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DISCLOSURE TRENDS

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Is Less More? SEC Chair White Speaks on the Future of Disclosure Reform

SEC Chair Mary Jo White spoke about the future of securities disclosure reform in a speech before the National Association of Corporate Directors.

Chair White noted that a common problem today is "information overload"—when investors are provided "too much" information—"a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant." The reasons for the increase are several: new rules issued by the Staff, legislative changes such as the Private Securities Litigation Reform Act, which led to a proliferation of risk factors, and the "say-on-pay" vote mandated by the Dodd-Frank Act, which led to 40+ pages of executive compensation disclosures, and a company's decision (typically prompted by their counsel) to provide more information in an effort to reduce the risk of litigation.

As required by the JOBS Act, the SEC Staff is reviewing current disclosure requirements to determine how to modernize and simplify the requirements, and to reduce the costs and other burdens of the disclosure requirements for emerging growth companies. Chair White said that the SEC expects to issue this report "very soon."

(continued on page 2)

CONTENTS

Is Less More? SEC Chair White Speaks on the Future of Disclosure Reform (continued from page 1)

The areas of disclosure reform for future consideration noted by Chair White include:

- Use of a "core document" or "company profile" containing base information that would be updated as required with information about offering, financial statements and significant events.
- Elimination of repetitive disclosures in filings, such as "legal proceedings" for which the identical information can appear in a Form 10-K four or more times.
- Revision of the Industry Guides, which, except for oil and gas, have not been updated in decades.
- Consideration of whether the applicable disclosure timeframes should be shortened in light of the increased use and speed of technology, including social media and smart phones.
- Whether there are required disclosures that are not necessary for investors or that investors do not want, such as share prices, dilution disclosures and earnings to fixed charges ratios. ■

[Return to Table of Contents]

Proposed Pay Ratio Disclosure—Delicate Balancing Act Between Congressional Mandate and Practical Implementation

The SEC has recently proposed the long-awaited and feared pay ratio rules. The proposed rules embodied in the new Item 402(u) of Regulation S-K implement the mandate of Section 953(b) of the Dodd-Frank Act to disclose the ratio of the median of annual total compensation of all employees (excluding the CEO) to the annual total compensation of the CEO.

In the proposed rules, the SEC provided registrants with significant flexibility in terms of various calculations that should be performed. However, the SEC conceded that permitting registrants to select a methodology for identifying the median, rather than prescribing a specific methodology, could enable a registrant to "alter the reported ratio to achieve a particular objective with the ratio disclosure, thereby potentially reducing the usefulness of the information."

WHAT IS THE PROPOSED DISCLOSURE REQUIREMENT?

The proposed Item 402(u) follows Section 953(b) of the Dodd-Frank almost verbatim, but provides some color on how to express the required ratio (see item (iii) below). It requires a registrant to disclose:

(i) the median of the annual total compensation of all employees of the registrant, except the principal executive officer[1] (PEO) of the registrant;

(ii) the annual total compensation of the PEO of the registrant; and

(iii) the ratio of the amount in (i) to the amount in (ii), presented as a ratio in which the amount in (i) equals one or, alternatively, expressed narratively as the multiple that the amount in (ii) bears to the amount in (i).

To clarify the presentation point in item (iii) above, the SEC provided the following example: "if the median of the annual total compensation of all employees of a registrant is $45,790 and the annual total compensation of a registrant's PEO is $12,260,000, then the pay ratio disclosed would be "1 to 268" (which could also be expressed narratively as 'the PEO's annual total compensation is 268 times that of the median of the annual total compensation of all employees')."

Companies would be required to describe the pay ratio information in registration statements, proxy and information statements, and annual reports that must include executive compensation information as set forth under Item 402 of Regulation S-K.

Emerging growth companies, smaller reporting companies and foreign private issuers will not be subject to the proposed rules.

WHO IS CONSIDERED AN EMPLOYEE UNDER THE PROPOSED RULES?

The term "employee" under the proposed rules is fairly broad and includes any full-time, part-time, seasonal or temporary U.S. or non-U.S.[2] worker employed by the registrant or any of its subsidiaries (including officers other than the PEO) as of the last day of the registrant's last completed fiscal year. However, independent contractors or "leased" workers or other temporary workers who are employed by a third party, will not be covered. For example, if the registrant pays a fee to a management company or an employee leasing agency that supplies workers to the registrant, and those workers receive compensation from that other company, they will not be counted as employees of the registrant for purposes of Item 402(u). (continued on page 3)

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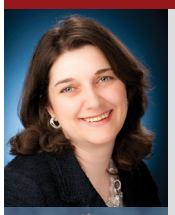

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DISCLOSURE TRENDS

Proposed Pay Ratio Disclosure—Delicate Balancing Act Between Congressional Mandate and Practical Implementation (continued from page 2)

This last day of the fiscal year calculation date for determining who is an employee under Item 402(u) will not capture seasonal or temporary employees that are not employed at year-end, which creates an interesting dilemma. Such calculation date enables a registrant with a significant amount of such workers to calculate a median that does not fully reflect its workforce, and, theoretically, some registrants could try to structure their employment arrangements to reduce the number of workers employed on the calculation date.

The SEC proposed to permit, but not to require, companies to annualize the total compensation for a permanent employee who did not work for the entire year (for example, new hires or employees on an unpaid leave of absence). However, full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary and seasonal workers, or cost-of-living adjustments for non-U.S. workers would not be permitted.

HOW TO FIND THE MEDIAN?

The most feared consequence of the rules implementing Section 953(b) of the Dodd-Frank Act was that, in order to identify the median, the company would need to determine total compensation amounts for every single employee. However, this is not the case with the proposed rules, which are very flexible and allow a registrant to use (i) a methodology that uses reasonable estimates to identify the median and (ii) reasonable estimates to calculate the annual total compensation or any elements of total compensation for employees other than the PEO. Moreover, in determining the employees from which the median is identified, the registrant may use not only its total employee population, but also statistical sampling or other reasonable methods. The SEC also proposed a practical approach to identifying the median by allowing registrants to use not only annual total compensation for the purposes of such determination, but also any other consistently applied compensation measure, such as compensation amounts reported in its payroll or tax records, as long as the registrant briefly discloses the compensation measure that it used as well as Item 402(c)(2)(x) total compensation for that median employee. Also, in a fairly rare move, the SEC provided in the proposing release sample disclosure related to the compensation measure used by a company: "We found the median using salary, wages and tips as reported to the U.S. Internal Revenue Service on Form W-2 and the equivalent for our non-U.S. employees."

(continued on page 4)

SRO NEWS

FINRA Enhances its Public Offering Review Process

FINRA has recently instituted enhancements to its public offering review process. Such enhancements include an immediate clearance process for certain shelf offerings, an expansion of its expedited review program for non-shelf offerings and the introduction of a new limited review process for certain non-shelf offerings of exchange-listed securities.

IMMEDIATE CLEARANCE

FINRA's review improvements provide member firms with immediate clearance, 24 hours per day, 7 days a week, for shelf filings. Immediate clearance is available for WKSI filings, new shelf registration statements, and shelf takedowns. In order to obtain immediate clearance, member firms must:

- provide background information related to the offering and make the representations required by the existing same-day clearance procedures;
- undertake to provide all information necessary to complete the filing within three business days; and
- provide the Fedwire number for the payment of the filing fee.

NON-SHELF OFFERINGS

FINRA now has three review programs available for non-shelf filings: full review, expedited review and limited review. All non-shelf filings will initially be considered to be full review unless a different request is subsequently made.

Expedited Review. Effective September 30th, FINRA expanded the expedited review program for non-shelf offerings. FINRA will determine whether to grant an expedited review request based on the complexity of the proposed arrangements. PIPEs, resale offerings distributed on a best efforts basis, non-traded investment programs and offerings in which a participating FINRA member firm has acquired unregistered securities during the review period will generally not be eligible for an expedited review.

(continued on page 4)

DISCLOSURE TRENDS

Proposed Pay Ratio Disclosure—Delicate Balancing Act Between Congressional Mandate and Practical Implementation (continued from page 2)

Generally, the proposed rules enable a company to use the methodology that would work best for its particular facts and circumstances, including, among others, such variables as:

- the size and nature of the workforce;
- the complexity of the organization;
- the stratification of pay levels across the workforce;
- the types of compensation the employees receive;
- the extent that different currencies are involved;
- the number of tax and accounting regimes involved;
- the number of payroll systems the registrant has and the degree of difficulty involved in integrating payroll systems to readily compile total compensation information for all employees.

The proposed rules require a brief disclosure and consistent application of (i) the methodology used to identify the median and (ii) any material assumptions, adjustments or estimates used to identify the median or to determine total compensation or any elements of total compensation. Companies also have to clearly identify any estimated amounts. The SEC explained that when statistical sampling is used, registrants should disclose the size of both the sample and the estimated whole population, any material assumptions used in determining the sample size, which sampling method (or methods) is used, and, if applicable, how the sampling method deals with separate payrolls such as geographically separated employee populations or other issues arising from multiple business or geographic segments.

Under Regulation S-K, a registrant is permitted to omit disclosure of the salary or bonus in the summary compensation table if it is not calculable through the latest practicable date. In such case, a registrant must include a footnote to the summary compensation table disclosing that fact and provide the date that the amount is expected to be determined. In addition, once determined, such amount must be disclosed under Item 5.02(f) of Form 8-K. A company relying on this accommodation would then have to disclose that the pay ratio is not calculable until the PEO's salary or bonus is determined. The SEC also proposed that once the PEO's total compensation is determined, the pay ratio disclosure will be provided under the same Item 5.02(f) of Form 8-K.

WHEN SHOULD WE START COMPLYING WITH PAY RATIO DISCLOSURE?

The SEC proposed that a registrant must begin to comply with Item 402(u) for the registrant's first fiscal year commencing on or after the effective date of the rule. For example, if the final rules become effective in 2014, a registrant with a fiscal year ending on December 31 will be first required to include pay ratio information relating to compensation for fiscal year 2015 in its definitive proxy or information statement for its 2016 annual meeting of shareholders (or written consents in lieu of such a meeting). If such proxy or information statement is not filed within 120 days of the end of 2015 (i.e., April 30, 2016), the registrant would need to file its initial pay ratio disclosure in its Form 10-K for 2015 or an amendment to that Form 10-K.

In addition, the proposed requirements permit new registrants that do not qualify as emerging growth companies, which are exempt from the proposed rule, to delay compliance, so that pay ratio disclosure would not be required in a registration statement for an initial public offering or a registration statement on Form 10. Instead, such registrant would be required to first comply with proposed Item 402(u) for the first fiscal year commencing on or after the date the registrant becomes subject to the requirements of Section 13(a) or Section 15(d) of the Exchange Act.

WHAT SHOULD WE DO NOW?

It is clear from the examples provided by the SEC in the proposing release that the SEC does not expect Item 402(u) to be effective for the 2014 proxy season. If approved as proposed, the new rule will not even apply to the 2015 proxy season, and companies with a calendar year end will need to start providing pay ratio disclosure only in 2016 for the year ending December 31, 2015. Nevertheless, companies should begin getting ready for the new disclosure in 2014 and 2015 by figuring out which assumptions or methodologies would work for their businesses, testing the statistical sampling that they would like to use or working through the issues posed by international data privacy laws in the case of multinational companies. ■

[Return to Table of Contents]

SRO NEWS

FINRA Enhances its Public Offering Review Process (continued from page 3)

Limited Review. On September 30th, FINRA implemented a new limited review process for certain non-shelf offerings. The member firm must submit a request for FINRA to consider whether to grant a limited review. For a member firm to request a limited review, the offering must satisfy all of the following criteria:

- securities must be listed on a national securities exchange;
- firm commitment or straight best efforts distribution methods must be used;
- total underwriting compensation must be within allowable guidelines and may not include securities;
- underwriting arrangements may not include prohibited terms as defined in FINRA Rule 5110(f)(2), such as indeterminate items of value;
- FINRA members must be identified in the offering documents and filing system;
- offering must be filed with the SEC; and
- offering must not include a new or novel product or be one that poses complex regulatory issues.

A member firm must also make six representations as part of its request for limited review, although four of such representations may be deferred past the initial request. ■ [Return to Table of Contents]

The SEC and FINRA Issue Proposed Crowdfunding Rules

The SEC has released the long-awaited proposed crowdfunding rules necessary to implement Title III of the JOBS Act. The proposed rules are subject to a 90 day comment period, and the floodgates to crowdfunding will probably not be open until the middle of 2014.

The SEC provided a fact sheet highlighting some of the requirements under the proposed rules. Under the proposed rules,

- A company would be able to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period.
- Investors, over the course of a 12-month period, would be permitted to invest up to:
  - $2,000 or 5% of their annual income or net worth, whichever is greater, if both their annual income and net worth are less than $100,000, or
  - 10% of their annual income or net worth, whichever is greater, if either their annual income or net worth is equal to or more than $100,000. During the 12-month period, these investors would not be able to purchase more than $100,000 of securities through crowdfunding.

Thankfully, the rules as proposed would allow companies to rely on an intermediary to determine that the aggregate amount of securities purchased by an investor will not cause the investor to exceed the investor limits, provided that the company does not have knowledge that the investor had exceeded, or would exceed, the investor limits as a result of purchasing securities in the company's offering.

- Both initial and subsequent holders of securities sold in a crowdfunding transaction under the proposed rule will not be counted toward the threshold that requires a company to register with the SEC under Section 12(g) of the Securities Exchange Act. Under Section 12(g), as amended by the JOBS Act, once a company has total assets exceeding $10,000,000 and a class of securities held of record by either 2,000 persons, or 500 persons who are not accredited investors, registration with the SEC is required.
- The proposed rules would require companies conducting a crowdfunding offering to file certain information with the SEC, provide it to investors and the intermediary facilitating the crowdfunding offering, and make it available to potential investors. Companies seeking to use the crowdfunding exemption would have to disclose in their offering documents, among other things:
  - Information about officers and directors as well as owners of 20% or more of the company,
  - A description of the company's business and the use of proceeds from the offering,
  - The price to the public of the securities being offered, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount,
  - Certain related-party transactions,
  - A description of the financial condition of the company, and
  - Financial statements of the company that, depending on the amount offered and sold during a 12-month period, would have to be accompanied by a copy of the company's tax returns or reviewed or audited by an independent public accountant or auditor.
- Companies would be required to amend their offering documents to reflect material changes and provide updates on the company's progress toward reaching the target offering amount.
- Companies relying on the crowdfunding exemption to offer and sell securities would be required to file an annual report with the SEC and provide it to investors.
- Consistent with the requirements of the JOBS Act, the proposed rules require that crowdfunding transactions take place exclusively through an online platform operated by an SEC-registered broker-dealer or funding portal. The proposed rules set forth various requirements for the operation of the funding portals. Funding portals will have to be registered with both the SEC and FINRA (or another national securities association). On October 23, 2013, FINRA released its own set of proposed rules for the registration and operation of funding portals.

Without a doubt, equity crowdfunding has the potential to dramatically alter the way companies raise capital in the United States. However, whether that potential is realized will depend heavily upon various factors, including whether start up companies will consider crowdfunding to be an efficient and cost-effective manner to raise funds, given various disclosure obligations proposed by the SEC. ■ [Return to Table of Contents]

Breaking Bad (Boy): SEC Issues Felon and "Bad Actor" Disqualification Guidance

The staff of the SEC released a Small Entity Compliance Guide discussing the application of the newly adopted regulations on the disqualification of felons and other "bad actors" from Regulation 506 offerings.

Generally, under the new regulations, an issuer may not rely on the Regulation 506 offering exemption if the issuer or any other person covered by Rule 506(d) has a relevant criminal conviction, regulatory or court order or other disqualifying event that occurred on or after September 23, 2013, the effective date of the rule amendments. Under Rule 506(e), for disqualifying events that occurred before September 23, 2013, issuers may still rely on Rule 506, but will have to comply with the disclosure provisions of Rule 506(e).

PERSONS COVERED BY THE RULE

Persons and entities that are covered by Rule 506(d) (i.e., potential "bad actors") include:

- the issuer, including its predecessors and affiliated issuers;
- directors, general partners, and managing members of the issuer;
- executive officers of the issuer, and other officers of the issuer that participate in the offering;
- 20 percent beneficial owners of the issuer, calculated on the basis of total voting power;
- promoters connected to the issuer;
- for pooled investment fund issuers, the fund's investment manager and its principals; and
- persons compensated for soliciting investors, including their directors, general partners and managing members

Some interesting guidance offered by the SEC includes the following:

- "Executive officers" of an issuer follows the standard SEC definition. For other officers, to be considered "participating in the offering" would require more than transitory or incidental involvement, and could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents, and communication with the issuer, prospective investors or other offering participants.
- 20 percent beneficial ownership is calculated on the basis of total voting power rather than on the basis of ownership of any single class of securities. Whether securities are "voting securities" depends on whether securityholders have or share the ability, either currently or on a contingent basis, to control or significantly influence the management and policies of the issuer through the exercise of a voting right. As an example, the SEC would consider that securities that confer to securityholders the right to elect or remove the directors or equivalent controlling persons of the issuer, or to approve significant transactions such as acquisitions, dispositions or financings, would be considered voting securities for purposes of the rule. Conversely, securities that confer voting rights limited solely to approval or changes to the rights and preferences of the class would not be considered voting securities for purposes of the rule.
- The category of "promoter" is broad. Securities Act Rule 405 defines a promoter as any person—individual or legal entity—that either alone or with others, directly or indirectly takes initiative in founding the business or enterprise of the issuer, or, in connection with such founding or organization, directly or indirectly receives 10% or more of any class of issuer securities or 10% or more of the proceeds from the sale of any class of issuer securities (other than securities received solely as underwriting commissions or solely in exchange for property). The test considers activities "alone or together with others, directly or indirectly;" therefore, the result does not change if there are other legal entities (which may themselves be promoters) in the chain between that person and the issuer.
- For issuers that are pooled investment funds, the rule covers investment advisers and other investment managers of the fund; the directors, general partners, managing members, executive officers and other officers participating in the offering of such investment managers; and

(continued on page 7)

Board Oversight of Political Contributions Is Steadily Rising

In September 2013, the Center for Political Accountability and the Zicklin Center for Business Ethics Research published their third annual index of political accountability and disclosure (2013 Index), which focuses on political spending disclosure of the top 200 companies in the S&P 500 Index. The Index reviews companies' policies disclosed on their websites and describes:

- the ways that companies manage and oversee political spending;
- the specific spending restrictions that many companies have adopted; and
- the policies and practices that need the greatest improvement.

The 2013 Index demonstrates that of the 195 companies reviewed in both 2012 and 2013, 78% of companies improved their overall scores for political disclosure and accountability. In particular, data from the 2013 Index indicates that a growing number of companies have some level of board oversight of their political contributions and expenditures. For example,

- 62% of companies said that their boards of directors regularly oversee corporate political spending in 2013, compared to 56% in 2012;
- 57% of companies said that a board committee reviews company policy on political spending in 2013, compared to 49% in 2012; and
- 56% of companies said that a board committee reviews company political expenditures in 2013, compared to 45% in 2012. ■

[Return to Table of Contents]

Breaking Bad (Boy): SEC Issues Felon and "Bad Actor" Disqualification Guidance (continued from page 6)

the directors, executive officers and other officers participating in the offering of the investment managers' general partners or managing members.

- Persons compensated for soliciting investors as well as their directors, general partners, managing members, executive officers and officers participating in the offering are subject to the rule. This category covers any persons compensated for soliciting investors but will typically involve broker-dealers and other intermediaries.

DISQUALIFYING EVENTS—"BAD ACTS"

Under the final rule, disqualifying events that make a covered person a "bad actor" include:

- **Criminal convictions:** Disqualification is triggered by criminal convictions in connection with: (i) the purchase or sale of a security, (ii) making a false filing with the SEC or (iii) the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities. The criminal conviction must have occurred within ten years of the proposed sale of securities, or five years in the case of the issuer and its predecessors and affiliated issuers.

- **Court injunctions and restraining orders:** Disqualification is triggered by court injunctions and restraining orders in connection with: (i) the purchase or sale of a security, (ii) making a false filing with the SEC or (iii) the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities. Disqualification only applies for injunctions and restraining orders that are in effect at the time of the proposed sale of securities and were entered within the preceding five years. Injunctions and court orders that have expired or are otherwise no longer in effect are not disqualifying, even if they were issued within the five-year look-back period. For example, an injunction that was issued four years before the proposed offering but lifted before the offering occurred would not be disqualifying.
- **Final orders of certain state and federal regulators:** Disqualification is triggered by final orders of state regulators of securities, insurance, banking, savings associations or credit unions; federal banking agencies; the Commodity Futures Trading Commission and the National Credit Union Administration that: (i) bar the covered person from associating with a regulated entity, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities or (ii) are based on fraudulent, manipulative, or deceptive conduct and were issued within 10 years of the proposed sale of securities. Some matters to note:
  - A "final order" is a written directive or declaratory statement issued by one of the federal or state regulatory agencies listed above, under applicable statutory authority that provides for notice and an opportunity for hearing, which constitutes a final disposition or action by that federal or state agency. An order will be considered final even though it is subject to an appeal. An order does not have to be non-appealable to be a "final order" under the bad actor rules.
  - There are no procedural requirements beyond the basic requirement that notice and opportunity for hearing be provided for in the statutes, rules and regulations under which an order is issued. No hearing need have occurred. For example, a settlement is considered to have been made after an opportunity for hearing.
  - Bars are orders issued by one of the specified regulatory authorities that have the effect of barring a person from association with an entity, or engaging in the business, that is regulated by that authority. Any final order that has one of those effects is a bar, regardless of whether it uses the term "bar." A bar is disqualifying only for as long as it has continuing effect. For example, a person who was barred indefinitely, with the right to apply to reassociate after three years, would be disqualified until such time as he or she is permitted to reassociate, assuming that the bar had no continuing effect after reassociation.
  - The final rules do not provide a specific definition of "fraudulent, manipulative or deceptive conduct," and in particular do not limit it to matters involving knowing misconduct or scienter.
- **SEC disciplinary orders:** Disqualification is triggered by SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons under Section 15(b) or 15B(c) of the Securities Exchange Act, or Section 203(e) or (f) of the Investment Advisers Act that: (i) suspend or revoke the person's registration as a broker, dealer, municipal securities dealer or investment adviser, (ii) place limitations on the person's activities, functions or operations or (iii) bar the person from being associated with any entity or from participating in the offering of any penny stock. Disqualification continues only for as long as some act is prohibited or required to be performed pursuant to the order. As a result, censures and orders to pay civil money penalties, assuming the penalties are paid in accordance with the order, are not disqualifying, and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires.
- **SEC cease-and-desist orders:** SEC orders to cease and desist from violations and future violations of: (i) the scienter-based anti-fraud provisions of the federal securities laws, including, for example, Section 17(a)(1) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5, Section 15(c)(1) of the Securities Exchange Act and Section 206(1) of the Investment Advisers Act or (ii) Section 5 of the Securities Act. Disqualification applies to cease-and-desist orders that were issued within five years before the proposed sale of securities and remain in effect.

(continued on page 8)

Breaking Bad (Boy): SEC Issues Felon and "Bad Actor" Disqualification Guidance (continued from page 7)

- **SEC stop orders:** An offering is disqualified if any covered person (as a registrant or issuer) has filed a registration statement or Regulation A offering statement that was the subject of an SEC refusal order, stop order or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine whether such an order should be issued. Similarly, an offering is disqualified if any covered person (as an underwriter of the securities proposed to be issued) was, or was named as, an underwriter of securities under a registration statement or Regulation A offering statement that was the subject of an SEC refusal order, stop order or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine whether such an order should be issued.
- **Suspension or expulsion from membership in an SRO or from association with an SRO member:** Under the rule, an offering is disqualified if any covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, a securities self-regulatory organization or "SRO" (i.e., a registered national securities exchange or national securities association, such as FINRA) for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.
- **U.S. Postal Service false representation orders:** An offering is disqualified if the issuer or another covered person is subject to a U.S. Postal Service false representation order entered within the preceding five years, or to a temporary restraining order or preliminary injunction with respect to conduct alleged to have violated the false representation statute that applies to U.S. mail.

As noted above, many disqualifying events include a look-back period (for example, a court injunction that was issued within the last five years or a regulatory order that was issued within the last ten years). The look-back period is measured from the date of the disqualifying event—in the example, the issuance of the injunction or regulatory order—and not the date of the underlying conduct that led to the disqualifying event.

REASONABLE CARE EXCEPTION

The final rule provides an exception from disqualification when the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering. According to the SEC, the steps an issuer should take to exercise reasonable care will vary according to particular facts and circumstances. The instruction to the rule states that an issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualification exists. In the adopting release, the SEC noted that factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings, may be sufficient in some circumstances, particularly if there is no information or other indicators suggesting bad actor involvement.

WAIVERS

The final rule provides for the ability to seek waivers from disqualification by the SEC for good cause shown. There are a number of circumstances that could, depending upon the specific facts, be relevant to the evaluation of a waiver request. The SEC suggests that interested persons view past applications and waivers granted under Regulation A that are available on-line. Staff in the Office of Small Business Policy is also available to discuss potential waiver concerns over the phone at (202) 551-3460.

Rule 506(d)(2) of Regulation D provides another way for issuers to request a waiver of disqualification. Disqualification will not arise if, before the relevant sale is made in reliance on Rule 506, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing—whether in the relevant judgment, order or decree or separately to the SEC or its staff—that disqualification under Rule 506 should not arise as a consequence of such order, judgment or decree.

DISCLOSURE OF PRE-EXISTING EVENTS

The effective date of the rule amendments was September 23, 2013; therefore matters that occurred before that date will not result in disqualification. However, matters that existed before the effective date of the rule and would otherwise be disqualifying are required to be disclosed in writing to investors. Issuers must furnish this written description to purchasers a reasonable time before the Rule 506 sale. Rule 506 is unavailable to an issuer that fails to provide the required disclosure, unless the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a disqualifying event was required to be disclosed. The rule looks to the timing of the triggering event (e.g., a criminal conviction or court or regulatory order) and not the timing of the underlying conduct. A triggering event that occurs after effectiveness of the rule amendments will result in disqualification, even if the underlying conduct occurred before effectiveness.

The SEC expects that issuers will give reasonable prominence to the disclosure to ensure that information about pre-existing bad actor events is appropriately presented in the total mix of information available to investors.

TRANSITION ISSUES

The rules affect only sales of securities made on or after September 23, 2013. Sales of securities made before the effective date of the bad actor provisions will not be affected by the disqualification and disclosure requirements, even if such sales are part of an offering that continues after the effective date. Only sales made after the effective date of the amendments will be subject to disqualification and mandatory disclosure.

Sales made before the occurrence of the disqualifying event will not be affected by it, but sales made afterward will not be entitled to rely on Rule 506 unless the disqualification is waived or removed, or, if the issuer is not aware of a triggering event, the issuer may be able to rely on the reasonable care exception.

Disqualifying events that exist at the time the offering is commenced but are only discovered later trigger disqualification or a disclosure obligation. Sales will not be eligible for reliance on Rule 506, subject to the application of the reasonable care exception. ■

[Return to Table of Contents]

Cuban Jury to SEC—No Cigar; Heinz Tippees Revealed (But Who Were the Tippers?)

The SEC loses some and wins some insider trading cases:

The SEC's five year old insider trading case against Dallas Mavericks owner, Mark Cuban, came to a sad conclusion for the SEC on Wednesday when a federal jury acquitted Mr. Cuban of insider trading charges.

The SEC had accused Mr. Cuban of insider trading in the securities of Mamma.com, a publicly traded Internet search engine company. According to the complaint, in June 2004, Mr. Cuban sold his entire 600,000 share position in Mamma.com after learning from the CEO that the company was planning to conduct a PIPE offering. The complaint alleged that Cuban avoided losses in excess of $750,000 by selling his stock prior to the public announcement of the PIPE offering.

The SEC alleged that Mr. Cuban verbally agreed to keep confidential and not trade on the information that the CEO gave him about the private offering. Mr. Cuban denied any such agreement and the jury agreed. Possibly hurting the SEC's position was the fact that their main witness, the Mamma.com CEO, did not testify in person.

And now for a win.

The SEC announced that they had come to a settlement with the previously unknown inside traders who pocketed 1.8 million in profits by trading call options in advance of the public announcement of the sale of the H.J. Heinz Company.

The SEC filed an emergency enforcement action earlier this year to freeze assets in a Swiss-based trading account used to reap the illegal trading profits in advance of the Heinz announcement.

In an amended complaint filed earlier this month, the SEC alleged that the order to purchase the Heinz options was placed by Rodrigo Terpins while he was vacationing at Walt Disney World in Orlando, and that the trading was based on material non-public information that he received from his brother Michel Terpins. The trades were made through an account belonging to a Cayman Islands-based entity. Rodrigo Terpins purchased nearly $90,000 in option positions in Heinz the day before the announcement, and those positions increased by more than 20 times the next day.

The Terpins brothers agreed to disgorge the entire $1.8 million in illegal profits made from trading Heinz options. The Terpins brothers also will pay $3 million in penalties.

Interestingly, the amended complaint does not reveal the identity of the "tipper" that provided the information to Michel Terpins, other than to say that the SEC believed that the "information source" had disclosed the information about the pending deal "in breach of a duty." ■

[Return to Table of Contents]

ENDNOTES

1. The term "principal executive officer" includes all individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level. See Item 402(a)(3)(i) of Regulation S-K. [Return to Article]
2. The SEC acknowledged that data privacy laws in various jurisdictions could have an impact on gathering and verifying the data needed to identify the median of the annual total compensation of all employees at multinational companies. However, registrants in this situation would be permitted to estimate the compensation of affected employees. [Return to Article]

QUESTIONS: If you have a question regarding the issues raised in this newsletter, you may obtain additional guidance from the authors and other Blank Rome attorneys listed below.

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