materially from results forecasted in, or suggested by, the forward-looking statements. [NOTE: The clause went on to provide meaningful cautionary statements that identified a variety of specific factors that could cause MedCo's actual results to differ from those in the forward-looking statements. For the sake of brevity, I have omitted those cautionary statements.] The Company undertakes no obligation to update forward-looking statements to reflect subsequently occurring events or circumstances. Any statements that provide guidance on future earnings are effective at the date given and will not be updated until the Company publicly announces updated guidance.*

Since January 4<sup>th</sup>, the medical device industry has continued to struggle along with the economy generally. During March, a number of MedCo’s competitors came out and publicly lowered their revenue and profit projections for 2009 – citing the global recession as the cause for their struggles. MedCo has made no further comment on its projections since they were made on January 4<sup>th</sup>.

Earlier today, Martha, who is MedCo’s CEO, was presenting at a big medical device conference. During a break in the action, Henry Grubman, a research analyst for Pierce Securities (a major Wall Street investment bank) who covers MedCo’s stock, bumped into Martha while they were both getting coffee. They exchanged polite conversation for a few moments, after which time Henry and Martha had the following exchange:

HENRY: You know that most of your competitors have lowered their projections for 2009 by at least 30%.

MARTHA: Yes, I know that.

HENRY: Is MedCo planning on lowering its projections?

MARTHA: No. We remain confident in our projections. I fully expect that we will meet our projections.

HENRY: Wow! The update that I will be writing on MedCo this afternoon just got a lot more interesting.

**Question No. 2 (15 points possible – 7½ minutes suggested):**

Why do companies routinely include disclaimers such as the Forward-Looking Statement Clause in their press releases and disclosure documents? In providing your analysis, please cite the specific statutory and regulatory provisions that apply.

**Question No. 3 (15 points possible – 7½ minutes suggested):**

Please explain why Regulation FD may have motivated MedCo to file the January Press Release with the SEC pursuant to Form 8-K? In providing your analysis, please cite the specific statutory and regulatory provisions that apply.

**Question No. 4 (40 points possible – 20 minutes suggested):**

After her conversation with Henry, Martha was concerned that she might have done something wrong. Martha called you and provided you with all of the above information. Please advise Martha on what, if anything, MedCo should do as a result of her conversation with Henry. In providing your analysis: (a) you can assume that confirmation of the earlier projections is material nonpublic information; and (b) please cite the specific statutory and regulatory provisions that apply.

**\*\*\*END OF MEDCO QUESTIONS\*\*\***

**Question No. 5 (110 points possible – 55 minutes suggested):**

**April 30, 2009 (please assume you are answering this question on that date):** You are an associate at Milkem and Bilkem, where you have been specializing in capital raising transactions for start-up companies for quite some time. One of your firm's start-up clients is Technology Co. ("TechCo"). TechCo is a relatively new start-up company that is working on developing some incredibly cool technology.

TechCo was founded in December 2007 and has conducted two financings to date, which can be summarized as follows:

**COMPLETED FINANCINGS**

<b>Amount Raised</b>	<b>Type of Security Sold</b>	<b>Purchasers</b>	<b>Exemption Relied On</b>	<b>Date Deal Was Closed</b>
\$1,000,000	Common Stock	The 3 founders	§4(2)	Dec. 1, 2007
\$700,000	Series A Convertible Preferred Stock	6 friends and family members <ul style="list-style-type: none"> <li>●All were located in 1 single state</li> <li>●5 would qualify as accredited investors</li> </ul>	Rule 504	Nov. 21, 2008

TechCo has used much of the previously-raised money to conduct a good portion of its core product development. TechCo has what it believes to be a workable product and has just begun beta-testing this product with two potential customers. TechCo now needs to raise substantial external funding to finalize product development, conduct a roll-out of the product and develop the internal infrastructure for the company. In order to do that, TechCo would like to raise approximately \$3 million as soon as practicable. Not surprisingly, any such financing must be conducted in a manner that is exempt from the registration requirements of §5 of the Securities Act.

Specifically, TechCo would like to conduct the following offering:

<b>Approximate Amount to be Raised</b>	<b>Type of Security to be Offered</b>	<b>Targeted Investors</b>	<b>Approximate Date to Commence Offer</b>
\$3 million	Series B Convertible Preferred Stock	<ul style="list-style-type: none"> <li>●A few very wealthy individuals</li> <li>●Certain key employees</li> </ul>	May 7, 2009

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

- The founders of TechCo have pre-existing relationships with a number of very wealthy individuals (each has a net worth well in excess of \$10 million). TechCo plans on marketing the offering exclusively to these individuals. It is envisioned that 4 or 5 of these very wealthy individuals will participate in the offering and they will collectively purchase \$2 million of the Series B offering. These various individuals live in a number of different states.
- Regarding the “key employees” for the Series B offering, it is currently anticipated that they would purchase approximately \$1,000,000 of the Series B offering. A summary of the expected parameters of what the “key employees” would look like (and what they would purchase) is set forth below:

<u>Name (or Classification)</u>	<u>Title</u>	<u>Estimated Annual Income from TechCo<sup>2</sup></u>	<u>Amount Expected to Purchase</u>
Martha Stewart	CEO & Director	\$150,000	\$500,000
Yao Ming	CTO	\$100,000	\$250,000
Andrew Fastow	CFO	\$100,000	\$200,000
Approx. 5 Sales Personnel	Sales Personnel	\$100,000 each	\$5,000 each (\$25,000 total)
Approx. 5 Engineers	Engineer	\$75,000 each	\$5,000 each (\$25,000 total)

TechCo’s facilities are located in the State of Xanadu and each of the above employees has an address in Xanadu.

One more bit of information that may be relevant: TechCo wants to minimize its disclosure requirements. In particular, TechCo does not want to provide written financial statements to anyone.

**Your specific assignment:**

- (a) What exemption (or exemptions) from Section 5 should TechCo use for its Series B financing? Please provide an explanation of why you think that exemption is the best choice (or those exemptions are the best choice). [Part (a) is worth 100 of the 110 possible points for Question No. 5.]
- (b) What is the relevance of the founders’ pre-existing relationship with the various wealthy individuals? [Part (b) is worth 10 of the 110 possible points for Question No. 5.]

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<sup>2</sup> These figures represent only the income received from TechCo. We will have to conduct further due diligence to determine each individuals total income from all sources.

## **BACKGROUND INFORMATION FOR QUESTIONS 6 and 7:**

WebVan Group, Inc. ("WebVan") is an Internet retailer of "grocery store" products (primarily food, non-prescription drug products and general merchandise). Through its innovative business design, WebVan (a) allows customers to perform their grocery store shopping over the Internet and (b) provides same-day home delivery of those purchases. Many leading industry experts believe that WebVan will revolutionize the way people shop and that WebVan has the potential to dominate the grocery store industry for the next few decades.

WebVan, which is currently a private company, has significant expansion plans. In order to fund these expansion plans, WebVan plans on conducting an initial public offering ("IPO") of its common stock. After interviewing approximately 15 investment banks to serve as underwriters for its IPO, WebVan chose Grubman, Blodgett & Spitzer ("GBS"), one of the leading investment banks on Wall Street, to serve as lead underwriter. The organizational meeting<sup>3</sup> was held in mid-March, at which time GBS proposed the following basic schedule for the IPO:

- March 23 – June 7, 2009: Conduct due diligence and draft the S-1 registration statement
- June 8, 2009: File the S-1 registration statement with the SEC
- July 13 – 28, 2009: Road show
- July 29, 2009: Go effective and price the deal

For the purpose of Questions 6 and 7, please assume that you are outside legal counsel representing WebVan.

### **Question No. 6 (15 points possible – 7½ minutes suggested):**

Please analyze whether it was permissible for WebVan to interview the 15 investment banks to serve as underwriters for the IPO. In providing your analysis, please cite the specific statutory and regulatory provisions that apply.

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<sup>3</sup> The purpose of the organizational meeting is (a) to go over the scheduling for the IPO, (b) to discuss any material issues that could impact the offering or its timing and (c) to assign the tasks and responsibilities to the various parties for the IPO. *Description and Flow Chart for a Hypothetical Initial Public Offering.*

**Question No. 7 (60 points possible – 30 minutes suggested):**

On April 30, 2009 (during the pre-filing period), WebVan explained to you that it would like to take out a full-page ad in the Wall Street Journal that would appear on May 1<sup>st</sup>. The primary text of the ad is as follows:

**WebVan**

The future of grocery shopping brought to you today!

Buying your groceries over the Internet is no longer a fantasy. It is how more and more Americans are doing their basic shopping. We project that by 2015, 30% of Americans will do the majority of their grocery shopping on-line.

Why wait for 2015? Join the on-line grocery shopping revolution today and shop through WebVan, America's No. 1 on-line grocery store. WebVan is at the forefront of this fundamental change.

More than 40% of on-line grocery purchases are made through WebVan, which means you can trust your on-line purchases with us. We expect to generate more than \$400 million in revenues in 2009, and \$600 million in 2010. Our strong financial performance ensures that we'll be around for a long time to serve our customers.

WebVan has asked for your advice on whether it can (or should) do the May 1<sup>st</sup> Wall Street Journal ad. In providing your analysis, please cite the specific statutory and regulatory provisions that apply.

**\*\*\*END OF WEBVAN QUESTIONS\*\*\***

**Question No. 8 (50 points possible – 25 minutes suggested):**

Low-Fares Air, Inc. ("LFA") operates a low-fare, no-frills scheduled passenger airline in the United States. LFA offers approximately 500 scheduled short-haul flights per day serving 90 locations. LFA has an operating fleet of 50 new Boeing 737-800 aircraft and in the year ended December 31, 2008, LFA served more than 20 million passengers. Amelia Earhart is the President and CEO of LFA.

In February 2009, LFA completed an initial public offering of its common stock. It was discovered in early April, however, that LFA had greatly exaggerated its 2008 profits in its S-1 registration statement. Specifically, LFA misreported a number of its fuel contracts, which caused LFA to report substantially lower expenses for the year, and therefore higher profits.

	<b>Reported</b>	<b>Actual</b>
2008 Revenues	\$723.0 million	\$723.0 million
2008 Total Expenses	\$643.0 million	\$720.0 million
2008 Profits	\$80.0 million	\$3.0 million

A series of lawsuits have been filed against LFA as well as a host of other defendants. For purposes of this question, you are to focus solely on the § 11 lawsuits that were filed against two specific defendants: Amelia Earhart (LFA's President and CEO) and Silverman Brothers Securities ("SBS", the lead underwriter for LFA's IPO). The § 11 lawsuits allege that LFA's S-1 registration statement contained material misstatements as a result of the misreported 2008 financial information. You are to assume the misreported 2008 financial information is material.

Each of Amelia and SBS are seeking to have the § 11 lawsuits dismissed. Each of the alleged material misstatements is contained in LFA's full-year 2008 financial statements that were audited by Arthur & Young ("A&Y"), LFA's public auditors. Both Amelia and SBS contend, pursuant to § 11(b)(3)(C) of the Securities Act, that they are entitled to rely on A&Y's unqualified audit opinions that LFA's 2008 financial statements fairly represented LFA's financial position and were presented in accordance with generally accepted accounting principles. Based on the BarChris and WorldCom decisions, please analyze the likelihood that the § 11 lawsuits against Amelia and SBS would be dismissed.

**Question No. 9 (40 points possible – 20 minutes suggested):**

On September 1, 2008, Michael Milken purchased 100,000 shares of NanoCom Series C Convertible Preferred Stock in a Rule 506 offering at a purchase price of \$50,000. On February 1, 2009, NanoCom conducted an IPO and listed its common stock on the New York Stock Exchange. The Series C Convertible Preferred Stock automatically converted (i.e., Milken was not required to provide any new consideration to make the conversion happen) into common stock (on a 1:1 ratio) at the time of the IPO. In order to pay for the shares he purchased on August 1<sup>st</sup>, Mr. Milken issued a promissory note to NanoCom for \$50,000 that was collateralized by Mr. Milken's house. Mr. Milken repaid the promissory note on April 1, 2009.

The trading volume for NanoCom's common stock over the last 4 weeks has been:

**Week 1** = 70,000 shares  
**Week 2** = 80,000 shares  
**Week 3** = 60,000 shares  
**Week 4** = 70,000 shares

Mr. Milken would like to immediately sell all 100,000 shares of his NanoCom stock. For purposes of this question, please assume that Mr. Milken is not an affiliate of NanoCom. When can Mr. Milken begin to sell his 100,000 shares of common stock under Rule 144? How many shares can he sell at that time? In providing your analysis, please cite the specific statutory and regulatory provisions that apply.

**Question No. 10 (15 points possible – 7½ minutes suggested):**

Why is it critical for securities lawyers to be very familiar with Rules 408 of the Securities Act and Rule 12b-20 of the Exchange Act when drafting disclosure documents?

\* \* \* \* \*

**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.