

possess material nonpublic information about Sullair when he sold or purchased the securities of the company. The corporation brought suit against Hooded to recover the profits Hooded made on these trades. Who wins? *Sullair Corporation v. Hooded*, 672 F.Supp. 337, Web 1987 U.S. Dist. Lexis 10152 (United States District Court for the Northern District of Illinois)

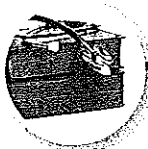
17.7 Transaction Exemption Stephen Murphy owned Intertie, a California company that was involved in financing and managing cable television stations. Murphy was both an officer of the corporation and chairman of the board of directors. Intertie would buy a cable television station, make a small cash down payment, and finance the remainder of the purchase price. It would then create a limited partnership and sell the cable station to the partnership for a cash down payment and a promissory note in favor of Intertie. Finally, Intertie would lease the station back from the partnership. Intertie purchased more than thirty stations and created an equal number of limited partnerships, from which it received more than \$7.5 million from approximately four hundred investors.

Evidence showed that most of the limited partnerships were not self-supporting but that this fact was not disclosed to investors. Intertie commingled partnership funds, taking funds generated from the sale of new partnership offerings to meet debt service obligations of previously sold cable systems; Intertie also used funds from limited partnerships that were formed but that never acquired cable systems. Intertie did not keep any records regarding the qualifications of investors to

purchase the securities and also refused to make its financial statements available to investors.

Intertie suffered severe financial difficulties and eventually filed for bankruptcy. The limited partners suffered substantial losses. Do each of the limited partnership offerings alone qualify for the private placement exemption from registration? Should the thirty limited partnership offerings be integrated? Has Murphy acted ethically in this case? *Securities and Exchange Commission v. Murphy*, 626 F.2d 633, Web 1980 U.S. App. Lexis 15483 (United States Court of Appeals for the Ninth Circuit)

17.8 Definition of Security The Farmer's Cooperative of Arkansas and Oklahoma (Co-Op) was an agricultural cooperative that had approximately 23,000 members. To raise money to support its general business operations, Co-Op sold promissory notes to investors that were payable upon demand. Co-Op offered the notes to both members and nonmembers, advertised the notes as an "investment program," and offered an interest rate higher than that available on savings accounts at financial institutions. More than 1,600 people purchased the notes, worth a total of \$10 million. Subsequently, Co-Op filed for bankruptcy. A class of holders of the notes filed suit against Ernst & Young, a national firm of certified public accountants that had audited Co-Op's financial statements, alleging that Ernst & Young had violated Section 10(b) of the Securities Exchange Act of 1934. Are the notes issued by Co-Op securities? *Reeves v. Ernst & Young*, 494 U.S. 56, 110 S.Ct. 945, 108 L.Ed.2d 47, Web 1990 U.S. Lexis 1051 (Supreme Court of the United States)



Ethics Cases

17.9 Ethics James O'Hagan was a partner in the law firm Dorsey & Whitney in Minneapolis, Minnesota. Grand Metropolitan PLC (Grand Met), a company based in London, England, hired Dorsey & Whitney to represent it in a secret tender offer for the stock of the Pillsbury Company, headquartered in Minneapolis. While this transaction was still secret, O'Hagan began purchasing call options for Pillsbury stock. Each call option gave O'Hagan the right to purchase one hundred shares of Pillsbury stock at a specified price.

O'Hagan continued to purchase call options for two months, and he became the largest holder of call options for Pillsbury stock. O'Hagan also purchased five thousand shares of Pillsbury common stock at \$39 per share. These purchases were all made while Grand Met's proposed tender offer for Pillsbury remained secret to the public. When Grand Met publicly

announced its tender offer one month later, Pillsbury stock increased to nearly \$60 per share. O'Hagan sold his Pillsbury call options and common stock, making a profit of more than \$4.3 million.

The U.S. Department of Justice charged O'Hagan with criminally violating Section 10(b) and Rule 10b-5. Because this was not a case of classic insider trading because O'Hagan did not trade in the stock of his law firm's client, Grand Met, the government alleged that O'Hagan was liable under the misappropriation theory for trading in Pillsbury stock by engaging in deceptive conduct by misappropriating the secret information about Grand Met's tender offer from his employer, Dorsey & Whitney, and from its client, Grand Met. *United States v. O'Hagan*, 521 U.S. 642, 117 S.Ct. 2199, 138 L.Ed.2d 724, Web 1997 U.S. Lexis 4033 (Supreme Court of the United States)

1. Describe the misappropriation theory.
2. Did O'Hagen act ethically in this case?
3. Did O'Hagen act illegally in this case?

17.10 Ethics R. Foster Winans, a reporter for the *Wall Street Journal*, was one of the writers of the "Heard on the Street" column, a widely read and influential column in the *Journal*. This column frequently included articles that discussed the prospects of companies listed on national and regional stock exchanges and the over-the-counter market. David Carpenter worked as a news clerk at the *Journal*. The *Journal* had a conflict of interest policy that prohibited employees from using nonpublic information learned on the job for their personal benefit. Winans and Carpenter were aware of this policy.

Kenneth P. Felis and Peter Brant were stockbrokers at the brokerage house Kidder Peabody. Winans agreed to provide Felis and Brant with information that was to appear in the "Heard" column in advance of its publication in the *Journal*. Generally, Winans would provide this information to the brokers the day before a story about a company was to appear in the *Journal*. Carpenter served as a messenger between the parties. Based on this advance information, the brokers bought and sold securities of companies discussed in the "Heard" column before publication of the information. During the course of one year, Felis and Brant's prepublication trades based on twenty-seven "Heard" columns netted

profits of almost \$690,000. The parties used telephones to transfer information. The *Wall Street Journal* is distributed by mail to many of its subscribers.

Eventually, Kidder Peabody noticed a correlation between the "Heard" column and trading by the brokers. After an SEC investigation, criminal charges were brought against defendants Winans, Carpenter, and Felis in U.S. District Court. Brant became the government's key witness at the trial, having made a plea bargain with the federal government to testify against his co-conspirators in exchange for a reduced sentence. Winans and Felis were convicted of conspiracy to commit fraud, in violation of Section 10(b) of the Securities Exchange Act of 1934, and wire and mail fraud. Carpenter was convicted of aiding and abetting the commission of securities, mail, and wire fraud. The defendants appealed their convictions. *United States v. Carpenter*, 484 U.S. 19, 108 S.Ct. 316, 98 L.Ed.2d 275, Web 1987 U.S. Lexis 4815 (Supreme Court of the United States)

1. What is insider trading? Does Section 10(b) apply to this case?
2. Did Winans act ethically in this case? Did Carpenter act ethically in this case? Did Felis and Brant act ethically in this case? Did Brant act ethically by turning government's witness?
3. Are the defendants Winans and Felis criminally liable for conspiring to violate Section 10(b) of the Securities Exchange Act of 1934?



Internet Exercises

1. Go to the website of NASDAQ, at www.nasdaq.com. Click on "Market Activity." Is the NASDAQ Composite Index up or down in price?
2. Go to <http://finance.yahoo.com>. In the "Get Quotes" box, type in the Microsoft's stock trading symbol, MSFT. What is the current price of Microsoft stock? Is it up or down in price?
3. Go to the New York Stock Exchange website, at www.nyse.com/about/listed/IPO_Index.html, to view the "IPO Showcase" list of the most recent IPOs. What is the most recent listing? Click on the company's name and read the brief history of the company.
4. Go to www.nasaa.org/industry__regulatory_resources/corporation_finance/535.cfm to read information about the Small Corporate Offering Registration (SCOR) and Form U-7.
5. Go to http://en.wikipedia.org/wiki/Martha_Stewart_insider_trading_charges and read about the insider trading case against Samuel Waksal and the case against Martha Stewart concerning their sales of ImClone Systems stock.
6. Visit the website of the Shanghai Stock Exchange, at www.sse.com.cn/sseportal/en_us/ps/home.shtml. Click on "About SSE" and read the brief introduction.

Endnotes

1. Public Law 107-204 (2002).
2. Public Law 111-203 (2010).
3. *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244, Web 1946 U.S. Lexis 3159 (Supreme Court of the United States).
4. 15 U.S.C. Sections 77a-77aa.
5. 283 F.Supp. 643, Web 1968 U.S. Dist. Lexis 3853 (United States District Court for the Southern District of New York).
6. 15 U.S.C. Section 77x.
7. Securities Act of 1933, Section 3(a)(11).