E-ALERT | Securities

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SENATE CONFEREES PROPOSE TO EFFECTIVELY OVERRULE *GUSTAFSON V. ALLOYD*

Perhaps lost in the flurry of activity as the House and Senate conferees seek to produce a version of financial services reform legislation is an effort by Senate conferees to add a provision intended to overturn the Supreme Court's 1995 decision in *Gustafson v. Alloyd Co., Inc.*[1] In *Gustafson*, the Court held that liability under §12(a)(2) of the Securities Act of 1933 was limited to sales effected by means of a prospectus meeting the requirements of §10 of that Act. In so holding, the Court resolved uncertainty as to whether §12(a)(2) liability attached to (i) private placements of newly-issued securities, (ii) M&A transactions structured as stock sales and (iii) secondary market transactions. Under *Gustafson*, §12(a)(2) liability typically does not attach in any of these situations.

Senate conferees have proposed to add to the bill being considered by the Conference Committee amendments to §§2(a)(10) and 12(a)(2) of the Securities Act to provide that the reference to "prospectus" in §12(a)(2) is to the broad definition in §2(a)(10) as opposed to the definition of a statutory prospectus in §10.[2] The proposal would also modify the definition of prospectus in §2(a)(10) to provide that it applies to offering documentation used in private placements as well as registered offerings.[3]

The definition of prospectus in §2(a)(10) would be modified to read as follows (new language underscored):

> The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security <u>(whether or not such security is offered or sold pursuant to a registration statement or the security or the transaction is exempt from this title or from section 5 of this title pursuant to the provisions of sections 3 or 4)</u> . . .
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> Section 12(a)(2) would be modified to read as follows:
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) and (14) of subsection (a) thereof), by means of a prospectus <u>(as defined in section 2(a)(10) of this title)</u> or oral communication, which includes an untrue statement of a material fact or

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[1] 513 U.S. 561 (1995).
[2] Senate Amendment 3976, proposing to add Section 9290 to Title IX, *Investor Protections and Improvements to the Regulation of Securities*, of the Restoring American Financial Stability Act of 2010 as passed by the Senate (S. 3217).
[3] The Senate conferees' proposal is identical to an amendment proposed on the floor of the Senate by Senators Levin, Coburn, Reid and Kaufman on May 11, 2010 (Senate Amendment 3976 to Bill S. 3217, 111th Cong., May 11, 2010, as published at page S3566 of the Federal Register). This amendment was never voted on by the Senate and there is no record of debate on it.

> omits to state a material fact necessary to make the statements, in the light of the circumstances under which they were made, not misleading . . .

The proposal is entitled "Restoration of Congressional Intent That Prospectus Is Not Restricted To Public Offerings," although there is no evidence in the record of such intent at the time of the adoption of the Securities Act or in subsequent legislative amendments. In addition to the identical version of this proposal that was introduced in the Senate on May 11, 2010 but never brought to a vote, a prior effort to overrule *Gustafson* was introduced in the Senate by Senator Reed on May 5, 2010, but was also never brought to a vote.[4] Although the Conference Committee is only supposed to consider provisions contained in a version of bills passed by either the House or the Senate, no procedural objection was made when this proposal was introduced, and no substantive objection has been raised by any member of the Conference Committee to date.

If adopted, the Conference Committee amendment fundamentally jeopardizes *Gustafson's* holding that private placements and M&A stock sale transactions are not subject to §12(a)(2) liability. Moreover, it could also impose §12(a)(2) liability on the full range of secondary trading transactions. A key distinction made by the majority in *Gustafson* was that the word "prospectus" as used in §12(a)(2) should be read to refer to the statutory prospectus described in §10 (a construction with which the dissent disagreed strongly). By amending §2(a)(10) directly, the Conference Committee amendment would appear to remove this argument, thus opening the door for imposing §12(a)(2) liability on all secondary market transactions.[5] The potential impact of such a change on risk allocation and trading practices in the capital markets is very significant, and the absence of meaningful (if any) Congressional debate (not to mention the seeming violation of rules governing the Conference Committee) is concerning.

Among the premises underscoring the *Gustafson* decision was the long-standing tenet of the Federal securities laws that sophisticated investors (arguably, at least under case law, the only investors eligible to participate in private placements) do not need the same scope of protections as other investors. In addition, the secondary markets are not designed to bear the burdens of potential §12(a)(2) liability on every communication utilized to offer or effect a trade in a security (including, for example, trade confirmations, email communications concerning securities and research reports). It is unclear how application of §12(a)(2) liability to regular-way secondary market trading would work in practice. How could a secondary market transaction participant (broker/dealer, seller)

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[4] Senate Amendment 3855 to Bill S. 3217, 111th Cong., May 5, 2010, as published at page S3278 of the Federal Register. There is also no record of debate on this proposed amendment, which would have amended §12(a)(2) as to read as follows:

> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) and (14) of subsection (a) thereof)<u>, and whether or not exempted by the provisions of section 4,</u> by means of a prospectus <u>or other offering document</u> or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements, in the light of the circumstances under which they were made, not misleading . . .

[5] Note also the expansion of scope from the May 5 Reed Senate amendment, which only referred to transactions exempt from section 5 pursuant to section 4. The Conference Committee amendment (which is identical to the May 11 Levin amendment as introduced in the Senate) would also sweep in securities exempt from section 5 pursuant to Section 3 (including commercial paper, bank and municipal securities), as well as securities exempt from any other provision of the Securities Act (it is not clear what additional transactions might be included by this vague language). This would appear to impose §12(a)(2) liability on secondary market trades in CP, bank and municipal securities, and perhaps other categories of securities, which would not have been covered by the Reed Senate amendment and likely would not have been covered in the broader pre-*Gustafson* interpretations that the Supreme Court overruled.

meet the reasonable care standard for avoiding liability? Even if feasible, what costs and delays would these additional procedures add to ordinary trading transactions?

The existence of rule 10b-5 liability on all transactions involving securities affords meaningful protection to investors, and meaningful disincentive to those who might seek to transact inappropriately in securities. Opponents to the rescission of *Gustafson* and the expansion of liability to private placements and secondary market transactions argue that these transactions needlessly will become more costly. Further, there are concerns that transactions and trading volume may migrate overseas, depriving US investors of investment and liquidity opportunities, and that US issuers (particularly smaller and start-up companies) may face more limited and costly access to capital.

This proposal appears to be one presented in haste, and the potential consequences have been considered, if at all, far too quickly. It is to be hoped that a more thoughtful study of the costs and benefits of such a proposal would be undertaken before such a fundamental reordering of the liability structure of the Federal securities law would occur.

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