2016 Securities Law Conference

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Kentucky Bar Association Business Law Section

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2016 Securities Law Conference

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October 28, 2016
Louisville, Kentucky

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RULE 14a-8(i)(7) PRACTICE IN THE AFTERMATH OF
TRINITY WALL STREET V. WAL-MART STORES, INC.

Dennis R. Honabach*

I. BACKGROUND

Securities & Exchange Act Rule 14a-8 requires management to include in its proxy any proposal that a "qualified security holder" intends to make at the upcoming meeting of security holders so long as the proposal was "a proper subject for action by the security holders."[1] Although seemingly simple, in concept, the Rule 14a-8 has proved quite troublesome.

Determining who is a "qualified security holder" has not presented any serious difficulties. Under the current rule, any security holder who owns at least $2,000 in market value, or 1 percent of the company's securities, is entitled to vote on the proposal and who has owned those securities for at least one year by the date the security holder submits the proposal meets the ownership requirement.[2] The security holder must continue to hold the securities through the date of the meeting.[3]

Determining what constitutes "a proper subject for action by the security holders," on the other hand, has proved quite difficult. In 1948, the SEC undertook its first step in defining what constituted a "proper purpose" under the shareholder proposal rule by declaring a company could exclude a shareholder proposal that was submitted "primarily for the purpose of enforcing a personal claim or of redressing a personal grievance" against the issuer or its management."[4] Since 1948, the SEC revised Rule 14a-8 several times to add additional bases for excluding a shareholder proposal. The present rule recognizes thirteen grounds for excluding a proposal. The existing thirteen exclusions can be grouped into three categories, although any such grouping is necessarily somewhat arbitrary and subject to overlap. The exclusions contained in Rules 14a-8(i)(2) ("violation of law"), 14a-8(i)(3) ("violations of proxy rules"), 14a-8(i)(8) ("director elections"),

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[1] Rule 12a-8.

[2] Rule 14a-8(b)(1).

[3] *Id.*

[4] Exch. Act Release No. 4185, 13 Fed. Reg. 6678, 1948 WL 28695 at *3. Companies were also permitted to exclude otherwise proper proposals that had been submitted by security holder who had failed without cause to attend a meeting in the prior two years previous to present proposal included by the issuer on its proxy, and to omit otherwise proper proposals that were "substantially the same proposal ... to the security holders for action at the last annual meeting of security holders or at any special meeting held subsequent thereto and received less than three percent of the total number of votes cast in regard to the proposal." *Id.*

14a-8(i)(9) ("conflicts with company's proposal"), 14a-8(i)(10) ("substantially implemented"), 14a-8(i)(11) ("duplication"), 14a-8(i)(12) ("resubmissions"), and 14a-8(i)(13) ("specific amounts of dividends") operate as anti-congestion/anti-confusion provisions.[5] The exclusions contained in Rules 14a-8(i)(4) ("personal grievance") and 14a-8(i)(6) ("absence of power/authority") function as "anti-crackpots" provisions. Finally, the exclusions found in Rules 14a-8(i)(1) ("not a proper subject ... under state law" exclusion), 14a-8(i)(5) ("relevance" exclusion), and 14a-8(i)(7) ("ordinary business" exclusion) operate as forms of merit-based provisions. Not surprisingly, the merit-based exclusions – particularly the "ordinary business" exclusion – have been the category most often litigated. And Rule 14a-8(i)(7)'s "ordinary business" exclusion remains the most troublesome.

Rule 14a-8(i)(7)'s "ordinary business" exclusion first found its way into the proxy rules in 1954 when the Commission added a provision to the shareholder proposal rules permitting management to exclude a proposal that consisted of a recommendation or a request that the management take action with respect to a matter relating to the conduct of the ordinary business operations of the issuer.[6] The core principle of the new exclusion was straightforward. It was intended to prevent a shareholder (or group of shareholders) attempting to involve themselves in the matters which their fellow shareholders had entrusted in management precisely because shareholders as a group lack the expertise and knowledge to make decisions on such matters. In other words, the "ordinary business" exclusion was – and it continues – to function as a brake on shareholder attempts to micromanage the affairs of the corporation.

Following the adoption of the new exclusion, companies relied, as intended, on the "ordinary business exclusion" to exclude proposals dealing with day-to-day business matters. However, they also relied on the exclusion to omit proposals that involved matters of considerable importance to the company and its shareholders. By 1976, the Commission had become concerned that the application of the "ordinary business' exclusion was resulting in a failure of the shareholder proposal rule "to assure to corporate shareholders the ability to exercise their right – some would *say* their duty – to control the important decisions which affect them in their capacity as stockholders."[7] In response, the Commission attempted to tweak the exclusion so as to limit its application. It proposed to amend the rule to permit companies to use the "ordinary business" exclusion to omit a proposal that dealt with a "routine, day-to-day matter relating

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[5] The terminology "anti-congestion/anti-confusion" was coined by Prof Alan R. Palmiter. *See* Alan R. Palmiter, "The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation," 45 Ala. L. Rev. 879, 883 (1994). The groupings used here differ from Professor Palmiter's in some instances.

[6] Exch. Act. Rel. No. 4979, 19 Fed. Reg, 246, 1954 WL 5772 (Jan. 5, 1954).

[7] Proposals by Security Holders – Notice of Proposed Amendments to Rule, Exch. Act. Rel. 34-12598, 41 Fed. Reg. 299282-29984, 1967 WL 160410 (July 7, 1976) (*citing* Medical Committee for Human Rights v. Securities and Exchange Commission, 432 F.2d 659, 680-681 (D.C. Cir. 1970), *vacated and dismissed as moot*, 404 U.S. 403 (1972).

to the conduct of the ordinary business operations of the issuer."[8] Companies, as the Commission indicated, would not be permitted to use the exclusion to omit proposals "involving important business matters, notwithstanding the fact that such matters generally would relate to the conduct of the company."[9] As a guideline, the Commission suggested that mundane matters that would be handled by management personnel without referral to the board of directors generally could be excluded under the revised rule but matters that would have required action by the board would not have been.[10]

Commentators were opposed to the proposed text. In particular, commentators were critical of the proposed director/management test on the grounds that there could be no consistent application of the test because board practices relating to the delegation of authority to management personnel varied greatly.[11] The Commission saw the potential lack of consistency of the proposed standard as a fatal drawback to its proposed scheme. In place of the proposed language, the Commission settled for a minor revision of the text amending the "ordinary business" exclusion to permit a company to exclude a shareholder proposal if it "deals with a matter relating to the conduct of the ordinary business operations of the issuer."[12] But, the Commission noted, in the past the staff had interpreted the term "ordinary business operations" to include certain matters involving significant policy and economic issues. The Commission indicated that going forward that would no longer be the analytical approach used by the Commission and the staff. On the other hand, companies would continue to be permitted to exclude proposals involving "business matters that are mundane in nature and do not involve any substantial policy or other considerations …."[13] Left unanswered was the important question of what constituted a significant policy and economic issue.

Not surprisingly, the staff continued to apply the term "ordinary business operations" inconsistently depending on whether at a particular moment the staff determined that a proposal involved a significant policy or economic issue. The confusion generated by the apparently inconsistent application of Rule 14a-8(i)(7) was exacerbated by the staff's decision in the so-called "Cracker Barrel controversy." In 1992 the staff issued a no-action letter to Cracker Barrel Old Country Stores, Inc., finding that under the "ordinary business" exclusion, the company could exclude a proposal made by the New York City Employee's Retirement System (NYCERS) seeking to have management include in its proxy

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[8] Such matters, the Commission believed, were of "little interest or importance" to most shareholders.

[9] *Id.*

[10] *Id.*

[11] Exchange Act Rel. No. 34-12999, 41 Fed. Reg. 52, 994, 1976 WL 160347 at *10 (Dec. 3, 1976).

[12] *Id.*

[13] *Id.*

materials NYCERS' proposal asking management to add sexual preference to its anti-discrimination policy and asking management to enforce the amended policy.[14] NYCERS had made its proposal in response to the company's announcement that it would not hire gay men or women. NYCERS contended that the "ordinary business" exclusion was not applicable because the proposal involved a substantial policy consideration. What shocked observers was the staff's decision to abandon the case-by-case approach it had been using in favor of a bright-line test left to employment-related proposals. The Commission ultimately reversed that bright-line approach as part of a series of amendments to the shareholder proposal rule adopted in 1998.[15]

The SEC admitted that the return to the case-by-case approach would once again engender difficult interpretative questions. In an apparent attempt to head off some criticisms, the SEC attempted to summarize the principal considerations the staff would use in applying the "ordinary business" exclusion. Recognizing that shareholders cannot as a practical matter decide how to solve ordinary problems, the staff would undertake two inquiries. First, the staff would determine whether the proposal relates solely to those tasks that are so fundamental to management's ability to run the company on a day-to-day basis that they could not be subjected to shareholder oversight or whether the proposal – although touching on day-to-day matters – focuses on significant social policy issues that fall outside the scope of management's decision-making prerogative. Second, the staff would attempt to determine the degree to which the proposal seeks to micromanage the company by delving into matters to such a degree that shareholders could not make an informed decision about the merits of the proposal.[16] The Commission indicated that if the staff determined that a proposal dealt primarily with day-to-day matters or would result in micromanagement by shareholders, it would permit exclusion of the proposal under Rule 14a-8(i)(7). The newly articulated policy ensured that application of the "ordinary business" exclusion would continue to be subjective.[17]

II. THE TRINITY WALL STREET V. WAL-MART STORES, INC. LITIGATION

The recent controversy over Wal-Mart's sale of large capacity rifles which culminated in the decision in Trinity Wall Street v. Wal-Mart Stores, Inc.[18] illustrates the continuing uncertainty regarding the application of Rule 14a-8(i)(7)'s "ordinary business" exclusion. On December 13, 2013, Trinity Wall Street, a Wal-Mart Stores, Inc. shareholder, submitted a proposal to Wal-Mart for

[14] Cracker Barrel Old Country Stores, Inc., SEC No-Action Letter, 1992 WL 289095 *3-*5 (Oct. 13, 1992).

[15] Exchange Act Release No. 40018, 63 Fed. Reg. 29106-01, at 29108, 1998 WL 254809 (May 21, 1998).

[16] 1998 WL 254809 at *4-*5.

[17] Exchange Act Release No. 40018, 63 Fed. Reg. 29106-01, at 29108, 1998 WL 254809 (May 21, 1998).

[18] 792 F.3d 323 (3d Cir. 2015), *cert. dismissed*, 136 S.Ct. 499 (Mem) (2015).

inclusion in its 2013 proxy.[19] The proposal requested Wal-Mart's board of directors amend the charter of its Compensation, Nominating and Governance Committee to add to that committee the duty of:

> Providing oversight concerning the formulation and implementation of, and the public reporting of the formulation and implementation of, policies and standards that determine whether or not the Company should sell a product that:
> 1) specially endangers public safety and well-being;
> 2) has the substantial potential to impair the reputation of the Company; and/or
> 3) would reasonably be considered by many offensive to the family and community values integral to the Company's promotion of its brand.[20]

In its Supporting Statement, Trinity Wall Street stated:

> The proposal, advanced by stockholder Trinity Wall Street, seeks to ensure appropriate and transparent Board oversight of the sale by the company of products that especially endanger public safety and well-being, risk impairing the company's reputation, or offend the family and community values integral to the company's brand.
>
> The company respects family and community interests by choosing not to sell certain products such as music that depicts violence or sex and high capacity magazines separately from a gun, but lacks policies and standards to ensure transparent and consistent merchandizing decisions across product categories. This results in the company's sale of products, such as guns equipped with high capacity magazines, that facilitate mass killings, even as it prohibits sales of passive products such as music that merely depict such violent rampages.
>
> The example of guns equipped with high capacity magazines, which are on sale at the company's stores, is instructive in other ways. There is a substantial question regarding whether these guns are well suited to hunting or shooting sports; it is beyond doubt that they are well suited to mass killing, and tragically more effective for the latter purpose, than are the handguns equipped to fire ten or fewer rounds that the company chooses not to sell except in Alaska. The former reduce opportunities for people to flee or overwhelm a shooter during reloading and have enabled many mass killings, including those at Newtown, Oak Creek, Aurora, Tucson, Fort Hood, Virginia Tech and Columbine.

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[19] Wal-Mart Stores, Inc., SEC No-Action Letter, 2014 WL 409085 (Mar. 20, 2014).

[20] *Id.* at *21.

> While guns equipped with high capacity magazines are just one example of a product whose sale poses significant risks to the public and to the company's reputation and brand, their sale illustrates a lack of reasonable consistency that this proposal seeks to address through Board-level oversight. This responsibility seems appropriate for the Compensation, Nominating and Governance Committee, which is charged with related responsibilities.[21]

Although couched in terms describing all of Wal-Mart's products, the Supporting Statement makes it clear that the real focus of the proposal was Wal-Mart's sale of high-capacity guns. The drafter of the proposal presumably drafted the proposal in general terms to avoid running afoul of earlier No-Action Letters in which the staff had permitted companies to omit "Stop-Sale" proposals targeted at a single product. As it would turn out, that decision may have been a tactical error.

Wal-Mart's reaction to the proposal was predictable. It sought a No-Action Letter from the SEC's staff, arguing that the proposal was excludable under the Rule 14a-8(i)(7). Wal-Mart noted that in its 1998 Release, the Commission had described the underlying policy of the "ordinary business" as an attempt "to confine the resolution of ordinary business problems to management and the board of directors, since it is impracticable for shareholders to decide how to solve such problems at an annual shareholders meeting." Walmart pointed out that in the same Release the Commission had identified two central considerations that underlie this policy. Most relevant here was the concern that "[c]ertain tasks are so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight."[22]

Wal-Mart contended that in calling on the board to establish policies that would govern its decisions whether to sell particular products, the proposal invaded the company's ability to decide which products it might sell. That decision, the company maintained, necessarily involved a consideration of a "myriad factors, including the tastes and preferences of customers, the products offered by the Company's competitors, the laws where the Company's stores and clubs are located and the availability and prices charged by the Company's suppliers."[23] Wal-Mart argued that balancing those interests was a complex issue and was so fundamental to management's ability to run the company on a day-to-day basis that it could not, as a practical matter, be subject to direct shareholder oversight.[24]

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[21] *Id.*

[22] *Id.*

[23] *Id.* at *10.

[24] *Id.* at *12-*13.

Wal-Mart's position found support in a number of earlier No-Action Letters in which the staff had permitted companies to omit proposals calling for a company to cease selling a particular product or line of products.[25] Anticipating Trinity Wall Street's argument that preventing gun violence raised a significant social policy concern and thus did not interfere with the company's ordinary business, Wal-Mart argued that by requesting the board to adopt policies that would govern its sale of all of its products that could conceivably "endanger public safety and well-being. . . impair the reputation of the Company" or "would reasonably be considered by many offensive to. . . family and community values," the proposal "extended far beyond any significant policy issue raised by gun violence."[26] Finally, Wal-Mart argued that because it was a retailer rather than a manufacturer of guns, the proposal inevitably dealt with the day-to-day decision of what products to sell.[27]

In response, Trinity Wall Street contended that its proposal was not excludable under the "ordinary business" exclusion because it dealt with "matters of corporate governance in that it called for board oversight of important merchandizing policies," and not the ordinary business of the company.[28] Trinity Wall Street also pointed out that the proposal dealt with "creating standards for avoiding community harm while fostering public safety and corporate ethics and thus did not relate exclusively to any individual product."[29] Finally it argued that its proposal raised "substantial issues of public policy, namely a concern for the safety and welfare of the communities served by the Company's stores."[30]

Trinity Wall Street emphasized that its proposal, if adopted, would not result in shareholders meddling in day-to-day business matters. Rather, it contended, adoption of the proposal would result in the board of directors acting to adopt appropriate company polices.[31] Trinity Wall Street sought to distinguish the precedents cited by Wal-Mart on the ground that unlike the proposals in those actions, its proposal did not deal with a particular product or product line.[32] Finally Trinity Wall Street described Wal-Mart's argument that it could exclude the proposal simply because it was a retailer rather than a manufacturer as "contrary

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[25] *See e.g.* Marriott Int'l Inc. SEC No Action Letter, 2004 WL 7211593 (Feb. 13, 2004) (permitting company to omit proposal calling for the company to adopt and enforce a policy at its owned and managed properties that prohibited the sale of sexually-explicit material.)

[26] 2014 WL 409085 at *3.

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.* at *4.

[32] Wal-Mart Stores, Inc. SEC No-Action Letter, 2014 WL 409085.

to common sense because merchandizing decisions can raise public social policy issues every bit as much as manufacturing decisions."[33]

On March 24, 2014, the staff somewhat predictably issued Wal-Mart its requested no-action letter.[34] Trinity Wall Street responded by seeking a declaratory judgment that Wal-Mart's decision to exclude its proposal violated Rule 14a-8.[35] It also sought a preliminary injunction to prevent Wal-Mart from issuing its 2014 proxy without including its proposal and a permanent injunction to prevent Wal-Mart from excluding the same proposal from its 2015 proxy materials.[36]

Faced with a very short deadline, the district court denied Trinity Wall Street's request for a preliminary injunction. The court determined that Trinity Wall Street had failed to meet its burden of showing a likelihood of success on the merits.

On November 26, 2014, Judge Stark issued his full opinion on the exclusion of Trinity Wall Street's proposal from Wal-Mart's 2014 proxy materials.[37] He noted that in its 1998 Release, the Commission had indicated the policy underlying the ordinary business exclusion was based on two central considerations: (1) the issue of the subject matter of the proposal; and (2) the question of whether the proposal dealt with matters so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight. On the other hand, the Commission had indicated that proposals focusing on sufficiently significant social policy issues (*e.g.,* significant discrimination matters) generally would not be considered to be excludable, because the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote. This second consideration focuses on the degree to which the proposal seeks to "micro-manage" the company.[38] Judge Stark concluded that because Trinity Wall Street's proposal only requested the board to create policies regarding the products to sell, it did not "undermine the policy underlying the ordinary business exclusion."[39] Moreover, he found, the proposal "focused on

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[33] *Id.* at *7.

[34] Wal-Mart Stores, Inc. SEC No-Action Letter, 2014 WL 409085.

[35] 75 F.Supp.3d. 617 (D. Del. 2014).

[36] *Id.* at 622.

[37] *Id.* at 625. Judge Stark ruled that he had jurisdiction to decide on the exclusion of the proposal from Wal-Mart's 2014 proxy under the "capable of repetition, yet evading review" doctrine recognizing that the short duration of the proxy season made full litigation on the merits of a shareholder proposal nearly impossible. *Id.* at 625-627. He concluded, however, that he did not have jurisdiction to rule on Trinity Wall Street's intent to resubmit its proposal in the upcoming proxy season. *Id.* at 628.

[38] *Id.* at 629.

[39] *Id.* at 630.

sufficiently significant social policy issues" – the social and community effects of sales of high capacity firearms at the world's largest retailer and the impact this could have on Wal-Mart's reputation, particularly if such a product sold at Wal-Mart is misused and people are injured or killed.[40] As a result, Judge Stark concluded that Trinity Wall Street's proposal transcended the day-to-day business matters and raised policy issues so significant that it would be appropriate for a shareholder vote. Finally, Judge Stark concluded that the proposal did not seek to "micro-manage" Wal-Mart or "probe too deeply into of [sic] a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment."[41] Therefore, Judge Stark concluded, the proposal was not excludable under the ordinary business exclusion.[42]

Wal-Mart appealed Judge Stark's decision, arguing once again that Trinity Wall Street's proposal was excludable under the "ordinary business" exemption and under Rule 14a-8(i)(3) because it was "vague" or "indefinite." Wal-Mart contended that in finding that Trinity Wall Street's proposal did not deal with the company's ordinary business because it directed the board of directors and not management to take an action, the district court had "wholly ignored the SEC's guidance from 1976 and 1983 making it clear that it is the underlying subject matter of a shareholder proposal, not the form of the requested action, that is dipositive in determining whether a proposal is excludable under Rule 14a-8(i)(7)."[43] Wal-Mart also contended that because it was a retailer, the proposal necessarily dealt with day-to-day business activities. It maintained that if implemented, the proposal would affect its choice of products it sells. Wal-Mart contended that the SEC had continuously refused to sanction proposals that dealt with the mix of products a retailer sold as opposed to the products a manufacturer made.[44] It furthered argued that the proposal did not fall within the "significant social policy issue" exception to Rule 14a-8(i)(7) because it did not focus on the issue of gun violence but rather merely implicated it.[45] Wal-Mart further maintained that even if Trinity Wall Street's proposal were deemed to raise a substantial policy regarding the sale of high capacity firearms, it was still excludable because "Wal-Mart, as a retailer, does not have a 'sufficient nexus' to the firearms that the Proposal references."[46] Finally, Wal-Mart asserted that if the decision of the district court were affirmed the "exceptions created by the court would swallow the rule, undo nearly forty years of SEC guidance on Rule 14a-

[40] *Id.* at 630-631.

[41] *Id.* at 631.

[42] *Id.* at 630. Judge Stark also rejected Wal-Mart's argument that Trinity Wall Street's proposal was excludable under Rule 14a-8(i)(3) because it was vague and indefinite. *Id.* at 633.

[43] Appellant's Opening Brief, 2015 WL 309194 at *6.

[44] *Id.* at 36.

[45] *Id.* at 30.

[46] *Id.* at 34.

8(i)(7), and flood public companies with proposals that [sic] subject to shareholder vote decisions regarding ordinary business matters."[47]

In its response to Wal-Mart's arguments, Trinity Wall Street explained that its mission included pursuing good works beyond the reach of other religious institutions. One of those missions, it maintained, is reducing violence in society. In light of this mission, Trinity Wall Street explained that it was deeply concerned by the recent proliferation of mass killings and the way in which the use of guns with high capacity magazines has contributed to those killings.[48] Trinity Wall Street maintained Judge Stark had correctly concluded that its proposal was not excludable because it was a governance proposal to amend the charter of a Board committee and thus dealt with the company's policies, not its day-to-day business.[49] Trinity Wall Street also argued that even if the court were to conclude that it dealt with matters of ordinary business exclusion, its proposal fell within the exception to Rule 14a-8(i)(7) because it raised a significant policy issue that was appropriate for a shareholder vote.[50] Trinity Wall Street described the issue as "whether a mass market retailer such as Wal-Mart should meet customer demand for products like guns equipped with high capacity magazines that are especially dangerous to the reputation, brand value of the Company, and/or the safety of the community it seeks to serve."[51]

Unpersuaded by Trinity Wall Street's arguments, the Court of Appeals reversed the district court's decision.[52] The members of the court unanimously agreed that Trinity Wall Street's proposal was excludable under Rule 14a-8(i)(7) because it dealt with the "ordinary business" of the company and that it did not fall within the "significant social policy" exception to that exclusion. There, however, was significant disagreement among the judges as to what the proper test was for making those decisions.

Writing for the majority, Judge Ambro first laid out the facts and procedural history of the case and the regulatory background.[53] His discussion of the history

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[47] *Id.* at 19.

[48] Trinity Wall Street further explained that it had discussed the issue of the sale of large capacity firearms with Wal-Mart and its lack "of written policies and Board oversight concerning its approach to products that could have momentous consequences for both society and corporate reputation and brand value." It was only when those discussions became fruitless that Trinity Wall Street had filed its proposal under Rule 14a-8. *Id*.

[49] *Id.* at *25.

[50] *Id.*

[51] *Id.* Trinity Wall Street maintained its proposal was not excludable under Rule 14a-8(i)(3) as its purpose was clear and neither the company nor its shareholders would find it ambiguous. *Id.* at *26.

[52] 792 F.3d 323 (3rd Cir. 2015).

[53] *Id.* at 327-340.

of the Rule 18a-8(i)(7) "ordinary business" exclusion[54] should be mandatory reading for any lawyer grappling with the exception for the first time. In determining whether Trinity Wall Street's proposal dealt with the company "ordinary business," Judge Ambro announced the court would apply a two-part test: (1) first it would determine the subject matter of the proposal; and (2) then determine whether that subject matter is related to the company's ordinary business. Even if the court determined that the subject matter of the proposal did relate to Wal-Mart's ordinary business of the company, the court would nevertheless not permit the proposal to be excluded unless Wal-Mart was able to prove that the proposal did not raise "a significant social policy issue that *transcends* the nuts and bolts of the retailer's business (emphasis added)."

Turning to the first issue, the subject matter of the proposal, Judge Ambro indicated that it was the substance of the proposal and not its form that mattered. "Clever drafting," he indicated, would not be determinative.[55] Judge Ambro believed that the district court had:

> . . . put undue weight on the distinction between a directive to management and a request for Board action. In the District Court's view, if the proposal had directed management to arrange its product assortment in a certain way, it would have been excludable. But because it merely asked the "***Board*** [to] oversee the development and effectuation of a Wal-Mart policy," it was not." (Emphasis in original.)[56]

Judge Ambro noted that in adopting this line of reasoning the district court had adopted the approach that the SEC had explicitly rejected in 1976.[57]

Judge Ambro also rejected Trinity Wall Street's contention that the purpose of its proposal was to improve "corporate governance over strategic matters of community responsibility, reputation for good corporate citizenship, and brand reputation, none of which can be considered ordinary business."[58] Judge Ambro dismissed that explanation, stating that "[t]he subject matter of the proposal is instead its *ultimate* consequence – here a potential change in the way Wal-Mart decides which products to sell."[59] Judge Ambro concluded:

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[54] *Id.* at 333-340.

[55] *Id.* at 342.

[56] *Id.*

[57] *Id.* Actually, the SEC proposed the adoption of such an approach in its 1976 proposing release but rejected it in the 1976 Adopting Release Rel.34-12999 Adoption of Amendments Relating to Proposals by Security Holders, 1976 WL 160347 at *12.

[58] 792 F.3d at 342.

[59] *Id.*

> For us, the subject matter of Trinity Wall Street's proposal is how Wal-Mart approaches merchandising decisions involving products that (1) especially endanger public-safety and well-being, (2) have the potential to impair the reputation of the Company, and/or (3) would reasonably be considered by many offensive to the family and community values integral to the company's promotion of the brand. A contrary holding – that the proposal's subject matter is "improved corporate governance" – would allow drafters to evade Rule 14a-8(i)(7)'s reach by styling their proposals as requesting board oversight or review.[60]

Judge Ambro rejected the latter approach.

Having determined the subject matter of the proposal, Judge Ambro turned to the question of whether the proposal related to Wal-Mart's ordinary business. On that point, Judge Ambro agreed with Wal-Mart's contention that Trinity Wall Street's proposal was simply an attempt to hold a shareholder referendum on how Wal-Mart selected its inventory. He noted that a retailer's decisions about which products it sells "is the bread and butter of its business." Citing the *amicus* brief by the National Association of Manufacturers,[61] he noted, "[p]roduct selection is a complicated task influenced by economic trends, data analytics, demographics, customer preferences, supply chain flexibility, shipping costs and lead-times, and a host of other factors best left to companies' management and boards of directors."[62] Finding that the proposal did relate to Wal-Mart's ordinary business, he noted it was excludable unless an exception to the exclusion applies.[63]

Turning to the question of whether Trinity Wall Street could avail itself of the "significant social policy" exception, Judge Ambro took guidance from the SEC Staff in Legal Bulletin No. 14E. There the staff had explained that when "a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote, the proposal generally will not be excludable under Rule 14a-8(i)(7) as long as a sufficient nexus exists between the nature of the proposal and the company."[64] Judge Ambro admitted that discerning whether a proposal that focuses on a significant social policy transcends a company's ordinary business is no easy task. "No doubt the calculus is complex. Yet we cannot sidestep what some may deem an unreckonable area. Thus we wade in."[65] He divided the analysis into two steps: (1) Determining whether the

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[60] *Id.* at 344.

[61] Brief for the National Association of Manufacturers as *Amicus Curiae* in Support of Appellant, 2015 WL 416653 at 12.

[62] *Id.* at 344.

[63] *Id.*

[64] SEC Staff Legal Opinion No.14E (CF), 2009 WL 4363205 at *2.

[65] 792 F.3d at 345.

proposal focuses on a significant social policy (be it social or, as noted below, corporate); and (2) if it does, determining whether that significant social policy transcends the company's ordinary business operations.[66] Turning to the first inquiry, Judge Ambos [sic] rejected Wal-Mart's argument that Trinity Wall Street's proposal did not focus on a significant social policy. But he also rejected the district court's conclusion that the proposal focused on the "social and community effects of the sale of high capacity firearms by the world's largest retailer." He noted that even Trinity Wall Street conceded that its proposal was focused on the broader issue of merchandising decisions of all products dangerous to the reputation, brand value, and community Wal-Mart should consider. While Wal-Mart asserted that the focus of the proposal was much too broad a concept of social policy, Judge Ambro, apparently applying what he described as the SEC's "we know it when we see it policy," concluded that Trinity Wall Street's proposal did raise concerns about a significant policy issue.[67]

Having determined that Trinity Wall Street's proposal raised concerns about a significant policy issue, Judge Ambro turned to the second step in his analysis – did that policy issue transcend Wal-Mart's ordinary business operations. As support for his imposition of the additional "transcendence" requirement, Judge Ambro turned again to the SEC staff's guidance. He noted that in Legal Bulletin No. 14E, the staff had stated that when "a proposal's underlying subject matter *transcends* the day-to-day business matters of the company *and* raises policy issues so significant that it would be appropriate for a shareholder vote, the proposal generally will not be excludable under Rule 14a-8(i)(7)."[68] (Emphasis added in original). Thus, Judge Ambro concluded, to render the ordinary business exclusion inapplicable, a shareholder must demonstrate both that its proposal focuses on a significant policy issue and that the subject matter of the proposal transcends the company's ordinary business.[69] Judge Ambro indicated that he believed the Commission had used the term "transcend" to refer to policy issues that are divorced from how a company approaches the nitty-gritty of its core business.[70] "For major retailers of myriad products," – Judge Ambro opined, "a policy issue is rarely transcendent if it treads on the meat of management's responsibility: crafting a product mix that satisfies consumer demand."[71] Elaborating on the "principles" he had thus developed, Judge Ambro pointed to the difference in treatment given by staff to stop-selling proposals sent to retailers and those sent to pure-play manufacturers. The latter are much more likely to transcend the companies' business, he indicated, and the staff had generally not permitted companies to exclude such proposals. On the other hand, staff had generally issued "No-Action" letters to retailers that had received stop-selling

[66] *Id*.

[67] *Id.* at 346.

[68] *Id*. (*citing* SEC Staff Legal Opinion No.14E (CF), 2009 WL 4363205).

[69] *Id.* at 347.

[70] *Id.* at 346-347.

[71] *Id.* at 347.

proposals. Judge Ambro thought that the different treatment was based on the fact that proposals to pure-play companies generally go to the very existence of the company which was not the case with respect to retailers.[72]

Turning to Trinity Wall Street's proposal, Judge Ambro concluded that consideration of the risk that certain of its products posed to its "economic success" and its "reputation for good citizenship" was intricately enmeshed in the way Wal-Mart runs its business. He then added "whether to put emphasis on brand integrity and brand protection, or none at all, is naturally a decision shareholders as well as directors entrust management to make in the exercise of their experience and business judgment."[73] He stated that a company can omit a shareholder proposal concerned with its reputation when that proposal is woven with the way the company does business. He opined that even if Trinity Wall Street's proposal raised sufficiently significant social and corporate policy issues, those issues did not transcend the ordinary business operations of Wal-Mart.[74] Finally, Judge Ambro concluded that "for a policy issue to transcend Wal-Mart's business operations, it must target something more than the choosing of one among tens of thousands of products it sells."[75] Judge Ambro ruled that Trinity Wall Street's proposal failed that test and thus was excludable under Rule 14a-8(i)(7).[76]

Judge Shwartz, who concurred with Judges Ambro and Vanaskie on the outcome, took a very different analytical approach to the application of the "ordinary business" exclusion. She rejected the approach adopted by Judges Ambro and Vanaskie, believing it to be so broad that it would permit companies to exclude proposals that shareholders should be permitted to consider.[77] Judge Shwartz rejected the majority's belief that whether a proposal focused on an issue that is socially significant is not a separate and distinct inquiry from whether the proposal transcends a company's ordinary business.[78] Rather than following the SEC's guidance, she maintained, the majority's test actually ignored the SEC guidance. She maintained that the majority's two-step analysis was inconsistent with both the SEC's guidance and underlying purpose of §14 of the Securities Exchange Act of 1934.[79] Rather, she believed, shareholders should be permitted

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[72] *Id.* 349-350.

[73] *Id.* at 350.

[74] *Id.* at 351.

[75] *Id.*

[76] *Id.*

[77] *Id.* at 353.

[78] *Id.*

[79] *Id.*

to vote on important social issues even if those issues were closely related to the ordinary business of the company.[80]

Having distanced herself from the majority's test, Judge Shwartz nevertheless found that Wal-Mart could exclude Trinity Wall Street's proposal because she determined that it lacked the focus needed to trigger the significant social policy exception to the "ordinary business" conclusion.[81] Ironically, she thought the proposal failed because it did not focus exclusively on the sale of firearms. Instead, had Trinity drafted its proposal to focus solely on the sale of high capacity firearms, Judge Shwartz would not have found the proposal excludable.[82]

III. THE AFTERMATH OF TRINITY WALL STREET V. WAL-MART STORES, INC.

The Trinity Wall Street majority's two-step test for determining the applicability of Rule 14a-8(i)(7)'s "ordinary business" exclusion is anything but an example of clarity. One commentator has concluded the court's approach "lacks administrability, predictability, and certainty."[83] The court's attempt to bifurcate the "significant social policy" analysis into a "social policy" prong and a "transcendence" prong is not easily applied. Indeed, one can argue that its analysis of the lack of "transcendence" of the Trinity Wall Street proposal seems little [sic] than a series of examples and a conclusion. In addition, in the court's attempt to advocate for a case-by-case approach to resolving the question of the applicability of proposals such as that made by Trinity Wall Street, the court appeared to adopt a bright-line test applicable to "stop sale" proposals received by retailers pursuant to which all such proposals would be excludable. Perhaps, the most enlightening and accurate statement of the court in Trinity Wall Street is the majority's penultimate paragraph in which Judge Ambro announced:

> Although a core business of courts is to interpret statutes and rules, our job is made difficult where agencies, after notice and comment, have hard-to-define exclusions to their rules and exceptions to those exclusions. For those who labor with the ordinary business exclusion and a social-policy exception that requires not only significance but "transcendence," we empathize. Despite the substantial uptick in proposals attempting to raise social policy issues that bat down the business operations bar, the SEC's last word on the subject came in the 1990s, and we have

[80] *Id.* at 354.

[81] *Id.*

[82] Judges Shwartz and Vanaskie also found that Trinity Wall Street's proposal was also excludable under Rule 14a-8(i)(3) as vague and ambiguous, a question Judge Ambro did not address.

[83] Stephen M. Bainbridge, "Revitalizing SEC Rule 14a-8's Ordinary Business Exemption: Preventing Shareholder Micromanagement by Proposal," UCLA School of Law, Law-Econ Research Paper No. 16-06 (March 29, 2016), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2750153 at 7.

> no hint that any change from it or Congress is forthcoming. As one former SEC commissioner has opined, "it is neither fair nor reasonable to expect securities experts [like the Commission and its staff] to deduce the prevailing wind on public policy issues that have yet to be addressed by Congress in any decisive fashion." (citation omitted) That remains true today.[84]

Judge Ambro ended his opinion with a call for the SEC to revise its proxy regulations and to issue new guidance.[85]

The Commission was quick to respond. On October 22, 2015, the Division of Finance Staff published Legal Bulletin No. 14H (CF).[86] There the Division rejected the two-prong test adopted by the majority in Trinity Wall Street. Instead, the Division, agreeing with Judge Shwartz's concurring opinion, noted:

> [T]he Commission has stated that proposals focusing on a significant policy issue are not excludable under the ordinary business exception "*because* the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote." (Citation omitted.) Thus, a proposal may transcend a company's ordinary business operations even if the significant policy issue relates to the "nitty-gritty of its core business." Therefore, proposals that focus on a significant policy issue transcend a company's ordinary business operations and are not excludable under Rule 14a-8(i)(7). (Citation omitted.)

The Division announced that when considering requests for No-Action Letters on the basis of Rule 14a-8(i)(7)'s "ordinary business," it would continue to apply Rule 14a-8(i)(7) "as articulated by the Commission and consistent with the Division's prior application of the exclusion, as endorsed by the concurring judge."[87]

The result appears to be something of a standoff between the Third Circuit and the Commission on the application of Rule 14a-8(i)(7) although the most likely result is that courts will defer to the staff's guidance. But, given that the

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[84] *Id.* at 351.

[85] The ironic post-script to the Trinity Wall Street/Wal-Mart litigation is that on August 26, 2015 – just seven weeks after the Court of Appeals announced its decision – Wal-Mart announced that it would stop the sale of all high-power rifles, including those with high capacity magazines. Hiroko Tabuch, "Walmart to End Sales of Assault-Style Rifles in U.S. Stores," The N.Y. Times, August, 26, 2015, available at http://www.nytimes.com/2015/08/27/business/walmart-to-end-sales-of-assault-rifles-in-us-stores.html?_r=0. For many, that decision will be seen as a victory for Trinity Wall Street.

[86] Available at https://www.sec.gov/interps/legal/cfslb14h.htm. *See* Appendix A for a copy of the relevant text.

[87] *Id.*

Commission-announced approach would narrow the availability of the exclusion, one can expect some companies to press both the Commission and the courts to adopt the Third Circuit's two-prong test.

In the meanwhile, since the decision in Trinity Wall Street, the SEC staff has issued eighty-five no-action letters in which the application of Rule 14a-8(i)(7) has been raised. The staff granted the requested no-action letter in forty-five of those decisions. Only three raised the Trinity Wall Street issue directly. In the first, a shareholder of Amazon.com, Inc., submitted a proposal calling for the company to issue a report addressing animal cruelty in its supply chain, and the company's policies on not selling products that involve animal cruelty.[88] Consistent with the policy announced in Staff Legal Bulletin No. 14H (CF), the SEC issued the requested no-action letter, noting that the sale of particular products and services are generally excludable under Rule 14a-8(i)(7).

More interesting are the staff's response to two requests for no-action letters by companies intending to exclude proposals specifically raising the issue of the sale of guns. In the first action, the shareholder – Trinity Wall Street again – submitted a proposal to Cabela Incorporated asking the company's board of directors to adopt a policy to not "sell (other than to police departments and other military and law enforcement agencies) weapons capable of discharging more than eight shells without reloading to general customers and to limit the sale of such guns."[89] In phrasing its proposal to ban the sale of high capacity weapons, Trinity Wall Street attempted to address Judge Shwartz's observation in Trinity Wall Street that its proposal had lacked the focus needed to trigger the significant social policy exception to the "ordinary business" exception. In its Supporting Statement Trinity Wall Street emphasized that its proposal was a response to the widespread problem of gun violence. It cited the shootings at Newtown, Oak Creek, Aurora, Tucson, Fort Hood, Virginia Tech, Emanuel AME Church, and the Planned Parenthood office in Colorado as evidence of the significant nature of its request.[90] Given the widespread concerns raised by those incidents of violence, it seems difficult to conclude that this time Trinity Wall Street had not raised a "significantly social" issue.

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[88] 2016 WL 246958 (S.E.C. No-Action Letter Mar. 11, 2016).

[89] 2016 WL 406281 (S.E.C. No-Action Letter Apr. 7, 2016) The text of the proposal was:

RESOLVED:

Consistent with the Company's commitment in its Business Code of Conduct & Ethics to "make business decisions not based only on financial risk and reward, but also on the impact to people, communities and the environment," and with Cabela's being a store for outdoor enthusiasts and their families, shareholders ask the Board of Directors to adopt and oversee the implementation of a policy to continue to sell handguns and rifles discharging up to eight shells without reloading, weapons connected to the sports of hunting and marksmanship, and not to sell (other than to police departments and other military and law enforcement agencies of government) firearms capable of discharging more than 8 shells without reloading, the weapons of choice for mass killings and illegal gun violence ("high-capacity weapons").

[90] *Id.* at *15.

Cabela nevertheless argued that it could omit the proposal under the "ordinary business" exclusion because the staff had consistently permitted companies to exclude proposals concerning the content and sale of products.[91] Cabela also argued that Trinity Wall Street could not avail itself of the "significant policy" exception to the "ordinary business" exclusion because it is a retailer and not a manufacturer of guns, noting that "[t]o the extent the Proposal touches upon any significant policy issue, the relationship between the significant policy issue and the Company's sale of certain firearms as a retailer is not sufficiently significant to preclude exclusion of the Proposal."[92] The underpinning for this conclusion is not clear. At best, it seems to assume the existence of a bright-line rule that proposals to retailers of products simply cannot raise transcendent social policy issues regarding the sale of particular products. The staff granted Cabela's request for a no-action letter, concluding that "[p]roposals concerning the sale of particular products and services are generally excludable under Rule 14a-8(i)(7)."[93]

On the same day it granted Cabela its requested no-action letter, the staff also dealt with a request by The Kroger Company for a no-action letter with respect to its decision to omit a proposal by Domini Social Equity Fund urging Kroger's board of directors to adopt a policy by December, 2016 that would ban the sale of semi-automatic firearms and accessories at all company owned and operated stores.[94] As did Wal-Mart and Cabela, Kroger contended that it could exclude the proposal pursuant to Rule 14a-8(i)(7) because the decision of what products and services it offers for sale is a matter relating to a retailer's ordinary business operations so inherently complex that it [sic] beyond the ken of shareholders.[95] It also argued that the Commission's consistent approach had been to not permit shareholders to exercise direct oversight of a retail company's product mix and that the proposal sought to micromanage the company activities because it sought to set a specific time-frame for board action. Again the staff agreed, noting as it did in Cabela, "[p]roposals concerning the sale of particular products and services are generally excludable under Rule 14a-8(i)(7)."[96]

In neither Cabela nor Kroger did the staff offer an explanation of what it meant when it stated that "proposals concerning the sale of particular products and

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[91] *Id.* at *16.

[92] *Id.* at *19.

[93] *Id.* at *1.

[94] The Kroger Co., 2016 WL 1426713 (S.E.C. No-Action Letter, Apr.7, 2016.) Although known primarily as an operator of supermarkets, Kroger also owns Fred Meyers stores, some of which sell firearms. The proposal read as follows:

> **Resolved**: Shareholders of Kroger (the "Company") urge the Board of Directors to adopt a policy to ban the sale of semi-automatic firearms and accessories at all company owned and operated stores. The policy should be adopted, and reported to shareholders, by December, 2016.

[95] *Id.* at *61.

[96] *Id.* at *1.

services are *generally* excludable under Rule 14a-8(i)(7)." (Emphasis added.) The term *generally* implies that some "stop-sale" proposals received by retailers would not be excludable. That proposals calling for a retailer to stop selling this or that product because a shareholder believes it to be unprofitable or to stop selling a product because a shareholder believes the sale of the product is inconsistent with the image of the company[97] would indeed seem to be excludable. Gun violence, on the other hand, surely has become a significant policy issue. It is not clear why a proposal asking the company board of directors to reconsider whether its decision to continue to include guns in its inventory of products for sale would seem to raise an issue that extends beyond the type of proposal concerning the sale of products that is excludable.

IV. THE FUTURE OF RULE 14A-8(I)(7)'S "ORDINARY BUSINESS" EXCLUSION

Trinity Wall Street and its aftermath has done little to clarify the application of Rule 14a-8(i)(7)'s "ordinary business" exclusion and the future of the exclusion remains unclear. As noted above, the two-part test announced by the court in Trinity Wall Street has not been well received by commentators.[98] Professor Bainbridge's conclusion that the court's approach "lacks administrability, predictability, and certainty" is spot on. On the other hand, Judge Shwartz's approach in her concurring opinion effectively reinstates the previous test with all of its uncertainty. Staff Legal Bulletin No. 14H (CF) offers no additional clarification. The somewhat rote responses of the staff to recent "no-sale" proposals received from retail companies has only further muddied the water as they seemingly adopt a bright line test that despite the protestations to the contrary treat retail companies differently from manufacturing companies while offering no coherent rationale for the distinction.

The current approach places the SEC staff in the untenable position of determining what is and is not a "significant social policy" issue. While it is not surprising that the staff has been prone to gravitate toward – or perhaps lurch toward – one bright line approach to another, the newest bright line treating "stop sale" proposals received by retailers differently than those received by manufacturers seems no more tenable than the position taken by the staff in the Cracker Barrel controversy. No one will be surprised to see a replay of that saga.

The uncertainty regarding the application of the "ordinary business" exclusion is, as noted above, not new. Perhaps the problems stem from the very premise of Rule 14a-8 itself. Professor Bainbridge has argued the rule is based on the

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[97] *E.g.* Marriott Int'l Inc. SEC No Action Letter, 2004 WL 7211593 (Feb. 13, 2004) (permitting company to omit proposal calling for the company to adopt and enforce a policy at its owned and managed properties that prohibited the sale of sexually-explicit material.)

[98] *See e.g.* Stephen M. Bainbridge, "Revitalizing SEC Rule 14a-8's Ordinary Business Exemption: Preventing Shareholder Micromanagement by Proposal," UCLA School of Law, Law-Econ Research Paper No. 16-06 (March 29, 2016), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2750153; J. Robert Brown, Jr., "Trinity Wall Street v. Wal-Mart Stores, Inc: Judicial Rewriting of the Proxy Rules (Part 2),", available at http://www.theracetothebottom.org/home/trinity-wall-street-v-wal-mart-stores-inc-judicial-rewriting-1.html.

misconceived "Shareholder Primacy" model of the corporation.[99] He would substitute a test that renders excludable any proposal that tracks state corporate law in that matters that are within the discretion of senior management, *i.e.* the selection of which products to sell, would be deemed to be ordinary matters while matters that only the board or the corporation's shareholders can resolve would be deemed to be extraordinary.[100] On the other hand, those who adhere to the Shareholder Primacy Model see the uncertainty as a product of an unwarranted fear that shareholders are intent on micromanaging corporations. These advocates might find attractive the former SEC Commissioner's conclusion that the solution is to eliminate the "ordinary business exception" entirely.[101]

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[99] Bainbridge *supra* note 113 at 7.

[100] *Id.* at 36-37.

[101] Harvey Pitt, "Remarks before the Council of Institutional Investors' Fall Conference," (Sept. 23, 2002) (available at https://www.sec.gov/news/speech/spch582.htm).

. . .

C. Rule 14a-8(i)(7)

In Trinity Wall Street v. Wal-Mart Stores, Inc., the U.S. Court of Appeals for the Third Circuit addressed the application of Rules 14a-8(i)(3) and 14a-8(i)(7).[23] Reversing a decision by the U.S. District Court for the District of Delaware which ruled that a shareholder proposal could not be excluded, a three-judge panel held that a shareholder proposal submitted to Wal-Mart Stores, Inc. ("Wal-Mart") was excludable under Rules 14a-8(i)(3)[24] and 14a-8(i)(7). The staff had previously agreed that Wal-Mart could exclude the proposal under Rule 14a-8(i)(7).[25]

In analyzing whether the proposal was excludable under Rule 14a-8(i)(7), the Third Circuit concluded that the proposal's subject matter related to Wal-Mart's ordinary business operations – specifically, "a potential change in the way Wal-Mart decides which products to sell." This conclusion was the same as our conclusion when responding to Wal-Mart's no-action request. We believe our analysis in this matter is consistent with the views the Commission has expressed on how to analyze proposals under the ordinary business exclusion, *i.e.,* the analysis should focus on the underlying subject matter of a proposal's request for board or committee review regardless of how the proposal is framed.[26]

The panel also considered whether the significant policy exception to the ordinary business exclusion applied. The majority opinion employed a new two-part test, concluding that "a shareholder must do more than focus its proposal on a significant policy issue; the subject matter of its proposal must 'transcend' the company's ordinary business."[27] The majority opinion found that to transcend a company's ordinary business, the significant policy issue must be "divorced from how a company

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[23] Rule 14a-8(i)(3) permits a company to exclude a shareholder proposal "[i]f the proposal or supporting statement is contrary to ... [Rule] 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials" and Rule 14a-8(i)(7) permits a company to exclude a shareholder proposal "[i]f the proposal deals with a matter relating to the company's ordinary business operations."

[24] Two judges concluded that the proposal could be excluded under Rule 14a-8(i)(3). The Division was not asked to express a view on the application of Rule 14a-8(i)(3) to this proposal in the no-action process and therefore we do not express a view in this bulletin.

[25] Wal-Mart Stores, Inc. (Mar. 20, 2014). In our view, the proposal was excludable because it related to the company's ordinary business operations and did not focus on a significant policy issue.

[26] Release No. 34-20091 (Aug. 16, 1983).

[27] Trinity, 792 F.3d at 346-347.

approaches the nitty-gritty of its core business."[28] This two-part approach differs from the Commission's statements on the ordinary business exclusion and Division practice.

In contrast, the concurring judge analyzed Rule 14a-8(i)(7) in a manner consistent with the approach articulated by the Commission and applied by the Division, including in Wal-Mart's no-action request. Summarizing the Commission's history on this exclusion, the judge noted that "whether a proposal focuses on an issue of social policy that is sufficiently significant is not separate and distinct from whether the proposal transcends a company's ordinary business. Rather, a proposal is sufficiently significant 'because' it transcends day-to-day business matters."[29] The judge also explained that the Commission "treats the significance and transcendence concepts as interrelated, rather than independent."[30]

Although we had previously concluded that the significant policy exception does not apply to the proposal that was submitted to Wal-Mart, we are concerned that the new analytical approach introduced by the Third Circuit goes beyond the Commission's prior statements and may lead to the unwarranted exclusion of shareholder proposals. Whereas the majority opinion viewed a proposal's focus as separate and distinct from whether a proposal transcends a company's ordinary business, the Commission has not made a similar distinction. Instead, as the concurring judge explained, the Commission has stated that proposals focusing on a significant policy issue are not excludable under the ordinary business exception "*because* the proposals would transcend the day-to-day business matters and raise policy issues so significant that it would be appropriate for a shareholder vote."[31] Thus, a proposal may transcend a company's ordinary business operations even if the significant policy issue relates to the "nitty-gritty of its core business." Therefore, proposals that focus on a significant policy issue transcend a company's ordinary business operations and are not excludable under Rule 14a-8(i)(7).[32] The Division intends to continue to apply Rule 14a-8(i)(7) as articulated by the Commission and consistent with the Division's prior application of the exclusion, as endorsed by the concurring judge, when considering no-action requests that raise Rule 14a-8(i)(7) as a basis for exclusion.

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[28] *Id.* at 347.

[29] *Id.* at 353 (Schwartz, J., concurring).

[30] *Id.*

[31] Release No. 34-40018 (emphasis added).

[32] Whether the significant policy exception applies depends, in part, on the connection between the significant policy issue and the company's business operations. *See* Staff Legal Bulletin No. 14E (Oct. 27, 2009) (stating that a proposal generally will not be excludable "as long as a sufficient nexus exists between the nature of the proposal and the company").

APPENDIX B –
POST-TRINITY WALL STREET SEC NO-ACTION LETTERS APPLYING RULE 14a-8(i)(7)*

I. SEC NO-ACTION LETTERS ISSUED

A. **Home Trust Bancshares, Inc.**, 2015 WL 4269620 (S.E.C. No-Action Letter Aug. 31, 2015)

Proposal that would mandate that "the company should make no acquisitions of any other financial institution or any part thereof until such time as the common stock of the bank has traded above its tangible book value for 60 consecutive trading days." Staff found that the proposal related to both extraordinary transactions and non-extraordinary transactions.

B. **The Walt Disney Company**, 2015 WL 7179994 (S.E.C. No-Action Letter Nov. 23, 2015)

Proposal requested board to approve the release of a song on Blu-ray. Staff concluded that proposal related to ordinary business operations and allowed it to be excluded.

C. **Viacom Inc.**, 2015 WL 6774394 (S.E.C. No-Action Letter Dec. 18, 2015)

The proposal asked the board "to issue a report assessing the company's policy responses to public concerns regarding linkages of food and beverage advertising to childhood obesity, diet-related diseases and other impacts on children's health." Because it related to advertising, the SEC allowed it to be excluded

D. **AT&T Inc.**, 2015 WL 8291791 (S.E.C. No-Action Letter Dec. 28, 2015)

The proposal would require AT&T to create a program to educate its employees on HIV/AIDS statistics.

E. ***Norfolk S. Corporation***, 2015 WL 9002932 (S.E.C. No-Action Letter Jan. 15, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

*Those italicized cited Trinity Wall Street.

F. **T. Rowe Price Group, Inc.**, 2015 WL 9304410 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal would require the audit committee request proposals for the audit engagement no less than every eight years.

G. **E. I. Du Pont De Nemours and Company**, 2015 WL 9480004 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

H. **Baxter International Inc.**, 2015 WL 9460209 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

I. **Colgate-Palmolive Co.**, 2015 WL 9480003 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

J. **3M Company**, 2015 WL 9592484 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

K. **NextEra Energy Inc.**, 2016 WL 392780 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

L. **United Technologies Corporation**, 2015 WL 9460210 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

M. **Praxair, Inc.**, 2015 WL 9480005 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

N. **Verizon Communications Inc.**, 2015 WL 9460208 (S.E.C. No-Action Letter Jan. 20, 2016)

The proposal requested company to conduct a study of solar geomagnetic storms and electromagnetic pulse events.

O. **Ace Limited**, 2016 WL 390054 (S.E.C. No-Action Letter Jan. 20, 2016)

The proposal asked the board to require the audit committee to request proposals for the audit engagement no less than every eight years; the SEC allowed it to be excluded.

P. **Intel Corporation**, 2016 WL 232399 (S.E.C. No-Action Letter Jan. 21, 2016)

The proposal would require the audit committee to request proposals for the audit engagement no less than every eight years.

Q. **Umpqua Holdings Corporation**, 2015 WL 9460201 (S.E.C. No-Action Letter Feb. 2, 2016)

The proposal would direct the board to initiate a plan to repay the citizens of the United States and the United States treasury the money still owed as a result of the Troubled Asset Relief Program (TARP).

R. **General Electric Company**, 2015 WL 9460212 (S.E.C. No-Action Letter Feb. 3, 2016)

The proposal asked the company to undertake an independent evaluation and prepare an independent report demonstrating that the company has assessed all potential sources of liability related to PCB discharges in the Hudson River, including all possible liability from NRD claims for PCB discharges, and offering conclusions on the most responsible and cost-effective way to address them.

S. **Ball Corporation**, 2015 WL 9479998 (S.E.C. No-Action Letter Feb. 4, 2016)

The proposal asked the company to issue a report reviewing the company's policies and plans to reduce BPA use in its products.

T. ***AT&T Inc.***, 2015 WL 8291792 (S.E.C. No-Action Letter Feb. 5, 2016)

The proposal asked the company to clarify its policies in providing information to law enforcement. It was decided that the proposal related to procedures for protecting customer privacy, and did not focus on a specific policy issue. Because a proposal can be excluded if the subject matter of the report involves a matter of ordinary business (even if the proposal is only asking for a report of information, and not for a specific action to be taken), the SEC allowed it to be excluded.

U. **Citigroup Inc.**, 2015 WL 9460204 (S.E.C. No-Action Letter Feb. 11, 2016)

The proposal urged the board to conduct a study of the company's derivatives activities, addressing how these operations are funded within the various holding company affiliates, supervision by various government

regulators (both domestic and foreign), and how they affect the risk profile and culture of the bank, and to report that information to shareholders.

V. **Apple Inc.**, 2015 WL 7252586 (S.E.C. No-Action Letter Nov. 16, 2015)

The proposal recommended that the company reform its compensation committee to include outside experts and adopt new compensation principles responsive to the economy.

W. **Merck & Co., Inc.**, 2016 WL 704348 (S.E.C. No-Action Letter Feb. 16, 2016)

The proposal asked the company to assign new employees to entry level positions only, and to hire from within for its higher level positions.

X. **JPMorgan Chase & Co.**, 2016 WL 232398 (S.E.C. No-Action Letter Feb. 16, 2016)

The proposal urged the board to conduct a study of the company's derivatives activities, addressing how these operations are funded within the various holding company affiliates, supervision by various government regulators (both domestic and foreign), and how they affect the risk profile and culture of the bank, and to report that information to shareholders.

Y. **Duke Energy Corporation**, 2016 WL 722854 (S.E.C. No-Action Letter Feb. 22, 2016)

The company could be permitted to omit a proposal requesting that a committee of the Board of Directors oversee a study of the potential future impact of changes in the electric utility industry, and prepare a report to shareholders which includes the company's plan on how to meet these challenges and protect shareholder value to be completed by September 1, 2016. (It was not permitted to exclude a proposal seeking a report assessing how Duke Energy is adapting, or could adapt, its business model to significantly increase deployment of distributed low-carbon electricity resources as a means to reduce societal greenhouse gas emissions and protect shareholder value.)

Z. **Chipotle Mexican Grill, Inc.**, 2016 WL 738066 (S.E.C. No-Action Letter Feb. 23, 2016)

The proposal asked the board to adopt principles for minimum wage reform to be published by October 2016.

AA. **Mondelēz International, Inc.**, 2016 WL 722855 (S.E.C. No-Action Letter Feb. 23, 2016)

The proposal asked the board to publish a report on the company's use of nanomaterial.

AB. **CVS Health Corporation**, 2016 WL 246956 (S.E.C. No-Action Letter Feb. 23, 2016)

The proposal asked the board to adopt principles for minimum wage reform to be published by October 2016.

AC. **Pilgrim's Pride Corporation**, 2016 WL 792083 (S.E.C. No-Action Letter Feb. 25, 2016)

The proposal asked the company to publish a report describing the company's policies, practices, performance and improvement targets related to occupational health and safety.

AD. **Pfizer Inc.**, 2015 WL 9319130 (S.E.C. No-Action Letter Mar. 1, 2016)

The proposal asked the company to issue a report describing the steps it has taken or will take to identify and remedy the flaws in its current distribution system for medicines listed in the formal execution protocols of certain U.S. states, in order to prevent their sale to prisons for the purpose of aiding executions.

AE. **Dunkin' Brands Group, Inc.**, 2016 WL 826854 (S.E.C. No-Action Letter Mar. 1, 2016)

The proposal asks the board to issue a public report describing the company's short and long-term strategies on water use management.

AF. **CVS Health Corporation**, 2016 WL 910349 (S.E.C. No-Action Letter Mar. 4, 2016)

The proposal instructed the board to immediately terminate the employment agreements with the company's named executive officers.

AG. **PG&E Corp.**, 2016 WL 246960 (S.E.C. No-Action Letter Mar. 7, 2016)

The proposal asked the board to institute a policy that there shall be no discrimination in hiring vendor contracts or customer relations.

AH. **Staples, Inc.**, 2016 WL 910344, at *1 (S.E.C. No-Action Letter Mar. 8, 2016)

The proposal asked the board to adopt principles for minimum wage reform. The SEC decided that general compensation matters are ordinary business operations, and allowed the proposal to be excluded.

AI. **The TJX Companies, Inc.**, 2016 WL 538379 (S.E.C. No-Action Letter Mar. 8, 2016)

The proposal requested that the company set company-wide quantitative targets to increase renewable energy sourcing and/or production.

AJ. **Best Buy Co., Inc.**, 2016 WL 626461 (S.E.C. No-Action Letter Mar. 8, 2016)

The proposal asked the board to adopt principles for minimum wage reform.

AK. ***Amazon.com, Inc.***, 2016 WL 246958 (S.E.C. No-Action Letter Mar. 11, 2016)

The proposal suggested that Amazon issue a report addressing animal cruelty in the supply chain, and the company's policies on not selling products because of involved animal cruelty.

AL. **USA Technologies, Inc.**, 2016 WL 1019231 (S.E.C. No-Action Letter Mar. 11, 2016)

The proposal suggested that the bylaws of the company should be amended to include rules of conduct for all shareholder meetings.

AM. **Perrigo Company plc**, 2016 WL 1254390 (S.E.C. No-Action Letter Mar. 16, 2016)

Part One of the proposal asked that the company not issue any stock options for less than $250 per share.

AN. **Amazon.com, Inc.**, 2016 WL 246961, at *1 (S.E.C. No-Action Letter Mar. 17, 2016)

The proposal requests that the board prepare a report on the company's policy options to reduce pollution and health problems from electronic waste.

AO. ***Cabela's Incorporated***, 2016 WL 406281 (S.E.C. No-Action Letter Apr. 7, 2016)

The proposal asked the board to adopt and oversee a policy to not sell firearms capable of discharging more than eight shells without reloading.

AP. ***The Kroger Co.***, 2016 WL 1426713 (S.E.C. No-Action Letter Apr. 7, 2016)

The proposal asked the board of directors to adopt a policy to completely ban the sale of semi-automatic firearms. The shareholders tried to differentiate from Wal-Mart by saying that the proposal was asking for a ban, not just a review of the policy.

AQ. **Netflix, Inc.**, 2016 WL 1044624 (S.E.C. No-Action Letter Mar. 14, 2016)

The proposal requested that the company issue a report on how it prevents and mitigates the risks of offensive and inaccurate portrayals of Native Americans.

AR. **ARIAD Pharmaceuticals, Inc.**, 2016 WL 1129295 (S.E.C. No-Action Letter June 1, 2016)

The proposal asked the company to respond to questions in the proposal regarding the conduct of certain board members, particularly regarding compensation, governance and financial matters. The SEC held the position that proposals relating primarily to the nature of communications between a company and its shareholders relate to ordinary business, and allowed this proposal to be excluded.

II. SEC NO-ACTION LETTERS NOT ISSUED

A. **Franklin Resources, Inc.**, 2015 WL 5862422, at *1 (S.E.C. No-Action Letter Nov. 24, 2015)

The proposal asked that the board issue a climate change report to the shareholders.

B. **Deere & Company**, 2015 WL 5862424 (S.E.C. No-Action Letter Dec. 3, 2015)

The proposal requested that the board annually report to shareholders a congruency analysis between the company's corporate values and the company's political contributions and activities. The SEC did not allow the proposal to be excluded.

C. **NorthWestern Corporation**, 2015 WL 9002930 (S.E.C. No-Action Letter Dec. 11, 2015)

The proposal sought a report on how the company is adapting or could adapt its business model to reduce greenhouse emissions.

D. **Apple Inc.**, 2015 WL 9315680 (S.E.C. No-Action Letter Dec. 11, 2015)

The proposal asked that the board adopt an accelerated recruitment policy requiring the company to increase the diversity of senior management and its board of directors.

E. **Apple Inc.**, 2015 WL 8959540 (S.E.C. No-Action Letter Dec. 14, 2015)

The proposal asked that the board review the company's guidelines for selecting countries for its operations, and requested that the report should identify the company's criteria for investing and operating in, and withdrawing from high-risk regions.

F. **Starbucks Corporation**, 2015 WL 7008819 (S.E.C. No-Action Letter Dec. 16, 2015)

The proposal asked for the management to review its policies related to human rights, and assess areas in which the company should adopt additional policies.

G. **Praxair, Inc.**, 2015 WL 9592482 (S.E.C. No-Action Letter Jan. 12, 2016)

The proposal asked the board to adopt and issue a general payout policy that gives preferences to share repurchases as a method to return capital to shareholders.

H. **Reynolds American Inc.**, 2016 WL 390052 (S.E.C. No-Action Letter Jan. 12, 2016)

The proposal asked the board to adopt and issue a general payout policy that gives preferences to share repurchases as a method to return capital to shareholders.

I. **PPG Industries, Inc.**, 2015 WL 9304405 (S.E.C. No-Action Letter Jan. 12, 2016)

The proposal asked the board to adopt and issue a general payout policy that gives preferences to share repurchases as a method to return capital to shareholders.

J. **ITT Corporation**, 2015 WL 9319125 (S.E.C. No-Action Letter Jan. 12, 2016)

The proposal asked the board to adopt and issue a general payout policy that gives preferences to share repurchases as a method to return capital to shareholders.

K. **Minerals Technologies Inc.**, 2015 WL 9319126 (S.E.C. No-Action Letter Jan. 13, 2016)

The proposal asked the board to adopt and issue a general payout policy that gives preferences to share repurchases as a method to return capital to shareholders.

L. **JPMorgan Chase & Co.**, 2016 WL 232397 (S.E.C. No-Action Letter Mar. 10, 2016)

The proposal suggested that the company should adopt an executive compensation philosophy with consideration of relevant social factors to improve the company's ethical conduct and public reputation.

M. **Chevron Corporation**, 2016 WL 246951 (S.E.C. No-Action Letter Mar. 11, 2016)

The proposal suggested that the company should increase the total amount authorized for capital distributions to shareholders, in light of the climate change related risks of stranded assets.

N. **The AES Corporation**, 2015 WL 9319128 (S.E.C. No-Action Letter Jan. 19, 2016)

The proposal requested that the company publish an assessment of the long-term impacts of the company's portfolio of public policies and technological advances that are consistent with limiting global warming.

O. **Lazard Ltd**, 2015 WL 9304399 (S.E.C. No-Action Letter Jan. 20, 2016)

The proposal asked for the board to adopt a policy prohibiting the vesting of equity-based awards for senior executives due to a voluntary resignation to enter government service.

P. **General Electric Company**, 2015 WL 9304407 (S.E.C. No-Action Letter Jan. 21, 2016)

The proposal asked that the board review the company's guidelines for selecting regions for its operations, and identify the company's criteria for investing in, operating in, and withdrawing from high-risk regions.

Q. ***Citigroup Inc.***, 2015 WL 9460205 (S.E.C. No-Action Letter Feb. 2, 2016)

The proposal requested that the company prepare a report demonstrating that the company does not have a gender pay gap.

R. **Citigroup Inc.**, 2015 WL 9480001 (S.E.C. No-Action Letter Feb. 3, 2016)

The proposal asked the board to amend the company's clawback policy in a manner set forth in the proposal.

S. **Bank of America Corporation**, 2015 WL 9489740 (S.E.C. No-Action Letter Feb. 3, 2016)

The proposal asked the board to amend the company's clawback policy in a manner set forth in the proposal.

T. **The Boeing Company**, 2015 WL 9304411 (S.E.C. No-Action Letter Feb. 5, 2016)

The proposal requested that the board provide a report of the company's sales of weapons-related products and services to Israel.

U. **Exelon Corporation**, 2015 WL 9489742, at *1 (S.E.C. No-Action Letter Feb. 16, 2016)

The proposal requested that the board adopt a policy to disclose a description of the specific minimum qualifications that the nominating committee believes must be met by a nominee to the board of directors and each nominee's gender, race/ethnicity, skills and experiences.

V. **Dominion Resources, Inc.**, 2015 WL 9480000 (S.E.C. No-Action Letter Feb. 16, 2016)

The proposal requested that a board committee oversee a study of the potential future threats and opportunities presented by climate-change, and issue a report on the company's plan to meet those challenges.

W. **Portland General Electric Company**, 2015 WL 9489737 (S.E.C. No-Action Letter Feb. 19, 2016)

The proposal requested that the company prepare a climate change adaptation report.

X. **Duke Energy Corporation**, 2016 WL 722854 (S.E.C. No-Action Letter Feb. 22, 2016)

The company could not exclude a proposal seeking a report assessing how Duke Energy is adapting, or could adapt, its business model to significantly increase deployment of distributed low-carbon electricity resources as a means to reduce societal greenhouse gas emissions and protect shareholder value. (The company was permitted to omit a second proposal requesting that a committee of the Board of Directors oversee a study of the potential future impact of changes in the electric utility industry, and prepare a report to shareholders which includes the company's plan on how to meet these challenges and protect shareholder value to be completed by September 1, 2016.)

Y. **JPMorgan Chase & Co.**, 2016 WL 246954 (S.E.C. No-Action Letter Feb. 23, 2016)

The proposal asked the board to amend the company's clawback policy in a manner set forth in the proposal.

Z. **Dominion Resources, Inc.**, 2016 WL 751725, at *1 (S.E.C. No-Action Letter Feb. 24, 2016)

The proposal requested that the company prepare a financial analysis reporting on a potential impact on earnings, share price and dividends, should the State Corporation Commission deny a certificate for the development of a nuclear reactor, and further deny the recovery of the costs associated with the construction of the reactor.

AA. **NextEra Energy, Inc.**, 2016 WL 751722 (S.E.C. No-Action Letter Feb. 24, 2016)

The proposal asked for the company to report material risks and costs of sea level rise to company operations, facilities and markets based on a range of sea level rise scenarios projecting forward to 2100, according to the best available science.

AB. **Netflix, Inc.**, 2016 WL 826856 (S.E.C. No-Action Letter Feb. 29, 2016)

The proposal requested the board to take the steps necessary so that each voting requirement in Netflix's charter and bylaws that calls for a greater than simple majority vote be eliminated and replaced by a requirement for a majority of the votes cast for and against applicable proposals, or a simple majority in compliance with applicable laws.

AC. **Netflix, Inc.**, 2016 WL 826855 (S.E.C. No-Action Letter Feb. 29, 2016)

The proposal asked the company to take the steps necessary to reorganize the board into one class with each director subject to election each year.

AD. **Hess Corporation**, 2016 WL 67593 (S.E.C. No-Action Letter Feb. 29, 2016)

The proposal asked that the company prepare and publish a report disclosing the financial risks to the company of stranded assets related to climate change and associated demand reductions.

AE. **Pfizer Inc.**, 2015 WL 9319123 (S.E.C. No-Action Letter Feb. 29, 2016)

The proposal suggested that any taxable event for the shareholders should be an event for the management and the board of directors.

AF. **CBS Corporation**, 2016 WL 406280 (S.E.C. No-Action Letter Mar. 1, 2016)

The proposal requested that the company adopt company goals for reducing greenhouse gas emissions.

AG. **Exxon Mobil Corporation**, 2016 WL 343245 (S.E.C. No-Action Letter Mar. 14, 2016)

The proposal asked the company to commit to increasing the total amount authorized for capital distributions to shareholders as a prudent use of investor capital in light of the climate change related risks of stranded carbon assets.

AH. **Re/Max Holdings, Inc.**, 2016 WL 1044627 (S.E.C. No-Action Letter Mar. 14, 2016)

The proposal dealt with the company's practice of advertising and leasing properties in the Israeli settlements and other locations.

AI. **CVS Health Corporation**, 2016 WL 246949 (S.E.C. No-Action Letter Mar. 16, 2016)

The proposal requested that the compensation committee initiate a review of the company's executive compensation policies.

AJ. **The TJX Companies, Inc.**, 2016 WL 538382 (S.E.C. No-Action Letter Mar. 16, 2016)

The proposal requested that the compensation committee initiate a review of the company's executive compensation policies.

AK. ***Freeport-McMoRan Inc.***, 2016 WL 1105435 (S.E.C. No-Action Letter Mar. 18, 2016)

The proposal asked that the board report on company actions being taken to reduce and mitigate health and environmental harms resulting from the company's enhanced oil recovery operations. The SEC stated that Wal-Mart was not applicable because the enhanced oil recovery practices have "a clear and meaningful relationship" to the company's business operations.

AL. **Exxon Mobil Corporation**, 2016 WL 1167061 (S.E.C. No-Action Letter Mar. 23, 2016)

The proposal requested that the company replace thermal units to assist the company in responding to climate change.

AM. **Chevron Corporation**, 2016 WL 246950 (S.E.C. No-Action Letter Mar. 23, 2016)

The proposal requested that the company publish an annual assessment of long-term portfolio impacts to 2035 of possible public climate change policies.

AN. **BlackRock, Inc.**, 2016 WL 343259 (S.E.C. No-Action Letter Apr. 6, 2016)

The proposal requested that the board issue a report which evaluates options for bringing the company's voting practices in line with its stated principle of linking executive compensation and performance, including adopting changes to proxy voting guidelines, adopting best practices of other asset managers and independent rating agencies and including a broader range of research sources and principles for interpreting compensation data.

OFFERING SECURITIES UNDER THE COMMISSION'S NEW REGULATION A+ RULES; PROPOSED AMENDMENTS TO RULE 147 (THE INTRASTATE EXEMPTION)

Rutheford B. Campbell, Jr.*

OVERVIEW OF PRESENTATION

My presentation is divided into three parts.

First is a broad look at the way in which the rules respecting the solicitation of external capital have changed. This focuses on the JOBS Act, the Commission's regulatory implementation of the JOBS Act, and other important laws and regulations. This short presentation should provide an overture to my presentation and those that follow.

Second is a look at the Commission's proposed amendments to Rule 147. This proposal, which seems to have attracted little attention, could, I'm afraid, have a significant impact on small business capital formation by (inadvertently, I'm convinced) limiting the availability of the intrastate exemption for offerings by small issuers. Starting on page 36, I reproduce part of the SEC's release proposing amendments to Rule 147.

Third is a look at the new Regulation A+, as implemented by the Commission's final rules. Starting on page 43, I reproduce an article of mine from the Kentucky Law Journal.

* Spears-Gilbert Professor of Law, University of Kentucky College of Law, Lexington, KY 40506.

Corrected to conform to Federal Register version

SECURITIES AND EXCHANGE COMMISSION

17 CFR PART 230

[Release Nos. 33-9973; 34-76319; File No. S7-22-15]

RIN 3235-AL80

Exemptions to Facilitate Intrastate and Regional Securities Offerings

AGENCY: Securities and Exchange Commission

ACTION: Proposed rules.

SUMMARY: We are proposing amendments to Rule 147 under the Securities Act of 1933, which currently provides a safe harbor for compliance with the Section 3(a)(11) exemption from registration for intrastate securities offerings. Our proposal would modernize the rule and establish a new exemption to facilitate capital formation, including through offerings relying upon recently adopted intrastate crowdfunding provisions under state securities laws. The proposed amendments to the rule would eliminate the restriction on offers and ease the issuer eligibility requirements, while limiting the availability of the exemption at the federal level to issuers that comply with certain requirements of state securities laws.

We further propose rule amendments to Rule 504 of Regulation D under the Securities Act to facilitate issuers' capital raising efforts and provide additional investor protections. The proposed amendments to Rule 504 would increase the aggregate amount of securities that may be offered and sold in any twelve-month period from $1 million to $5 million and disqualify certain bad actors from participation in Rule 504 offerings.

DATES: Comments should be received by January 11, 2016.

I. INTRODUCTION AND BACKGROUND

Today's proposals are part of the Commission's efforts to assist smaller companies with capital formation consistent with other public policy goals, including investor protection. These proposals also complement recent efforts by the U.S. Congress,[6] state legislatures,[7] and state securities regulators[8] to modernize existing federal and state securities laws and regulations to assist smaller companies with capital formation. We believe that the proposed amendments to Rule 147 and the amendment to increase the offering amount limitation in Rule 504 will help to facilitate capital formation by smaller companies by increasing the utility of these rules while maintaining appropriate protections for investors who purchase securities in these offerings. We believe that the proposed disqualifications of certain bad actors from participation in Rule 504 offerings will provide for greater consistency across Regulation D and increase investor protection in such offerings.

We propose to modernize and expand Rule 147 under the Securities Act, a safe harbor for intrastate offerings exempt from registration pursuant to Securities Act Section 3(a)(11).[9] Consistent with the suggestions of market participants and state securities regulators,[10] the proposal would expand upon the statutory exemption in order to modify

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[6] Congress enacted the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"), which was signed into law by President Obama on April 5, 2012. Pub. L. No. 112-106; 126 Stat. 306. Pursuant to Title II of the JOBS Act, the Commission adopted new paragraph (c) of Rule 506 of Regulation D, removing the prohibition on general solicitation or general advertising for securities offerings relying on Rule 506. *See* SEC Rel. No. 33-9415 (July 10, 2013). Pursuant to Title IV of the JOBS Act, the Commission amended Regulation A in order to permit issuers to raise up to $50 million annually. SEC Rel. No. 33-9741 (March 25, 2015) ("2015 Regulation A Release"). Pursuant to Title III of the JOBS Act, the Commission adopted rules permitting companies to use the Internet to offer and sell securities through crowdfunding ("Regulation Crowdfunding"). *See* SEC Rel. No. 33-9974 (Oct. 30, 2015) ("Regulation Crowdfunding Adopting Release").

[7] *See, e.g.*, Ala. Code §8-6-11; Ariz. Rev. Stat. Ann. §44-1844 (2015); Colo. Rev. Stat. §11-51-304(6) (2014); Fla. Stat. §517.021, 517.061, 517.0611, 517.121, 517.161, 626.9911; Ind. Code §6-3.1-24-14 (2014); Ky. Rev. Stat. Ann. §292.410-292.415 (2015); Me. Rev. Stat. Ann. tit. 32, §16304, sub-§6-a (2014).

[8] *See, e.g.*, D.C. Mun. Regs. tit. 26-B, §250 (2014); Ga. Comp. R. & Regs. 590-4-2-.08 (2011); Idaho Code Ann. §30-14-203 (providing an exemption by order on a case-by-case basis); Kan. Admin. Regs. §81-5-21 (2011).

[9] 15 U.S.C. §77c(a)(11) (exempting "any security which is part of an issue offered and sold only to persons resident within a single state or territory, where the issuer of such security is a person residing and doing business within, or, if a corporation, incorporated by and doing business within such state or territory.").

[10] *See, e.g.*, Transcript of Record at 78, SEC Advisory Committee on Small and Emerging Companies (June 3, 2015), *available* at http://www.sec.gov/info/smallbus/acsec/acsec-minutes-060315.pdf; State Based Crowdfunding, presentation by Michael S. Pieciak, NASAA Corporate Finance Chair, SEC Advisory Committee on Small and Emerging Companies (June 3, 2015), *available* at http://www.sec.gov/info/smallbus/acsec/state-based-crowdfunding.pdf; Letter from Stanley Keller, Fed. Regulation of SEC Comm. of the Bus. Law Section of the American Bar Assoc., to Linda C. Quinn and Mary E.T. Beach of the SEC Div. of Corp. Fin. ("ABA Letter"), submitted as appendix to letter from Stanley Keller to the SEC Advisory Committee on Small and

certain regulatory requirements of the rule that no longer comport with modern business practices or communications technology, thereby limiting the utility of the safe harbor for intrastate offerings, particularly in offerings by issuers seeking to raise capital pursuant to recently adopted crowdfunding provisions under state securities laws. The proposed amendments would eliminate the current restriction on offers, while continuing to require that sales be made only to residents of the issuer's state or territory. The proposed amendments also would redefine what it means to be an "intrastate offering" and ease some of the issuer eligibility requirements in the current rule, making the rule available to a greater number of businesses seeking intrastate financing. We also propose to limit the availability of the exemption to offerings that are either registered in the state in which all of the purchasers are resident or conducted pursuant to an exemption from state law registration in such state that limits the amount of securities an issuer may sell pursuant to such exemption to no more than $5 million in a twelve-month period and imposes an investment limitation on investors.

Emerging Companies (June 1, 2015), *available* at http://www.sec.gov/comments/265-27/26527-50.pdf.

TEXT OF PROPOSED AMENDMENTS

List of Subjects in 17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77b note, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, and Pub. L. 112-106, sec. 201(a), sec. 401, 126 Stat. 313 (2012), unless otherwise noted.

* * * * *

2. Section 230.147 is revised to read as follows:

§230.147 Intrastate sales exemption

(a) *Scope of the exemption.* Offers and sales by or on behalf of an issuer of its securities made in accordance with all of the provisions of this section (§230.147) are exempt from section 5 of the Act (15 U.S.C. 77e) if the issuer:

(1) Registers the offer and sale of such securities in the state in which all purchasers of the securities are resident; or

(2) Conducts the offer and sale of such securities pursuant to an exemption from registration in the state in which all purchasers of the securities are resident that limits the amount of securities;

(i) An issuer may sell pursuant to such exemption to no more than $5 million in a twelve-month period; and

(ii) An investor may purchase in such offering (as determined by the appropriate authority in such state).

(b) *Manner of offers and sales.* An issuer, or any person acting on behalf of the issuer, may rely on this exemption to make offers and sales using any form of general solicitation and general advertising, so long as the issuer complies with the provisions of paragraphs (c), (d), and (f) through (h) of this section.

(c) *Nature of the issuer.* The issuer of the securities shall at the time of any offers and sales pursuant to this section:

(1) Have its principal place of business within the state or territory in which all purchasers of the securities are resident. The issuer shall be deemed to have its principal place of business in a state or territory in which the officers, partners or managers of the issuer primarily direct, control and coordinate the activities of the issuer; and

(2) Meet at least one of the following requirements:

(i) The issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in or from the rendering of services within such state or territory;

(ii) The issuer had at the end of its most recent semi-annual fiscal period prior to an initial offer of securities in any offering or subsequent offering pursuant to this section, at least 80% of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;

(iii) The issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to this section (§230.147) in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory; or

(iv) A majority of the issuer's employees are based in such state or territory.

NOTE 1 TO PARAGRAPH (C)(1). An issuer that has previously conducted an intrastate offering pursuant to this section (§230.147) may not conduct another intrastate offering pursuant to this section (§230.147), based upon satisfaction of this principal place of business definition contained in paragraph (c)(1) of this section (§230.147(c)(1)) in a different state or territory, until the expiration of the time period specified in paragraph (e) of this section (§230.147(e)), calculated on the basis of the date of the last sale in such offering.

NOTE 1 TO PARAGRAPH (C)(2)(i). Revenues must be calculated based on the issuer's most recent fiscal year, if the first offer of securities pursuant to this section is made during the first six months of the issuer's current fiscal year, and based on the first six months of the issuer's current fiscal year or during the twelve-month fiscal period ending with such six-month period, if the first offer of securities pursuant to this section is made during the last six months of the issuer's current fiscal year.

(d) *Residence of purchasers.* Sales of securities pursuant to this section (§230.147) shall be made only to persons that the issuer reasonably believes at the time of the sale are residents of the state or territory in which the issuer has its principal place of business. For purposes of determining the residence of purchasers:

(1) A corporation, partnership, limited liability company, trust or other form of business organization shall be deemed to be a resident of a state or territory if, at the time of the sale to it, it has its principal place of business, as defined in paragraph (c)(1) of this section, within such state or territory.

(2) Individuals shall be deemed to be residents of a state or territory if such individuals have, at the time of sale to them, their principal residence in the state or territory.

(3) A corporation, partnership, trust or other form of business organization, which is organized for the specific purpose of acquiring securities offered pursuant to this

section (§230.147), shall not be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory.

(e) *Limitation on resales.* For a period of nine months from the date of the sale by the issuer of a security pursuant to this section (§230.147), any resale of such security by a purchaser shall be made only to persons resident within the purchaser's state or territory of residence, as determined pursuant to paragraph (d) of this section.

Instruction to Paragraph (e): In the case of convertible securities, resales of either the convertible security, or if it is converted, the underlying security, could be made during the period described in paragraph (e) only to persons resident within such state or territory. For purposes of this paragraph (e), a conversion in reliance on section 3(a)(9) of the Act (15 U.S.C. 77c(a)(9)) does not begin a new period.

(f) *Precautions against interstate sales*. (1) The issuer shall, in connection with any securities sold by it pursuant to this section:

(i) Place a prominent legend on the certificate or other document evidencing the security stating that: "Offers and sales of these securities were made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of nine months from the date of the sale by the issuer of these securities, any resale of these securities (or the underlying securities in the case of convertible securities) by a purchaser shall be made only to persons resident within the purchaser's state or territory of residence."; and

(ii) Issue stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, of, if the issuer transfers its own securities, make a notation in the appropriate records of the issuer.

(2) The issuer shall, in connection with the issuance of new certificates for any of the securities that are sold pursuant to this section (§230.147) that are presented for transfer during the time period specified in paragraph (e), take the steps required by paragraphs (f)(1)(i) and (ii) of this section.

(3) The issuer shall, at the time of any offer or sale by it of a security pursuant to this section (§230.147), prominently display to each offeree in the manner in which any such offer is communicated and to each purchaser of such security in writing the following: "Sales will be made only to residents of the same state or territory as the issuer. Offers and sales of these securities are made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of nine months from the date of the sale by the issuer of the securities, any resale of the securities (or the underlying securities in the case of convertible securities) by a purchaser shall be made only to persons resident within the purchaser's state or territory of residence."

(g) *Integration with other offerings.* Offers or sales made in reliance on this section will not be integrated with:

(1) Prior offers or sales of securities; or

(2) Subsequent offers or sales of securities that are:

(i) Registered under the Act, except as provided in paragraph (h) of this section;

(ii) Exempt from registration under Regulation A (§230.251 *et seq.*);

(iii) Exempt from registration under Rule 701 (§230.701);

(iv) Made pursuant to an employee benefit plan;

(v) Exempt from registration under Regulation S (§§230.901 through 230.905);

(vi) Exempt from registration under section 4(a)(6) of the Act (15 U.S.C. 77d(a)(6));

(vii) Made more than six months after the completion of an offering conducted pursuant to this section.

Note to Paragraph (g): If none of the safe harbors applies, whether subsequent offers and sales of securities will be integrated with any securities offered or sold pursuant to this section (§230.147) will depend on the particular facts and circumstances.

(h) *Offerings limited to qualified institutional buyers and institutional accredited investors.* Where an issuer decides to register an offering under the Securities Act after making offers in reliance on Rule 147 limited only to qualified institutional buyers and institutional accredited investors referenced in Section 5(d) of the Securities Act, such offers will not be subject to integration with any subsequent offering. If the issuer makes offers in reliance on Rule 147 to persons other than qualified institutional buyers and institutional accredited investors referenced in Section 5(d) of the Securities Act, such offers will not be subject to integration if the issuer (and any underwriter, broker, dealer, or agent used by the issuer in connection with the proposed offering) waits at least 30 calendar days between the last such offer made in reliance on Rule 147 and the filing of the registration statement with the Commission.

3. In §230.504, the section heading and paragraph (b)(2) are revised, and paragraph (b)(3) is added, to read as follows:

§230.504 Exemption for limited offerings and sales of securities not exceeding $5,000,000.

THE SEC'S REGULATION A+: SMALL BUSINESS GOES UNDER THE BUS AGAIN

Rutheford B. Campbell, Jr.[1]

Reprinted with permission, 104 Ky. L. J. 325 (2015-2016).

Title IV of the JOBS Act, which is entitled "Small Company Capital Formation," requires the Securities and Exchange Commission to adopt new rules regarding offerings under Regulation A. The Commission has now adopted its final regulations implementing Title IV and providing a new regulatory regime for exempt offerings under Section 3(b) of the Securities Act of 1933. The new regime is generally referred to as Regulation A+.

Unfortunately, history and empirical data regarding the use of Regulation A and Regulation D strongly suggest that the final Regulation A+ rules are unlikely to provide any material relief for small businesses in their difficult search for efficient sources of external capital. Instead, the exemption provided by Regulation A+ will likely be attractive only to larger businesses that are not currently reporting companies under the Securities Exchange Act of 1934.

To a significant extent, this outcome is the result of an effective campaign mounted by state securities regulators, prosecuted through their trade association, the North American Securities Administrators Association (NASAA), and enabled by the Securities and Exchange Commission (Commission). Once again, NASAA – aided and abetted by the Commission – effectively blocked small businesses from a fair and efficient path to external capital, destroying an important component of the JOBS Act that was specifically designed to facilitate small business capital formation. In the vernacular of the day, small businesses were – again – thrown under the bus.

INTRODUCTION

Title IV of the JOBS Act, which is entitled "Small Company Capital Formation," requires the Securities and Exchange Commission to adopt new rules regarding offerings under Regulation A.[2] The Commission has now adopted its final regulations that implement Title IV[3] and provide a new regulatory regime for exempt offerings under Section 3(b) of the Securities Act of 1933 (the 1933 Act).[4] The new regime is generally referred to as Regulation A+.[5]

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[2] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §401(b)(2), 126 Stat. 306, 323-24 (codified at 15 U.S.C. §77c(b)(2) (2012)).

[3] Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), 80 Fed. Reg. 21,806 (April 20, 2015) (to be codified at 17 C.F.R. pts. 200, 232, 239, 240, 249, and 260) [hereinafter Adopting Release Regulation A].

[4] *See* 15 U.S.C. §77c(b).

[5] *See e.g.,* Michael Raneri, "Raising Growth Capital via Regulation A+," CFO (May 29, 2015), http://ww2.cfo.com/credit-capital/2015/05/raising-growth-capital-via-regulation/. On May 22, 2015,

While the anticipation of the Regulation A+ rules generated enthusiasm in some quarters,[6] the new, final Regulation A+ rules seem unlikely to provide any material relief for small businesses in their difficult search for efficient sources of external capital. Unfortunately, history and empirical data regarding the use of Regulation A and Regulation D strongly suggest small businesses will not be able to utilize Regulation A+. Instead, the exemption provided by Regulation A+ will likely be attractive only to larger businesses that are not currently reporting companies under the Securities Exchange Act of 1934 (the 1934 Act).[7]

To a significant extent, this outcome is the result of an effective campaign mounted by state securities regulators, prosecuted through their trade association, the North American Securities Administrators Association (NASAA), and enabled by the Securities and Exchange Commission (SEC or Commission). Once again, NASAA – aided and abetted by the Commission – effectively blocked small businesses from a fair and efficient path to external capital. In the vernacular of the day, small businesses were – again – thrown under the bus.

Today, only the most extreme free market economists would argue that capital formation needs no governmental intervention – that the entirely free and unregulated capital market will result in an efficient allocation of capital. Governmental regulation of capital formation, however, must be logical, fair, and directed to improving, not throttling, efficient and fair allocation of our precious capital among businesses in our market economy.

With regard to the rules governing capital formation by small businesses, it is impossible to conclude that an efficient and fair allocation of capital in the case of small businesses is facilitated by imposing fifty-plus separate and independent securities registration regimes on small businesses when they search for external capital. At the risk of overly simplifying one's criticism – but not at the risk of overstatement – such a regulatory system is bizarre.

Nonetheless, NASAA for decades has fought vigorously and successfully to preserve such a system to govern small business capital formation. Even more disturbing, perhaps, is the fact that the Commission – for reasons that are difficult to understand –

Maura Healey, Attorney General of the Commonwealth of Massachusetts, filed a Petition for Review with the United States Court of Appeals for the District of Columbia Circuit "relating to the preemption of state securities law registration and qualification requirements for certain Regulation A securities." Petition for Review at 1, Galvin v. SEC, No. 15-1150 (D.C. Cir. May 22, 2015). The Petition asks the Court to issue a permanent injunction against the preemption rules. *Id.* at 2. As a basis for that relief, the Petition states that the rules are "arbitrary, capricious, and otherwise not in accordance with the Administrative Procedures Act, the Securities Act of 1933, and other law." *Id.* At the time of this article, the case is still pending.

[6] *See, e.g.*, Raneri, *supra* note 5.

[7] Under Section 12(g) of the Securities and Exchange Act of 1934, a company becomes subject to periodic reporting requirements if the company has assets in excess of $10 million and either 2,000 shareholders of record or 500 unaccredited shareholders of record, 15 U.S.C. §78l(g) (2014).

has cooperated with NASAA, allowing state laws and regulations to eviscerate efficient and well-conceived federal exemptions from registration, rules that were designed for small businesses and their special needs and compelling circumstances.[8] Perhaps it should be no surprise, therefore, that it has happened again in the Commission's final Regulation A+ rules.

The purposes of this article are to explain the Regulation A+ rules and their likely impact – if any – on small business capital formation and to offer comments regarding who bears responsibility for the failure of these new rules to offer small businesses an efficient access to external capital.

I. SMALL BUSINESSES

It is difficult, at least with precision, to define a "small business." When considering the issue of capital formation, one can typically begin with the categories used by the Small Business Administration (SBA) for collecting and publishing data about small businesses.[9] Historically, the SBA has reported data for firms employing less than twenty persons and firms employing less than one hundred persons.

SBA data indicates that there are about five million firms in the United States operating with less than twenty employees.[10] These very small firms account for approximately eighteen percent of the employment in America.[11] Historical data also indicate that there are about five and one-half million firms with less than one hundred employees and that such firms over the years usually account for around thirty-five percent of employment.[12]

We also know that these firms overwhelmingly need external capital and that there are unique structural and economic impediments these small firms face when they attempt to secure external capital.[13] Specifically, the small firms typically have high relative transaction costs when they go after external capital. They need small amounts of external capital, which means that their relative offering costs (offering costs as a

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[8] *See* Rutheford B. Campbell, Jr., "The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions," 66 Bus. Law 919, 937-38 (2011) [hereinafter Campbell, "The Wreck of Regulation D"] ("The testimony and prepared remarks of then-Chairman Levitt offered during the legislative hearings skillfully dodged any support for broad preemption of state authority over securities offerings.").

[9] *See, e.g.*, Rutheford B. Campbell, Jr., "Regulation A: Small Businesses' Search for 'a Moderate Capital,'" 31 Del. J. Corp. Law 77, 84-85 (2006) [hereinafter Campbell, "A Moderate Capital"].

[10] Small Bus. Admin., The Small Business Economy: A Report to the President 2010 at 121 (2010).

[11] *Id.*, *see* Rutheford B. Campbell, Jr., "Regulation A and the JOBS Act: A Failure to Resuscitate," 7 Ohio St. Entrepreneurial Bus. L. J. 317, 320 (2012) [hereinafter Campbell, "A Failure to Resuscitate"].

[12] Small Bus. Admin., The Small Business Economy: A Report to the President 2004 at 179 (2004).

[13] *See* Campbell, "A Moderate Capital," *supra* note 9, at 86-88.

percentage of the total size of the offering) go up.[14] Additionally and related to the matter of relative offering costs, financial intermediation is typically not available for small offerings. Small offerings simply will not support the costs that reputable investment bankers or brokers encounter in learning and selling small deals.[15]

Title IV of the JOBS Act, by most appearances, was designed to provide efficient access to external capital for these small businesses. The title of Title IV, after all, is "Small Company Capital Formation."[16]

It is these five million-plus businesses that this article addresses, and, regrettably, that this article concludes will not, to any material extent, be able to use Title IV as a means to access external capital.

II. A BRIEF LOOK BACK AT THE HISTORY OF SECTION 3(b) AND REGULATION A[17]

Regulation A was first adopted by the Commission in 1936[18] and was extensively revised in 1941.[19] It was 1953, however, before the modern structure for Regulation A was finally enacted by the Commission.[20] There were later amendments to Regulation A by the Commission. In 1992, for example, the Commission amended Regulation A to increase the limit of the offering to $5 million and to add the "test the waters" provision.[21] Nonetheless, at the time the JOBS Act became law in 2012, the core of the exemption provided by Regulation A had been unchanged for decades.

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[14] *See* Rutheford B. Campbell, Jr., "The New Regulation of Small Business Capital Formation: The Impact – If Any – of the JOBS Act," 102 Ky. L. J. 815, 817-18 (2014) [hereinafter Campbell, The Impact of JOBS]. For example, if offering expenses (*e.g.*, fees paid to lawyers, accountants, underwriters, etc.) amount to $10 and the total amount of the offering is $100, the relative offering costs are ten percent.

[15] *See generally id.* at 818 (showing that only 5.8 percent of all Regulation D offerings of $1 million or less from a sample had financial intermediation).

[16] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, tit. IV, 126 Stat. 306, 323-25 (2012) (codified as amended at 15 U.S.C. §77c(b), 77r(b)4, 77d).

[17] For a history of Regulation A, *see generally* 7 J. William Hicks, Exempted Transactions under Securities Act of 1933 §§6.2-6.4, (2d ed. 2014; 3 Louis Loss & Joel Seligman, Securities Regulation 1322-27 (3d ed. 1989).

[18] Securities Act Release No. 627, 1936 WL 30895 (Jan. 21, 1936).

[19] Securities Act Release No. 2410, 1940 WL 7107, at *1-2 (Dec. 3, 1940). These amendments are discussed in Louis Loss, Securities Regulation 380-87 (1951).

[20] *See* Hicks, *supra* note 17, §6.3.

[21] Securities Act Release No. 6949, 57 Fed. Reg. 36,442 (Aug. 13, 1992). The "test the waters" provision enabled issuers using Regulation A to solicit indications of interest from potential investors before filing the offering statement with the Commission. 17 CFR §230.254(a) (2012).

Fundamentally, the Regulation A exemption was predicated on filing and disclosure. Issuers relying on Regulation A were required to file an offering statement (roughly similar to a registration statement in a registered offering) with the Commission and provide investors with an offering circular (roughly similar to a prospectus in a registered offering).[22] Both the offering statement and the offering circular contained prescribed investment information that the Commission, over time, had determined to be appropriate for these offerings by small businesses.[23]

Because Regulation A offerings were designed for small businesses – the exemption was limited to $5 million[24] and available only for issuers that were not reporting under the 1934 Act[25] -- the Commission made an effort to scale back the disclosure requirements from the more extensive disclosures required in a registration statement under the 1933 Act.[26] This was apparently in response to the high relative offering costs encountered by small issuers searching for small amounts of external capital. The Commission was also no doubt influenced by Section 2(b) of the 1933 Act – enacted as a part of the National Securities Markets Improvement Act of 1996 (NSMIA) – which required the Commission, in enacting its rules governing capital formation, to "consider, in addition to the protection of investors, whether the action will promote . . . capital formation."[27]

It is significant in this brief look at the history of Regulation A to recall that at the time the JOBS Act was signed into law, Regulation A was the only generally available federal exemption from registration that enabled a small business to make broad, interstate solicitations for external capital.[28]

Notwithstanding the fact that there were approximately five million small businesses with less than twenty employees and that the large majority of those businesses needed

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[22] 17 CFR §230.251(d) (2012).

[23] For an overview of the filing and disclosure requirements, *see* Campbell, "A Moderate Capital," *supra* note 9, at 104-06.

[24] At the time of the passage of the JOBS Act, the Securities Act of 1933 limited Regulation A offerings to $5 million. 15 U.S.C. §77c(b) (2011).

[25] 17 CFR §230.251(a)(2).

[26] *See id.*, Campbell, "A Moderate Capital," *supra* note 9, at 104-05 (discussing the nature and extent of these disclosures).

[27] National Securities Market Improvement Act of 1996, Pub. L. No. 104-290 §106(b), 110 Stat. 3416, 3424-25 (1996) (codified at 15 U.S.C. §77b(b) (2014)).

[28] For an explanation of why other federal exemptions of general availability were unavailable for offers involving a broad, interstate solicitation for investors, *see* Campbell, "A Moderate Capital," *supra* note 9, at 92-99. Stated briefly and simply, the private placement exemption provided by Section 4(a)(2) of the 1933 Act, 15 U.S.C. §77d(a)(2) (2014), was unavailable because it prohibited any public solicitation for investors; the intrastate exemption provided by Rule 147, 17 CFR §230.147 (2015), was unavailable because it prohibited any interstate solicitation for investors; and the exemptions provided by Regulation D, 17 CFR §230.504-.506, were unavailable because they prohibited any general solicitation or general advertising. Campbell, "A Moderate Capital," *supra* note 9, at 92-99.

external capital to survive and compete,[29] in the decades before the JOBS Act, Regulation A fell into nearly complete disuse.

Table I, immediately below, provides information regarding the use of Regulation A in two recent time periods.

TABLE I[30]

Time Periods	Total Number of Regulation A Offerings During the Period	Average Annual Number of Regulation A Offerings During the Period
1/1/95 – 12/31/04	78	7.8
1/1/05 – 1/1/11	162	23.1

While this data may at first seem curious, the most apparent principal cause for the non-use of Regulation A was state blue sky registration requirements. The burden of meeting the registration requirements of the fifty states raised relative offering costs associated with a Regulation A offering to an unbearable level for small businesses.[31]

The apparent purpose of Title IV of the JOBS Act was to turn Regulation A into a workable exemption for small business capital formation. Thus, the title of Title IV of the JOBS Act is "Small Company Capital Formation."[32]

The strategy that Congress used to achieve this goal was to provide in Title IV a skeletal statutory structure and then to delegate very broad authority to the Commission to implement Title IV, including broad authority for the Commission to preempt state registration authority over offerings made under the new regulations.[33]

III. OVERVIEW OF FINAL REGULATION A+ RULES

Fundamentally, the Commission's final Regulation A+ amendments remain philosophically consistent with the pre-JOBS Act Regulation A rules.[34] Regulation A+

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[29] *See generally* Campbell, "A Moderate Capital," *supra* note 9, at 84-88 (detailing historical data on the number and nature of small businesses and small businesses' demand for external capital).

[30] Campbell, "Failure to Resuscitate," *supra* note 11, at 321.

[31] *See* Campbell, "A Moderate Capital," *supra* note 9, at 106-12, 119-21.

[32] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§401-02, 126 Stat. 306, 323-25 (2012) (codified in scattered sections of 15 U.S.C.); Press Release, Sec. & Exch. Comm'n, SEC Adopts Rules to Facilitate Smaller Companies' Access to Capital (Mar. 25, 2015), http://www.sec.gov/news/pressrelease/2015-49.html.

[33] *See* 15 U.S.C. §77r(b)(4)(D)(ii) (2014) (preempting of state registration authority over securities that are "offered or sold to a qualified purchaser, as defined by the Commission").

[34] *Compare* 17 CFR §§230.251-.263 (2015), *with* 17 CFR §§230.251-.263 (2011).

continues as an exemption that is predicted on filing prescribed information with the Commission and providing prescribed investment information to investors.[35] The new rules, however, make significant changes from the pre-JOBS Act Regulation A requirements.

To explain these changes and the nature of offerings likely to be conducted under Regulation A+, it is helpful to emphasize two new definitions in Regulation A+: Tier 1 offerings and Tier 2 offerings. The limit on a Tier 1 offering is $20 million, and the limit on a Tier 2 offering is $50 million.[36] There is no lower amount limit for a Tier 2 offering.[37]

The Commission in Regulation A+ establishes somewhat different requirements for a Tier 1 offering and a Tier 2 offering. There are, however, a number of important requirements that apply to both Tier 1 and Tier 2 offerings.

Consider first the more significant of these generally applicable requirements. Both Tier 1 and Tier 2 offerings are subject to the same requirements regarding the nature of the issuer that may use Regulation A+. These include the requirement that the issuer is a United States or Canadian entity and, most importantly, the requirement that the issuer is not a company subject to the reporting requirements under the 1934 Act.[38]

Regulation A+ provides both Tier 1 and Tier 2 offerings regulatory safe harbors from integration. These include a safe harbor from integration with any prior offering and a safe harbor from integration with any offering made six months after the Regulation A+ offering.[39]

All Regulation A+ offerings, no matter whether Tier 1 or Tier 2, are subject to filing and disclosure requirements that, at least as a matter of process are similar to the filing and disclosure requirements of a registered offering.[40] Generally under Regulation A+, no

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[35] 17 CFR 230.251-.264 (2015).

[36] *Id.* §230.251(a)(1)-(2). As proposed by the Commission, the upper limit of a Tier 1 offering was $5 million in a twelve-month period. Proposed Rule Amendments for Small and Additional Issues Exemptions under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3936 (proposed Jan. 23, 2014) (to be codified at 17 CFR pts. 230, 232, 239, 240, and 260) [hereinafter Proposed Regulation A+ Amendments].

[37] *See* 17 CFR §230.251(a)(2). This means that an issuer selling only $2 million in securities, for example, may rely on the Tier 2 conditions for a Regulation A+ exemption, provided, of course, that the issuer is able to meet all of the Tier 2 conditions.

[38] *Id.* §230.251(b)(1)-(2). Under Section 13 of the 1934 Act, an issuer becomes subject to the reporting requirements of the 1934 Act if it has a class of securities registered pursuant to Section 12 of the 1934 Act. Securities Exchange Act of 1934, Pub. L. No. 73-291 §13, 28 Stat. 881, 894-95 (codified at 15 U.S.C. §78m(a) (2014)). Under Section 12(g) of the 1934 Act, a company is required to register any class of equity securities if the company has assets in excess of $10 million and either 2,000 shareholders of record or 500 unaccredited shareholders of record for the class of equity securities. Act of Aug. 20, 1964, Pub. L. No. 88-467 §3(c), 78 Stat. 565, 566-68 (codified at 15 U.S.C. §78(g) (2014)).

[39] 17 CFR §230.251(c).

[40] *Compare* 17 CFR §230.251(d), *with* 15 U.S.C. §77(e)[sic].

offers can be made until the offering statement has been filed.[41] After the offering statement has been filed, the issuer can, for example, make oral offers and offers through the use of a preliminary offering circular.[42] Generally, only after the offering statement is qualified (roughly equivalent to a final registration statement that is declared effective by the Commission) is the issuer permitted to sell the Regulation A+ securities.[43]

Regulation A+ also retains, with some changes, the "test the waters" concept of the pre-JOBS Act Regulation A, and this provision is also applicable to Tier 1 and Tier 2 offerings alike.[44] This provision is an exception to the general prohibition in Regulation A+ of pre-filing offers. Issuers may, under the final Regulation A+ rules, communicate with potential investors about the offering and seek from the potential investors indications of interest in the proposed Regulation A+ offering.[45] These communications are expressly made subject to antifraud provisions and require the offer to contain protective and informative legends and disclaimers.[46] "Testing the water" communications may continue after filing the offering statement, but during that period such communications must be accompanied by a preliminary offering circular or provide the offeree with information as to where such preliminary offering circular can be obtained.[47]

Tier 1 offerings and Tier 2 offerings under Regulation A+ do, however, differ in regard to the nature and extent of disclosure obligations. Broadly stated, Tier 2 offerings require significantly more disclosures than Tier 1 offerings, both at the time of the offerings (*ex ante* disclosures) and following the completion of the offering (*ex post* disclosures). This stepped up or "scaled" approach[48] in Regulation A+ is an attempt by the Commission to balance investor protection and capital formation, which is a statutory obligation of the Commission when it enacts regulatory exemptions from the registration requirement of

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[41] 17 CFR §230.251(d)(1)(i).

[42] *Id.* §230.251(d).

[43] *Id.* §230.251(d)(2)(i)(A).

[44] *See id.* §230.255(a). In the pre-JOBS era, this concept had become essentially unusable. The reason was that state blue sky laws applied to pre-JOBS offerings under Regulation A, and such actions as testing the waters were almost certain to run afoul of state registration provisions. *See* Campbell, "A Moderate Capital," *supra* note 9, at 110.

[45] 17 CFR §230.255(a).

[46] *See id.* §230.255(b). The required legends and disclaimers must inform the offeree, for example, that no offer to buy can be accepted until the offering statement is qualified and that the offeree's indication of interest creates no obligation to purchase. *Id.* §230.255(b)(2)-(3).

[47] *Id.* §230.255(b)(4).

[48] In earlier works, I used the term "stepped" for disclosures that vary according to the size of the offering. Campbell, "The Wreck of Regulation D," *supra* note 8, at 926. The Commission uses the term "scaled." *E.g.*, Adopting Release Regulation A, *supra* note 3, at 21,830. I accede to the Commission's wisdom on this matter and adopt the term "scaled" for the balance of this article.

the 1933 Act.[49] It amounts to a sensible response to the stifling effect of relative offering costs on small businesses' capital formation.[50]

The *ex ante* narrative disclosures required in Tier 1 and Tier 2 offerings, although somewhat different,[51] are to a large extent similar. There are fourteen items of narrative disclosures required.[52] These disclosures, while less than the disclosures required in Form S-1, are nonetheless extensive and will certainly impact the relative offering costs in a Regulation A+ offering, especially for smaller offerings.[53]

There are significant differences, however, between the financial disclosures required in a Tier 1 offering and a Tier 2 offering, both with regard to *ex ante* and *ex post* financial disclosures.

The requirements for *ex ante* financial disclosures in a Tier 1 offering are for two years of financial statements (in some cases, interim statements may also be required), but the statements do not have to be audited and do not have to be prepared in compliance with Regulation S-X.[54] The only *ex post* filing or disclosure for a Tier 1 offering is the obligation to file an "exit report" with the Commission upon termination of the offering.[55]

A Tier 2 offering, on the other hand, requires the issuer to file and disclose significantly more financial information, both *ex ante* and *ex post*, than is required in a Tier 1 offering. *Ex ante*, the principal difference from Tier 1 is that Tier 2 offerings must provide audited financial statements and meet the requirements of a significant part of Regulation S-X.[56]

An even more important difference in a Tier 2 offering is the *ex post* obligation to continue to report narrative and financial information to the Commission in filings that are reminiscent of the periodic reporting requirements found in the 1934 Act. Regulation A+ imposes on issuers utilizing Tier 2 the obligation to file annual reports, semiannual reports, and current reports with the Commission.[57] These amount to significant

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[49] *See* 15 U.S.C. §77b(b) (2014).

[50] *See supra* notes 13-15 and accompanying text.

[51] *See, e.g.*, Adopting Release Regulation A, *supra* note 3, at 21,828, 21,830 (discussing the compensation disclosure requirements in Item 11 of the Offering Circular requirements).

[52] Form 1-A: Regulation A Offering Statement under the Securities Act of 1933, at 10-23 (2015), http://www.sec.gov/about/forms/form1-a.pdf [hereinafter Form 1-A]; *see also* Adopting Release Regulation A, *supra* note 3, at 21,903-13.

[53] *See* Campbell, "The Impact of JOBS," *supra* note 14, at 840-43.

[54] Form 1-A, *supra* note 52, at Part F/S(b).

[55] *See* Adopting Release Regulation A, *supra* note 3, at 21, 899. This is filed on a simple form that requires no financial statements. Form 1-Z, Exit Report under Regulation A (2015), https://www.sec.gov/about/forms/form1-z.pdf.

[56] Form 1-A, *supra* note 52, at Part F/S(c).

[57] Adopting Release Regulation A, *supra* note 3, at 21,899.

obligations and may have a dramatic impact on relative offering costs, especially for small Regulation A+ offerings. For example, the annual report, which is filed on Form 1-K, in addition to extensive narrative disclosures about the company's business and management's discussion and analysis of financial condition, requires two years of audited financial statements that are compliant with a significant portion of Regulation S-X.[58]

Importantly, this obligation of periodic reporting continues until such time as the issuer becomes subject to the reporting requirements under the Securities Exchange Act of 1934 or the securities of the issuer are held by less than 300 shareholders of record.[59] In all events, the issuer is required to go through one annual cycle of reporting, even if the issuer has less than 300 shareholders.[60]

Finally, the most significant difference between Tier 1 and Tier 2 offerings is that Regulation A+ preempts state authority over registration in Tier 2 offerings but does not preempt state authority over registration in Tier 1 offerings.

As originally proposed, the Commission has preempted state authority over Tier 2 offerings and had offered what was an unworkable compromise with regard to preemption over Tier 1 offerings. Specifically, the Commission had proposed that in Tier 1 offerings, state authority over registration be preempted with regard to offers but not with regard to sales.[61] This, upon reflection, appeared to be an unworkable compromise[62] and was not part of the final version of Regulation A+.[63] In the final rules, states continue to exercise authority over registration in Tier 1 offerings.

It is worth noting that the battle over preemption was robust and fought out on various fronts. The Commission's release adopting Regulation A+ devotes a significant amount

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[58] *See* Form 1-K: Annual Reports and Special Financial Reports, at 4-5, Part II, Item 1, 2, 7 (2015), http://www.sec.gov/about/forms/form1-k.pdf; Form 1-A, *supra* note 52, at Item 7, 9(a)-(b), (d).

[59] *See* Adopting Release Regulation A, *supra* note 3, at 21,899-900.

[60] Adopting Release Regulation A, *supra* note 3, at 21, 853. The issuer's ability to extricate itself from the periodic reporting requirements of Regulation A+ will be significant in regard whether small businesses making small offerings will migrate to Tier 2 offerings. *See infra* note 123 and accompanying text.

[61] The JOBS Act amended the preemption in NSMIA by preempting state registration authority over Regulation A+ securities "offered or sold to a qualified purchaser, as defined by the Commission. . ." 15 U.S.C. §77r(b)(4)(D)(ii) (2014). In the Commission's initial proposed Regulation A+ rules, proposed Rule 256 stated: "For the purposes of Section 18(b)(3) of the Securities Act [15 U.S.C. §77r(b)(3)], a 'qualified purchaser' of a security offered or sold pursuant to Regulation A means any offeree of such security and, in a Tier 2 offering, any purchaser of such security." Proposed Regulation A+ Amendments, *supra* note 36, at 4003.

[62] *See* Campbell, "The Impact of JOBS," *supra* note 14, at 845-47.

[63] The final version of Rule 256 states: "[A] 'qualified purchaser' means any person to whom securities are offered or sold pursuant to a Tier 2 offering of this Regulation A." Adopting Release Regulation A, *supra* note 3, at 21,899.

of space to recounting the spirited debate and tactics deployed in the effort to preserve state authority over registration of Regulation A+ offerings and to explain its final reckoning on the matter.[64] Not surprisingly, this effort was principally from state regulators and NASAA.[65] United States Senators and Representatives were also convinced to write letters in support of continuing state registration authority over Regulation A+ offerings.[66]

In addition to attacking the Commission's authority to preempt state registration authority over Regulation A+ offerings, NASAA – following the publication of the Commission's proposed Regulation A+ rules – adopted a multi-state coordinated review program for offerings under Regulation A+ and reported that forty-nine of NASAA's fifty-three members had agreed to participate in the program.[67]

These strategies may have provided the incentive for a compromise by the Commission and its final decision to withdraw any preemption of state registration authority over Tier 1 offerings. Even this, however, was not enough to satisfy state regulators, and on May 22, 2015, a suit was filed asking the court to issue a permanent injunction against the preemption of state authority over Tier 2 offerings.[68]

IV. A CRITICAL EVALUATION OF THE COMMISSION'S FINAL REGULATION A+ RULES: DO THE RULES PROMOTE EFFICIENT AND FAIR "SMALL COMPANY CAPITAL FORMATION'?[69]

A. Overview

The Commission's Regulation A+ rules will do little for small businesses. Neither the Tier 1 regime nor the Tier 2 regime offers small issuers an efficient access to external capital. It is unlikely that small businesses will make Tier 1 offerings, because there is no preemption of state registration authority for Tier 1 offerings. Migration to Tier 2 solves the state registration problems for small businesses, but it may increase small issuers' relative offering costs to an intolerable level.

These predictions of an unfortunate, inefficient, and seemingly unintended outcome for the Commission's final Regulation A+ rules are based on the history one finds regarding Regulation A, Regulation D, and NASAA's attempts to corral states into coordinated actions regarding states' registration provisions.

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[64] *See id.* at 21,856-62.

[65] *Id.* at 21,857 n.772 (*citing* letters from NASAA and individual state regulators).

[66] *Id.* (*citing* letters from United States Congressmen and Senators).

[67] *Id.* at 21,860-61, 21,861 n.826.

[68] *See* Petition for Review, Galvin v. SEC, No. 15-1150 (D.C. Cir. May 22, 2015).

[69] Title IV of JOBS is entitled "Small Company Capital Formation." Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§401-02, 126 Stat. 306, 323-24 (2012) (codified in scattered sections of 15 U.S.C.).

B. Tier 1 Offerings: Nothing Has Changed

Prior to the JOBS Act, Regulation A had fallen into nearly total disuse. This disuse is reflected in Table I in Section II of this article.[70] The data in Table I become even more dramatic when one realizes that during the years covered by the Table there were about five million small businesses in the United States,[71] and most of those businesses needed external capital to survive and compete.[72]

One may speculate, of course, that some small businesses may have been reluctant to use Regulation A because of the requirements for constructing and filing an offering statement with the Commission and constructing and providing an offering circular to investors. Small issuers may also have had a general fear of getting tangled up with the Commission. The Commission, however, took steps to ameliorate those concerns by scaling back the expensive disclosure requirements for Regulation A – especially as concerned financial disclosures – in a manner that should have made Regulation A popular for offerings in excess of $1 million.[73]

The most apparent principal culprit in the failure of Regulation A was state registration requirements. The niche for Regulation A was public offerings: the ability of firms in Regulation A offerings to make broad, interstate solicitations for capital. But state registration obligations seemingly destroyed that space. The five million small businesses in the United States apparently were unwilling to underwrite the costs of complying with the registration requirements of fifty states, each with its own individual registration regime.[74]

The regime under Tier 1 changes nearly nothing for small businesses.[75] Issuers utilizing Tier 1 are still required to file an offering statement with the Commission and to provide

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[70] *See supra* Table I. For Regulation A data covering periods before that reflected in Table I, *see* Hicks, *supra* note 17, at §6.3, tbls. 2, 2.1 (providing data on the use of Regulation A for most years from 1947 through 1988).

[71] For historical data on the number and nature of small businesses and small businesses' demand for external capital, *see* Campbell, "A Moderate Capital," *supra* note 9, at 84-88.

[72] *See id.* at 86-87 ("Data show that slightly over 85 percent of firms with ten to nineteen employees utilize some form of credit as a source of funding. That number increases to slightly over 90 percent for firms employing between twenty and ninety-nine persons.").

[73] *See id.* at 101-06.

[74] *See* U.S. Gov't Accountability Off., GAO-12-839, Securities Regulation: Factors That May Affect Trends in Regulation A Offerings (2012), http://www.gao.gov/assets/600/592113.pdf [hereinafter GAO Report]. In its adopting release, the Commission reported that the GAO "found that state securities laws were among several central factors that may have contributed to the lack of use of Regulation A." Adopting Release Regulation A, *supra* note 3, at 21,856.

[75] In fact, the financial disclosure requirements for a Tier 1 offering are, at least to some degree, even more demanding than the requirements for a pre-JOBS Act Regulation A offering. For example, the pre-JOBS Act offering circular required only one year's financial statements. *See* 17 CFR §239.90 (2011); Form 1-A, *supra* note 52, at Part F/S; Tier 1 offering under the Commission's final Regulation A+ requires two years' financial statements. *Id.*

an offering circular to investors,[76] and – most importantly – the Tier 1 issuers are still required to meet the registration requirements of all states in which they conduct an offering.[77] Since nothing has changed, one should not expect a different outcome, and it seems highly unlikely, therefore, that small business will, to any meaningful degree, utilize Tier 1 offerings.

C. Inefficient Options for Small Businesses to Meet State Registration Requirements in Tier 1 Offerings.

As is always the case, there are options for how small businesses making a Tier 1 offering can meet state registration requirements. Even the best of those options, however, is unworkable for small businesses that wish to use Regulation A+.

1. NASAA's New Coordinated Review Program for Regulation A+ Offerings – The JOBS Act was signed into law in April of 2012, and it offered the Commission, once again,[78] the opportunity to preempt state registration authority over Section 3(b) offerings, specifically in this case, Regulation A+ offerings.[79] Indeed, such a targeted, statutory restatement of the Commission's authority could be viewed as strong evidence that Congress intended for the Commission to do something this time.

In what appears to have been a strategic response, NASAA published a release in October of 2013 requesting comments on a new Proposed Coordinated Review Program for Section 3(b)(2) (Regulation A+ Coordinated Review).[80] This NASAA proposal was in place at the time the Commission first proposed its Regulation A+ rules in January 2014.[81] NASAA subsequently reported that forty-nine of its fifty-three members had signed on to participate in the coordinated review program.[82]

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[76] *See* 17 CFR §230.251(d), .252, .253 (2015); *see* Form 1-A, *supra* note 52, at Part F/S.

[77] *See* 17 CFR §230.256 (2015) (limiting preemption to Tier 2 offerings).

[78] In 1996, NASAA delegated authority to the Commission to expand preemption by regulation for any offering of securities "to qualified purchasers, as defined by the Commission by rule." National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290 §18(b)(3), 110 Stat. 3416, 3418 (1996) (codified as amended at 15 U.S.C. §77r(b)(3) (2014)). The Act continued by stating: "the Commission may define the term 'qualified purchaser' differently with respect to different categories of securities, consistent with the public interest and the protection of investors." *Id.* Prior to the enactment of the JOBS Act, the Commission had never used that authority for any meaningful regulatory expansion of preemption over exempt offerings.

[79] *See* 15 U.S.C. §77r(b)(4)(D).

[80] "Notice of Request for Public Comment: Proposed Coordinate Review Program for Section 3(b)(2)," NASAA, (Oct. 30, 2013), http://www.nasaa.org/27427/notice-request-public-comment-proposed-coordinated-review-program-section-3b2-offerings/.

[81] *See id.*, Proposed Regulation A+ Amendments, *supra* note 36.

[82] *See* Adopting Release Regulation A, *supra* note 3, at 21,861 n.826. NASAA members include states, territories and the District of Columbia. "About Us," NASAA, http://www.nasaa.org/about-us/ (last visited Dec. 27, 2015).

Under this Regulation A+ Coordinated Review, an issuer can file a single state registration statement, which will then be circulated to all states participating in the coordinated review program.[83] The registration statement is first reviewed by one lead state for compliance with disclosure matters.[84] A second lead state is appointed to deal with merit qualifications if any of the states involved in the offering also are subject to merit regulation.[85] The lead state or states prepare comments on the registration statement (both regarding matters of disclosure and merit standards) that are then circulated to all the other participating states.[86] Each of the participating state or states, in turn, has the right to make its own comments and return the comments to the lead state or states.[87] The lead state or states then forward the combined comments to the issuer, who, in the usual manner in which these matters are resolved, is required to work with all states to resolve matters raised by each of the states' comments.[88] The lead state or states are the go between and mediator to facilitate the resolution of each states' comments with the issuer.[89]

Not surprisingly, a number of the comments offered on the Commission's proposed Regulation A+ rules expressed strong doubts that the Regulation A+ Coordinated Review program would provide a workable regime for small businesses to meet blue sky registration provisions in the fifty states.[90] Commenters pointed out that even if all states participated in the programs, each state's laws remained applicable to an offering in each state.[91] Commenters expressed concerns about delays and expenses and generally about getting tangled with the large number of sovereign state regulators with

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[83] "NASAA Coordinated Review of Regulation A Offerings: Review Protocol," NASAA, (Mar. 7, 2014), http://www.nasaa.org/wp-content/uploads/2014/05/NASAA-Regulation-A-Review-Protocol-final-Adopted-March-7.pdf [hereinafter "NASAA Coordinated Review Protocol].

[84] *Id.*

[85] The GAO Report states that "most states. . . conduct merit reviews." GAO Report, *supra* note 74, at 13. The Report goes on to discuss the significant differences in merit standards among the states. *Id.* at 14. ("Merit reviews have varying degrees of stringency, with some states applying stricter standards than others.").

[86] "NASAA Coordinated Review Protocol," *supra* note 83, at 2.

[87] *Id.*

[88] *Id.*

[89] *See id.* ("The lead examiners will communicate with the applicant and participating jurisdictions, as necessary, to resolve any outstanding comments.").

[90] *See, e.g.*, Catherine T. Dixon, Comment Letter on Proposed Regulation A+ Amendments, (Apr. 3, 2014), http://www.sec.gov/comments/s7-11-13/s71113-99.pdf [hereinafter ABA BLS Letter]; Robert R. Kaplan, Jr. & T. Rhys James, Comment Letter on Proposed Regulation A+ Amendments, (March 23, 2014), http://www.sec.gov/comments/s7-11-13/s71113-89.pdf [hereinafter KVCF Letter]; Michael L. Zuppone, Comment Letter on Proposed Regulation A+ Amendments, (March 24, 2014), http://www.sec.gov/comments/s7-11-13/s71113-73.pdf [hereinafter Hastings Letter].

[91] *See, e.g.*, KVCF Letter, *supra* note 90.

different legal rules.[92] Thus, for example, in the states that apply merit requirements, each state's individual merit requirements must be met, and as the GAO Report emphasized, merit requirements vary from state to state.[93] It would also seem that the "test the waters"[94] provision of Regulation A+ would cause trouble for offerings in particular states, since all matters regarding "offers" and "sales" still remain a matter of each state's laws. Commenters also emphasized that each state retained the right to charge registration fees for its state.[95] This generates both out of pocket expenses for the state fees and legal expenses in determining the amount and required process for paying those fees.

If one overlays such concerns and issues on the process described above, one sees that NASAA's Regulation A+ Coordinated Review program is unlikely to attract a significant amount of use from small businesses making Tier 1 offerings under Regulation A+. History also supports this conclusion.

Over the decades, state regulators and NASAA have made attempts at uniformity. These initiatives have, at best, appeared to enjoy modest success. For example, NASAA's Uniform Limited Offering Exemption (ULOE)[96] was designed to permit a uniform state regime for coordination of some Regulation D offerings with state blue sky laws and was widely adopted by states.[97] It turned out, however, that the ULOE provisions varied significantly from state to state.[98]

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[92] *See, e.g.*, *id;* Hastings Letter, *supra* note 90.

[93] The GAO Report states that "[m]erit reviews have varying degrees of stringency, with some states applying stricter standards than others." GAO Report, *supra* note 74, at 14. This point was also emphasized by a commenter. *See* ABA Letter, *supra* note 90.

[94] 17 CFR §230.254 (2015).

[95] *See, e.g.*, Hastings Letter, *supra* note 90.

[96] *See generally* Reg D/ULOE: Uniform Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6101 (Apr. 29, 1989).

[97] "Jurisdictions Adopting the Uniform Security Act," 1 Blue Sky L. Rep. (CCH) ¶ 5500 (Aug. 2004); Rutheford B. Campbell, Jr., "The Insidious Remnants of State Rules Respecting Capital Formation," 78 Wash. U. L. Rev. 407, 419 (2000) [hereinafter Campbell, "The Insidious Remnants"].

[98] *See* Therese H. Maynard, "The Uniform Limited Offering Exemption: How 'Uniform' is 'Uniform?' – An Evaluation and Critique of the ULOE," 36 Emory L. J. 357, 389-95 (1986). As Professor Maynard notes:

> The ULOE was intended to ease [the] burden by providing a uniform exemption in all fifty states which would also coordinate with Regulation D. In actual practice, however, the ULOE has not achieved its goal. The modifications made by the NASAA member states have resulted in the same confusing array of exemptive requirements that existed prior to the ULOE.

Id. at 504.

In a 2000 article, I gathered and presented data regarding NASAA's Small Company Offering Registration initiative (SCOR), relying on a ten state sample.[99] NASAA described SCOR as designed to "provide for the uniform treatment of registrations of small company offerings which are exempt from federal registration under Rule 504 of Regulation D, Regulation A, or Rule 147."[100] While my research indicated that states had widely adopted SCOR, that research also suggested that SCOR was less than uniform across states and had barely been utilized by issuers.[101]

More recent data show that SCOR registrations continue to rarely be used. SCOR filings can now be filed centrally within multi-state regions or with individual states. The total number of central filings of SCOR registration statements in all regions during more recent periods were: three in 2012; three in 2013; and one in 2014.[102] The total number of individual state filings during those periods from a nine state sample were: four in 2012; four in 2013; and one in 2014.[103]

In my 2000 article, I also looked at NASAA's Coordinated Equity Review initiative, and found similar results as with SCOR: participating states retained sovereignty over rules respecting offers and sales of securities, and the small amount of information available suggested that Coordinated Equity Review was very lightly used by issuers.[104] Recently

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[99] *See* Campbell, "The Insidious Remnants," *supra* note 97, at 420, 423. For my sample states, I selected Kentucky and other states falling close to Kentucky alphabetically. *Id.* at 420 n.52. Much of the data I used was gathered from individual states, since I was at that time unable to find any centralized source for the data.

[100] "Score Statement of Policy," NASAA, (Apr. 28, 1996), http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/score-statement-of-policy/.

[101] *See* Campbell, "The Insidious Remnants," *supra* note 97, at 424. ("Iowa reports that only four SCOR registration statements have become effective. . . during each of the calendar years 1997, 1998, and 1999. Indiana reports that only two SCOR registration statements became effective between January, 1997 and August, 1999. Information gathered from other same states reflects similarly modest utilization of SCOR.").

[102] Email from Joy Sakamoto-Wengel, Assistant Attorney Gen., Md. Div. of Sec., Atl. CR-SCOR Region, to author (Nov. 20, 2015, 15:10 EST) (on file with author); Telephone interview with Lynn Hammes, Dir., Fin. & Admin., Kan. Sec. Comm'r's Office, Midwest CR-SCOR Region, (Nov. 19, 2015); Telephone interview with Patricia Loutherback, Dir., Registration Div., Tex. State Sec. Bd., Sw. CR-SCOR Region, (Nov. 19, 2015); Telephone interview with Sarah Reynolds, Div. of Sec., Wash. State Dep't of Fin. Insts., W. CR-SCOR Region, (Nov. 19, 2015).

[103] Out of the ten sample states used in my 2000 article, we were able to get data on nine of the states. Indiana, Kansas, Kentucky, Louisiana, Maine, and Maryland, had zero SCOR filings in 2012, 2013, and 2014. Email from Patrick Sanders, Registrations Attorney, Ind. Sec. Div., to author (Jan. 13, 2016) (on file with author); Telephone interview with Steven Wassom, Exec. Dir., Kan. Sec. Comm'r's Office (Dec. 22, 2015); Telephone interview with Anthony Murphy, Registration Branch Manager, Div. of Sec., Ky. Dep't of Fin. Insts. (Jan. 6, 2016); Telephone interview with Len Riviere, Deputy Chief Exam'r, Sec. Div., La. Office of Fin. Insts. (Dec. 28, 2015); Telephone interview with Paige Turney, Assistant Sec. Admin'r, Office of Sec., Me. Dep't of Prof'l and Fin. Regulation (Dec. 28, 2015); Email from Joy Sakamoto-Wengel, *supra* note 102.

[104] Campbell, "The Insidious Remnants," *supra* note 97, at 425-27, 426 n.93 (only two coordinated reviews by 1997, and only seventeen coordinated review offerings had become effective by 1999).

I updated this data and found that during the three years 2012-2014, only one Coordinated Equity Review was filed.[105]

My data regarding the use of SCOR and Coordinated Equity Review are consistent with softer anecdotal evidence. For example, evidence gathered for the 2012 GAO Report from state securities administrators suggests that usage of such uniformity initiatives has been insignificant with regard to any Regulation A offerings.[106]

Finally, preliminary data suggest that NASAA's newly minted Regulation A+ Coordinated Review program will have limited appeal for issuers, especially small issuers. The Regulation A+ final regulations became effective on June 19, 2015. Between that date and May 24, 2016, only thirty-seven Tier 1 Regulation A+ offerings were filed with the Commission.[107] As of June 2, 2016, only eleven Tier 1 Regulation A+ filings had utilized NASAA's Regulation A+ Coordinated Review program.[108]

In summary, history supports the conclusion that NASAA's Regulation A+ Coordinated Review initiative will not solve the problems of small businesses in Tier 1 offerings under Regulation A+.

2. Migration of Tier 1 Offerings to the Tier 2 Regime – It is possible for offerings by small businesses within the amount limit of Tier 1 to migrate to a Tier 2 offering, since there is

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[105] Telephone interview with Brett Warren, Counsel, Div. of Corp. Fin., Pa. Sec. Comm'n (Dec. 28, 2015).

[106] GAO Report, *supra* note 74, at 15 ("According to several of the state securities administrators . . . they have not participated in regional reviews or used SCOR forms for Regulation A filings because there have been so few Regulation A filings in their state. Similarly, . . . some of these methods, like SCOR, have not been widely used because of the low number of Regulation A filings in recent years.").

While these data may appear thin, this anecdotal evidence suggests that such uniformity initiatives have not been able to overcome the negative effect of state registration rules on Regulation A offerings.

[107] Regulation A+ data were obtained from the subscription-only Lexis Securities Mosaic website. *See* Form 1-A Data, Lexis Sec. Mosaic, www.lexissecuritiesmosaic.com (last visited May 24, 2016) (click "SEC Filings" tab; then follow "SEC Filings" hyperlink; then search "Form 1-A").

During that same period there were twenty-five Tier 2 offerings of less than $20 million, a range in which issuers could have relied on Tier 1 rules. *Id.*

[108] Following the passage of the JOBS Act, NASAA adopted a new coordinated review regime for offerings under Regulation A+. "NASAA Coordinated Review Protocol," *supra* note 83, at 1.

NASAA reported that the regime had been adopted by forty-nine of its fifty-three members. Adopting Release Regulation A, *supra* note 3, at 21,861 n.826; 17 CFR §230.251-.263 (2015). As of June 2, only eleven coordinated reviews had been filed with the states. Email from Faith L. Anderson, Esq., Chief of Registration & Regulatory Affairs, Wash. Dep't of Fin. Insts. Sec. Div., to author (June 2, 2016, 5:17 PM EST) (on file with author).

no lower amount limitation on Tier 2 offerings under Regulation A+.[109] Some small businesses seeking an amount of external capital within the Tier 1 limit, therefore, may be tempted to try to solve their state registration problems by migrating to a Tier 2 offering, because the Regulation A+ rules preempt state registration authority over Tier 2 offerings.[110] Similar strategies have been extensively employed by small businesses in Regulation D offerings.[111]

Rule 504 is a Regulation D exemption from registration that is designed for and attractive to small businesses seeking small amounts of capital.[112] The exemption allows small businesses to offer up to $1 million in securities,[113] and it does not require disclosures or any offeree or purchaser qualifications (such as sophistication or accredited investor status).[114] On the other hand, Rule 506, another Regulation D exemption, provides an exemption that is unlimited in amount but may require either accredited investors or significant disclosures of prescribed investment information, or both.[115]

Notwithstanding the additional burdens and compliance costs, small offerings under Regulation D within the $1 million limit of Rule 504 overwhelmingly migrate to Rule 506.[116] Data show that approximately 80 percent of Regulation D offerings of $1 million or less are made as Rule 506 offerings.[117] Issuers migrated from Rule 504 in order to solve their state blue sky problems, since NSMIA preempts state registration authority over offerings under Rule 506.[118]

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[109] *See* 17 CFR §230.251(a)(2) (2015). The only amount limitation on a Tier 2 offering is that the offering cannot "exceed $50,000,000." *Id.*

[110] *See id.* §230.256.

[111] *See* Campbell, "The Wreck of Regulation D," *supra* note 8, at 933-36.

[112] *See* 17 CFR §230.504.

[113] The Commission has proposed raising the limit of Rule 504 to $5 million. *See* Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 9973, Exchange Act Release No. 76319, 2015 WL 6662108 (October 30, 2015).

[114] *Id.*

[115] *Id.* §230.506. For an overview of Rule 504 and Rule 506, *see generally* Campbell, "The Wreck of Regulation D," *supra* note 8, at 923-26.

[116] *See* Campbell, "The Wreck of Regulation D," *supra* note 8, at 928. A recent article by Professor Manning Warren shows the relatively small number of Regulation D offerings that utilize Rule 504 or Rule 505. Manning Gilbert Warren III, "The False Promise of Publicly Offered Private Placements," 68 SMU L. Rev. 899, 903 fig.1 (2015) (noting that out of a sample of 33,440 Regulation D filings, only 450 were Rule 504 offerings and only 825 were Rule 505 offerings).

[117] *Id.* tbl. III.

[118] *See* 15 U.S.C. §77r(b)(4)(E) (2014).

Migrating to Rule 506, however, has costs for the issuer. One possible cost in moving from a Rule 504 offering to a Rule 506 offering is the expense of extensive disclosures that may be required in a Rule 506 offering.[119] These disclosures, however, are not required if the Rule 506 offering is limited to accredited investors.[120] Not surprisingly, therefore, one finds that the vast majority of offerings that migrate from Rule 504 to Rule 506 are limited to accredited investors. Thus, in a sample I constructed and used in prior research, I found that 88 percent of Rule 506 offerings of $1 million or less were limited to accredited investors.[121]

The net of this is that in small Regulation D offerings, the principal cost of migrating to a Rule 506 offering is the cost of limiting the offering to accredited investors. While this certainly amounts to a significant reduction in the pool of investors,[122] the out of pocket expenses – for example, legal and accounting costs – in moving to a Rule 506 offering may not be great.

Under Regulation A+, however, the costs of migration to a Tier 2 offering are different from the Regulation D migration and would seem to be significantly more daunting for a small issuer attempting to raise a relatively small amount of capital. Most important here are the additional disclosure requirements generated by moving to the Tier 2 regime. As described above in Section III, *ex ante* disclosures, especially the financial disclosures, are significantly more demanding, and thus more expensive, in a Tier 2 offering.[123] But more off-putting for a small issuer are the *ex post* disclosure requirements, which may require periodic filings with extensive narrative and financial disclosures for years to come.

There is also the matter of the opportunity costs in migrating to a Tier 2 offering. Faced with the practical loss of Tier 1 offerings due to continuing state authority over registration, there may be other opportunities that are more attractive for the small issuer that needs to make a broad solicitation for external capital. A more likely migration for small issuers foreclosed from Tier 1 offerings may be – as it was for Rule 504 – to a Rule 506 offering limited to accredited investors. Under new Rule 506(c), if limited to accredited investors, a small issuer may offer its securities through a general solicitation and sell to an unlimited number of purchasers.[124] Rule 506(c) imposes no mandated

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[119] *See* 17 CFR §230.502(b).

[120] *Id.* at §230.502(b)(1).

[121] Campbell, "The Wreck of Regulation D," *supra* note 8, at 930 tbl. VII.

[122] While it is difficult to be precise, data suggest that accredited investors may amount to 3 percent to 5 percent of the population. An analysis of Internal Revenue Service data shows that approximately 3.62 percent of all 2012 tax returns reported income of $200,000 or more. Justin Bryan, "High-Income Tax Returns for 2012," IRS Stat. Income Bull., Spring 2015, at 4, fig. C. For tax year 2007, *see* Justin Bryan, "High-Income Tax Returns for 2007," SOI Bulletin, Spring 2010, at 4 fig. A (noting that 3.172 percent of all 2007 tax returns reported income of $200,000 or more).

[123] *See supra* note 48-59 and accompanying text.

[124] *See* 17 CFR §230.506(c).

disclosure requirements or offeree qualification requirements[125] (such as sophistication), and state registration authority over Rule 506(c) offerings is preempted.[126] It may seem more likely that small issuers precluded from Tier 1 offerings would migrate to Rule 506(c), not to Tier 2.

Preliminary data suggest that few small offerings under Regulation A+ will migrate from a Tier 1 offering to a Tier 2 offering. From June 19, 2015, the effective date for the Regulation A+ rules, to May 24, 2016, only twenty-five Regulation A+ offerings of $20 million or less – offerings that could have been filed under the Tier 1 regime – were filed as Tier 2 offerings.[127]

In summary, it is difficult to see how Regulation A+ will materially benefit small issuers searching for a small amount of external capital. For such businesses using the Tier 1 regime under the new Regulation A+ rules, essentially nothing has changed. The requirements and impediments faced by issuers using Tier 1 are fundamentally the same as the requirements and impediments faced by issuers using Regulation A+ in its pre-JOBS Act form. Migration to Tier 2 for such small offerings by small businesses seems likely to generate unacceptably high offering and post offering costs and thus does not appear to be an attractive path for small businesses to solicit broadly for external capital.

V. WHO WILL USE REGULATION A+? IS THE OUTCOME BAD?

Although Regulation A+ may not work well for small issuers seeking relatively small amounts of external capital, as the size of the offering increases, Tier 2 offerings under Regulation A+ may become more attractive. Relative transaction costs decrease as the size of the offering increases, and thus the expenses associated with the Tier 2 disclosure requirements becomes less of an impediment to financing.

The most significant limitation on the availability of Regulation A+ for these larger Tier 2 offerings is that the issuer cannot be a reporting company under the 1934 Act.[128] The niche for Regulation A+ offerings, therefore, seems likely to be for offerings by businesses with the need for significant amounts of external capital – perhaps amounts between $5 million and $50 million – provided that those businesses are not subject to the reporting requirements of section13(a)[129] or section 15(d)[130] of the 1934 Act.[131]

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[125] *See id.*

[126] 15 U.S.C. §77r(b)(4)(E) (2014).

[127] Regulation A+ data were obtained from the subscription-only Lexis Securities Mosaic website. *See* Form 1-A Data, LEXIS SEC. MOSAIC, www.lexissecuritiesmosaic.com (last visited May 24, 2016) (click "SEC Filings" tab; then follow "SEC Filings" hyperlink, then search "Form 1-A").

[128] 17 CFR §230.251(a)(2) (establishing that Regulation A+ is available only if the "issuer. . . [i]s not subject to section 13 or 15(d) of the Securities Exchange Act of 1934. . .immediately before the offering.").

[129] 15 U.S.C. §78m(a) (2011).

[130] 15 U.S.C. §78o(d) (2014).

One point of this discussion is to recognize that there may be a niche for Tier 2 offerings, although the niche is likely limited to a group of larger privately and semi-privately owned companies.[132] The existence of this limited niche, however, does not change the fundamental fact that Regulation A+ is unlikely to provide any material relief for small businesses searching for small amounts of external capital. Still, one may question whether denying small businesses access to Regulation A+ is significant. One might, for example, point out that small businesses are no worse off than they were before Regulation A+.

My view is that the Commission's failure is significant. The Commission, by its failure to make Regulation A+ available to small businesses with small capital needs, missed the opportunity offered by the JOBS Act to construct a much better overall exemption regime for small businesses.

Considered as a whole, the JOBS Act, although certainly not without its challenges to regulatory implementation, offered the Commission the opportunity to construct three essentially new and rational paths for small business capital formation. Title II opened the way for a broad solicitation of accredited investors under Rule 506.[133] Rule 506(c) now permits a broad solicitation for investors, imposing the investor protection provision – which is the accredited status of the investors – at the point of *purchase*.[134] The correct implicit assumption of this is that no material harm to investors results from the broad solicitation, so long as the *purchasers* meet the accredited investor requirement.

Title III of the JOBS Act opened the way for internet offerings of up to $1 million through a technique referred to as crowdfunding, but subject to the disclosure of investment information to investors.[135] Essentially, this permits small issuers to post their offerings on the internet but prohibits any other sales activities.

The third leg of the JOBS Act for small business capital formation is Title IV, and it is an important complement to Title II and Title III. Title IV permits broad solicitation for investors, does not limit purchasers to accredited investors, and allows the use of

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[131] One might also assume that many or more of the issuers considering a Tier 2 offering would be unwilling to make the offering under Regulation A+ if as a result the company became subject to the 1934 Act. Under §12(g) of the 1934 Act, companies generally are required to file a registration statement with the Commission and thus become subject to the provisions of the 1934 Act when they have $10 million in assets and 500 shareholders of record that are not accredited investors. 15 U.S.C. §78l(g) (2014).

[132] As previously described, a petition for review was filed with the United States Court of Appeals for the District of Columbia Circuit asking for a permanent injunction regarding the preemption of state registration authority over securities sold under Regulation A+. *See* Petition for Review, Galvin v. SEC, No. 15-1150 (D.C. Cir. May 22, 2015). A successful challenge to the preemption over Tier 2 offerings would, of course, significantly limit the use of Regulation A+ for larger offerings within the $50 million limit of the exemption.

[133] *See* Campbell, "The Impact of JOBS," *supra* note 14 at 825-30.

[134] 17 CFR §230.506(a)-(c) (2015).

[135] 15 U.S.C. §77d-1(b) (2011); *see also* Campbell, "The Impact of JOBS," *supra* note 14 at 830-39.

traditional and usual selling efforts and techniques, but subject to prescribed, scaled disclosures.[136]

Without a viable Title IV, the JOBS Act limits small businesses to selling to accredited investors, which amounts to a small percentage of the population, and the passive posting of offers on the internet. There is, in short, no way under the JOBS Act for small businesses to raise a small amount of capital through traditional marketing techniques that have always been and will always be at the heart of small business capital formation.

VI. WHO IS TO BLAME? WHO CAN FIX THE PROBLEM?

NASAA and the Commission are two obvious parties to blame for what appears to be a subversion of the legislative intent of Title IV, which apparently was to provide an efficient exemption from registration for small offerings by small businesses.

NASAA and its members have long and with remarkable success fought preemption of state authority over registration, especially as it relates to exempt offerings by small businesses. NASAA and state regulators, for example, mounted a successful fight in the adoption process for the National Securities Market Improvement Act of 1996 (NSMIA)[137] to materially limit NSMIA's preemption of state registration authority over exempt offerings.[138] NSMIA, which was originally introduced as the Capital Markets Deregulation and Liberalization Act of 1995,[139] in its original form would have preempted all state registration authority over exempt offerings, except for shares offered under the federal intrastate exemption.[140] As enacted, however, NSMIA had significantly more limited preemption and, most importantly, did not preempt state authority over offerings under Section 3(b) of the 1933 Act.[141]

A more exotic strategy to limit preemption, and a strategy generally considered to have been orchestrated by NASAA,[142] occurred in connection with the enactment of the Dodd-

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[136] 17 CFR §230.251; *see also* Campbell, "The Impact of JOBS," *supra* note 14 at 839-47.

[137] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 and 29 U.S.C.).

[138] *See* "Capital Markets Deregulation and Liberalization Act of 1995: Hearing on H.R. 2131 before the Subcomm. on Telcomms. & Fin. of the H. Comm. on Commerce," 104th Congress 307 (1996) [hereinafter "Hearing on H.R. 2131"] (statement of Dee R. Harris, President, North American Securities Administrators Association) ("NASAA is opposed to the preemption of state authority to register and review securities offerings.").

[139] H.R. 2131, 104th Cong. (1995).

[140] The statutory basis for the intrastate exemption is 15 U.S.C. §77c(a)(11) (2014). Section 3(a) of the Capital Markets Deregulation and Liberalization Act of 1995 preserved state registration authority over intrastate offerings. H.R. 2131.

[141] *See* 15 U.S.C. §77r(b) (2014). Section 3(b) of the 1933 Act is statutory basis for exemptions provided by Rule 504, Rule 505, and Regulation A. *Id.* §77c(b) (2014).

[142] *E.g.,* Scott Edward Walker, "A Personal Letter to Senator Dodd Regarding his Anti-Angel Investment Bill," Walker Corp. L. Group (Mar. 31, 2010), http://walkercorporatelaw.com/angel-

Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[143] In 2009, an early discussion draft of that legislation was made available.[144] That draft of the legislation, even at that early stage, was an exceedingly contentious and complex bill that ran well over one thousand pages and was designed to enact significant reforms in the conduct of financial institutions and Wall Street practices and to avert future financial crisis of the type that had severely damaged the economy in 2008. Buried deep in that document, however, was a provision that had nothing to do with financial institutions or Wall Street reform. Specifically, Section 928 would have eliminated preemption of state registration authority over Rule 506 offerings, which was the only meaningful preemption in NSMIA of state registration authority over small business capital formation.[145] Ultimately, the provision did not survive the legislative process, and the preemption of state registration authority over Section 506 offerings continued.

NASAA continues its vigorous opposition to preemption of state authority over registration. It has established the NASAA Preemption Resource Center on its website, where it offers up its various activities and its encouragement in the fight against preemption.[146]

Not surprisingly, NASAA and its members fought preemption of state authority over Regulation A+ offerings, following a traditional path of expressing opposition to preemption through letters commenting on the Commission's rules.[147] One might additionally assume that NASAA and its members were also influential in convincing members of the House and Senate to write letters directly to the Chair of the Commission opposing preemption over Regulation A+ offerings.[148] It is difficult to miss the implied threat in such letters from members of the body that controls the Commission's budget. Finally, a new strategy was unleashed in response to the

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issues/a-personal-letter-to-senator-dodd-regarding-his-anti-angel-investment-bill; Broc Romanek, "Dodd Bill Peculiarities: The SEC's Reg D Preemption Gets Hammered," The Corp. Couns. (Mar. 23, 2010), http://www.thecorporatecounsel.net/blog/2010/03/an-office-of-investor-advocate.html; Bill Carleton & Joe Wallin, "Dodd's Attack on Angel Financing," Puget Sound Bus. J. (Mar. 15, 2010, 1:15 PM), http://www.bizjournals.com/seattle/blog/techflash/2010/03/congress_attack_on_angel_financing.html.

[143] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[144] Restoring American Financial Stability Act of 2009, S. 3217, 111th Cong. (2009) (as introduced by Senator Dodd for discussion), *available at* http://www.llsdc.org/assets/DoddFrankdocs/bill-111th-s3217-discussion-draft.pdf.

[145] *Id.*

[146] "NASAA Preemption Resource Center," NASAA, http://www.nasaa.org/issues-and-advocacy/nasaa-preemption-resource-center/ (last visited Dec. 28, 2015).

[147] *See* Adopting Release Regulation A+, *supra* note 3, at 21,857 n.772 (citing the list of letters sent in opposition). A significant majority of the letters cited therein opposing preemption were either from NASAA, from those apparently inspired by NASAA's lobbying efforts, or from members of NASAA (*i.e.*, state securities regulators). *See id.*

[148] *See id.*

Commission's preemption of state authority over Tier 2 Regulation A+ offerings, which was to challenge preemption in the courts.[149]

NASAA is subject to criticism for the adverse and inefficient effects its efforts have had on small business capital formation. Efficient and well-balanced federal exemptions from registration designed specifically to promote efficient capital formation for small businesses have been wrecked by state authority over registration.[150] One may, of course, put various spins on NASAA's activities, but it has at least the specter of turf protection at the expense of efficient capital formation. It also substantially misallocates state resources, which could be much more efficiently used to prevent fraud.[151]

One must realize, however, that NASAA and the state securities regulators that comprise its membership will never change. They will continue to be – as they have in the past – an organized, vocal, and formidable force advocating the nonsensical position that it is appropriate in a market economy to require small businesses that search for external capital to comply with fifty-plus separate registration regimes.

The Commission for its part has a history over the last twenty years of actions and inactions enabling NASAA. Principally, the Commission's enabling of NASAA has taken two forms. The Commission has failed to advocate in favor of preemption, and the Commission has failed responsibly to use its delegated authority to expand preemption.

Actions of the Commission in connection with the enactment and implementation of NSMIA provide examples of the Commission's significant failures. First, in the Congressional hearing leading to the adoption of NSMIA, the Commission refused to support preemption.[152] State authority over registration was choking small business capital formation, yet the Commission refused to support the Congressional remedy that was originally offered, namely broad preemption of state authority over registration.[153]

Even without the Commission's support for preemption, Congress in NSMIA handed the Commission broad authority to expand preemption by regulation. It did so by

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[149] *See* Petition for Review, Galvin. SEC, No. 15-1150 (D.C. Cir. May 22, 2015).

[150] *See, e.g.*, Campbell, "The Wreck of Regulation D," *supra* note 8, at 922; *see also* Campbell, "A Moderate Capital," *supra* note 9, at 80-81.

[151] *See* Rutheford B. Campbell, Jr., "Federalism Gone Amuck: The Case for Reallocating Governmental Authority over Capital Formation Activities of Businesses," 50 Washburn L.J. 573, 574-74 (2011) (arguing that states should reallocate "scarce state resources to their most efficient use, which is the support of the states' enforcement of their antifraud provisions.").

[152] *See, e.g.*, "Hearing on H.R. 2131," *supra* note 138, at 102-31 (statement of Arthur Levitt, Chairman of the SEC); *see also* Campbell, "The Wreck of Regulation D," *supra* note 8, at 937 ("The testimony and prepared remarks of then-Chairman Levitt offered during the legislative hearings skillfully dodged any support for broad preemption of state authority over securities offerings.").

[153] As described above, as originally introduced, NSMIA provided for broad preemption of state authority over registration, including a preemption of authority over offerings under Section 3(b) exemptions. *See supra* notes 139-141 and accompanying text.

preempting in NSMIA state registration authority over offerings to "qualified purchasers" and delegating broad authority to the Commission to define "qualified purchasers."[154]

In the twenty years after the passage of NSMIA, however, the Commission has never acted to expand preemption over exempt offerings by small businesses,[155] even as states' registration obligations have continued to choke small business capital formation and wreck the Commission's rational, efficient exemptions from federal registration.[156]

The second sin of the Commission, therefore, was its refusal to use its broad delegated authority to expand preemption by regulation in a manner that enhanced efficient small business capital formation. This latter failure of the Commission seems to have been significant enough to cause Congress to say it again in Title IV of the JOBS Act. Specifically, Title IV of the JOBS Act, in the same language as used in NSMIA, preempted state authority over Regulation A+ offerings that are "offered or sold to a qualified purchaser, as defined by the Commission."[157]

Even with this somewhat dramatic reiteration, the Commission once again refused to enact a regulatory expansion of preemption that would make Regulation A+ relevant for small business capital formation. Small business – once again – went under the bus as a result of the Commission's enabling action or inaction, and Regulation A+ wound up providing a small niche that practically is available only for larger, closely held (or at least non-reporting) companies.

Perhaps the Commission saw a risk that an expanded preemption over Tier 1 offerings would draw a court challenge from NASAA and state regulators, claiming that such a regulation exceeded its delegated authority under Title IV of the JOBS Act. Obviously, that fear would have been justified, in light of the fact that a suit challenging the preemption over Tier 2 offerings has been filed.[158]

Although any suit challenging preemption inevitably will have a significant disruptive effect,[159] it is difficult to imagine that a court will conclude that a broad preemption over all Regulation A+ offerings exceeds the Commission's delegated authority under Title IV.

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[154] *See* 15 U.S.C. §77r(b)(3) (2014).

[155] The only significant move by the Commission, to define "qualified purchaser," occurred in 2001. The Commission proposed to define "qualified purchaser" as "any accredited investor" under Regulation D. Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, 66 Fed. Reg. 66,839, 66,847 (proposed Dec. 27, 2001) (to be codified at 17 CFR pt. 230). The Commission failed to adopt this proposal.

[156] *See* Campbell, "The Wreck of Regulation D," *supra* note 8, at 922; *see also* Campbell, "A Moderate Capital," *supra* note 9, at 80-81.

[157] 15 U.S.C. §77r(b)(4)(D)(ii).

[158] *See* Petition for Review, Galvin v. SEC, No. 15-1150 (D.C. Cir. May 22, 2015).

[159] It seems unlikely, for example, that many issuers will utilize Tier 2 offerings until the litigation is resolved. Indeed, these disruptive effects may be part of the new NASAA strategy. The delay of the effectiveness of the regulation and the risk that a court may strike down the regulation reduce the anticipated value of the regulation. In addition, the Commission also faces the costs of litigating the matter. This reduction in the value of the regulation and the regulation's increased

Following the adoption of NSMIA, I wrote urging the Commission to adopt and implement an expansive view of its power to preempt state registration authority through the regulatory definition of "qualified purchasers."[160] In preparing that article, I examined the legislative history of NSMIA as it related to the Commission's delegated authority to define "qualified purchaser," and I found Committee language that was confusing, contradictory, and ultimately inconclusive.[161]

The statutory language of NSMIA itself, however, shows a very broad delegation of Commission authority to define "qualified purchaser." As if to emphasize the breadth of that delegated authority, the statute states that the Commission may define the term "differently with respect to different categories of securities."[162] The only limitation on the Commission's authority in the statute is the requirement that the definition must be "consistent with the public interest and the protection of investors."[163] Another section of NSMIA states that when the Commission in its rulemaking is required to act "in the public interest, the Commission shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[164] In the case of Title IV, the same statutory language authorizes – once again – the Commission to preempt state registration authority over Regulation A+ offerings.[165]

Any claim that the Commission would exceed its delegated authority by the preemption of state registration authority over Tier 1 or Tier 2 Regulation A+ offerings seems unsupportable. Both Tier 1 and Tier 2 offerings depend on the issuer's disclosing closely-tailored investment information to each investor. The claim that the Commission

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costs may deter the Commission from beneficial risk taking with regard to regulatory expansion of preemption.

[160] *See* Rutheford B. Campbell, Jr., "Blue Sky Laws and the Recent Congressional Preemption Failure," 22 J. Corp. L. 175, 207-10 (1997). Obviously, my arguments fell on deaf ears. *See supra* notes 154-156 and accompanying text.

[161] While there is some legislative history of NSMIA reflecting a limitation on the Commission's authority to define "qualified purchaser," the language from the Committee considering NSMIA is so confusing as to be essentially worthless. For example, the report states that the definition of "qualified purchasers" should "[i]n all cases. . .be rooted in the belief that 'qualified' purchasers are sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary." H.R. Rep. No. 104-622, at 31 (1996). In the same paragraph, however, the Report states that "the Commission may define the term 'qualified purchaser' differently with respect to different categories of securities, consistent with the public interest (including consideration of efficiency, competition and capital formation) and the protection of investors." *Id.* at 32. The two sentences cannot be reconciled, since the first sentence seems to say that the only definition for qualified purchaser is sophistication, while the second sentence says that the Commission may define the term differently and explains the factors that can go into that determination.

[162] 15 U.S.C. §77r(b)(3).

[163] *Id.*

[164] *Id.* §77b(b).

[165] *See id.* §77r(b)(3), (b)(4)(D)(ii).

could not declare an investor that is protected by disclosure of investment information prescribed by the Commission to be a "qualified purchaser" is contrary to the core principle of the 1933 Act, which is disclosure as the bedrock protection for investors.

Even if there is some risk of an erroneous outcome in which a court declares that the Commission's definition of qualified purchaser exceeds its delegated authority, the Commission fails its responsibility if it allows the risk of disruption and the remote risk of an erroneous, adverse court opinion to keep it from doing the right thing, which is to craft a Regulation A+ that offers small businesses an efficient access to external capital. Such risks do not justify a bad outcome that is contrary to the purpose of Title IV.

Notwithstanding, history suggests that the Commission, like NASAA, will continue down the path it has been on for twenty years, continuing to be unwilling to expand preemption via regulation. If the Commission is unwilling to do this – even after Congress has re-delegated to the Commission broad authority in a piece of legislation entitled "Small Company Capital Formation" – it seems unlikely that a broadly worded delegation will ever generate the will at the Commission to preempt state registration over small business capital formation. Indeed, a moment of reflection reveals that the only preemptions of state authority over exempt offerings by small businesses have been the result of statute, specifically the preemption over Rule 506 offerings[166] and crowdfunding.[167]

Simply stated, my conclusion is that the Commission will continue to enable NASAA and state regulators to preserve a regime that makes it unnecessarily difficult, inefficient, and unfair for small businesses to access external capital. My other simple, related conclusion is that only Congress can break this gridlock by enacting statutory preemptions of state authority over registration.

CONCLUSION

The Commission's regulatory implementation of Title IV of the JOBS Act fails to provide small businesses with an efficient and fair access to external capital. Regulation A+ -- assuming, as is likely, that it survives the court challenge to the preemption of state authority over Tier 2 offerings – may find some life as an exemption for public offerings by larger, non-reporting companies, but the Regulation A+ rules offer nearly nothing to the millions of small businesses that are an important component of our national economy.

It is an inescapable irony that Title IV of the JOBS Act, which is entitled "Small Company Capital Formation," is of no material benefit to small businesses searching for external capital. But history continues to repeat itself, and once again, in the face of an aggressive campaign by NASAA and state regulators, the Commission was unwilling to use its delegated authority in a way that would benefit small businesses and the economy as a whole.

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[166] *Id.* §77r(b)(4)(C).

[167] *Id.* §77r(c)(2)(F).

PRIVATE OFFERINGS UNDER RULE 506

Manning Warren*

I. INTRODUCTION

Both state and federal regulation of securities offerings encompass two basic regulatory structures. One requires formal disclosure through registration of all offers and sales of securities, absent an available exemption. The second requires those offerors and sellers (and buyers) not to engage in fraudulent behavior in connection with purchases and sales of securities. These two regulatory prongs are the primary concerns of securities lawyers, as well as general business lawyers who occasionally counsel both start-up businesses and well-established businesses in raising capital through the offer and sale of securities. Those securities generally take the form of shares in a corporation, membership interests in a limited liability company (LLC), units in a limited partnership, and convertible notes or other debt securities issued by those business entities. Virtually none of your business clients will want to pursue a full-blown registration of their proposed securities offerings, even assuming a slight chance an investment banker would have the slightest interest in underwriting the offering. Going public is a very expensive exercise, including preparation of the registration statement and exchange listing application, conducting due diligence, conforming financial statements to both GAAP and the Securities and Exchange Commission's (SEC) Regulation S-X, and incurring outsized legal and accounting costs, as well as hundreds of hours of the management team's time over several months. And that's only the beginning. After the securities distribution has been completed, the now publicly held company has continuing disclosure obligations under the Securities Exchange Act of 1934 (1934 Act), requiring preparation and filing of Forms 10-K, 10-Q, and 8-K, among others. As a reporting company, the business also becomes subject to a wide variety of regulatory obligations, including the short swing profits rule, the proxy and tender offer rules and the Sarbanes-Oxley regulations, among others. It can be safely said that 99.9 percent of business entities in the United States have never pursued a registered public offering with the U.S. Securities and Exchange Commission (SEC) and never will.

Since the equity in virtually all limited liability entities is held in the form of securities, whether common shares or membership or partnership interests, these privately held companies must have found exemptions from registration under both federal and state securities laws at the moment of their formation. The overwhelming majority of these issuers, and, unfortunately, their counsel, failed to even think about the securities registration and exemption issues. They just formed the corporation, the LLC, or the limited partnership, which, in turn, offered, sold, and then issued equity interests to the founders of these companies. These individual investors typically would be fully involved in their businesses and would have total access to all material information about their own businesses. If challenged by a federal regulator for failure to register, the

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issuer could assert reliance on the statutory private placement exemption provided by Section 4(a)(2) of the Securities Act of 1933 (1933 Act), which exempts "transactions by an issuer not involving any public offering." Inadvertent reliance, although hardly optimal, is usually good enough. However, the Supreme Court in SEC v. Ralston Purina Co.[1] held long ago that an offering of securities to those who do not have meaningful intellectual and physical *access* to that material information about the issuer could be deemed a "public offering," even if the offering was only made to a handful of offerees. In other words, the term "public offering" under Ralston Purina and its progeny of decisions interpreting Section 4(a)(2) cannot be defined by a numerical reference to ten, twenty-five, thirty-five or any other number of offerees. Consequently, if your client enterprise intends to raise capital from outsiders or passive investors, it is highly advisable to search out other available exemptions from registration.

II. EXEMPTIONS FROM FEDERAL REGISTRATION

As counsel for a business client seeking to raise capital from passive investors, you have a bewildering array of possible exemptions from the federal registration requirements in the 1933 Act. They include, among others, the following:

1) Section 3(a)(11) [and Rule 147] intrastate exemption;

2) Rule 504 of Regulation D for $1,000,000 or less;

3) Rule 505 of Regulation D for $5,000,000 or less;

4) Rule 506(b) of Regulation D for unlimited amounts;

5) Rule 506(c) of Regulation D for unlimited amounts; and

6) Regulation Crowdfunding under Section 4(a)(6) for $1,000,000 or less.

The practical lawyer is unlikely to recommend reliance on the intrastate offering exemption or the Rule 504 and 505 exemptions because these exemptions are for securities offerings not involving "covered securities." Consequently, securities offerings offered pursuant to these federal exemptions remain fully subject to state "blue sky" registration requirements and failure to register remedies. The practical lawyer is even more unlikely to rely on the SEC's new *crowdfunding* exemption. Mandated by Congress in Title III of the Jumpstart Our Business Startups Act (JOBS Act) in 2012, the SEC's Regulation Crowdfunding (Regulation CF) became effective on May 16, 2016. It permits issuers to offer and sell, through registered funding portals or broker-dealers, up to $1,000,000 annually in securities to investors without registration at the federal or state regulatory levels. Issuers need not be concerned with whether these investors are insiders or outsiders, rich or poor, or smart or dumb. However, issuers are required to file Form C with the SEC, a quasi-registration requirement that imposes a considerable laundry list of mandatory disclosure items. Issuers are also required to provide financial statements prepared in accordance with

[1] 346 U.S. 119 (1953).

GAAP, certified by the chief executive officer for offerings of $100,000 or less, *reviewed* by an independent CPA for offerings of $100,000 to $500,000, and except for the first crowdfunding issuance, *audited* by an independent CPA for offerings of $500,000 to $1,000,000. In addition, Regulation CF provides for ongoing disclosure requirements, including an annual report that includes revised and updated Form C information. Finally, issuers, including their officer and directors, are subject to a *strict liability* remedy, similar to Section 12(a)(2) of the 1933 Act, for material misrepresentations and omissions in any oral or written communications to investors. Issuers' only substantive defense is that they did not know and in the exercise of reasonable care could not have known of the untruth or omission. Investors are not required to prove reliance or scienter (intent to deceive) in order to recover damages against issuers and their principal agents. The SEC, fearful of potential fraud, simply overregulated the crowdfunding exemption Congress forced it to promulgate. In the view of most securities lawyers, this crowdfunding exemption is not a truly viable means for raising capital.

III. RULE 506 EXEMPTIONS

This complex of federal statutory and regulatory exemptions has created, quite haphazardly, a regulatory vortex that drives the practical securities lawyer to the two exemptions provided by Rule 506 of Regulation D. Securities offered under either Rule 506(b) or Rule 506(c) exemptions are deemed "covered securities," and, accordingly, reliance (and compliance) with these rules exempts the offering from registration at the federal level and effectively *preempts* securities registration requirements at the state level of regulation. Moreover, both Rule 506 exemptions impose no formal disclosure requirements for offerings to *accredited investors*. That term presently includes, among others, individual investors who are managing insiders of the issuer (directors, officers, and general partners of the issuer) and rich outsiders who have a net worth over $1,000,000 (exclusive of equity in their primary residence) or who have annual incomes for the past two years (and prospectively for the following year) exceeding $200,000. At these thresholds, which are now being reconsidered by the SEC, this group of wealthy potential investors now approximates nine million households in the United States alone. Both Rule 506 exemptions allow issuers to raise an unlimited amount of capital from an unlimited number of offerees. The major differences between these Rule 506 exemptions concern sales to non-accredited investors and the use of advertising and general solicitation. Rule 506(b) permits sales to up to thirty-five (35) non-accredited investors who, either alone or with a purchaser representative, are capable of understanding the merits and risks of the investment. Rule 506(c) does not permit any sales to non-accredited investors. Rule 506(b) permits sales to an unlimited number of accredited investors, who generally self-certify their accreditation status. Rule 506(c) permits sales to an unlimited number of *verified* accredited investors, which requires issuers to engage in a verification process in order to make an objective determination of the investors' accreditation status. This would require review not only of investor self-certifications, but also review of investors' tax returns, bank and brokerage statements and appraisal reports of third parties or written confirmations of accredited investor status from investors' broker-dealers, investment advisers, accountants or attorneys. The major "advantage" Rule 506(c) affords issuers is that they can now engage in advertising and general

solicitation. Under Rule 506(c), issuers of all sizes are allowed to raise capital by going directly to the general public. They can market their securities through Super Bowl ads, Facebook, television infomercials, seminars, websites, billboards and any other media without registration. Issuers and their financial intermediaries do not have to have any pre-existing substantive relationship with investors as they do under Rule 506(b), which prohibits all advertising and general solicitation. Superficially, it would appear that Rule 506(c) would be the obvious choice. Issuers would readily forego sales to the relatively small number of smart non-accredited investors allowed by Rule 506(b) in favor of advertised offerings under Rule 506(c) that permits them to extend offers to the entire general public of offerees in order to effect sales to any number of those nine million households of accredited investors.

IV. THE PROFESSIONAL PREFERENCE

The superficially obvious choice of Rule 506(c)'s *public* ("noisy") private offering exemption has turned out not to be the actual choice of issuers and their securities lawyers during the three years since its promulgation. Instead, the overwhelming choice they have made in practice has been in favor of Rule 506(b)'s traditional private offering exemption. Last year, I undertook a study of SEC data and related Form D filings to determine how extensive issuer reliance on the new Rule 506(c) had been during the first year and a half following its adoption. As you know, Form D is the notice filing required under Regulation D for offerings made in reliance on Rule 506(b) and Rule 506(c) (as well as the two other Regulation D exemptions). The form requires issuers to indicate which exemptions are being relied upon in their unregistered offerings. The data showed that roughly 92 percent of Rule 506 filings indicated reliance on Rule 506(b) rather than the new Rule 506(c). In terms of actual capital raised in these offerings, of the $880 billion raised under Rule 506(b) and 506(c) during that initial eighteen month period, almost $860 billion or 97.5 percent was raised in reliance on Rule 506(b). More recent data for the period from Rule 506(c)'s inception through the end of last year shows that of the combined Rule 506(b) and Rule 506(c) offerings, issuers relied on Rule 506(b) in almost 96 percent of Rule 506 offerings.

V. THE PRIMARY RELUCTANCE FACTORS

Just why are issuers and their attorneys so extremely reluctant to employ the Rule 506(c) exemption? After all, this exemption permits them to raise unlimited amounts of capital, with no formal disclosure requirements and with no presale regulatory scrutiny by state or federal regulatory agencies, by offering securities to billions of offerees to attract purchases from millions of accredited investors. Since Rule 506(c)'s September 2013 effective date, I have made continual inquiries to practicing securities counsel to answer this perplexing question. In addition, I undertook a survey of attorneys who specialize in private placements of securities. I believe the results of my inquiries and my survey provide very useful insights to all attorneys who assist their business clients in the capital formation process. My work in this area has produced what I have termed the primary *reluctance factors* that explain both the strong reluctance to use Rule 506(c) and the corollary preference for Rule 506(b).

A. Issuers and their counsel have found the traditional Rule 506(b) model, now in use for some thirty-four (34) years, to be a highly practicable and reliable private placement structure and their established familiarity with its requirements provides an obvious best practices inertia. In my survey, a vast majority of securities lawyer respondents expressed satisfaction with the preexisting Rule 506(b) regulatory requirements, following a variant of the adage, "if it ain't broke, don't fix it." Significantly, approximately 80 percent of the lawyer respondents affirmed that their issuer clients had access to adequate capital from accredited investors without any resort to solicitation of the general public.

B. Issuers and their counsel are profoundly reluctant to offer securities to *accredited strangers*, as opposed to investors with whom they have preexisting personal and business relationships. Most securities lawyers believe it is not beneficial to their clients' best interests to recruit anonymous investors. The underlying rationale for their view is that strangers who become dissatisfied with their investment are much more likely to file lawsuits against issuers, their principals and their counsel. Even if these accredited strangers do not file formal complaints, they are perceived as being much more likely to be "ankle biters," demanding constant attention, expressing frequent informal complaints, and otherwise consuming an inordinate amount of management time. Issuers and their intermediaries obviously prefer accredited investors whom they know and trust based on the existence of substantive relationships that precede the investment. Business clients conducting private placements should be very cautious about relatively anonymous investors who may have the money but may have scant experience in making money and losing money in private equity transactions. From the issuers' perspective, Rule 506(b)'s prohibition on general solicitation has proven fundamentally beneficial in providing a more secure investor base. From the investors' perspective, the issuer's need to employ general solicitation may raise the frightening possibility that issuers are raising money from "last resort" accredited strangers because their offerings have been largely rejected by traditional accredited investors already known to them. Consequently, general solicitation may "red flag" the merits of securities offerings and reduce investor interest.

C. Issuers and their lawyers generally prefer to preserve the confidentiality of their private securities offerings and their related business plans, including their proposed use of proceeds, business strategies and financial information. Advertising and general solicitation would provide public notice of the offering and cause unwelcome exposure of material information to both existing and would be competitors. Providing this information solely to a targeted group of accredited investors already well known to issuers and their counsel offers considerably more protection of business confidentiality.

D. Issuers and their counsel not only prefer to protect the confidentiality of their securities offerings from potential competitors but also from state and federal regulators. Most professionals believe public private placements under Rule 506(c) will place issuers in a *regulatory spotlight*.

State regulators vigorously opposed Title II of the JOBS Act which added Section 4(b) to the 1933 Act and mandated the SEC's promulgation of Rule 506(c). State securities administrators are positioned to insist on strict compliance with Rule 506(c)'s conditions. Issuers' failure to satisfy their burden of proof will result in the loss of preemption and, consequently, violation of state registration requirements. The SEC has indicated that it is closely monitoring Rule 506's general solicitation regime. At the time of its promulgation of Rule 506(c), the SEC also proposed rules that would superimpose additional disclosure requirements, including, among others, specific information on the types of general solicitation used, special legends in the offering materials, an "Advance Form D," and issuers' filing of written general solicitation materials with the SEC. Although none of these proposed rules have yet been adopted, their proposal has produced a *regulatory overhang* that generates further reluctance by issuers and their attorneys to utilize Rule 506(c).

E. Issuers and their lawyers are also reluctant to use Rule 506(c) because of its mandate that issuers engage in an independent verification process in order to objectively determine the accredited investor status of each accredited investor in Rule 506(c) offerings. The SEC has advised that this verification requirement must be satisfied by issuers even in offerings where all investors are proven to be, in fact, accredited investors. Most securities lawyers have not yet developed a comfort level with the necessary "reasonable steps to verify." Moreover, this compliance requirement could chill the interests of many significant investors who have understandable reluctance to share their tax returns, brokerage statements and other confidential financial information with issuers' management and attorneys. In my survey of securities lawyers, some two-thirds of the respondents expressed concerns over compliance with the verification requirement. Consequently, Rule 506(b) offerings are preferential since accredited investor status can be established based on issuers' "reasonable belief," generally based on investor self-certifications, that prospective investors satisfied the accredited investor criteria. The possibilities that accredited investors will walk away from Rule 506(c) offerings based on privacy concerns clearly contributes to issuer reluctance to use Rule 506(c) and to a corollary preference to use Rule 506(b) as the exemption from registration.

Based on my ongoing discussions with securities lawyers, the factors discussed above are the primary reasons issuers and their counsel are reluctant to pursue exempt offerings under Rule 506(c). The primary reluctance factors I have identified do not constitute an exhaustive list. As stated previously, Rule 506(c), unlike Rule 506(b), permits no sales to non-accredited investors, no matter how financially sophisticated they may be. Moreover, unlike Rule 506(b), issuers relying on Rule 506(c) cannot fall back on the statutory private placement exemption provided by Section 4(a)(2) of the 1933 Act in the event of non-compliance with the technical requirements of Regulation D. The statutory private placement exemption, like Rule 506(b), strictly prohibits any advertising or general solicitation. Although no single reluctance factor may be determinative, these factors collectively dissuade the vast majority of issuers and their securities

lawyers from reliance on Rule 506(c) and strengthen their corollary preference for the traditional Rule 506(b) offering of securities.

VI. CONCLUSION

The federal exemptive scheme for private offerings of securities has been significantly simplified as a result of the National Securities Market Improvement Act of 1996 and its defining the term "covered securities" to include, among others, all securities offered in reliance on Rule 506(b) or Rule 506(c). By preempting the states from imposing registration requirements on these securities, Congress effectively eliminated issuers' reliance on the other exemptions provided by the 1933 Act. Three years ago, Congress, with great fanfare, ordered the SEC to adopt Rule 506(c) to allow general advertising and general solicitation in private placements of securities. In doing so, Congress forced the SEC to create a regulatory framework for publicly offered private placements. However, in practice, the new scheme has not been widely accepted by issuers and their counsel. The primary reluctance factors addressed explain in large part why the new Rule 506(c) exemption has not enjoyed significant success.

A SYNOPSIS OF REGULATION D AND THE KENTUCKY EXEMPTIONS: THE EXEMPTIVE SCHEME FOR LIMITED OFFERINGS OF SECURITIES

Professor Manning G. Warren III

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I. INTRODUCTION

Regulation D, which first became effective on April 15, 1982, is a series of eight rules, Rules 501-508 (17 C.F.R. §§230.501-508), governing the limited offer and sale of securities without registration with the SEC. Its primary purposes, as set forth in SEC Release No. 33-6389, were to simplify and clarify the pre-existing limited offering exemptions, to expand their availability and to achieve uniformity among state and federal exemptions. Since its original adoption, Regulation D has been amended numerous times, including amendments, among others, to:

- Modify the notice requirement (SEC Rel. No. 33-6663);
- Expand the accredited investor concept (SEC Rel. No. 33-6758);
- Introduce a *substantial compliance* defense (SEC Rel. No. 33-6825);
- Implement the SEC's small business initiatives (SEC Rel. Nos. 33-6949 and 33-6996);
- Add a safe harbor for announcements of certain unregistered offerings (SEC Rel. No. 33-7053);
- Increase restrictions on the resale of Rule 504 securities (SEC Rel. No. 33-7644), to amend the net worth calculation for individual accredited investors (SEC Rel. 33-9287);
- Amend Rule 506 by adding a new Rule 506(c) exemption permitting general solicitation in offerings made solely to *verified* accredited investors (SEC Rel. 33-9415); and
- Impose "bad boy" provisions disqualifying certain issuers from use of Rule 506(b) or (c) (SEC Rel. 33-9414), effective September 23, 2013.

Regulation D Rules 501-503 provide the definitions and conditions, Rules 504-506 set forth the substantive exemptions, and Rules 507 and 508 deal, respectively, with failure to file notices and the substantial compliance defense.

Clearly, the most widely used regulatory exemption under Regulation D is Rule 506(b), formerly Rule 506. It presently accounts for over 90 percent of all Regulation D offerings and in recent years has accounted for 99 percent of funds raised under Regulation D. Under Rule 506(b), issuers are permitted to raise an unlimited amount of capital from an unlimited number of accredited investors and up to thirty-five non-accredited investors but must refrain from general

solicitation. Moreover, as a result of the National Securities Market Improvement Act of 1996 (NSMIA), securities offerings made in compliance with Rule 506(b) or (c) have been deemed "covered securities," and, hence, not subject to *state registration* requirements. However, the issuer has the burden of proving that a purported Rule 506(b) or (c) offering actually satisfies all conditions of the exemption. *See, e.g.*, Brown v. Earthboard Sports USA, Inc., 481 F.3d 901 (6th Cir. 2007); Risdall v. Brown-Wilbert, Inc., 753 N.W.2d 723 (Minn. 2008); Buist v. Time Domain Corp., 926 So.2d 290 (Ala. 2005). For example, it has been held that the disclosure requirements of an exemptive rule are not satisfied where the offering memorandum contains material misrepresentations or omissions. *See, e.g.*, Johnston v. Bumba, 764 F. Supp. 1263 (N.D. Ill. 1991); Weprin v. Peterson, 736 F. Supp. 1124 (N.D. Ga. 1988). In order to sustain the issuer's burden of proof that the conditions of Rule 506(b) or (c) exemptions have been satisfied, counsel for the issuer should ensure that the issuer retain all documentation relating to the availability of the exemption.

Rule 506's attractiveness as the predominant regulatory exemption from registration has been significantly enhanced as a result of the Congressional mandate in Section 201(a) of the Jumpstart Our Business Startups Act of 2012 (JOBS Act). This provision required the SEC to eliminate one of Rule 506's historical conditions, its prohibition on general solicitation and advertising for offers and sales of securities pursuant to Rule 506, provided that all purchasers of the securities are accredited investors and the issuer has taken reasonable steps to *verify* their accredited investor status.[1] In response to this mandate, the SEC promulgated Rule 506(c), which in effect bifurcates Rule 506, retaining (1) the traditional Rule 506(b) exemption for securities sold to both accredited and non-accredited investors without general solicitation, and (2) establishing a new Rule 506(c) exemption for generally solicited exempt offerings sold solely to *verified* accredited investors. *See* SEC Rel. 33-9415 (July 10, 2013). In effect, the new Rule 506(c) offering to verified accredited investors is, ironically, an exempt "public" private offering.[2]

It should be noted that historically Rule 506 has been used in conjunction with the statutory private placement exemption provided by Section 4(a)(2) of the 1933 Act. That will no longer be the case for issuers relying on Rule 506(c). Any use of general solicitation in a Rule 506(c) offering to accredited investors would render the *statutory* private placement exemption at Section 4(a)(2) of the 1933 Act unavailable. According to the SEC's release, "an issuer relying on Section 4(a)(2) outside of the Rule 506(c) exemption will be restricted in its ability to make public communications to solicit investors for its offering because public advertising will continue to be incompatible with a claim of exemption under Section 4(a)(2)." The JOBS Act mandate, according to the SEC, was intended to affect only the Rule 506 safe harbor and not Section 4(a)(2) offerings in general.

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[1] Rule 506(c)(2)(ii) provides verification methodologies for purchasers accredited by income or net worth.

[2] The Rule 506(c) exemption should not be confused with the completely distinct *crowdfunding* exemption at Section 4(a)(6) of the 1933 Act and recently implemented by the SEC in Regulation CF, effective May 16, 2016. SEC Rel. 33-9974 (Oct. 30, 2015). *See generally*, Sara Hanks, "SEC Adopts Regulation Crowdfunding," 48 Sec. Reg. L. Rep. 28 (Jan. 4, 2016).

Counsel should be forewarned that traditional and often successful efforts to fall back on the statutory exemption will no longer be possible when the issuer has engaged in any general solicitation.

In the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), at Section 926, Congress required the SEC to amend Rule 506 to *disqualify* securities offerings involving certain felons and other bad actors, so-called "bad boys," from reliance on Rule 506. Pursuant to this mandate, the SEC adopted disqualifying provisions in new Rule 506(d) under Regulation D. *See* SEC Rel. 33-9414 (July 10, 2013). Consequently, an issuer will not be entitled to rely on either the traditional Rule 506(b) exemption or its Rule 506(c) counterpart if the issuer, its affiliated or predecessor issuers, its executive officers (or other officers participating in the offering), its general partners or managing members, its major shareholders (20 percent beneficial owners), its promoters and those soliciting purchasers for direct or indirect remuneration, and any director, executive officer, general partner or managing member of such solicitors have been subject to certain disqualifying events within prescribed five and ten year time frames. These disqualifying events, include, among others, felony and misdemeanor convictions related to securities transactions, false filings, judicial and administrative orders restraining securities related conduct or practices, certain state securities, banking and insurance authorities' final orders, and SEC orders suspending or revoking registration and other orders delimiting securities related activities. Significantly, issuers are provided with a reasonable care defense if they actually show they made factual inquiries into whether disqualifications existed. Moreover, the SEC has provided in Rule 506(d) that the rule will apply only to disqualifying events that occur after its effective date. It should be emphasized that if an issuer conducts an offering while subject to disqualification under Rule 506(d), it not only loses its Rule 506 exemption but may also become subject to applicable state registration requirements.

Lastly, broker-dealers and their agents who participate in any Regulation D offering should be especially mindful of their obligation to conduct a reasonable investigation of both the issuer and the offered securities in order to establish a reasonable basis for recommending the securities for investment by their clients. In addition to this "reasonable basis" *suitability*, these securities professionals must also conduct a "customer specific" *suitability* analysis to determine whether the securities are suitable for each specific customer. *See* FINRA Rule 2111, formerly NASD Rule 2310; *FINRA Regulatory Notices* 11-02, 11-25 and 12-25 (May 2012); Frequently Asked Questions on FINRA Rule 2111 (Suitability); FINRA Rule 2090 ("Know Thy Customer"), formerly NYSE Rule 405. Broker-dealers and their agents should be especially careful to distinguish the *accredited investor* from the *suitable investor* – they are unrelated concepts utilized in entirely different contexts. Moreover, in recommending any security to its customers, broker-dealers and their agents implicitly represent that they have made a reasonable investigation and that the recommendation rests on the conclusions reached as a result of that investigation. *See generally FINRA Regulatory Notice* 10-22 (April 2010). Failure to comport with this obligation could constitute not only a violation of FINRA Rules but also a violation of state and federal securities antifraud provisions. *See also*, 808 KAR 10:440, providing examples of dishonest or unethical practices for broker-dealers and agents, including violation of the suitability standards. *Id.* at Sec. 1(13).

II. THE SEC'S REGULATION D EXEMPTIONS[3]

	Rule 504
(1) Statutory authority:	§3(b) of 1933 Act.
(2) Predecessor:	Rule 240.
(3) Aggregate offering price:	$1,000,000 in twelve months.
(4) Integration doctrine:	Six month safe harbor.
(5) Number of offerees:	Unlimited.
(6) Number of purchasers:	Unlimited.
(7) Disclosure requirements:	No specific requirements.
(8) Issuer qualifications:	Not available to reporting companies, "blank check" companies or investment companies.
(9) Manner of offering:	No general solicitation permitted except for state-registered offerings.
(10) Commissions:	Permitted for registered broker-dealers.
(11) Offeree qualifications:	No suitability determinations.
(12) Purchaser qualifications:	No suitability determinations.
(13) Resale limitations:	Unrestricted only as to state-registered or state-exempt accredited investor offerings. Resale of all other securities is subject to registration, another exemption, *e.g.*, Reg. A, or the one-year holding period of Rule 144.
(14) Notice of sales:	Form D must be filed in electronic format within fifteen days after first sale.

NOTE: Failure to file is not a condition to any Reg. D exemption, but under Rule 507, may serve to disqualify the issuer from future Reg. D availability. *See also* Rule 508 permitting substantial, as opposed to strict, compliance with the Reg. D requirements.

[3] *See* SEC, *Compliance & Disclosure Interpretations* (C&DI's), Sec. 254-260, which provides periodic guidance for issuers engaged in exempt offerings under Regulation D.

Rule 505

(1) Statutory authority:	§3(b) of 1933 Act.
(2) Predecessor:	Rule 242.
(3) Aggregate offering price:	$5,000,000 in twelve months.
(4) Integration doctrine:	Six month safe harbor.
(5) Number of offerees:	Unlimited.
(6) Number of purchasers:	Thirty-five purchasers, excluding (i) relatives living in same household; (ii) trusts or estates in which purchaser or relatives have more than 50 percent beneficial interest; (iii) entities of which purchaser and relatives own more than 50 percent equity interest; and (iv) accredited investors.

NOTE: Accredited investors include (i) institutional investors; (ii) private business development companies; (iii) corporations, limited liability companies, and entities described in I.R.C. §501(c)(3) with over $5,000,000 in assets and not formed for the purpose of acquiring the securities; (iv) directors, officers and general partners of issuers; (v) individuals with net worth or joint net worth in excess of $1,000,000 (excluding positive equity in their primary residence); (vi) individuals with over $200,000 income, or joint income of over $300,000 for two (2) years and year of sale; (vii) trusts with over $5,000,000 in assets if purchase is directed by a sophisticated person; and (viii) entities owned solely by accredited investors. *See* Rule 215 and Rule 501(a).

(7) Disclosure requirements:	None specified as to accredited investors. For other investors, *reporting companies* may use either of two sets of documents filed with the SEC, supplemented by more current information required to be filed with the SEC, together with a description of the securities to be offered, use of proceeds and any material changes not disclosed in previously filed reports. *Non-reporting companies* eligible to use Reg. A may use for *non-financial statement information* Part II of Form 1-A. If ineligible to use Reg. A. the issuer must use Form S-1. For *financial statement information*, the non-reporting issuer may use, for offerings up to $2,000,000, the information required under Article 8 of Reg. S-X (with an audited balance sheet). For offerings from $2,000,000 to $5,000,000, the issuer may

	use the requirements of Form S-1 applicable to smaller reporting companies. If *unreasonably burdensome*, the issuer may provide an audited balance sheet and limited partnership issuers may use tax basis financials. An opportunity for each prospective investor's questions to be answered must be given prior to sale.
(8) Issuer qualifications:	Not available to investment companies or "bad boys."
(9) Manner of offering:	No general solicitation (except for announcements by reporting companies under Rule 135c).
(10) Commissions:	Permitted for registered broker-dealers.
(11) Offeree qualifications:	None.
(12) Purchaser qualifications:	None.
(13) Resale limitations:	Restricted securities. *See* Rules 144, 144A, and 145; §4(a)7 of 1933 Act.
(14) Notice of sales:	Form D within fifteen days after first sale.

Rule 506(b)

(1) Statutory authority:	§4(a)(2) of 1933 Act.
(2) Predecessor:	Rule 146.
(3) Aggregate offering price:	Unlimited.
(4) Integration doctrine:	Six month safe harbor.
(5) Number of offerees:	Unlimited.
(6) Number of purchasers:	Thirty-five purchasers, excluding same three classes of related persons or entities and same eight classes of accredited investors as Rule 505.
(7) Disclosure requirements:	Same as Rule 505 except for offerings over $7,500,000, non-reporting companies must provide the financial information required by Form S-1 or other permissible registration form, subject to the same *unreasonably burdensome* exception.

(8) Issuer qualifications:	Not available to "bad boys" under Rule 506(d). *See* Rule 506(e) required disclosure; C&DI Questions, Sec. 260.
(9) Manner of offering:	No general solicitation.
(10) Commissions:	Permitted for registered broker-dealers.
(11) Offeree qualifications:	None. Note §4(a)(2) cases requiring offeree *access* to material information about the issuer and its securities.
(12) Purchaser qualifications:	Sophistication requirement for non-accredited purchasers, but use of "purchaser representative" permitted.
(13) Resale limitations:	Restricted securities.
(14) Notice of sales:	Form D within fifteen days after first sale.

Rule 506(c)

(1) Statutory authority:	§§4(a)(2) and 4(b) of 1933 Act.
(2) Predecessor:	None.
(3) Aggregate offering price:	Unlimited.
(4) Integration doctrine:	Six month safe harbor.
(5) Number of offerees:	Unlimited.
(6) Number of purchasers:	Unlimited.
(7) Disclosure requirements:	None specified, but issuers must avoid material misrepresentations and omissions.
(8) Issuer qualifications:	Not available to "bad boys" under Rule 506(d). *See also* Rule 506(e).
(9) Manner of offering:	General solicitation permitted.
(10) Commissions:	Permitted for registered broker-dealers.
(11) Offeree qualifications:	None.
(12) Purchaser qualifications:	All purchasers must be *verified* accredited investors.

(13) Resale limitations:	Restricted securities.
(14) Notice of sales:	Form D within fifteen days after first sale (revised to require issuers to "check the box" for Rule 506(c) offerings). The SEC has proposed that issuers in Rule 506(c) offerings file an Advance Form D fifteen days before first use of general solicitation and requiring more expansive disclosure.

III. KENTUCKY REGISTRATION EXEMPTIONS

Under the Kentucky Securities Act, it is unlawful to offer or sell any "security" in Kentucky unless:

(1) The security is registered in Kentucky; or
(2) It is an exempt security; or
(3) It is offered and sold in an exempt transaction; or
(4) It is a "covered security."

A. Covered Securities under NSMIA

Under §18(b) of the 1933 Act, "covered securities" include:

1. Securities listed on the New York or American Stock Exchanges or NASDAQ/NMS;

2. Securities issued by mutual funds and other registered investment companies;

3. Securities sold to "qualified purchasers;" or

4. Securities sold in transactions exempt under §4(a)(2) based SEC *rules*, *i.e.*, Rule 506(b) or (c) of Regulation D (if proven by the issuer to *actually* qualify for the exemption).

NOTE: The Kentucky Securities Act, as amended, and as permitted under §18(b) of the 1933 Act, requires a notice filing and a fee in connection with investment company and Rule 506 securities. *See* Kentucky Revised Statutes (KRS) 292.327.

B. Exempt Securities

KRS 292.400 provides exemptions from registration for the following securities, among others:

1. Municipal, state or federal securities;

2. Bank, savings and loans, credit union, and insurance company securities;

3. Not-for-profit corporation securities;

4. Securities listed on the first tier of recognized stock exchanges;

5. Certain short-term commercial paper; and

6. Certain securities issued in connection with employee benefit plans.

C. Exempt Transactions

KRS 292.410(1) provides exemptions from registration for the following transactions, among others:

1. Isolated non-issuer transactions;

2. Non-issuer distributions of certain fixed income obligations;

3. Unsolicited non-issuer transactions effected through a broker-dealer;

4. Transactions by executors, receivers and similar persons on behalf of others;

5. Transactions by *bona fide* pledgees;

6. Offers or sales to certain financial institutions;

7. Issuer offers or sales, without general solicitation, to purchasers for investment purposes only if:

   a. Each purchaser has *access* to all material facts; or

   b. Fifteen (15) or fewer Kentucky investors with *access*, plus an unlimited number of accredited investors; or

   c. $1,000,000 aggregate offering price to thirty-five (35) or fewer investors (excluding accredited investors).

8. Offers or sales of preorganization certificates or subscriptions to twenty-five (25) or fewer subscribers without commission or payment;

9. Offers or sales to existing security holders without commission; and

10. Certain non-issuer transactions in reporting company securities.

D. Kentucky's Regulation D Corollary Exemption

In addition to the various statutory exemptions, Kentucky has a regulatory exemption, 808 KAR 10:210, which, although now rarely used, was adopted as the state's corollary to Regulation D.

1. Rules 501-503 and 504 and 505 of Regulation D are incorporated fully by reference, with further conditions which must be satisfied.

2. Persons receiving commissions must be registered or otherwise in compliance with KRS 292.330.

3. "Bad boy" provisions are applicable, subject to waiver.

4. For Rule 506(b) and (c) offerings, Form D must be filed within fifteen (15) days after the first sale from or into Kentucky, with one copy of information (private placement memorandum) as furnished to offerees, together with consent to service of process. For Rule 504 offerings, Form D must be filed at least ten (10) days before the first sale.

5. A $250 filing fee is required.

6. Suitability standards for *non-accredited* investors in Rule 504 offerings are reasonable grounds to believe, and after making reasonable inquiry, shall believe that the purchaser, either alone or with a purchaser representative, has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.

NOTE. Kentucky has established a safe harbor for certain membership interests in limited liability companies (LLCs) by excepting those interests from "investment contracts" included within the definition of a "security." This safe harbor, at 508 KAR 10:360, only applies to LLC membership interests in LLCs with thirty-five or fewer members and only if each member is actively engaged in the LLC's management, or the LLC's articles or operating agreement vests management in its members, or each member is authorized to act for and bind the LLC. The SEC has not promulgated a similar exclusion for member-managed LLC membership interests from investment contract securities.

For additional information regarding the adoption and development of Regulation D, *see* Warren, "The False Promise of Publicly Offered Private Placements," 68 SMU L. Rev. 899 (2015); Warren, "The Role of the States in the Regulation of Private Placements," 102 Ky. L. J. 971 (2014); Warren, "An Essay on Rule 506 of Regulation D: Its Questionable Origins, Regulatory Oblivion and Judicial Revitalization," 38 Sec. Reg. L. J. 5 (2010); Warren, "A Review of Regulation D: The Present Exemption Regimen for Limited Offerings under the Securities Act of 1933," 33 American U. L. Rev. 355 (1984). *See generally*, R. Elkins & L. Meeks, Regulation D, BNA Corporate Practice Series, No. 51-2nd.

Bad Actor Questionnaire: Rule 506 Offering

BRADLEY BERMAN, MORRISON & FOERSTER LLP,
WITH PRACTICAL LAW CORPORATE & SECURITIES

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A standard form questionnaire for obtaining information from persons covered by the "bad actor" disqualification provision of Rule 506(d) of Regulation D under the Securities Act. Rule 506(d) disqualifies securities offerings from the safe harbor provided by Rule 506 if any covered person, including the issuer, its directors and certain officers and stockholders, and any "compensated solicitors" for the offering, was involved in a disqualifying event. **This Standard Document assumes that the issuer is not a pooled investment fund.**

DRAFTING NOTE: GENERAL

Rule 506 is the most frequently used safe harbor for exemption from registration under Regulation D under the Securities Act. Rule 506 allows issuers to raise unlimited capital from an unlimited number of accredited investors (and, under some circumstances, up to 35 non-accredited investors) without having to register the offering with the SEC. Rule 506(d) prohibits reliance on the Rule 506 safe harbor for a securities offering if the issuer, the placement agent or certain other persons covered by the rule have certain disqualifying events, such as criminal convictions relating to the sale of securities, in their past. Parties that have experienced these disqualifying events are referred to as "bad actors."

Rule 506(d)(2)(iv) provides an exception from disqualification if an issuer can show that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed. To satisfy this burden, the issuer must show that it conducted a factual inquiry tailored to the facts and circumstances of the particular offering and its participants. This exception applies to situations in which the issuer:

- Identified all the persons covered by the rule, but, despite the exercise of reasonable care, was unable to discover that one or more of them was subject to a disqualifying event.
- Despite the exercise of reasonable care, was unable to determine that a particular person was a covered person.
- Initially reasonably determined that a particular person was not a covered person, but later learned that determination was incorrect.

(Question 260.23, SEC Securities Act Rules Compliance & Disclosure Interpretations (Securities Act Rules C&DIs)).

An offering is not disqualified from relying on the Rule 506 safe harbor based on events that occurred before September 23, 2014 (the day Rule 506(d) became effective). However, Rule 506(e) requires written disclosure to purchasers, at a reasonable time before a sale of securities, of matters that would have triggered disqualification except that they occurred before September 23, 2013. SEC guidance also describes actions a working group may take to avoid an offering being disqualified when a disqualifying event pertaining to a placement agent or other similar party occurs **during** an offering (Question 260.15, Securities Act Rules C&DIs). In addition, under Rule 506(d)(2)(ii), the SEC may grant a waiver of the disqualification provision upon a showing of good cause.

For more information on Rule 506(d), including a list of disqualifying events under the rule, see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Bad Actors Disqualified from Relying on Safe Harbor (8-382-6259). For more information on bad actor disqualification waivers, see Article, Securing a Rule 506 Bad Actor Disqualification Waiver (7-591-3607).

This standard document can be used as a starting point for drafting a questionnaire to be completed by persons covered by Rule 506(d) to help determine whether those persons have a disqualifying event in their past. **This Standard Document assumes that the issuer is not a pooled investment fund.** If the issuer is a pooled investment fund, additional persons not listed on the cover page of the questionnaire should be added in and should complete the questionnaire.

INSTRUCTIONS FOR USE OF THE QUESTIONNAIRE

Issuer's counsel typically prepares, distributes and collects the bad actor questionnaire on behalf of the issuer. Under Rule 506(d)(1) and SEC guidance, the following persons are covered persons under the bad actor disqualification provision:

- The issuer itself.
- Any predecessor of the issuer.
- Any "affiliated issuer." This means any affiliate (as defined in Rule 501(b) under Regulation D) of the issuer that is issuing securities in the same offering, including offerings subject to integration with the offering under Rule 502(a) of Regulation D (Question 260.16, Securities Act Rules C&DIs). Disqualifying events relating to an affiliated issuer that occurred before the two entities were affiliated do not trigger disqualification under certain circumstances (Rule 506(d)(3)).
- Any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer. The term "executive officer" is defined in Rule 501(f) of Regulation D and Rule 405 under the Securities Act, and may include certain vice president-level employees. The term "officer" is defined in Rule 405.
- Any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power. Counsel should review SEC guidance on the meanings of beneficial owner and outstanding voting equity securities under Rule 506(d). For a discussion of this guidance, see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Determination of 20% beneficial owners under Rule 506(d) (8-382-6259). A shareholder that first becomes a 20% beneficial owner by purchasing securities in an offering is not a covered person under Rule 506(d) with respect to that offering (Question 260.28, Securities Act Rules C&DIs).
- Any promoter connected with the issuer in any capacity at the time of the sale of securities.
- Any investment manager of an issuer that is a pooled investment fund.
- Any person, whether or not that person is a registered broker-dealer or associated person, that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale of securities (a "compensated solicitor").
- Any general partner or managing member of any such investment manager or compensated solicitor.

- Any director, executive officer or other officer participating in the offering of any:
  - such investment manager or compensated solicitor; or
  - general partner or managing member of any such investment manager or compensated solicitor.

SEC guidance has clarified what activities cause an officer of a compensated solicitor to be considered "participating" in an offering (Questions 260.18 and 260.19, Securities Act Rule C&DIs). For further guidance on these categories, see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Bad Actors Disqualified from Relying on Safe Harbor (8-382-6259). **This Standard Document assumes that the issuer is not a pooled investment fund.** If the issuer is a pooled investment fund, additional persons not listed on the cover page of the questionnaire should be added in and should complete the questionnaire.

Each of these persons should complete this questionnaire unless the issuer has already obtained the same type of information from that person, and that information is current (see When Must Disqualification Be Tested?). For example, an issuer may have already obtained the information requested by this questionnaire from its directors and executive officers in a recent directors' and officers' (D&O) questionnaire. One advantage to including questions related to bad actor disqualification in a D&O questionnaire is that the information will be updated annually. For sample questions related to bad actor disqualification that can be included in a D&O questionnaire, see Standard Document, Directors' and Officers Questionnaire: Periodic Reports (1-517-9474).

When Must Disqualification Be Tested?

An issuer must determine whether its offering is subject to bad actor disqualification at any time it offers and sells securities in reliance on Rule 506. As a practical matter, however, an issuer often sends out its bad actor questionnaires well in advance of offers or sales of securities in an offering (see Additional Timing Considerations).

SEC guidance states that an issuer may reasonably rely on a covered person's agreement (in, among other documents, a questionnaire) to provide notice of the occurrence of subsequent potential or actual disqualifying events. The guidance also states, however, that if an offering is continuous, delayed or long-lived, the issuer must update its factual inquiry periodically (Question 260.14, Securities Act Rule C&DIs).

This questionnaire requests responses be given as of the date the covered person signs the questionnaire. It also requires a covered person to agree to notify the issuer of any changes to that person's responses. However, an issuer and its counsel must consider, in light of SEC guidance and the facts and circumstances of each offering, whether previously completed questionnaires or other inquiries must be updated.

Additional Timing Considerations

An issuer should generally initially send this questionnaire to each prospective compensated solicitor (such as a placement agent) and its related parties before it engages that institution. This allows the issuer to decline to engage an institution if that institution's participation in the offering would trigger Rule 506(d) disqualification, or to engage it subject to certain conditions (for example, that the institution receive a disqualification waiver from the SEC or dismiss an associated person subject to a disqualification event). An issuer may also include provisions related to bad actor disqualification in its engagement letter with a compensated solicitor, if this document is used for the offering. For an example engagement letter that includes provisions related to bad actor disqualification, see Standard Document, Engagement Letter: Unregistered Offering (5-530-6210).

An issuer should generally initially send this questionnaire to all other covered persons as soon as possible after the issuer begins contemplating a Rule 506 offering. This allows the issuer to take appropriate action in response to information it learned from reviewing the completed questionnaires. Action may include:

- Not permitting certain officers of the issuer to participate in the offering.
- Seeking a disqualification waiver from the SEC.

- Conducting the offering under a different exemption from registration.
- When possible, ending the issuer's relationship with a covered person subject to a disqualifying event.

Foreign Disqualifying Events

Rule 506(d) is not triggered by actions such as convictions, court orders or injunctions issued by foreign courts and regulators (Question 260.20, Securities Act Rules C&DIs). **This Standard Document has been drafted to be slightly overinclusive, and does not instruct persons completing the questionnaire to exclude foreign events from their response.**

CONFIDENTIAL

[ISSUER NAME]

Rule 506 Disqualification Event Questionnaire

Date: _____

Name: _____

This Questionnaire is being furnished to you to obtain information in connection with an offering (the "**Offering**") of securities by [ISSUER NAME] (the "**Issuer**"), under Rule 506 of the Securities Act of 1933 (the "**Securities Act**"). As used in this Questionnaire, "you" also refers to any entity on whose behalf you are responding.

Important Note: Please answer every question. If the Issuer has completed portions of the Questionnaire on your behalf, please confirm the accuracy of that information. If your answer to a question is "Yes," please provide details in the explanation. Unless otherwise stated, your answers should be given as of the date you sign the Questionnaire. Please note that certain questions are necessarily broad in scope, so if you have doubts regarding whether something should be included in your response please err on the side of over-inclusion. The Issuer may have additional follow-up questions for you in connection with the Offering.

Once you have completed the Questionnaire, please sign it to indicate: (i) your consent for the Issuer to rely upon the information provided in this Questionnaire; (ii) your acknowledgement that the Securities and Exchange Commission (the "**SEC**") may require the Issuer to publicly disclose the information provided in this Questionnaire, and your consent to such public disclosure; (iii) your agreement to promptly notify the Issuer of any changes in information provided in the Questionnaire occurring after the date you sign the Questionnaire; and (iv) your confirmation that the information contained in the Questionnaire is true and correct, to the best of your knowledge and belief after a reasonable investigation, as of the date you sign the Questionnaire.

Please complete the Questionnaire and return it by [DATE]. Please return the completed Questionnaire to the Issuer's legal counsel, [NAME OF COUNSEL], Attn: [NAME], by e-mail to [E-MAIL ADDRESS]. If you have any questions with respect to these matters, please call [NAME] at [TELEPHONE NO.].

THE EXISTENCE AND CONTENTS OF THE QUESTIONNAIRE, AS WELL AS YOUR ANSWERS AND ALL NOTES AND DRAFTS PREPARED BY YOU, ARE CONSIDERED EXTREMELY CONFIDENTIAL AND PROPRIETARY BY THE ISSUER AND SHOULD BE TREATED ACCORDINGLY.

This Questionnaire must be completed by the following persons:

- The Issuer.
- Any predecessor of the Issuer.
- Any "affiliated issuer" (1).

- Any director, executive officer (2), other officer participating in the offering, general partner or managing member of the Issuer.
- Any beneficial owner of 20% or more of the Issuer's outstanding voting equity securities, calculated on the basis of voting power.
- Any promoter (3) connected with the Issuer in any capacity at the time of the sale of securities.
- Any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with the sale of securities (a "compensated solicitor").
- Any general partner or managing member of any compensated solicitor.
- Any director, executive officer or other officer participating in the offering of any:
  - compensated solicitor; or
  - general partner or managing member of any compensated solicitor.
  - (1) An *affiliated issuer* is a person or entity that is issuing securities in the Offering (including offerings subject to integration with the Offering under Rule 502(a) of Regulation D) that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with, the Issuer.
  - (2) The term *executive officer* includes the Issuer's president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, and any other person who performs similar policy making functions for the Issuer, including executive officers of an affiliate of the Issuer if such executive officers perform policy making functions for the Issuer.
  - (3) The term *promoter* includes:

    (i) any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer; or

    (ii) any person who, in connection with the founding and organizing of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of such securities. However, a person who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this paragraph if such person does not otherwise take part in founding and organizing the enterprise.
- All persons coming within the definition of *promoter* in paragraph (i) of this definition may be referred to as founders or organizers or by another term provided that such term is reasonably descriptive of those persons' activities with respect to an issuer.

1. Name, Address, Telephone Number and E-mail

   Your full name:

   Please provide all previous, assumed or fictitious names or aliases:

   Business Address: Home Address:

   Business Telephone: (____) _____ Home Telephone: (____) _____

   E-mail Address: _____

2. Have you been convicted, within ten (10) years of the date hereof (or five (5) years, in the case of the Issuer, its predecessors and affiliated issuers), of any felony or misdemeanor:

- in connection with the purchase or sale of any security;
- involving the making of any false filing with the SEC; or
- arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment advisor or paid solicitor of purchasers of securities?

  ____ Yes. If yes, please explain:

  ____ No

3. Are you subject to any order, judgment or decree of any court of competent jurisdiction, entered within five (5) years of the date hereof, that, on the date hereof, restrains or enjoins you from engaging or continuing to engage in any conduct or practice:

- in connection with the purchase or sale of any security;
- involving the making of any false filing with the SEC; or
- arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities?

  ____ Yes. If yes, please explain:

  ____ No

4. Are you subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the Commodity Futures Trading Commission; or the National Credit Union Administration that:

- on the date hereof, bars you from:
  - association with an entity regulated by such commission, authority, agency or officer;
  - engaging in the business of securities, insurance or banking; or
  - engaging in savings association or credit union activities; or
- constitutes a final order, entered within ten (10) years of the date hereof, that is based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct?

  A "final order" is a written directive or declaratory statement issued by any of the regulators listed in this Question 4 under applicable statutory authority that provides for notice and an opportunity for a hearing, which constitutes a final disposition or action by that regulator.

  ____ Yes. If yes, please explain:

  ____ No

5. Are you subject to an order of the SEC entered pursuant to Section 15(b) or 15B(c) of the Securities Exchange Act of 1934 (the "Exchange Act") or Section 203(e) or 203(f) of the Investment Advisers Act of 1940 (the "Advisers Act") that, on the date hereof:

- suspends or revokes your registration as a broker, dealer, municipal securities dealer or investment adviser;
- places limitations on your activities, functions or operations; or
- bars you from being associated with any entity or from participating in the offering of any penny stock?

  ____ Yes. If yes, please explain:

  ____ No

6. Are you subject to any order of the SEC, entered within five (5) years of the date hereof, that, on the date hereof, orders you to cease and desist from committing or causing a violation of or future violation of:

- any scienter-based anti-fraud provision of the federal securities laws, including, but not limited to, Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 15(c)(1) of the Exchange Act and Section 206(1) of the Advisers Act, or any other rule or regulation thereunder; or
- Section 5 of the Securities Act.

  ____ Yes. If yes, please explain:

  ____ No

7. Have you been suspended or expelled from membership in, or suspended or barred from association with a member of, a securities self-regulatory organization (e.g., a registered national securities exchange or a registered national or affiliated securities association) for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade?

____ Yes. If yes, please explain:

____ No

8. Have you filed (as a registrant or issuer), or were you named as an underwriter in, any registration statement or Regulation A offering statement filed with the SEC that, within five (5) years of the date hereof, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or are you, on the date hereof, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued?

____ Yes. If yes, please explain:

____ No

9. Are you subject to a United States Postal Service false representation order entered within five (5) years of the date hereof, or are you, on the date hereof, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the United States Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations?

____ Yes. If yes, please explain:

____ No

If any information furnished by me in this Questionnaire becomes inaccurate, incomplete or otherwise changes, I will promptly advise the Issuer to that effect and furnish any supplementary information that may be appropriate as a result of any developments, including the passage of time and any new relationships that may develop in the future.

The foregoing answers are correctly and fully stated to the best of my knowledge, information and belief after a reasonable investigation.

Date: _____ Signature: _____

Print Name: _____

09-16

Investor Questionnaire

PRACTICAL LAW CORPORATE & SECURITIES

Search the Resource ID numbers in blue on Practical Law for more.

This Standard Document is a form of Investor Questionnaire (also known as an Accredited Investor Questionnaire) for use in an unregistered offering that relies on any exemption from registration or related safe harbor other than new Rule 506(c) of Regulation D. This questionnaire can be used in a company's private placement under Section 4(a)(2) or Rules 504, 505 or 506(b) of Regulation D or other unregistered offering of securities to help collect and verify information relating to potential investors about which neither the company nor, if applicable, the placement agent has sufficient knowledge to determine on its own. In particular, this questionnaire can be used to determine whether a potential investor is an accredited investor as long as the company is not relying on the safe harbor in new Rule 506(c) of Regulation D. This Standard Document has integrated notes with important explanations and drafting tips.

DRAFTING NOTE: READ THIS BEFORE USING DOCUMENT

A private placement is a transaction by a company in which it offers and sells securities in a transaction that is not a public offering, without registering under the Securities Act (typically in reliance on an exemption from registration under Section 4(a)(2) or the safe harbor provisions of Rules 504, 505 or 506 of Regulation D). The Investor Questionnaire is used in a company's private placement of securities to help collect and verify information relating to potential investors about which neither the company nor, if applicable, the placement agent has sufficient knowledge to determine on its own. The procedures applicable to a particular private placement depend on the specific private placement exemption being claimed by the company. Investor participation in a private placement is usually limited to persons that are accredited investors. However, it may also include a certain number of persons that are sophisticated investors. "Sophisticated investors" is not defined in the Securities Act but is commonly interpreted to refer to investors that are sufficiently sophisticated in

finance and business matters to evaluate the investment or able to bear the investment's economic risk.

The company has the burden of determining the status of potential investors. If the company sells its securities in a private placement to an unqualified investor, the company may lose the benefit of the private placement exemption. Without a valid private placement exemption and without having registered the securities under the Securities Act, the company faces liability under Section 12(a), which would allow all of the purchasers in the private placement to rescind their purchase and recover their purchase price from the company for one year following completion of the private placement. Therefore, companies have relied on an investor questionnaire to help satisfy the burden of determining that potential investors are either accredited investors or sophisticated investors. This burden may be complicated with new accommodations available under the JOBS Act (see below).

The questionnaire can be sent out with some or all of the private placement documents. Typically the questionnaire is distributed with, at a minimum, the preliminary private placement memorandum. Depending on the specific procedures of the private placement, these documents may also be accompanied by a draft subscription or purchase agreement and registration rights agreement. However, these agreements can also be sent out separately after the company and, if applicable, the placement agent have obtained indications of interest.

Company counsel typically prepares, distributes and collects the questionnaire on behalf of the company. Company counsel must receive completed questionnaires from potential investors before the private placement can close. However, while the questionnaires are outstanding, company counsel can be completing the remaining private placement documents (usually just negotiation of the subscription or purchase agreement and registration rights agreement) so that the company can complete the private placement as soon as possible after the questionnaires are returned.

If a potential investor is not an accredited investor, but qualifies as a sophisticated investor because it is using a purchaser representative, a questionnaire must also be sent to the purchaser representative to verify that the person or entity acting as purchaser representative is qualified to do so. The purchaser representative questionnaire assists the company in ensuring the status of its potential investors so that it does not lose the benefit of its private placement exemption.

The company may (or may not) know in advance which of the potential investors may require a purchaser representative. The company or, if applicable, the placement agent, may choose to send the purchaser representative questionnaire out to all potential investors together with the investor questionnaire in case the additional questionnaire is needed. If the company or, if applicable, the placement agent knows the potential investors in advance of the private placement, they can send the purchaser representative questionnaire together with the investor questionnaire only to those potential investors that they believe require a purchaser representative. Otherwise, the company and, if applicable, the placement agent can send out the investor questionnaire to all potential investors and, based on the responses they receive back (because within the questionnaire the investor must indicate whether he, she or it is an accredited investor or a sophisticated investor), can determine which investors will need a purchaser representative and then send out the purchaser representative questionnaire separately to those investors only.

For more information on unregistered offerings, accredited investors and the use of investor questionnaires, see Practice Notes, Conducting an Unregistered Offering: Overview (3-385-2547), Section 4(a)(2) and Regulation D Private Placements (8-382-6259) and Road Map for Undertaking a Private Offering (4-501-6353).

The following is a form of investor questionnaire for use by a company in an unregistered offering that does **not** rely on new Rule 506(c) of Regulation D and does **not** utilize general solicitation

or advertising. This Standard Document can be used in conjunction with Standard Document, Purchaser Representative Questionnaire (2-381-2279). A company that intends to conduct a Rule 506(c) offering must take additional steps to verify accredited investor status of its potential investors, and cannot rely solely on an investor questionnaire (see below). For a form of accredited investor representation letter for Rule 506(c) offerings, see Standard Document, Accredited Investor Representation Letter for Rule 506(c) Offering (0-554-2865).

IMPACT OF THE JOBS ACT

Section 201(a)(1) of the JOBS Act directs the SEC to revise Regulation D to:

- Remove Regulation D's prohibition on general solicitation and general advertising in offerings and sales made under Rule 506, provided that all purchasers of the securities sold in these offerings are accredited investors.
- Require issuers to take **reasonable steps to verify** that purchasers are accredited investors, using methods that the SEC determines. Currently, Rule 506 of Regulation D provides that if an issuer sells securities to a purchaser the issuer reasonably believes is an accredited investor, that sale will count as a sale to an accredited investor even if it turns out the purchaser was not, in fact, an accredited investor. This is because the issuer's reasonable belief is built into the definition of accredited investor contained in Rule 501(a) of Regulation D.

On July 10, 2013, the SEC approved final rules implementing Section 201(a)(1). The rules create subsection (c) of Rule 506, under which an issuer can use general solicitation and general advertising to offer and sell securities in a Rule 506(c) offering if:

- Each purchaser in the offering is an accredited investor (either because the purchaser falls into one of the Rule 501(a) categories, or because the issuer reasonably believes the purchaser falls into one of those categories at the time it sells securities to the purchaser).
- The issuer takes reasonable steps to verify that each purchaser is an accredited investor.
- All other terms and conditions of Rules 501, 502(a) and 502(d) are satisfied.

Importantly, the pre-existing Rule 506 safe harbor is preserved. This means that issuers can choose to either comply with Rule 506(c) or conduct offerings without general solicitation or advertising in compliance with Rule 506(b). An issuer might choose to comply with Rule 506(b), for example, because it wants to sell securities to non-accredited investors, finds the additional verification steps burdensome or simply does not need or want to market its offering through general solicitation. Issuers conducting Rule 506 offerings without the use of general solicitation and general advertising are exempt from the new verification rule, and can continue to conduct their offerings in the same manner as past Rule 506 offering practice, including the use of investor questionnaires such as this Standard Document.

For more information on the rules and the safe harbors, see Practice Note, Section 4(a)(2) and Regulation D Private Placements (8-382-6259). For a form of accredited investor representation letter for Rule 506(c) offerings, see Standard Document, Accredited Investor Representation Letter for Rule 506(c) Offering (0-554-2865).

Investor Questionnaire

To be completed by: _____ (Investor)

This Questionnaire is being distributed to _____ (the "**Investor**") by [COMPANY], a [STATE OF ORGANIZATION] [TYPE OF ENTITY] (the "**Issuer**"), to enable the Issuer to determine whether the Investor is qualified to invest in the [CLASS OF SECURITY] (the "**Securities**") of the Issuer.

DRAFTING NOTE: CLASS OF SECURITY

If the class of security to be offered is common or preferred stock, include the par value per share. If it is a debt security, include the full name of the debt, such as "Promissory Notes due 2012" or "$50,000,000 aggregate principal amount of 5% Notes due 2012".

To be qualified to invest in the Securities, the Investor must either (i) be an "accredited investor" (as that term is defined in Rule 501(a) of Regulation D promulgated under Section 4(a)(2) of the Securities Act of 1933, as amended (the "**Securities Act**")), or (ii) have (and if applicable, its officers, employees, directors or equity owners have) either alone or with his, her or its purchaser representative or representatives, if any, such knowledge and experience in financial and business matters that he, she or it is capable of evaluating the merits and risks of an investment in the Securities.

DRAFTING NOTE: QUALIFIED TO INVEST

This form assumes that sophisticated investors will be allowed to participate in the offering and includes questions and representations related to the sophistication of these investors. If this is not the case, the questionnaire must be modified to retain only accredited investor questions and eliminate questions and references to sophisticated investors and purchaser representatives.

The Issuer will rely upon the accuracy and completeness of the information provided in this Questionnaire in establishing that the issuance of the Securities is exempt from the registration requirements of the Securities Act.

ACCORDINGLY, THE INVESTOR IS OBLIGATED TO READ THIS QUESTIONNAIRE CAREFULLY AND TO ANSWER THE ITEMS CONTAINED HEREIN COMPLETELY AND ACCURATELY.

ALL INFORMATION CONTAINED IN THIS QUESTIONNAIRE WILL BE TREATED CONFIDENTIALLY. However, the Investor understands and agrees that the Issuer may present, upon giving prior notice to the Investor, this Questionnaire to such parties as the Issuer deems appropriate if called upon to establish that the issuance of the Securities (i) is exempt from the registration requirements of the Securities Act or (ii) meets the requirements of applicable state securities laws; provided however that the Issuer need not give prior notice to the Investor of its presentation of this Questionnaire to the Issuer's regularly employed legal, accounting and financial advisors.

The Investor understands that this Questionnaire is merely a request for information and is not an offer to sell, a solicitation of an offer to buy, or a sale of the Securities. The Investor also understands that the Investor may be required to furnish additional information.

PLEASE NOTE THE FOLLOWING INSTRUCTIONS BEFORE COMPLETING THIS INVESTOR QUESTIONNAIRE.

Unless instructed otherwise, the Investor should answer each question on the Questionnaire. If the answer to a particular question is "None" or "Not Applicable," please so state. If the Questionnaire does not provide sufficient space to answer a question, please attach a separate schedule to your executed Questionnaire that indicates which question is being answered thereon. Persons having questions concerning any of the information requested in this

Questionnaire should consult with their purchaser representative or representatives, lawyer, accountant or broker or may call [NAME OF CONTACT PERSON AT COMPANY'S COUNSEL], Esq., [COMPANY COUNSEL], at [TELEPHONE NUMBER].

One signed and dated copy of the Questionnaire should be returned as soon as possible to [COMPANY] at:

c/o [NAME OF CONTACT PERSON] [ADDRESS] [ADDRESS] Attn:

The other copy should be retained for the Investor's files.

DRAFTING NOTE: CONTACT PERSON

This form contemplates that company counsel will be responsible for answering questions from prospective investors. This form also assumes that the company will collect the questionnaires. However, if a placement agent is involved, the placement agent may prefer that it or its own counsel be the contact person and collect the questionnaires.

PART I—FOR INDIVIDUALS

DRAFTING NOTE: PART I—FOR INDIVIDUALS

Ordinarily, if no individuals are being solicited as investors in the private placement, this Part I can be deleted. However, if the company or the placement agent believes that any entity being solicited will only qualify as an accredited investor because its owners are accredited investors, then this Part I must remain, because the owners will be required to provide this information.

1. Personal Data

Name: _____

Residence Address: _____

_____

_____

Business Address: _____

_____

_____

State of residence, if different: _____

Telephone: Residence _____ Business _____

Age: _____ Citizenship: _____

Social Security or Taxpayer No.: _____

Send all correspondence to: Residence _____ Business _____

2. Employment and Business Experience

Present occupation: _____

Salary: _____

Do you own your own business or are you otherwise employed? _____

Name and type of business employed by or owned: _____

_____

Description of responsibilities: _____

_____

_____

Length of service with present employer or length of ownership of present business: _____

_____

Present title or position: _____

Length of service in present title or position: _____

Prior occupations, employment, and length of service during the past five (5) years:

Occupation	Name of Employer or Owned Business (and identify which)	Years of Service

Do you have any professional licenses or registrations, including bar admissions, accounting certificates, real estate brokerage licenses, investment adviser registrations and SEC or state broker-dealer registrations? Yes: _____ No: _____

If yes, please list such licenses or registrations, the date(s) you received the same, and whether they are in good standing:

3. Education (college and postgraduate)

Institution Attended	Degree	Dates of Attendance

4. Current Investment Objectives

My current investment objectives (indicate applicability and priority) are:

Current income: _____

Appreciation: _____

Tax Shelter: _____

Other: _____

5. Other Relevant Information

Please describe any additional information that reflects your knowledge and experience in business, financial, or investment matters and your ability to evaluate the merits and risks of this investment.

6. *Investor Status*

To be qualified to invest in the Securities, the Investor must either (i) be an Accredited Investor, or (ii) have, either alone or with your purchaser representative or representatives, such knowledge and experience in financial and business matters that you are capable of evaluating the merits and risks of such investment.

Please check the appropriate representation that applies to you.

Accredited Investors:

_____ I am an Accredited Investor (as defined in Rule 501 of Regulation D promulgated under the Securities Act) because I certify that (check all appropriate descriptions that apply):

a. _____ I am a natural person whose individual net worth, or joint net worth with my spouse, exceeds $1,000,000. For purposes of this item 6, "net worth" means the excess of total assets at fair market value (including personal and real property, but excluding the estimated fair market value of a person's primary home) over total liabilities. Total liabilities excludes any mortgage on the primary home in an amount of up to the home's estimated fair market value as long as the mortgage was incurred more than 60 days before the Securities are purchased, but includes (i) any mortgage amount in excess of the home's fair market value and (ii) any mortgage amount that was borrowed during the 60-day period before the closing date for the sale of Securities for the purpose of investing in the Securities.

DRAFTING NOTE: DODD-FRANK ACT CHANGES TO DETERMINATION OF NET WORTH

This clause reflects changes to the accredited investor definition adopted by the SEC on December 21, 2011, implementing Section 413(a) of the Dodd-Frank Act. For more information, see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Accredited Investors (8-382-6259).

The new definition of accredited investor includes an exception to the calculation of net worth excluding primary residences and related mortgages under certain circumstances for investors that are exercising rights to buy the securities being offered (see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Accredited Investors (8-382-6259)). If the company had issued rights to buy the securities now being offered before July 20, 2010, and any Investor being solicited will participate in this offering of securities because he held rights to buy those securities (such as warrants or options), as well as other securities issued by the company, on July 20, 2010, then the exclusion of the primary home and related mortgage debt from the definition of net worth does not apply. In that case, consider including an additional clause immediately following this clause:

(b) [_____ I am a natural person (i) whose individual net worth, or joint net worth with my spouse, exceeds $1,000,000 (where net worth means the excess of total assets at fair market value (including personal and real property) over total liabilities); (ii) who, on July 20, 2010, owned rights to buy the Securities (the "**Rights**"), (iii) who, on July 20, 2010, also owned other securities (in addition to the Rights) issued by the Issuer; (iv) who qualified as an accredited investor on the basis of net worth at the time that I acquired the Rights; and (v) will be exercising those Rights to invest in the Securities.]

If the company or the placement agent expects that potential investors may check off this additional subparagraph (b) box because one or more investor is relying on the exception to the recently amended net worth test in the definition of accredited investors, consider requiring the investor to provide information on the Rights by adding representations to Section 7 below about the specific Rights to be exercised, including when these Rights were acquired.

b. _____ am a natural person who had individual income exceeding $200,000 in each of the last two calendar years and I have a reasonable expectation of reaching the same income level in the current calendar year. [For purposes of this Section 6, "income" means annual adjusted gross income, as reported for federal income tax purposes, plus (i) the amount of any tax-exempt interest income received; (ii) the amount of losses claimed as a limited partner in a limited partnership; (iii) any deduction claimed for depletion; (iv) amounts contributed to an IRA or Keogh retirement plan; [and] (v) alimony paid[; and (vi) any gains excluded from the calculation of adjusted gross income pursuant to [the provisions of Section 1202 of] the Internal Revenue Code of 1986, as amended].]

DRAFTING NOTE: DEFINITION OF INCOME

The SEC does not define income, but intended to permit a flexible approach to income that considers the source of income under specific circumstances. In the Regulation D adopting release, the SEC identified one possible method of defining income: using adjusted gross income as reported for federal income tax purpose, and increasing this amount for any:

- Deductions for depletion under IRC Section 611.
- Partnership losses allocated to a limited partner reported under Schedule E of Form 1040.
- Exclusions for interest under IRC Section 103.
- Deductions for long term capital gains under Internal Revenue Code (IRC) Section 1202. (When the IRC was amended in 1986, which occurred after the date of the Regulation D adopting release, Section 1202 and the deduction for capital gains for individuals was repealed. A new Section 1202 was added in 1993. Instead of describing deductions of long term capital gains, it now refers to a partial exclusion of certain long term capital gains for qualified small business stock.)

(See SEC Release No. 33-6389 (Mar. 8, 1982)).

The SEC has also indicated that income contributed to retirement plans or accounts may be considered if an individual's right to the contribution is vested (see *Raymond James & Associates, Inc., SEC No-action Letter,* 1984 WL 45958 (Nov. 19, 1984)).

The definition of income proposed in this clause is based on these interpretations. The company or the placement agent should evaluate this definition of income, and the items to be added back to calculate income, and modify it to the extent the company or placement agent wishes to be more restrictive or less restrictive.

c. _____ I am a natural person who had joint income with my spouse exceeding $300,000 in each of the last two calendar years and I have a reasonable expectation of reaching the same income level in the current calendar year, as defined above.

d. _____ I am a director, executive officer or general partner of the Issuer, or a director, executive officer or general partner of a general partner of the Issuer. (For purposes of this Section 6, executive officer means the president; any vice president in charge of a principal business unit, division or function, such as sales, administration or finance; or any other person or persons who perform(s) similar policymaking functions for the Issuer.)

DRAFTING NOTE: DEFINITION OF EXECUTIVE OFFICER

The definition of executive officer in this clause comes from Rule 501(f) of Regulation D.

Other Investors:

_____ I am qualified to invest in the Securities because I have, either alone or with my purchaser representative or representatives, such knowledge and experience in financial and business matters that I am capable of evaluating the merits and risks of such investment, as discussed in Section 7(a) below.

DRAFTING NOTE: OTHER INVESTORS

The company must evaluate whether to deliver purchaser representative questionnaires to all potential investors simultaneously with the investor questionnaire or wait to discover if a potential investor checks off the "Other Investors" box and then deliver a purchaser representative questionnaire only to that potential investor. For a form of purchaser representative questionnaire, see Standard Document, Purchaser Representative Questionnaire (2-381-2279).

7. Representations

I represent that:

a. I have sufficient knowledge and experience in similar investments to evaluate the merits and risks of an investment in [COMPANY], or I have retained an attorney, accountant, financial advisor or consultant as my purchaser representative. If applicable, the name, employer, address, and telephone number of my purchaser representative follows:

b. I and, if applicable, my purchaser representative, have received the private placement memorandum relating to this offering (the "Private Placement Memorandum"); and I and, if applicable, my purchaser representative, understand the Private Placement Memorandum and the risks involved in this offering. I and, if applicable, my purchaser representative have been given the opportunity to ask questions and obtain material and relevant information from the Issuer enabling me to make an informed investment decision. All data that I and, if applicable, my purchaser representative, have requested has been furnished to me.

DRAFTING NOTE: RECEIPT OF INFORMATION

This clause assumes that the investor questionnaire is delivered to investors simultaneously with, or after, the delivery of other subscription information. If this is not the case, the company must have the investor make this representation in some other way (in a stand-alone certificate or in a subscription agreement) before allowing that investor to participate in the offering.

c. Any Securities I may acquire will be for my own account for investment and not with any view to the distribution thereof, and I will not sell, assign, transfer or otherwise dispose of any of the Securities, or any interest therein, in violation of the Securities Act or any applicable state securities law.

d. I understand that (i) any Securities I may acquire will not be registered under the Securities Act or any applicable state securities law and may not be sold or otherwise disposed of unless it is registered or sold or otherwise disposed of in a transaction that is exempt from such registration and (ii) the certificates representing the Securities will bear appropriate legends restricting the transferability thereof.

e. If applicable, I have not incurred any debt secured by my primary residence for the purpose of inflating my net worth to qualify as an accredited investor or for the purpose of raising funds to invest in the Securities. Between the date I complete this Questionnaire and the date the Securities are sold, I do not intend to, and will not, incur any debt to be secured by my primary residence for the purpose of either inflating my net worth to qualify as an accredited investor or raising funds to invest in the Securities.

DRAFTING NOTE: DEBT

This clause offers additional comfort to the company that any potential investor qualifying as an accredited investor based on net worth satisfies the definition at the time that the sale of securities is completed (see Drafting Note, Dodd-Frank Act Changes to Determination of Net Worth). This representation should help reduce incentives for individuals to "game" the net worth standard or for any sales people to encourage individuals to take on more debt to be able to participate in the offering.

f. I understand that the Issuer will rely upon the completeness and accuracy of the Investor's responses to the questions in this Questionnaire in establishing that the contemplated transactions are exempt from the Securities Act and hereby affirm that all such responses are accurate and complete. I will notify the Issuer immediately of any changes in any of such information occurring prior to the acceptance of my subscription.

8. Manner of Solicitation

Please state the manner in which you became aware of the investment (i.e., by personal contact or acquaintance with an investment advisor or counselor, with [COMPANY] personnel, a broker-dealer, or otherwise), the name of the contact person, and the date such contact was made:]

PART II—PURCHASERS WHO ARE NOT INDIVIDUALS

1. General Information

Name of Entity: _____

Address of Principal Office: _____

_____

_____

Type of Organization: _____

Date and State of Organization: _____

2. Business

Major Segments of Operation: _____

_____

_____

Length of operation in each such segment: _____

_____

_____

Are you a reporting entity under the Securities Exchange Act of 1934, as amended?

_____ Yes _____ No

If you are not a reporting entity, please provide the following:

a. The names and business experience of each of your officers and directors, partners, or other control persons for the past five years. If additional space is required to answer any question, please attach separate pages to the back of this Questionnaire and identify all questions answered in this fashion by their respective question numbers.

b. The educational background of each of your officers and directors, partners, or other control persons, including the institutions attended, the dates of attendance, and the degrees obtained by each. If additional space is required to answer any question, please attach separate pages to the back of this Questionnaire and identify all questions answered in this fashion by their respective question numbers.

c. Have each of your controlling persons complete Part I of this Questionnaire. Please attach these additional pages to the back of this Questionnaire.

3. Current Investment Objectives

The current investment objectives of the entity (indicate applicability and priority) are:

Current income: _____

Appreciation: _____

Tax Shelter: _____

Other (please state objectives): _____

4. Other Relevant Information

Please describe any additional information that reflects your knowledge and experience in business, financial, or investment matters and your ability to evaluate the merits and risks of this investment. If additional space is required to answer any question, please attach separate pages to the back of this Questionnaire and identify all questions answered in this fashion by their respective question numbers.

5. Accredited Investor Status

To be qualified to invest in the Securities, the Investor must either (i) be an Accredited Investor, or (ii) have, and if applicable, its officers, employees, directors or equity owners have, either alone or with its purchaser representative or representatives, such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of such investment.

Please check the appropriate description which applies to you.

a. _____ A bank, as defined in Section 3(a)(2) of the Securities Act or any savings and loan association or other institution as defined in Section 3(a)(5)(A) of the Securities Act, whether acting in an individual or a fiduciary capacity.

b. _____ A broker or dealer registered under Section 15 of the Securities Exchange Act of 1934, as amended.

c. _____ An insurance company, as defined in Section 2(13) of the Securities Act.

d. _____ An investment company registered under the Investment Company Act of 1940 or a business development company, as defined in Section 2(a)(48) of that act.

e. _____ A Small Business Investment Company licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958.

f. _____ A plan established and maintained by a state, its political subdivisions or any agency or instrumentality of a state or its political subdivisions for the benefit of its employees, if the plan has total assets in excess of $5 million.

g. _____ An employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, if the investment decision is being made by a plan fiduciary, as defined in Section 3(21) of such act, and the plan fiduciary is either a bank, an insurance company, or a registered investment adviser, or if the employee benefit plan has total assets in excess of $5 million.

h. _____ A private business development company, as defined in Section 202(a)(22) of the Investment Advisers Act of 1940.

i. _____ A corporation, Massachusetts or similar business trust, or partnership, or an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986, as amended, that was not formed for the specific purpose of acquiring the Securities, and that has total assets in excess of $5 million.

j. _____ A trust with total assets in excess of $5 million not formed for the specific purpose of acquiring the Securities, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii) under the Securities Act.

k. _____ An entity in which all of the equity owners are accredited investors and meet the criteria listed in Part I, Section 6 of this Questionnaire. Please also see additional questions below.

Other Investors:

_____ The undersigned entity is qualified to invest in the Securities because it has, and if applicable, its officers, employees, directors or equity owners have, either alone or with its purchaser representative or representatives, such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of such investment, as discussed in Section 6(a) below.

DRAFTING NOTE: OTHER INVESTORS

The company must evaluate whether to deliver purchaser representative questionnaires to all potential investors simultaneously with the investor questionnaire or wait to discover if a potential investor checks off the "Other Investors" box and then deliver a purchaser representative questionnaire only to that potential investor. For a form of purchaser representative questionnaire, see Standard Document, Purchaser Representative Questionnaire (2-381-2279).

If you checked (k), please complete the following part of this question:

(1) List all equity owners:

(2) What is the type of entity?

(3) Have each equity owner respond individually to Part I, Section 6 of this Questionnaire. Please attach these additional pages to the back of this Questionnaire.

6. Representations

The undersigned entity represents that:

a. The entity has, and if applicable, its officers, employees, directors or equity owners have, sufficient knowledge and experience in similar investments to evaluate the merits and risks of an investment in [COMPANY], or the entity has retained an attorney, accountant, financial advisor or consultant as its purchaser representative. If applicable, the name, employer, address, and telephone number of the purchaser representative follows:

b. The entity and, if applicable, its purchaser representative, has received the private placement memorandum relating to this offering (the "Private Placement Memorandum"); and the entity and, if applicable, its purchaser representative, understand the Private Placement Memorandum and the risks involved in this offering. The entity and, if applicable, its purchaser representative have been given the opportunity to ask questions and obtain material and relevant information from the Issuer enabling it to make an informed investment decision. All data that the entity and, if applicable, its purchaser representative, have requested has been furnished to it.

DRAFTING NOTE: RECEIPT OF INFORMATION

This clause assumes that the investor questionnaire is delivered to investors simultaneously with, or after, the delivery of other subscription information. If this is not the case, the company must have the investor make this representation in some other way (in a stand-alone certificate or in a subscription agreement) before allowing that investor to participate in the offering.

c. Any Securities the entity may acquire will be for its own account for investment and not with any view to the distribution thereof, and it will not sell, assign, transfer or otherwise dispose of any of the Securities, or any interest therein, in violation of the Securities Act or any applicable state securities law.

d. The entity understands that (i) any Securities it may acquire will not be registered under the Securities Act or any applicable state securities law and may not be sold or otherwise disposed of unless it is registered or sold or otherwise disposed of in a transaction that is exempt from such registration, and (ii) the certificates representing the Securities will bear appropriate legends restricting the transferability thereof.

e. The entity understands that the Issuer will rely upon the completeness and accuracy of the Investor's responses to the questions in this Questionnaire in establishing that the contemplated transactions are exempt from the Securities Act, and hereby affirms that all such responses are accurate and complete. The entity will notify the Issuer immediately of any changes in any of such information occurring prior to the acceptance of its subscription.

DRAFTING NOTE: OTHER REPRESENTATIONS

The company should consider whether additional representations may be necessary here. For example, a company may need to add representations regarding compliance with the Employee Retirement Income Security Act of 1974 (ERISA) for those potential investors that claim accredited investor status as employee benefit plans under Section 4(f) or Section 4(g). Additional provisions should be included if the company permits investments by employee benefits plans governed by ERISA or Section 4975 of the Internal Revenue Code (IRC) or by investors whose assets are deemed to include the assets of those plans under the Department of Labor's "plan asset regulation" (29 CFR § 2510.3 101, as modified by ERISA § 3(42)). For sample ERISA representations that may be included in a subscription agreement for a private placement of equity securities, see Standard Clauses, Subscription Agreement Language, Private Placement of Equity Securities (Regulation D): ERISA Representations (2-558-8145) and Subscription Agreement Language, Private Placement of Debt Securities (Regulation D): ERISA Representations (5-561-0927).

7. Manner of Solicitation

Please state the manner in which you became aware of the investment (i.e., by personal contact or acquaintance with an investment advisor or counselor, with [COMPANY] personnel, a broker-dealer, or otherwise), the name of the contact person, and the date such contact was made:

Individual

_____

Name:
(Please type or print)

_____

Signature

Date:_____

STATE OF _____ ss.

COUNTY OF _____

Subscribed and sworn to before me this _____ day of _____, 20_____,
by _____.
WITNESS my hand and official seal.
My commission expires:

_____

Notary Public]

Partnership, Corporation or Other Entity

_____

Print or Type Name

By:_____
Name:
Title:

Date:_____

STATE OF _____ ss.

COUNTY OF _____

Subscribed and sworn to before me this _____ day of _____, 20_____,
by _____.
WITNESS my hand and official seal.
My commission expires:

_____

Notary Public

DRAFTING NOTE: SIGNATURES

If no individuals are being solicited as investors in the private placement, the "Individual" signature block can be deleted.

09-16

Subscription Agreement: Private Placement of Equity Securities (Regulation D)

LLOYD S. HARMETZ, MORRISON & FOERSTER LLP,
WITH PRACTICAL LAW CORPORATE & SECURITIES

Search the Resource ID numbers in blue on Practical Law for more.

A subscription agreement for a private placement of common equity securities to accredited investors in reliance on Rule 506(b) or Rule 506(c) of Regulation D. The agreement includes a form of cover sheet with subscription instructions for investors. This Standard Document has integrated notes with important explanations and drafting and negotiating tips.

Subscription Agreement

DRAFTING NOTE: READ THIS BEFORE USING DOCUMENT

This is a form of subscription agreement for a private placement of common equity securities to accredited investors (as defined in Rule 501 of Regulation D under the Securities Act) in reliance on Rule 506(b) or Rule 506(c) of Regulation D. By conducting a private placement, a company can issue and sell securities in a transaction that is not a public offering, without registering that transaction under the Securities Act.

Rule 506, adopted under Section 4(a)(2) of the Securities Act, places no limit on the amount of capital that can be raised in an offering. In addition, there are no restrictions on the types of issuers that can use Rule 506 (except for companies disqualified under the "bad actor" provisions of Rule 506(d) (see Standard Document, Bad Actor Questionnaire (4-507-2037))).

An offering under Rule 506(b) adopted pursuant to the JOBS Act and not under Section 4(a)(2) of the Securities Act, is available to an unlimited number of accredited investors and up to 35 non-accredited investors who must be both able to bear the economic risk of the investment and, either alone or together with their purchaser representative, sufficiently sophisticated in finance and business matters to evaluate the investment. Though it is not a term that is defined in the Securities Act, this type of non-accredited investor is often referred to as a "sophisticated investor."

An offering under Rule 506(c) that uses general solicitation or general advertising is available to an unlimited number of accredited investors (but only accredited investors) as long as all other requirements of Rule 506(c) are satisfied. See Drafting Note, Offerings under Rule 506(c).

The subscription agreement:

- Describes the type of securities purchased by the investor and the purchase price.

- Sets out representations and warranties of the issuer relating to the issuance of the securities.
- Includes representations and warranties and other acknowledgements by the investor to help ensure the issuer's compliance with applicable US securities laws in connection with the issuance and sale of the securities. For a discussion of US securities law compliance in this context, see Practice Note, Unregistered Offerings: Overview (9-382-8837).

This form of subscription agreement assumes that the issuer is a Delaware C-corporation and that the investor is purchasing common equity securities of the issuer. However, the agreement may be modified for use by a corporation issuing preferred stock, a limited liability company (LLC) issuing LLC interests or a limited partnership (LP) issuing LP interests.

For a form subscription agreement for a Delaware corporation issuing debt securities, see Standard Document, Subscription Agreement: Private Placement of Debt Securities (Regulation D) (7-525-0306).

DOCUMENTS NEEDED TO COMPLETE A PRIVATE PLACEMENT

Depending on the specific procedures of the private placement, an issuer may be required to deliver to the purchaser the following documents:

- **Subscription agreement.** Some agreements provide that the consideration to be delivered is detailed on a separate stand-alone Appendix to the subscription agreement, which must be delivered in addition to the signed agreement.
- Private placement memorandum.
- Registration rights agreement.
- **Investor questionnaire.** This document is used to collect and verify information about potential investors which neither the company nor, if applicable, the placement agent has sufficient knowledge to determine on its own. The burden of determining investor eligibility is placed on the company. If the company sells its securities in a private placement to an ineligible investor, it may lose the benefit of the private placement exemption. Without a valid exemption and without having registered the securities under the Securities Act, the company faces potential liability under Section 12(a), which would allow all purchasers in the private placement to rescind and recover their purchase price from the company for one year following completion of the offering. For an investor questionnaire for an offering under Rule 506(b), see Standard Document, Investor Questionnaire (5-518-0753).

If the issuer uses general solicitation in an offering under Rule 506(c), additional documents should be obtained from investors to satisfy that rule's requirement that the issuer take "reasonable steps" to verify each investor's accredited investor status (see Drafting Note, Verification of Accredited Investor Status and Standard Documents, Accredited Investor Representation Letter for Rule 506(c) Offering (0-554-2865) and Third-party Accredited Investor Verification Letter for a Rule 506(c) Offering (0-563-8165)).

- **Purchaser representative questionnaire.** If a potential investor in a Rule 506(b) offering is using a purchaser representative to support its eligibility for the offering, a questionnaire should be sent to the purchaser representative to verify that it is qualified to serve in that role. See Standard Document, Purchaser Representative Questionnaire (5-384-4189).
- **Additional offering materials.** If the issuer engages in general solicitation in a Rule 506(c) offering, it may prepare and distribute additional offering materials.

COVER SHEET WITH SUBSCRIPTION INSTRUCTIONS

In some private placements, the issuer or placement agent may provide investors with specific instructions on how to subscribe and which documents must be delivered to the company or its representative. For a sample cover sheet with language that can be tailored to reflect the details of a specific private placement, see *Attachment, Cover Sheet with Subscription Instructions* below.

THE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933 OR THE SECURITIES LAWS OF ANY STATE OR ANY OTHER JURISDICTION. THERE ARE FURTHER RESTRICTIONS ON THE TRANSFERABILITY OF THE SECURITIES DESCRIBED HEREIN.

THE PURCHASE OF THE SECURITIES INVOLVES A HIGH DEGREE OF RISK AND SHOULD BE CONSIDERED ONLY BY PERSONS WHO CAN BEAR THE RISK OF THE LOSS OF THEIR ENTIRE INVESTMENT.

DRAFTING NOTE: SECURITIES LAW LEGENDS

A subscription agreement typically has securities law legends on its cover page. The legends are placed on the agreement and on the securities issued to investors to assist the issuer in complying with applicable US securities laws. Each offer or sale of securities must be registered by the issuer with the SEC under Section 5 of the Securities Act unless there is an available registration exemption (such as the Section 4(a)(2) and Regulation D exemptions for private placements).

Securities issued pursuant to these exemptions are restricted securities that cannot be freely resold by an investor without registration or exemption from registration with the SEC (see Drafting Note, Issuance of Restricted Securities and Practice Note, Section 4(a)(2) and Regulation D Private Placements: Limitations on Resale (8-382-6259)). Among other qualification requirements, to fall within the Section 4(a)(2) and Regulation D exemptions, the placement cannot involve a public offering or public distribution of privately placed securities. This prohibition applies to both the initial sale by the issuer and any further resales by the investors of the restricted securities. Specifically, for an issuer to qualify for a Regulation D exemption, Rule 502(d) requires the issuer to take reasonable steps to ensure that the securities are not bought by underwriters (as defined broadly in Section 2(a)(11) of the Securities Act) and that the purchasers are aware that they are buying restricted securities. The issuer can demonstrate reasonable care by, among other things:

- Obtaining written certifications from each purchaser in the initial private placement. These certifications usually take the form of representations and warranties and covenants made by the purchaser at the time of the investment.
- Giving adequate written disclosure to each purchaser prior to sale that the securities have not been registered under the Securities Act and cannot be resold unless they are registered or an exemption from registration is available. This disclosure typically takes the form of a restrictive legend in the subscription agreement or appropriate disclosure in the offering memorandum (if one is used).
- Placing a restricted security legend on the securities stating that the securities have not been registered under the Securities Act and cannot be resold by the purchaser in the US without registration or an applicable registration exemption.

For more on restrictive legends, see Practice Note, Securities Act Restrictive Legends and Rule 144 Sales (9-526-4406).

[ISSUER NAME]
[ADDRESS]
[ADDRESS]

Ladies and Gentlemen:

The undersigned understands that [NAME OF ISSUER], a corporation organized under the laws of Delaware (the "**Company**"), is offering an aggregate of [NUMBER] shares of its common stock, par value $[AMOUNT] per share (the "**Securities**") in a private placement. This offering is made pursuant to the Offering Memorandum, dated [DATE] [and any other relevant documents] (collectively, the "**Offering Documents**"), all as more particularly described and set forth in the Offering Documents. The undersigned further understands that the offering is

being made without registration of the Securities under the Securities Act of 1933, as amended (the "**Securities Act**"), or any securities law of any state of the United States or of any other jurisdiction, and is being made only to "accredited investors" (as defined in Rule 501 of Regulation D under the Securities Act).

DRAFTING NOTE: ACCREDITED INVESTORS

OFFERINGS UNDER RULE 506(B)

In a traditional Rule 506 offering under Rule 506(b), the issuer must reasonably believe that the prospective investor is an accredited investor or that it has enough knowledge and sophistication to properly evaluate the investment opportunity. This standard is often met by prospective investors' self-certifications and by a further review of prospective investors by the issuer.

If the issuer is using a placement agent to solicit investors, it can rely on the placement agent's existing relationship with a potential investor to help evaluate the investor's eligibility. For example, where a broker is acting as a placement agent, the broker may compile part of an investor's investor questionnaire itself based on the broker's existing records and its familiarity with:

- The size and nature of the prospective investor's accounts with the broker's firm and elsewhere.
- The prospective investor's financial resources, knowledge, sophistication and investment history and objectives.

If a placement agent assists in preparing an investor questionnaire, the questionnaire should be reviewed by the investor for completeness and accuracy before it is signed and submitted. Usually, the participating broker's supervisor will review the documents and undertake a follow-up review, including conversations with the participating broker and a review of:

- Client account opening cards, monthly statements and other account records.
- Additional internal and external sources of information.

Supervisory and compliance personnel should not approve an investor questionnaire with any incomplete responses or uncertainties regarding:

- The existing relationship with the prospective investor.
- The prospective investor's suitability or accredited investor status.
- The appropriateness of the investment for the individual.

If the issuer in a Rule 506(b) offering does not engage a placement agent, the issuer should require prospective investors to complete an investor questionnaire and undertake a follow-up review, which may include seeking additional documents or back-up information from prospective investors.

Even in an offering without general solicitation under Rule 506(b), the accredited investor status of each purchaser should be carefully confirmed because of the more extensive disclosure requirements that apply to sales made to non-accredited investors under Regulation D (see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Information Requirements for Non-Accredited Investors (8-382-6259)). Rule 502(b)(2) of Regulation D requires disclosure to non-accredited investors similar to the type provided in a Securities Act registration statement. This level of disclosure is time-consuming and burdensome for an issuer to prepare and, therefore, is typically impractical.

OFFERINGS UNDER RULE 506(C)

Rule 506(c) permits the use of general solicitation and general advertising in a Rule 506 offering that meets the following additional conditions:

- All purchasers of the securities must be accredited investors.
- The issuer must take reasonable steps to verify that all purchasers are accredited investors.

In the adopting release for Rule 506(c), the SEC staff indicated that whether the steps an issuer takes to verify accredited investor status constitute "reasonable steps" is an

objective, principles-based determination. The SEC noted that reasonable steps to verify investor status should consider:

- The nature of the purchaser.
- The nature and amount of information about the purchaser.
- The nature of the offering.

Rule 506(c) itself provides a non-exclusive list of verification methods that, if used by an issuer to determine the accredited status of a natural person, will be deemed to constitute reasonable steps (see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Non-exclusive List of Steps to Verify Accredited Investor Status (8-382-6259)).

For a form of letter designed to help an issuer satisfy the reasonable steps verification requirement under Rule 506(c), see Standard Document, Accredited Investor Representation Letter for Rule 506(c) Offering (0-554-2865). For a form of letter to be delivered by an attorney, accountant, broker-dealer or investment adviser to help the issuer satisfy the verification requirement, see Standard Document, Third-party Accredited Investor Verification Letter for a Rule 506(c) Offering (0-563-8165).

CHANGES TO THE DEFINITION OF ACCREDITED INVESTOR

Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directed the SEC to change its net worth threshold for natural persons qualifying as accredited investors by excluding the value of an investor's primary residence in determining the investor's net worth. This change took effect upon the enactment of the Dodd-Frank Act. On December 21, 2011, the SEC adopted final rules amending the definition of accredited investor under Rule 501(a) of Regulation D and other Securities Act provisions to conform it to this section of the Dodd-Frank Act (SEC Release No. 33-9287 (Dec. 21, 2011)). Under amended Rule 501(a)(5), generally, in calculating whether a person qualifies as an accredited investor by having a net worth (the amount of assets in excess of liabilities) of more than $1 million:

- The value of the person's primary residence is not included as an asset.
- The amount of debt secured by the primary residence, up to its estimated fair market value, is not included as a liability.

However, any debt secured by the primary residence in excess of the estimated fair market value of the home at the time of the sale of securities is included as a liability. Under certain circumstances, additional debt secured by the primary residence may be included in the calculation, or none of these additions to and subtractions from net worth may be considered. For more information on the calculation of individual net worth under Rule 501(a)(5), see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Accredited Investors (8-382-6259).

The amendments to the net worth standard were required to remain in effect until July 21, 2014. Starting in 2014, the SEC must review the accredited investor definition every four years and make further amendments as it deems necessary. In December 2015, the SEC's staff issued a detailed report relating to potential changes to the definition (https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf). As of the date of this document, we anticipate revisions to be made through the SEC's rulemaking process.

1. Subscription. Subject to the terms and conditions hereof and the provisions of the Offering Documents, the undersigned hereby irrevocably subscribes for the Securities set forth in Appendix A hereto for the aggregate purchase price set forth in Appendix A, which is payable as described in Section 4 hereof. The undersigned acknowledges that the Securities will be subject to restrictions on transfer as set forth in this subscription agreement (the "**Subscription Agreement**").

DRAFTING NOTE: SUBSCRIPTION

This Section 1 may be modified to describe the number and type of securities purchased by the investor as well as the purchase price, as set out below. Appendix A of this agreement should be omitted if the agreement instead includes the alternate form of subscription language provided below.

[Subject to the terms and conditions of this subscription agreement (the "**Subscription Agreement**"), on the date of the Closing referred to in Section 3 hereof, the undersigned shall purchase from the Company, and the Company shall sell and issue to the undersigned [NUMBER AND TYPE OF SECURITIES TO BE PURCHASED] for the aggregate purchase price of US$[AMOUNT].]

2. Acceptance of Subscription and Issuance of Securities. It is understood and agreed that the Company shall have the sole right, at its complete discretion, to accept or reject this subscription, in whole or in part, for any reason and that the same shall be deemed to be accepted by the Company only when it is signed by a duly authorized officer of the Company and delivered to the undersigned at the Closing referred to in Section 3 hereof. Subscriptions need not be accepted in the order received, and the Securities may be allocated among subscribers. Notwithstanding anything in this Subscription Agreement to the contrary, the Company shall have no obligation to issue any of the Securities to any person who is a resident of a jurisdiction in which the issuance of Securities to such person would constitute a violation of the securities, "blue sky" or other similar laws of such jurisdiction (collectively referred to as the "**State Securities Laws**").

DRAFTING NOTE: ACCEPTANCE OF SUBSCRIPTION AND ISSUANCE OF SECURITIES; BLUE SKY LAWS

Blue sky is the popular name for state statutes and related rules providing for the regulation, qualification and supervision of securities offerings and sales. Blue sky laws may require issuers to register an offering of securities with a state agency that reviews selling documents for accuracy and completeness. They also often regulate securities brokers.

Since the passage of the National Securities Markets Improvement Act of 1996 (NSMIA), securities offered under Rule 506 of Regulation D qualify as "covered securities" under Section 18(b)(4) of the Securities Act. As a result, under Section 18(a)(1)(A) of the Securities Act, securities sold under Rule 506 enjoy a blanket exemption from the registration and qualification requirements of state-level securities laws. However, NSMIA permits state regulators to require that issuers make state notice filings and pay filing fees with respect to covered securities, subject to exceptions for securities that are listed or approved for listing on a national securities exchange (including the NYSE and NASDAQ) and securities of an issuer with such listed securities that rank senior to, or are equal in rank to, the listed securities.

Though requirements vary from state to state, state notice filings for Rule 506 offerings generally must be accompanied by a paper copy of the Form D that the issuer files electronically with the SEC. States that participate in the Electronic Filing Depository (EFD) system maintained by the North American Securities Administrators Association (NASAA) may permit, or may require, issuers to file Form D with the state electronically. For more information on state-level filing mechanics for Form D, see Practice Note, Form D: Notice of Exempt Offering of Securities: Blue Sky: State Notice Filing Requirements

for Rule 506 Offerings (3-573-7885) and Standard Document, Blue Sky Filing Cover Letter, Regulation D Rule 506 Offering (5-526-6228).

Generally, the best practice is to consult blue sky counsel before conducting offers and sales of securities to ensure compliance with applicable state statutes. In practice, the placement agent often provides the company with a list of states in which the securities are being offered and sold, to assist counsel in determining in which states any filings must be made.

For a form cover letter for state-level NSMIA notice filings for a Rule 506 offering, which includes links to state-specific blue sky Q&A guides for several key states, see Standard Document, Blue Sky Filing Cover Letter, Regulation D Rule 506 Offering (5-526-6228).

3. The Closing. The closing of the purchase and sale of the Securities (the "**Closing**") shall take place at the offices of [NAME OF LAW FIRM OR COMPANY], at [TIME] a.m. on [DATE], or at such other time and place as the Company may designate by notice to the undersigned.

4. Payment for Securities. Payment for the Securities shall be received by the Company from the undersigned by wire transfer of immediately available funds or other means approved by the Company at or prior to the Closing, in the amount as set forth in Appendix A hereto. The Company shall deliver certificates representing the Securities to the undersigned at the Closing bearing an appropriate legend referring to the fact that the Securities were sold in reliance upon an exemption from registration under the Securities Act.

5. Representations and Warranties of the Company. As of the Closing, the Company represents and warrants that:

(a) The Company is duly formed and validly existing under the laws of Delaware, with full power and authority to conduct its business as it is currently being conducted and to own its assets; and has secured any other authorizations, approvals, permits and orders required by law for the conduct by the Company of its business as it is currently being conducted.

(b) [The Securities have been duly authorized and, when issued, delivered and paid for in the manner set forth in this Subscription Agreement, will be validly issued, fully paid and nonassessable, [and will conform in all material respects to the description thereof set forth in the Offering Memorandum.]]

DRAFTING NOTE: REPRESENTATIONS AND WARRANTIES OF THE COMPANY

A user of this form may add representations and warranties appropriate for the particular issuer and security. This form does not include many material representations by the issuer, which would typically be included in a related placement agency agreement with a broker, or otherwise could be set out in a subscription agreement of this kind.

6. Representations and Warranties of the Undersigned. The undersigned hereby represents and warrants to and covenants with the Company that:

(a) General.

(i) The undersigned has all requisite authority (and in the case of an individual, the capacity) to purchase the Securities, enter into this Subscription Agreement and to perform all the obligations required to be performed by the undersigned hereunder, and such purchase will not contravene any law, rule or regulation binding on the undersigned or any investment guideline or restriction applicable to the undersigned.

(ii) The undersigned is a resident of the state set forth on the signature page hereto and is not acquiring the Securities as a nominee or agent or otherwise for any other person.

(iii) The undersigned will comply with all applicable laws and regulations in effect in any jurisdiction in which the undersigned purchases or sells Securities and obtain any consent, approval or permission required for such purchases or sales under the laws and regulations of any jurisdiction to which the undersigned is subject or in which the undersigned makes such purchases or sales, and the Company shall have no responsibility therefor.

(b) Information Concerning the Company.

(i) The undersigned has received a copy of the Offering Documents. The undersigned has not been furnished any offering literature other than the Offering Documents and has relied only on the information contained therein.

(ii) The undersigned understands and accepts that the purchase of the Securities involves various risks, including the risks outlined in the Offering Documents and in this Subscription Agreement. The undersigned represents that it is able to bear any loss associated with an investment in the Securities.

(iii) The undersigned confirms that it is not relying on any communication (written or oral) of the Company or any of its affiliates, as investment or tax advice or as a recommendation to purchase the Securities. It is understood that information and explanations related to the terms and conditions of the Securities provided in the Offering Documents or otherwise by the Company or any of its affiliates shall not be considered investment or tax advice or a recommendation to purchase the Securities, and that neither the Company nor any of its affiliates is acting or has acted as an advisor to the undersigned in deciding to invest in the Securities. The undersigned acknowledges that neither the Company nor any of its affiliates has made any representation regarding the proper characterization of the Securities for purposes of determining the undersigned's authority to invest in the Securities.

(iv) The undersigned is familiar with the business and financial condition and operations of the Company, all as generally described in the Offering Documents. The undersigned has had access to such information concerning the Company and the Securities as it deems necessary to enable it to make an informed investment decision concerning the purchase of the Securities.

(v) The undersigned understands that, unless the undersigned notifies the Company in writing to the contrary at or before the Closing, each of the undersigned's representations and warranties contained in this Subscription Agreement will be deemed to have been reaffirmed and confirmed as of the Closing, taking into account all information received by the undersigned.

(vi) The undersigned acknowledges that the Company has the right in its sole and absolute discretion to abandon this private placement at any time prior to the completion of the offering. This Subscription Agreement shall thereafter have no force or effect and the Company shall return the previously paid subscription price of the Securities, without interest thereon, to the undersigned.

(vii) The undersigned understands that no federal or state agency has passed upon the merits or risks of an investment in the Securities or made any finding or determination concerning the fairness or advisability of this investment.

DRAFTING NOTE: LIABILITY UNDER THE SECURITIES ACT; ACCESS TO COMPANY INFORMATION

The representations set out in Section 6(b) have a dual role to:

- Address the need for the investor to have access to the information of the company to evaluate the investment that it is undertaking.
- Limit the liability of the company to the information that has been provided to the investor.

SECTION 17 OF THE SECURITIES ACT

Section 17 of the Securities Act is the general antifraud provision of the Securities Act. It applies to any purchase of securities, whether part of a registered or an exempt offering. Section 17 prohibits the use of any means of interstate commerce to:

- Employ any device, scheme or artifice to defraud (Section 17(a)(1)).
- Obtain money or property by means of material misstatements or omissions (Section 17(a)(2)).
- Engage in any course of business that would operate as a fraud (Section 17(a)(3)). This section only protects purchasers and only operates against sellers, unlike Section 10(b) of the Exchange Act, which operates against both purchasers and sellers.

Unlike Sections 11 and 12, Section 17 does not give a private right of action to a purchaser. Instead, claims based on Section 17 may be enforced by the SEC. The liability provisions of Section 17(a)(2) only apply to the disclosure documents provided to the investor before or at the time of the contract of sale. For more details on the liability provisions for offerings, see Practice Note, Liability Provisions: Securities Offerings (6-381-1466).

SECTION 10(B) OF THE EXCHANGE ACT

Section 10(b) of the Exchange Act makes it unlawful for any person: "to use or employ ... in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." This section applies to all offerings of securities (debt and equity). However, the statute requires the SEC to prescribe rules to implement it. The most important of the SEC's rules enacted under Section 10(b) is Rule 10b-5, the general anti-fraud rule. Rule 10b-5 prohibits any of the following in connection with the purchase or sale of a security:

- Fraudulent devices and schemes, material misstatements and omissions of any material facts.
- Acts and practices that operate as a fraud or deceit on any person.

Neither Section 10(b) nor Rule 10b-5 provide an express private right of action to securities purchasers injured by a violation. However, an implied right of action has developed over time in the federal courts based on basic common law principles used in fraud cases. For civil liability to attach under Section 10(b) and Rule 10b-5, there must be:

- A false statement about, or omission of, a material fact.
- The false statement or omission must be made with scienter (that is, an intent to deceive, manipulate or defraud).
- Evidence that the plaintiff justifiably relied on the statement or omission.
- Evidence that reliance on the false statement or omission caused damages.

Accordingly, insufficient or incorrect disclosures about the issuer in the relevant offering documents or in the subscription agreement's representations or warranties, if made with scienter, could form the basis of a Rule 10b-5 claim against the issuer.

(c) Non-reliance.

(i) The undersigned represents that it is not relying on (and will not at any time rely on) any communication (written or oral) of the Company, as investment advice or as a recommendation to purchase the Securities, it being understood that information and explanations related to the terms and conditions of the Securities and the other transaction documents that are described in the Offering Documents shall not be considered investment advice or a recommendation to purchase the Securities.

(ii) The undersigned confirms that the Company has not (A) given any guarantee or representation as to the potential success, return, effect or benefit (either legal, regulatory, tax, financial, accounting or otherwise) of an investment in the Securities or (B) made any representation to the undersigned regarding the legality of an investment in the Securities under applicable legal investment or similar laws or regulations. In deciding to purchase the Securities, the undersigned is not relying on the advice or recommendations of the Company and the undersigned has made its own independent decision that the investment in the Securities is suitable and appropriate for the undersigned.

DRAFTING NOTE: DISCLOSURE

These provisions seek to preclude any claims by the purchaser for implied representations and warranties of the issuer. This acknowledgment is particularly important if this agreement is used for a purchaser who is an unaffiliated third-party investor.

(d) Status of Undersigned.

(i) The undersigned has such knowledge, skill and experience in business, financial and investment matters that the undersigned is capable of evaluating the merits and risks of an investment in the Securities. With the assistance of the undersigned's own professional advisors, to the extent that the undersigned has deemed appropriate, the undersigned has made its own legal, tax, accounting and financial evaluation of the merits and risks of an investment in the Securities and the consequences of this Subscription Agreement. The undersigned has considered the suitability of the Securities as an investment in light of its own circumstances and financial condition and the undersigned is able to bear the risks associated with an investment in the Securities and its authority to invest in the Securities.

(ii) The undersigned is an "accredited investor" as defined in Rule 501(a) under the Securities Act. The undersigned agrees to furnish any additional information requested by the Company or any of its affiliates to assure compliance with applicable U.S. federal and state securities laws in connection with the purchase and sale of the Securities. [The undersigned acknowledges that the undersigned has completed the Investor Questionnaire contained in Appendix B and that the information contained therein is complete and accurate as of the date thereof and is hereby affirmed as of the date hereof. Any information that has been furnished or that will be furnished by the undersigned to evidence its status as an accredited investor is accurate and complete, and does not contain any misrepresentation or material omission.]

DRAFTING NOTE: INVESTOR STATUS REPRESENTATIONS; ERISA

Under Regulation D, the burden of determining the status of potential investors is placed on the company. In Section 6(d), the purchasers represent to the company that they are investors that are both sophisticated and accredited. For further information, see also Drafting Note, Accredited Investors, Drafting Note, Liability Under the Securities Act; Access to Company Information.

Counsel to the issuer typically also wants to include a requirement that the purchaser complete and execute an investor questionnaire in addition to making the representations contained in this agreement (see Standard Document, Investor Questionnaire (5-518-0753)). If an investor questionnaire is not attached as an exhibit/appendix to the subscription agreement, this provision should be modified accordingly. See also Drafting Note, Accredited Investors.

ERISA

Additional provisions should be included if the issuer permits investments by employee benefits plans governed by the Employee Retirement Income Security Act of 1974 (ERISA) or Section 4975 of the Internal Revenue Code (IRC) or by investors whose assets are deemed to include the assets of those plans under the Department of Labor's "plan asset regulation" (29 CFR § 2510.3-101, as modified by ERISA § 3(42) (29 U.S.C. § 1002(42))). For a sample ERISA representation that may be included in a subscription agreement for a private placement of equity securities, see Standard Clause, Subscription Agreement Language, Private Placement of Equity Securities (Regulation D): ERISA Representation (2-558-8145).

(e) Restrictions on Transfer or Sale of Securities. As applies to the Purchaser:

(i) The undersigned is acquiring the Securities solely for the undersigned's own beneficial account, for investment purposes, and not with a view to, or for resale in connection with, any distribution of the Securities. The undersigned understands that the Securities have not been registered under the Securities Act or any State Securities Laws by reason of specific exemptions under the provisions thereof which depend in part upon the investment intent of the undersigned and of the other representations made by the undersigned in this Subscription Agreement. The undersigned understands that the Company is relying upon the representations and agreements contained in this Subscription Agreement (and any supplemental information) for the purpose of determining whether this transaction meets the requirements for such exemptions.

(ii) The undersigned understands that the Securities are "restricted securities" under applicable federal securities laws and that the Securities Act and the rules of the U.S. Securities and Exchange Commission (the "**Commission**") provide in substance that the undersigned may dispose of the Securities only pursuant to an effective registration statement under the Securities Act or an exemption therefrom, and the undersigned understands that the Company has no obligation or intention to register any of the Securities, or to take action so as to permit sales pursuant to the Securities Act (including Rule 144 thereunder). Accordingly, the undersigned understands that under the Commission's rules, the undersigned may dispose of the Securities principally only in "private placements" which are exempt from registration under the Securities Act, in which event the transferee will acquire "restricted securities" subject to the same limitations as in the hands of the undersigned. Consequently, the undersigned understands that the undersigned must bear the economic risks of the investment in the Securities for an indefinite period of time.

DRAFTING NOTE: ISSUANCE OF RESTRICTED SECURITIES

In Section 6(e)(ii), the purchaser acknowledges that the securities are restricted securities issued in a private placement. Under the Securities Act, the purchaser cannot resell restricted securities without registration or an exemption from registration under the Securities Act. Absent a resale of the securities in a registered offering (such as in an initial public offering (IPO)), if the purchaser wishes to resell the securities before an IPO, the purchaser must ensure the sale falls within an applicable exemption from registration with the Securities Act (see Practice Note, Unregistered Offerings: Overview: Registration Exemptions and Safe Harbors (9-382-8837)) or in compliance with the conditions of Rule 144.

Rule 144 is one of the main methods used to resell securities. Resales are secondary distributions or trading transactions by persons other than the issuer of the securities. Most resales are unregistered. Sellers can generally rely on Rule 144 to publicly resell securities to anyone so long as the seller has held the securities for at least six months (if the issuer of the securities is a reporting company) or one year (if the issuer is a non-reporting company), as applicable. For detailed discussion of the requirements of Section 4(a)(1) and Rule 144, see Practice Note, Resales Under Rule 144 (4-382-8769).

(iii) The undersigned agrees: (A) that the undersigned will not sell, assign, pledge, give, transfer or otherwise dispose of the Securities or any interest therein, or make any offer or attempt to do any of the foregoing, except pursuant to a registration of the Securities under the Securities Act and all applicable State Securities Laws, or in a transaction which is exempt from the registration provisions of the Securities Act and all applicable State Securities Laws; (B) that the certificates representing the Securities will bear a legend making reference to the foregoing restrictions; and (C) that the Company and it affiliates shall not be required to give effect to any purported transfer of such Securities except upon compliance with the foregoing restrictions.

(iv) [The undersigned acknowledges that neither the Company nor any other person offered to sell the Securities to it by means of any form of general solicitation or advertising, including but not limited to: (A) any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio or (B) any seminar or meeting whose attendees were invited by any general solicitation or general advertising.]

DRAFTING NOTE: USE OF GENERAL SOLICITATION AND GENERAL ADVERTISING

The purchaser representation in Section 6(e)(iv) is presented as bracketed optional language. This provision should be retained (that is, the brackets should be removed) if the issuer is conducting the offering under Rule 506(b), which prohibits the use of general solicitation. However, if the issuer is conducting the offering under Rule 506(c), which permits the use of general solicitation, this provision should be deleted entirely.

7. Conditions to Obligations of the Undersigned and the Company. The obligations of the undersigned to purchase and pay for the Securities specified in Appendix A and of the Company to sell the Securities are subject to the satisfaction at or prior to the Closing of the following conditions precedent: the representations and warranties of the Company contained in Section 5 hereof and of the undersigned contained in Section 6 hereof shall be true and correct as of the Closing in all respects with the same effect as though such representations and warranties had been made as of the Closing.

8. Obligations Irrevocable. The obligations of the undersigned shall be irrevocable.

9. Legend. The certificates representing the Securities sold pursuant to this Subscription Agreement will be imprinted with a legend in substantially the following form:

"THE SECURITIES EVIDENCED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR THE SECURITIES LAWS OF ANY STATE OR OTHER JURISDICTION. THE SECURITIES MAY NOT BE OFFERED, SOLD, PLEDGED OR OTHERWISE TRANSFERRED EXCEPT (1) PURSUANT TO AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OR (2) PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT, IN EACH CASE IN ACCORDANCE WITH ALL APPLICABLE STATE SECURITIES LAWS AND THE SECURITIES LAWS OF OTHER JURISDICTIONS, AND IN THE CASE OF A TRANSACTION EXEMPT FROM REGISTRATION, UNLESS THE COMPANY HAS RECEIVED AN OPINION OF COUNSEL REASONABLY SATISFACTORY TO IT THAT SUCH TRANSACTION DOES NOT REQUIRE REGISTRATION UNDER THE SECURITIES ACT AND SUCH OTHER APPLICABLE LAWS."

DRAFTING NOTE: LEGENDS ON CERTIFICATES REPRESENTING THE SECURITIES

For a discussion of the importance of the securities law legends, see Drafting Note, Securities Law Legends.

10. Waiver, Amendment. Neither this Subscription Agreement nor any provisions hereof shall be modified, changed, discharged or terminated except by an instrument in writing, signed by the party against whom any waiver, change, discharge or termination is sought.

11. Assignability. Neither this Subscription Agreement nor any right, remedy, obligation or liability arising hereunder or by reason hereof shall be assignable by either the Company or the undersigned without the prior written consent of the other party.

12. Waiver of Jury Trial. THE UNDERSIGNED IRREVOCABLY WAIVES ANY AND ALL RIGHT TO TRIAL BY JURY WITH RESPECT TO ANY LEGAL PROCEEDING ARISING OUT OF THE TRANSACTIONS CONTEMPLATED BY THIS SUBSCRIPTION AGREEMENT.

DRAFTING NOTE: WAIVER OF JURY TRIAL

Most sophisticated parties prefer that a judge hear and decide any dispute arising out of the agreement rather than a jury of people who may not appreciate and understand the potentially complex issues involved in the litigation. However, this clause is not enforceable in all jurisdictions. Counsel must review all applicable laws and regulations to determine if it is enforceable.

If the purchaser under the agreement is a member of management or an unaffiliated third-party investor, the company may want to add the following acknowledgments for the parties:

[Each party to this Subscription Agreement certifies and acknowledges that (a) no representative of any other party has represented, expressly or otherwise, that such other party would not seek to enforce the foregoing waiver in the event of a legal action; (b) such party has considered the implications of this waiver; (c) such party makes this waiver voluntarily; and (d) such party has been induced to enter into this Agreement by, among other things, the mutual waivers and certifications in this section.]

13. Submission to Jurisdiction. With respect to any suit, action or proceeding relating to any offers, purchases or sales of the Securities by the undersigned ("**Proceedings**"), the undersigned irrevocably submits to the jurisdiction of the federal or state courts located in the Borough of Manhattan in New York City, which submission shall be exclusive unless none of such courts has lawful jurisdiction over such Proceedings.

DRAFTING NOTE: SUBMISSION TO JURISDICTION

The submission to jurisdiction clause permits the parties to select the forum in which a claim can be brought. Most agreements allow for claims to be brought in both federal (assuming that the federal court has subject matter jurisdiction over the particular claim) and state courts, provided that both parties submit to the personal jurisdiction of these courts and include a waiver of any objections to the venue. This clause works with the governing law clause (see below) to provide some certainty on how the agreement might get interpreted or a dispute resolved. The designated forum does not have to be in the state whose laws govern the agreement.

14. Governing Law. This Subscription Agreement shall be governed by and construed in accordance with the laws of the State of New York.

15. Section and Other Headings. The section and other headings contained in this Subscription Agreement are for reference purposes only and shall not affect the meaning or interpretation of this Subscription Agreement.

16. Counterparts. This Subscription Agreement may be executed in any number of counterparts, each of which when so executed and delivered shall be deemed to be an original and all of which together shall be deemed to be one and the same agreement.

17. Notices. All notices and other communications provided for herein shall be in writing and shall be deemed to have been duly given if delivered personally or sent by registered or certified mail, return receipt requested, postage prepaid to the following addresses (or such other address as either party shall have specified by notice in writing to the other):

If to the Company: [COMPANY ADDRESS]
Facsimile: [FAX NUMBER]
E-mail: [E-MAIL ADDRESS]
Attention: [TITLE OF OFFICER TO RECEIVE NOTICES]

with a copy to:	[COMPANY LAW FIRM] Facsimile: [FAX NUMBER] E-mail: [E-MAIL ADDRESS] Attention: [ATTORNEY NAME]
If to the Purchaser:	[PURCHASER ADDRESS] Facsimile: [FAX NUMBER] E-mail: [E-MAIL ADDRESS] Attention: [TITLE OF OFFICER TO RECEIVE NOTICES]
with a copy to:	[PURCHASER LAW FIRM] Facsimile: [FAX NUMBER] E-mail: [E-MAIL ADDRESS] Attention: [ATTORNEY NAME]

DRAFTING NOTE: NOTICES AND COMMUNICATIONS

Alternatively, this provision can require that the contact information for the purchaser be provided in an Appendix to the agreement.

It is good practice to require that counsel to the company or the purchaser receive a copy of any notice or other communication between the parties.

18. Binding Effect. The provisions of this Subscription Agreement shall be binding upon and accrue to the benefit of the parties hereto and their respective heirs, legal representatives, successors and assigns.

19. Survival. All representations, warranties and covenants contained in this Subscription Agreement shall survive (i) the acceptance of the subscription by the Company and the Closing, (ii) changes in the transactions, documents and instruments described in the Offering Documents which are not material or which are to the benefit of the undersigned and (iii) the death or disability of the undersigned.

DRAFTING NOTE: SURVIVAL OF REPRESENTATIONS AND WARRANTIES AND ACKNOWLEDGMENTS AND AGREEMENTS

When dealing with a third-party investor, company counsel may want to add this provision to ensure the company has a cause of action against the purchaser should a breach of any of the purchaser's representations and warranties lead to a loss or damages for the company (for example, if the purchaser breaches the accredited investor representation in Section 6). For the representations and warranties and other agreements of the purchaser to form a basis for a post-closing claim and liability, these provisions must survive the closing.

20. Notification of Changes. The undersigned hereby covenants and agrees to notify the Company upon the occurrence of any event prior to the closing of the purchase of the Securities pursuant to this Subscription Agreement which would cause any representation, warranty, or covenant of the undersigned contained in this Subscription Agreement to be false or incorrect.

21. Severability. If any term or provision of this Agreement is invalid, illegal or unenforceable in any jurisdiction, such invalidity, illegality or unenforceability shall not affect any other term or provision of this Agreement or invalidate or render unenforceable such term or provision in any other jurisdiction.

DRAFTING NOTE: SEVERABILITY

The severability clause makes clear that, if one or more terms or provisions are held to be invalid, illegal or unenforceable, the parties intend the agreement as a whole to survive by severing the invalid, illegal or unenforceable terms or provisions from the agreement.

IN WITNESS WHEREOF, the undersigned has executed this Subscription Agreement this [DAY] OF [MONTH], [YEAR].

PURCHASER (if an individual):

By _____

Name:

PURCHASER (if an entity):

_____

Legal Name of Entity

By _____

Name:

Title:

State/Country of Domicile or Formation: _____

Aggregate Subscription Amount: US$ _____

The offer to purchase Securities as set forth above is confirmed and accepted by the Company as to _____ shares of common stock.

[NAME OF COMPANY]

By _____
Name:
Title:

APPENDIX A

Consideration To Be Delivered

Securities to Be Acquired	Aggregate Purchase Price to be Paid
_____ shares of common stock	US$ _____

COVER SHEET WITH SUBSCRIPTION INSTRUCTIONS

Enclosed herewith are the documents necessary to subscribe for [NUMBER] shares of common stock (the "**Securities**") of [NAME OF ISSUER], a corporation organized under the laws of Delaware (the "**Company**"). The Securities are being offered to qualified investors pursuant

to the Offering Memorandum, dated [DATE] [and any other relevant documents] (collectively, the "**Offering Documents**"). Set forth herein are instructions for the execution of the enclosed documents.

A. Instructions.

Each person considering subscribing for Securities should review the following instructions:

- Subscription Agreement: Two copies of the Subscription Agreement must be completed, executed and delivered to the Company at the address set forth below. If your subscription is accepted, the Company will execute both copies of the Subscription Agreement and return one copy to you for your records.
- [*To be added if the offering is being made under Rule 506(c)*: Back-up Documentation and Certification. If the investor is a natural person, please provide copies of the following relevant documents:

  (A) Income: If the investor is basing accredited investor status on income, please provide any Internal Revenue Service form that reports the investor's income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040); the investor's signature on the [Subscription Agreement/[INVESTOR QUESTIONNAIRE]] constitutes the investor's written representation that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year; **or**

  (B) Net Worth: If the investor is basing accredited investor status on net worth, please provide one or more of the following types of documentation dated within the prior three months, and the investor's signature on the [Subscription Agreement/[INVESTOR QUESTIONNAIRE]] constitutes the investor's written representation that all liabilities necessary to make a determination of net worth have been disclosed:

  - *With respect to assets*: Bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and
  - *With respect to liabilities*: A consumer report from at least one of the nationwide consumer reporting agencies; **or**

  (C) Third Party Verification: Please provide a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the investor is an accredited investor within the prior three months and has determined that the investor is an accredited investor:

  - A registered broker-dealer;
  - An investment adviser registered with the Securities and Exchange Commission;
  - A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or
  - A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.]
- Payment: Payment of US$[AMOUNT] for the Securities subscribed for shall be made by delivery by Closing (as defined in Section [NUMBER] of the Subscription Agreement) of cash to the Company at the address set forth below or an account specified by the Company.
- Acceptance or Rejection of Subscription: The Company shall have the right to accept or reject any subscription, in whole or in part. An acknowledgment of the Company's acceptance of your subscription for the Securities subscribed for will be returned to you promptly after acceptance.

DRAFTING NOTE: VERIFICATION OF ACCREDITED INVESTOR STATUS UNDER RULE 506(C)

Rule 506(c)(2)(ii) requires an issuer to take reasonable steps to verify that each purchaser of securities sold in any offering under Rule 506(c) is an accredited investor. The issuer shall be deemed to take reasonable steps to verify if the issuer uses, at its option, specified non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor (as long as the issuer does not otherwise have knowledge that the person is not an accredited investor). The documentation listed above tracks the methods set out in Rule 506(c)(2)(ii). If a prospective investor cannot provide the specified information or documentation, there may be other reasonable steps that an issuer can take to verify whether the proposed investor is an accredited investor.

The methods set out in Rule 506(c)(2)(ii) apply only to natural persons. For others, the SEC has described the required "reasonable steps" to verify accredited investor status as a principles-based, objective determination by the issuer (or those acting on its behalf) in the context of the particular facts and circumstances of each purchaser and transaction. Among the factors that issuers should consider under this facts-and-circumstances analysis are:

- The nature of the purchaser and the type of accredited investor that the purchaser claims to be.
- The amount and type of information that the issuer has about the purchaser.
- The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

For additional information on verification methods in a Rule 506(c) offering, see Practice Note, Section 4(a)(2) and Regulation D Private Placements: Guidance on Reasonable Steps to Verify Accredited Investor Status (8-382-6259).

For a form of letter designed to help an issuer satisfy the reasonable steps verification requirement under Rule 506(c), see Standard Document, Accredited Investor Representation Letter for Rule 506(c) Offering (0-554-2865). For a form of letter to be delivered by an attorney, accountant, broker-dealer or investment adviser to help the issuer satisfy the verification requirement, see Standard Document, Third-party Accredited Investor Verification Letter for a Rule 506(c) Offering (0-563-8165).

B. Communications.

All documents and checks should be forwarded to:

[CONTACT INFORMATION]

Attn: [NAME]

09-16

THE BRAVE OLD WORLD OF PRIVATE RESALES

Douglas C. Michael[*]

In the Fixing America's Surface Transportation (FAST) Act,[1] Congress included provisions related to the federal securities laws. Among them was an amendment to the Securities Act of 1933 (hereafter "Securities Act" or "'33 Act") intended to codify the so-called "§4(a)(1½) exemption" from registration for private non-issuer sales of restricted, control person, or other securities. This paper reviews the history of this informal exemption, its codification, and the place of the new exemption within the attorney's tool kit when advising his or her clients seeking to resell securities acquired from an issuer in exempt transactions. The new exemption, intended only to restate the agreed "best practices" in private resale opinions, may add slightly to the options of such security holders.

I. BACKGROUND OF THE SECTION 4(a)(1½) EXEMPTION

The exemption known as §4(a)(1½) owes its existence to the strange confluence of interpretation of the terms "distribution" and "public offering" as they are used in the '33 Act. This intermingling began with the very drafting of the Act.[2] By the time the statute reached its first anniversary, Congress determined that §4(a)(2)[3] could be amended by eliminating the phrase "not with or through an underwriter" because, according to an explanatory memorandum, "the [Federal Trade] Commission has recognized by its interpretations that a 'public offering' is necessary for a 'distribution.'"[4]

Nearly a generation later, the Second Circuit closed the loop with its decision in Gilligan, Will & Co. v. SEC.[5] The case was an appeal from a Securities and

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[1] P.L. 114-94, 129 Stat. 1312 (2015).

[2] "The Section '4(1½)' Phenomenon: Private Resales of 'Restricted' Securities," 34 Bus. Law. 1961, 1964 (1979) (report to the ABA Business Law Section Committee on Federal Regulation of Securities) (hereafter "ABA Report"). This is the seminal work on the development of the §4(a)(1½) exemption. On equal footing is Carl W. Schneider, "Section 4(1½) – Private Resales of Restricted or Control Securities," 49 Ohio St. L.J. 501 (1988).

[3] All section references are to the current citations of the '33 Act. This provision prior to amendment exempted "sales by an issuer 'not with or through an underwriter and not involving any public offering.'" *Id*. at 1964.

[4] "ABA Report," *supra* note 2, at 1964 (*quoting* "Memorandum Explanatory of Suggested Amendments to the Securities Act," S. 3420, 73d Cong., 2d Sess.,78 Cong. Rec. 8669 (1934)). The statute before Congress was, of course, what would become the Securities Exchange Act of 1934, Title II of which included amendments to the '33 Act, including the one discussed in the text. Before the creation of the Securities and Exchange Commission by this statute in 1934, the '33 Act was administered by the Federal Trade Commission.

[5] 267 F.2d 461 (2d Cir. 1959).

Exchange Commission (hereafter "Commission" or "SEC") enforcement action against Gilligan, Will, a broker-dealer, for violation of the registration requirements of the '33 Act. The firm had purchased debentures, and later stock, of a company, and immediately resold some of that allocation to a few individuals. In response to the Commission's charges, the petitioners argued to the court that they were within the exemption provided by §4(a)(1)[6] with the following logic.

> Petitioners assert that they were not "underwriters" within the meaning of the exemption provided by … §4[(a)](1). Since §2[(a)](11), defines an "underwriter" as "any person who has purchased from an issuer with a view to * * * the distribution of any security" and since a "distribution" requires a "public offering," *see* H.R.Rep. No. 1838, 73d Cong., 2d Sess. (1934) at p. 41, the question is whether there was a "public offering." Petitioners, disclaiming any reliance on the [§4(a)(2)] exemption … for "transactions by an issuer not involving any public offering," assert that whether there was a "distribution" must be judged solely by their own acts and intention, and not by the acts or intention of the issuer or others. In other words they claim that whether the total offering was in fact public, their purchases and resales may be found to be exempt on the ground that they were not underwriters if their own resales did not amount to a public offering.[7]

The court took up the petitioners' invitation, and determined, pursuant to the rules then recently announced by the Supreme Court in Ralston Purina,[8] that their resales *did* amount to a "public offering."[9] Tracing the syllogism back to its source, the court held that there was thus a "distribution," and that the petitioners were "underwriters" unable to claim the §4(a)(1) exemption.

Stated another way, there can be no "distribution" (not a defined term) if there is not a "public offering." So the rules from Ralston Purina about what makes an offering a public offering became relevant in determining whether a distribution has taken place, and thus whether the person taking part in that event would be

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[6] Securities Act §4(a)(1) exempts "transactions by any person other than an issuer, underwriter, or dealer." All statutory citations are to the Securities Act unless otherwise indicated.

[7] *Id*. at 466.

[8] In SEC v. Ralston Purina Co., 346 U.S. 119 (1953), the Supreme Court determined that the existence of a "private offering" exemption under §4(a)(2) was to be determined by whether the offerees "could fend for themselves," by having, or having access to, the kind of information which a registration statement would provide. 346 U.S. at 125-27. A "public offering," by contrast, would be one made to offerees who had no such ability. Gilligan, Will*, supra,* 267 F.2d at 467-68.

[9] The facts as stipulated by the parties stated "that the purchasers 'were not supplied with material information of the scope and character contemplated by the Securities Act.'" Gilligan, Will, *supra,* 267 F.2d at 466.

considered an underwriter.[10] In this fashion, the establishment by resellers of a §4(a)(1) exemption (by not being an underwriter) came to depend upon concepts relevant in deciding an issuer's exemption under §4(a)(2), and §4(a)(1½) was born.[11]

II. THE CODIFICATION MOVEMENT

The §4(a)(1½) exemption is well established in the lexicon of '33 Act attorneys. It has even received indirect recognition from the Commission.[12] Section 4(a)(1½) opinions have become fairly common among securities practitioners.[13] The drive for additional certainty, however, came primarily from resale market makers who wanted the assurance which legislative or regulatory recognition of this exemption would provide.[14]

Proponents of codification identified three major areas where the private markets relied substantially on §4(a)(1½).

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[10] This definition and justification may need some repeating to be understood. "The Act's statutory pattern, and the judicial and administrative precedents … provide a poor theoretical framework for determining the precise limits of the Section 4[(a)](1½) exemption." Schneider, *supra* note 2, at 501.

[11] It is well settled that the §4(a)(1½) exemption is a §4(a)(1) exemption. "ABA Report," *supra* note 2, at 1975; I Louis Loss, Joel Seligman and Troy Paredes, Fundamentals of Securities Regulation 575 (6th ed. 2011) ("But the answer, of course, is simply §4[(a)](1).")

[12] *See* "ABA Report," *supra* note 2, at 1971-74. Note that the ABA Report summarizing no-action positions was issued just prior to the Commission closing of the door on §4(a)(1) no-action letters in Securities Act Release No. 6253, 45 Fed. Reg. 72,644 at 72,646. *See* Schneider, *supra* note 2, at 504 n. 25 (summarizing SEC staff positions).

[13] "Despite the lack of formal guidance, the legal bar is generally comfortable providing legal opinions that affirm that these transactions are exempt from SEC registration under a Rule 4(a)(1½) analysis (assuming the essential conditions for a private placement have been met) and multiple law firms do so for hundreds of private company secondary share transactions each year." Legislative Proposals to Enhance Capital Formation For Small And Emerging Growth Companies, Part II: Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises, U.S. House of Representatives Committee On Financial Services 78 (113th Cong., 2d Sess., May 1, 2014) (hereafter "2014 House Hearings") (testimony of Annemarie Tierney, Executive Vice President and General Counsel, Second Market Holdings, Inc., (now NASDAQ Private Market)), available at http://financialservices.house.gov/uploadedfiles/113-77.pdf.

[14] *See, e.g.,* Hearings, Advisory Committee on Small and Emerging Companies, U.S. Securities and Exchange Commission, p. 91 (need for legislation or SEC regulation) and p. 103 (proposal "codifies existing opinion practice") (Mar. 4, 2015), available at www.sec.gov/info/smallbus/acsec/acsec-transcript-030415.pdf (hereafter "ACSEC Hearings") (remarks of Ms. Tierney); Cong. Rec. Oct. 6, 2015, p. H6807, remarks of Rep. Carolyn B. Maloney on the RAISE Act, which was identical to the §4(a)(1½) provisions which became part of the FAST Act (*see* H.R. Rep. No. 357, 114th Cong., 1st Sess. 545) ("…it is a very good idea to finally codify [§4(a)(1½)] so that everyone knows the rules of the road and investors can have confidence that they are complying with the law when they resell private securities to other sophisticated investors.").

- *Employee stock options.* Employees in private companies cannot otherwise exercise stock options and then immediately sell shares to cover the costs of exercise, taxes and fees. Many employees, it was alleged, cannot afford to pay in cash these substantial up-front costs.[15]

- *Regulation A+ resales.* Under the revitalized Regulation A, known colloquially as Regulation A+, sales by existing security holders may constitute a portion of the securities offered in either Tier 1 or Tier 2 offerings. But once the qualified sales are completed, the securities are not "restricted securities" within the meaning of Rule 144 in the hands of the purchaser.[16] This means that Rule 144 offers no safe harbor for making a §4(a)(1) determination for any subsequent sales. In this area, §4(a)(1½) has been useful in establishing the ability to resell these securities.[17]

- *Sales by affiliates generally.* Rule 144 provides a safe harbor to avoid characterization as an "underwriter" and, therefore, favorable treatment under §4(a)(1).[18] The safe harbor is fairly circumscribed, however, for sales by "affiliates" of the issuer. The term "affiliate" is defined broadly in terms of "control,"[19] and the determination of "control" is an area in which

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[15] "[T]here are situations under which employees and affiliates of [an] issuer may not be able to meet the conditions of Rule 144. One common example is an option holder seeking a "cashless" exercise of employee options. In this case, the holding period requirements in Rule 144 often prevent the holder from being able to resell shares immediately upon exercise in order to pay the exercise price and other costs of acquiring the shares underlying the options."

Advisory Committee on Small and Emerging Companies, U.S. Securities and Exchange Commission, *Recommendation Regarding the §4(1½) Exemption* 1 at ¶ 5 (June 3, 2015) (hereafter *ACSEC Recommendation*), available at https://www.sec.gov/info/smallbus/acsec/acsesc-4a-one-and-a-half-recommendation.pdf. *See also* H.R. Rep. No. 357, FAST Act Conference Report, 114th Cong., 1st Sess. 545 (purpose of addition of §4(a)(7) is "to facilitate the sale of company-issued securities by employees of private companies"); Cong. Rec. H6807 (Oct. 6, 2015) (remarks of Rep. McHenry) ("The bill would … allow[] startup employees the ability to execute trades in a way that is consistent, clear, and certain."); "ACSEC Hearings," *supra* note 14, at 107 (remarks of Ms. Tierney) ("97 percent of what we see is stock that's held in the form of options that could not be exercised and sold on the venture capital market if this legislation is not in place.")

[16] Section 3(b)(2)(C).

[17] *See* Rutheford B. Campbell, "Resales of Securities Under the Securities Act of 1933," 52 Wash. & Lee L.Rev. 1333, 1359-1362 (1995) (resales of Regulation A securities require separate analysis under §4(a)(1)); H.R. Rep. No. 281, Reforming Access for Investments in Startup Enterprises, 114th Cong., 1st Sess. 3 (Report on legislation adding §4(a)(7), which was later incorporated into FAST Act) (amendment will "ensure that the legal framework … supports the secondary market for the shares offered and sold in Regulation A+ offerings").

[18] Of course, the safe harbor is provided only so long as the seller is also neither an issuer nor dealer, but those are not as complicated questions. *See* Rule 144, Preliminary Note 2.

[19] "An affiliate of an issuer is a person that directly, or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." Rule 144(a)(1).

the SEC offers little or no administrative guidance.[20] Thus, there exists substantial uncertainty for anyone in a control relationship with the issuer who would like to resell the issuer's securities under the many situations in which Rule 144's safe harbor is not available.[21] The codification was heralded as a way to bring certainty to this market.[22] Rule 144A permits resales immediately, of course, but only in the limited universe of initial purchasers who come within that rule.

Legislation was first discussed in Congress in 2014 in the nature of a "fix" to the Regulation A+ provisions of the JOBS Act,[23] in order to assure that resales of Regulation A+ securities would proceed unencumbered by concerns about registration.[24] The bill as initially introduced included only two qualifications on the §4(a)(1½) codification: (1) that each purchaser be an accredited investor, and (2) that if advertising is permitted, all sales be made "through a platform available only to accredited investors."[25] The bill was amended in the House Committee on Financial Services to appear as enacted.[26] It was passed by the House as the Reforming Access for Investments in Startup Enterprises (RAISE) Act of 2015 on Oct. 6, 2015.[27] It was referred to the Senate but never taken up, and was

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[20] In Securities Act Release No. 6253, Procedures Utilized by the Division of Corporation Finance for Rendering Informal Advice, 45 Fed. Reg. 72,644 (Nov. 3, 1980), the Commission announced areas of "no comment" in which no-action relief would not be provided. Those include "affiliate or control status" as well as availability of the §4(a)(1) exemption. *Id.* at 72,645-46.

[21] In addition to a six-month or one-year holding requirement of Rule 144(d), affiliates must comply with the information requirement of Rule 144(c) without lapse (even for non-reporting companies), as well as the amount and manner of sale restrictions of Rule 144(e) and (f).

[22] *See, e.g.,* "ACSEC Hearings," *supra* note 14, at 129 (remarks of Ms. Tierney) ("It is an absolute necessity that some rules along these lines get adopted in order for a venture capital exchange to be successful, otherwise, the amount of stock that could trade on a venture capital exchange in a private company space is very, very, limited and there won't be liquidity.")

[23] Jumpstart Our Business Startups (JOBS) Act, P.L. 112-106, §401, 126 Stat. 306 at 323 (2012).

[24] *See* "2014 House Hearings," *supra* note 1313, at 6 (remarks of Rep. McHenry) ("the discussion draft on Regulation A in the resale of restricted securities simply codifies the spirited intent of Title IV of the JOBS Act, reviving the exemption to connect small enterprises and everyday investors. Furthermore, the draft amendment to the 1933 Act also codifies policy that efficiently cultivates liquidity in secondary trading of restricted securities among sophisticated investors.").

[25] H.R. 1389 (114th Cong., 1st Sess., introduced Apr. 16, 2015) §2(a), available at http://financialservices.house.gov/uploadedfiles/bills-114hr1839ih.pdf.

[26] Committee Markup, Jul. 28, 2015, available at https://www.youtube.com/watch?v=um-EEln-mME.

[27] *See* Cong. Rec. H6808 (114th Cong., 1st Sess., Oct. 6, 2015).

considered instead as appended to the FAST Act,[28] and in that fashion ultimately adopted.[29]

The statute adds new §4(a)(7) as a '33 Act transaction exemption, but the details of the exemption are provided in §4(d):

- Sales may be made only to Rule 501 accredited investors.
- No general solicitation or advertising is permitted.
- Information about the *issuer* must be provided by the *seller* to the *purchaser* if the issuer is not a reporting company or an exempt foreign government or foreign private issuer.
- The security being sold must be of a class that has been authorized and outstanding for ninety days.
- The exemption is not available to:
  - Issuers;
  - "Bad actors" as defined in Rule 506(d)(1);
  - Sellers of securities of issuers in bankruptcy or "blank check, blind pool, or shell company that has no specific business plan," or
  - Underwriters disposing of an unsold allotment, or brokers or dealers in a redistribution.

Section 4(e) describes the consequences beyond §5 relief. The §4(a)(7) securities are "deemed to have been acquired in a transaction not involving any public offering," the securities are restricted securities for purposes of Rule 144, and the transaction is deemed not to be a distribution under §2(a)(11). This is curious "belt-and-suspenders" coverage. It would do to say either that the securities are acquired "not in a public offering" or that they are "restricted" under Rule 144 to make that point. The additional language may be added to make clear that §4(a)(7) sales are not within the volume limitations applicable to affiliate sales, by virtue of Rule 144(e)(vii)(C). That said, to use both terms is redundant and may further open courts and others to injecting more §4(a)(2) concepts by this tempting use of §4(a)(2) language. And to state that the transaction is not a distribution under §2(a)(11) seems to cater to the assumption that this is a variety of a §4(a)(1) exemption; but §4(a)(7) is a free-standing exemption in its own right.[30] If this language was an attempt to remove the "statutory underwriter" status in the last sentence of §2(a)(11), deeming the transaction "not a distribution" will likely not help in that regard. The purchaser in a §4(a)(7) sale from a control person would remain at risk of underwriter status

[28] *See* H.R. Rep. No. 357, 114th Cong., 1st Sess. 545.

[29] P.L. 114-94, §76001, 129 Stat. 1312, 1787-90 (2015). This title of the FAST Act retained the designation of this statute as the RAISE Act, *see id.*, Tit. LXXVI, 129 Stat. at 1787.

[30] *See* Legislative Proposals to Enhance Capital Formation and Reduce Regulatory Burdens: Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises, U.S. House of Representatives Committee on Financial Services 55 (114th Cong., 1st Sess., Apr. 29, 2015) (hereafter "2015 House Hearings") (remarks of Prof. Theresa Gabaldon, The George Washington University Law School) (provisions are either unclear or unnecessary).

with respect to any resale. In addition, the §4(a)(7) transaction involves "covered securities" exempt from state regulation.[31]

III. ALTERNATIVES TO SECTION 4(a)(7)

How does this new exemption compare to the existing alternatives for finding an exemption for resales? I consider here the usual candidates for resale exemptions: Rule 144, Rule 144A, the old §4(a)(1½), and §3(a)(11).[32]

Rule 144 has relatively clear requirements for resellers who wish to take advantage of the §4(a)(1) exemption, but it has many conditions attached to that relief, particularly for affiliates of the issuer.[33] Section 4(a)(7) has the obvious advantage of no required holding period for any resellers. Beyond that, however, it offers few advantages for non-affiliates. Affiliates face similar information and manner-of-sale requirements under both rules.[34] One benefit is that §4(a)(7) sales do not "count against" an affiliate's Rule 144 volume limitations,[35] making the new exemption useful for sales in excess of those limits. However, §4(a)(7) sales retain (or obtain) the status of "restricted securities" in the hands of the purchaser.[36] This means that such sales "are likely to be executed at a discount as compared to resales under Rule 144 or in the public markets."[37]

Rule 144A provides that sales within its provisions are deemed to not be distributions. Therefore, purchasers from an issuer may *immediately* resell, even if that was the purchaser's initial plan. The rule only reaches a limited class of issuers (qualified institutional buyers or QIBs) and securities (not a class of publicly-traded securities).[38] The requirement of current public information is less

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[31] As provided in §18(b)(4)(G).

[32] For a comprehensive listing, *see* I Loss, Seligman and Paredes, *supra* note 11, at 566-92; Campbell, *supra* note 17, at 1341-76. I have omitted coverage of the more specialized resale provisions: Rule 145, Regulation S, and transactions exempted under §§3(a)(9) and (10).

[33] *See supra* note 21.

[34] Compare the list in §4(d)(3) with the list in Securities Exchange Act Rule 15c2-11, which is the applicable menu of information which needs to be provided under Rule 144 if the issuer is not a reporting company under the Securities Exchange Act of 1934, *see* Rule 144(c)(2). The requirements for financial statements are more detailed in §4(d)(3)(J) than in Rule 15c2-11(a)(5)(xii)-(xiii).

[35] *See* Rule 144(e)(vii)(C). Section 4(a)(7) sales meet these Rule 144 requirements by virtue of §4(e); *see supra* text accompanying note 30.

[36] Section 4(e)(1)(C).

[37] Christopher C. Paci and Paolo Cioppa, "Fast Act Eases Resale of Unregistered Securities and Adds New Accommodations for Emerging Growth Companies: Top Points" 3 (DLA Piper Alert, Dec. 21, 2015), available at www.dlapiper.com/en/us/insights/publications/2015/12/fast-act-eases-resale-of-unregistered/.

[38] Rule 144A(d)(1) and (3).

exacting under Rule 144A than under §4(a)(7).[39] Section 4(a)(1½) remains useful in the case of asset-backed securities deals with non-QIBs which cannot satisfy the requirements of Rule 144A. Section 4(a)(7) is not helpful here because of the ninety-days-outstanding requirement.[40]

The existing Section 4(a)(1½) exemption is different from §4(a)(7) in "good news and bad news" respects. First, the good news. Offers and sales are not subject to state registration. And, of course, the statute provides the certainty of a statutory exemption. Second, the bad news. Section 4(a)(7) has a fairly onerous requirement of current public information provided by the *seller* but being information about the *issuer*. The statute requires that the purchasers be "accredited investors," whereas the common-law of §4(a)(1½) is that the purchasers need only be "sophisticated investors," which would allow sales to persons who do not meet the wealth and income requirements of Rule 501(a).[41] And, of course, there is the "bad actor" disqualification present in §4(a)(7) but not in §4(a)(1½). I discuss these differences in more detail in Part IV below.

Section 3(a)(11), the intrastate offering exemption, is technically available only for issuers. That said, it has long been interpreted as available for sales by persons controlling the issuer.[42] In addition, some have asserted that the nine-month rule of Rule 147(e), although technically only part of the issuer's exemption, provides a safe harbor for interstate resales after expiration of the nine months. This is likely poor reasoning,[43] but the notion persists nonetheless.[44] Used as an exemption for controlling persons, §3(a)(11) provides a broader exemption than §4(a)(7). Given the dubious pedigree of §3(a)(11) as cover for resales, however, it is clear that §4(a)(7) would be an improvement,

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[39] Compare Rule 144A(d)(4) with §4(d)(3).

[40] The ninety-day requirement is in §4(d)(8). *See* Charles A. Sweet, "The Fast Act, New Section 4(a)(7), and Section 4(a)(1½)" at 3 (Morgan Lewis Lawflash, Jan. 4, 2016), available at www.morganlewis.com/pubs/the-fast-act-new-sections?p=1.

[41] There is a difference of opinion among practitioners. Some describe "[c]urrent opinion practice … requires that the transferee certify that he/she/it is an accredited investor," "ACSEC Recommendation," *supra* note 15, at 2 (¶ 7), while others require only purchaser representations of "sophistication and investment intent," Morrison & Foerster, "The New Dynamic: Exempt Securities Offerings in the United States and Resales of Restricted Securities" 57 (Feb. 24, 2016), available at https://media2.mofo.com/documents/160224exemptsecuritiesofferings.pdf; Schneider, *supra* note 2, at 509 (no risk-bearing or sophistication requirement should be imposed); 2 Arthur N. Field and Jeffrey M. Smith, Legal Opinions in Business Transactions §7:5 at p. 206 (3rd ed. 2014) (§4(a)(1½) (opinion letters are "usually based on representations … from the purchaser as to its eligibility to participate in a private offerings, similar to what is required for a 4(a)(2) private offering opinion.").

[42] *See* Rule 147, Preliminary Note 4.

[43] *See* Campbell, *supra* note 17, at 1353-54.

[44] *See, e.g., id.* at 1353 (citing SEC no-action letters); I Loss, Seligman, and Paredes, *supra* note 11, at 592 (citing the nine-month requirement in Rule 147 as a "mercifully simple" answer to the question of exemption of resales).

although even old §4(a)(1½) or even unadorned §4(a)(1) are likely more useful still.

IV. EVALUATION

The new §4(a)(7) has intriguing positive features. As the first new exemption for resales, it offers the first chance since 1934 to broadly rethink secondary market practices and regulation. The most tempting new feature is the pre-emption of state regulation; it is the only resale exemption which does so. The back story of this provision is the difficulty that second-market proponents had in working with state regulators in drafting a resale exemption.[45] Other experts dismissed the need for state pre-emption, however, noting that Rule 144A has developed robust trading without such a provision.[46]

Balancing out these new features are clear additional costs. Four particular downsides are apparent from the statute when compared with existing alternatives.

First is the information requirement, which is imposed upon the seller of the securities to deliver information about the issuer.[47] There are varying predictions on the impact of this requirement. On the one hand, §4(a)(1½) opinions often require or assume provision of available information, in order to track a §4(a)(2) exemption as closely as possible.[48] This could simply carry over into new §4(a)(7) opinions, but the assumptions as to information provided can be more certain.[49] On the other hand, actually arranging for the production of the information will require some foundational work when the securities are first issued; investors may demand an issuer covenant to provide §4(a)(7) information when requested to facilitate resales.[50] The information may not be difficult for

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[45] *See* "ACSEC Hearings," *supra* note 14, at 91 (remarks of Ms. Tierney) ("I don't think [the state regulators are] going to be able to adopt similar legislation in all fifty states, and if they do it's going to be the same problem with all these other exemptions…. It's just a complete patchwork that's unworkable.").

[46] *See* "2015 House Hearings," *supra* note 30, at 55 (remarks of Prof. Theresa Gabaldon, The George Washington University Law School) ("Eliminating state authority over resales to accredited investors is unfortunate and unnecessary. Rule 144A does not preempt state regulation; nonetheless, the Rule 144A market has thrived.").

[47] Section 4(d)(3).

[48] "2015 House Hearings," *supra* note 30, at 53-54 (remarks of Prof. Gabaldon) ("Lawyers giving advice on 4(a)(1½) transactions traditionally have advised as closely paralleling a Section 4(a)(2) transaction as possible – including provision of available information.").

[49] *See* Katherine J. Blair, "Congress Takes the FAST Lane to Important Securities Reforms" at 4 (Manatt, Phelps & Phillips Insights, Dec. 21, 2015), available at www.manatt.com/insights/Newsletters/Securities-Law/Congress-Takes-the-FAST-Lane-to-Important-Securi ("Law firms … may start issuing Section 4(a)(7) resale opinions, with far more comfort than the previously issued Section 4(a)(1½) opinions, with a likely caveat regarding the sufficiency or accuracy of any Company Information.").

[50] *Id*.

issuers to provide and, in any event, this is not the first instance where issuer cooperation is necessary for a resale.[51]

Second is the requirement of investor accreditation.[52] The statute incorporates the wealth and income tests of Rule 501, whereas §4(a)(1½) more broadly would permit "access or sophistication" in line with the Ralston Purina test, or even more lenient treatment of offerees and purchasers.[53] This was one of the initial requirements in the first draft of this legislation, which paralleled the requirements placed by the JOBS Act on what would be Rule 506(c).[54] Perhaps, since this was familiar territory from previous legislation and apparently fairly common opinion practice,[55] there was little concern about the accreditation requirement. An unsophisticated purchaser could, however, still likely be covered by an old-fashioned §4(a)(1½) opinion letter, or, more likely, could wait the six months or one year required for non-affiliate resales under Rule 144.[56]

Third, there is the "90-days-outstanding" requirement, which applies not to the securities sold but to the class of securities outstanding.[57] This does not allow the use of §4(a)(7) in the Rule 144A setting, where immediate resales of newly-issued securities are desired.[58]

Finally, there is the "bad actor" disqualification, incorporating the rules in Rule 506(d)(1) and §3(a)(39) of the Securities Exchange Act. This continues the modern trend of congressionally-written exemptions in Rule 506, Regulation A+, and the crowdfunding exemption.[59] Without passing any value judgment, it is

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[51] Cleary Gottlieb Steen & Hamilton LLP, "FAST ACT Amendments to the U.S. Securities Laws" 6 (Cleary Gottlieb Alert Memorandum, Dec. 16, 2015), available at https://www.clearygottlieb.com/~/media/cgsh/files/publication-pdfs/fast-act-amendments-to-the-us-securities-laws.pdf ("It is common, however, for private companies to contractually regulate permitted transferees anyway, by imposing pre-approval requirements at the time of an initial investment. In any event, we expect the market may require an issuer in a private offering to covenant to make the information required by Section 4(a)(7) available to sellers on request, similar to the covenant to make information available to a prospective investor required by Rule 144A(d)(4).").

[52] Section 4(d)(1).

[53] The old no-action letters are silent or equivocal here, and the chief reporters on §4(a)(1½) agree that there should be no investor qualification requirement. "ABA Report," *supra* note 2, at 1973-74 and 1976; Schneider, *supra* note 2, at 509.

[54] *See supra* note 25 (restrictions in bill as originally introduced).

[55] *See supra* note 41 (some difference of opinion on the requirement).

[56] *See* Rule 144(b)(1).

[57] Section 4(d)(8).

[58] *See supra* note 40 and accompanying text.

[59] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act §926,. P.L. No. 111-203, 124 Stat. 1376, 1851 (2010) (requiring such amendments to Rule 506); JOBS Act, *supra* note 23,

safe to say that it would be easy to run afoul of this long list of prohibitions, and §4(a)(1½) remains available to these persons.

In addition, there may be unforeseen ways that the new world of securities exemptions may work together. The modifications to the Rule 144 holding periods may affect the need to use non-rule-based resale methods, but the effect could be to either increase or decrease reliance on the rule, depending on the client situation. The new world of Rule 506(c) solicited sales may put new pressure on §4(a)(1½) as an exemption for resales.[60] True, most practitioners agree that §4(a)(1½), being at root a §4(a)(1) exemption, will not admit of any advertising. However, it is possible the residual results of the 506(c) solicitation may remain effective, and the limits on §4(a)(1½) are not solid in any event. Developing non-regulated secondary markets could well, through §4(a)(1½), develop beyond the rarified realm of accredited investors and Rule 144A qualified institutional buyers.[61]

So it remains at the end of the day that §4(a)(7) adds only marginally to the practitioner's toolbox. It adds the certainty of a statutory exemption with some moderate benefits, but comes with substantial additional costs. So the world remains old, in the sense that familiar patterns remain; indeed, the §4(a)(1½) exemption retains its validity.[62] The new confluence of statutory exemptions will likely assure that §4(a)(1½) retains its utility in the brave new world which may develop.

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§401 (adding §3(b)(2)(G)(ii) disqualification to Regulation A+); *Id*. §302(d)(2) (requiring the Commission to adopt disqualification provisions in its crowdfunding regulations).

[60] *See* Robert B. Thompson and Donald C. Langevoort, "Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising," 98 Cornell L. Rev. 1573 at 1623 (2013) (predicting reliance on §4(a)(1½) for resales within the first year after 506(c) offerings).

[61] *See* Elizabeth Pollman, "Information Issues on Wall Street 2.0," 161 U. Pa. L. Rev. 179, 221-23 (2012) (discussing information asymmetries in secondary trading markets).

[62] *See* §4(e)(2).

A. Crowdfunding Exemption – Section 4(a)(6) of the Securities Act of 1933 (15 U.S.C.A. §77d)

B. Crowdfunding Requirements – Section 4A of the Securities Act of 1933 (15 U.S.C.A. § 77d-1)

C. Securities Exchange Act – Provisions Applicable to Funding Portals

1. Funding Portal Definition (15 U.S.C.A. §78c(a)(80)).

2. Limited Exemption for Funding Portals (15 U.S.C.A. §78c(h)).

D. Regulation Crowdfunding, General Rules and Regulations – 17 C.F.R §§227.100-227.503

E. SEC Rel. No 33-9974 Crowdfunding – Final Rules Adopting Release issued October 30, 2016 (https://www.sec.gov/rules/final/2015/33-9974.pdf)

F. SEC Rel. No 33-9470 Crowdfunding – Rules Proposal Issued October 23, 2013 (http://www.sec.gov/rules/proposed/2013/33-9497.pdf)

G. Regulation Crowdfunding: Compliance Guide for Issuers (May 13, 2016) (https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm)

H. Regulation Crowdfunding – Compliance and Disclosure Interpretations for Issuers (May 13, 2016) (https://www.sec.gov/divisions/corpfin/guidance/reg-crowdfunding-interps.htm)

I. Funding Portals Registration Guide (February 29, 2016) (https://www.sec.gov/divisions/marketreg/tmcompliance/fpregistrationguide.htm)

J. Regulation Crowdfunding: Compliance Guide for Crowdfunding Intermediaries (May 13, 2016) (https://www.sec.gov/divisions/marketreg/tmcompliance/cfintermediaryguide.htm)

K. FINRA Regulatory Notice 16-06 – SEC Approval of FINRA Funding Portal Rules and Related Forms (Effective Date: January 29, 2016) (http://www.finra.org/sites/default/files/Regulatory-Notice-16-06.pdf)

L. FINRA Portal Funding Rules (http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=12218)

M. FINRA – Registered Funding Portals (as of August 31, 2016) (http://www.finra.org/about/funding-portals-we-regulate)

N. KRS 292.411 – Kentucky Intrastate Crowdfunding Exemption

O. 808 KAR 10:500 – Required forms, fees, filing procedures, and recordkeeping requirements for the Kentucky Intrastate Crowdfunding Exemption

A BRIEF GUIDE TO THE SEC'S FINAL CROWDFUNDING RULES:
12 FACTS YOU NEED TO KNOW
LEGAL UPDATE, NOVEMBER 16, 2015

C. Andrew Eckman* and Alan K. MacDonald**

By now, most people have heard of "crowdfunding" or have some idea of what the term means. Crowdfunding is a technique for raising small amounts of capital from a large number of people over the Internet.

Less understood, however, is the distinction between (i) crowdfunding on websites like Kickstarter or GoFundMe, which allow companies to fund ideas by giving away "rewards" (thereby avoiding the need to comply with federal and state securities laws), and (ii) crowdfunding on websites that allow people to purchase an ownership interest in a business ("equity crowdfunding"), which involves the purchase and sale of a security.

Facebook's 2014 acquisition of Oculus, a virtual reality gaming startup, starkly illustrated the difference between rewards-based crowdfunding and equity crowdfunding. In 2012, Oculus raised over $2.4 million on Kickstarter from 9,522 "backers" using rewards-based crowdfunding. For their monetary contributions, which Oculus used to build and market its initial product, Oculus backers received posters, t-shirts and other rewards.

You can imagine the reaction of these backers when less than two years later they learned that Facebook had acquired Oculus for over $2 billion, and they would receive nothing from the sale proceeds. Crowdfunder.com, an equity crowdfunding website, estimated that had the original Oculus backers had the opportunity to purchase equity, they would have received a return of 200 times on their investment.

At the time, federal securities laws only allowed equity crowdfunding sites to accept investments from "accredited investors" – individuals who make more than $200,000 per year or have a net worth of $1,000,000 or more, as well as business organizations with total assets of more than $5,000,000.

On October 30, 2015, the Securities and Exchange Commission (SEC) released final rules to make investing through equity crowdfunding available nationally to all investors. The final rules will go into effect in May 2016.

What funding opportunities does equity crowdfunding present for entrepreneurs and small businesses? How will the new rules work? Here are twelve important questions for companies interested in equity crowdfunding as a potential fund raising vehicle.

Note: The SEC's release adopting the final rules governing the exemption for crowdfunding offerings is 686 pages long. This article provides a brief introduction to the rules and does not purport to be comprehensive. For more information, please contact Alan MacDonald or Drew Eckman in Frost Brown Todd's Business Department.

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1. How does a company conduct a crowdfunding offering?

A company must conduct a crowdfunding offering through either a registered broker-dealer or a funding portal – a new, less regulated type of broker limited to selling securities through crowdfunding. A company can use only one such intermediary to conduct its crowdfunding offering. In addition, a crowdfunding offering must be conducted online in order to enable the public to access and share information regarding the offering – thereby engaging the collective "wisdom of the crowd."

Before commencing a crowdfunding offering, a company must file certain information with the SEC. It must also deliver the information to the funding portal that hosts the offering, where the information will be posted on the portal's website and made available to potential investors. The required information is discussed in more detail in the responses to questions (5) through (7) below.

Any money received by a broker-dealer in a crowdfunding offering must be filed in a separate bank account. Funding portals may not handle money at all, so investors must transmit money directly to a bank or other "qualified third party." A company may receive the proceeds from an offering only if the target offering amount is met or exceeded.

Finally, after completing a crowdfunding offering, a company must file an annual report and post the report on its website. A company's post-offering reporting obligations are discussed in the response to question (12) below.

2. Who is eligible to conduct a crowdfunding offering?

The following companies are NOT eligible to use the crowdfunding exemption:

- Companies domiciled outside the United States.
- Public companies registered under the federal Securities Exchange Act.
- Investment funds, whether or not registered under the federal Investment Company Act of 1940.
- Companies disqualified as "bad actors" under applicable SEC rules.
- Companies that previously completed a crowdfunding offering, but failed to comply with the annual reporting requirements during the two years immediately preceding a new crowdfunding offering.
- Companies that have no specific business plan or whose business plan is to engage in a merger or acquisition with an unidentified company or companies.
- Any other company that the SEC, by rule or regulation, determines is not eligible.

3. How much money can a company raise through crowdfunding?

A company can raise a maximum of $1 million through crowdfunding in a twelve-month period. The aggregate amount does not include capital raised under any other exemption from securities registration. Also, a crowdfunding offering will not be integrated with any other exempt offering made by the company, provided that the company has met all the conditions for the other exemption.

The amount of securities sold in a crowdfunding offering by a predecessor, an entity controlled by the company, or an entity under common control with the company will be aggregated with the amounts sold in a crowdfunding offering by the company.

4. How much can members of the crowd invest?

Anyone, regardless of his or her annual income or net worth, may invest in a crowdfunding offering. However, the SEC imposes a limit on the amount a person can invest based on the individual's income and net worth. The maximum investment is an aggregate limit, meaning it limits the total amount an individual may invest in all crowdfunding offerings every twelve months.

During any twelve-month period, an investor is limited to investing:

- The greater of $2,000 or 5 percent of the lesser of the investor's annual income or net worth, if either annual income or net worth is less than $100,000; or

- 10 percent of the lesser of the investor's annual income or net worth, not to exceed $100,000, if both annual income and net worth are $100,000 or more.

Under this approach, an investor with annual income of $50,000 a year and $105,000 in net worth would be subject to an investment limit of $2,500. The below chart, provided by the SEC in its final rules, illustrates a few examples:

Investor Annual Income	Investor Net Worth	Calculation	Aggregate Investment Limit
$30,000	$105,000	Greater of $2,000 or 5% of $30,000 ($1,500)	$2,000
$150,000	$80,000	Greater of $2,000 or 5% of $80,000 ($4,000)	$4,000
$150,000	$100,000	10% of $100,000 ($10,000)	$10,000
$200,000	$900,000	10% of $200,000 ($20,000)	$20,000
$1,200,000	$2,000,000	10% of $1,200,000 ($120,000), or subject to $100,000 cap	$100,000

A company may rely on the portal's record of an investor's investments, provided the company does not have actual knowledge that the investor has exceeded, or would exceed, the investment limits as a result of purchasing shares in the company's offering.

5. What information must a company provide to prospective investors?

A company must make the following information available to potential investors by filing it with the SEC and posting it on the funding portal's website:

- The name, legal status, physical address and website address of the company.
- The names of the company's directors and officers (and any persons of similar status and function), and each person holding more than a 20 percent interest in the company.
- A description of the business and the anticipated business plan of the company.
- A description of the financial condition of the company.
- The target offering amount, the deadline to reach such amount and regular updates about the progress of the company in meeting the target offering amount.
- A description of the stated purpose and intended use of the proceeds of the offering, based on the target offering amount sought by the company.
- The price of the securities offered or the method for determining the price.
- A description of the ownership and capital structure of the company. Financial statements of the company.

The SEC may require additional disclosures as it deems necessary for the protection of investors and in the public interest.

6. What financial statements must a company provide?

The financial statements a company must provide for a crowdfunding offering depend on the size of the offering and whether the company has previously raised funds through crowdfunding.

- For an offering of $100,000 or less, the company must disclose the amount of total income, taxable income and total tax reflected in the company' s federal income tax returns. In lieu of providing a copy of the tax returns, the company's principal executive officer must certify that the tax information provided accurately reflects the information in the company's federal income tax returns.

- However, if the company offering $100,000 or less has financial statements that have been reviewed by an independent public accountant, the company must provide those financial statements.

- For an offering of more than $100,000, but not more than $500,000, the company must provide financial statements reviewed by a public accountant that is independent of the company.

- A company offering more than $500,000 in reliance on the crowdfunding exemption for the first time is permitted to provide financial statements reviewed by an independent public accountant. However, if the company offering more than $500,000 has previously sold securities in reliance on the crowdfunding exemption, it must provide financial statements audited by an independent public accountant.

- Whenever a company has financial statements that have been audited by an independent public accountant, the company must provide the audited financial statements.

7. What must a company file with the SEC during the course of its crowdfunding offering?

The company makes its initial filing with the SEC on Form C, and must amend its filing to report any material changes. The Form C requires disclosures regarding the company's size, location, securities offered, and offering amounts. A copy of the disclosures on Form C must be made available to the funding portal at least twenty-one days before the crowdfunding offering commences, and must remain on the portal' s website until the offering is completed or cancelled.

In addition, the company must make SEC filings periodically during the course of its crowdfunding offering to report the total amount of securities sold in the offering. This requirement may be satisfied if the funding portal frequently updates its website and makes the information available to the public.

A company must file a report at the end of the offering to disclose the total amount of securities sold in the offering. This final filing is required even if the company is relying on the portal to update the disclosure about the offering's progress.

8. What is the role of a "funding portal" in a crowdfunding offering?

A funding portal is a new type of securities broker whose activities are limited to facilitating crowdfunding offerings.

The participation of a funding portal in a crowdfunding offering is intended to (i) help ensure that the offering is accessible to the public; (ii) facilitate the sharing of information that will allow the crowd to decide whether or not to fund the idea or business; and (iii) provide safeguards for potential investors.

A funding portal (or a broker serving as the intermediary for a crowdfunding offering) is required to:

- Provide investors with educational materials.
- Take measures to reduce the risk of fraud.
- Make available information about the company and the offering.
- Provide communication channels to permit discussions about offerings on the Internet platform.
- Facilitate the offer and sale of crowdfunded securities.

Like a general securities broker, a portal must register with the SEC and be a member of FINRA, the self-regulatory agency that oversees the securities industry. However, funding portals are subject to more limited regulation than a general securities broker, reflecting the limited activities in which portals may engage.

Funding portals are not permitted to engage in the following activities conducted by general securities brokers:

- Offering investment advice or making recommendations.
- Soliciting purchases, sales or offers to buy securities offered or displayed on its website.
- Imposing certain restrictions on compensating people for solicitations.
- Holding, possessing, or handling investor funds or securities.

9. What educational materials must a funding portal provide to investors?

The funding portal must provide general information about conducting a crowdfunding offering as well as the various risks involved, including the following:

- The process for the offer, purchase and issuance of securities through the funding portal.
- The risks associated with investing in securities offered and sold in a crowdfunding offering.
- The types of securities that may be offered on the portal's platform and the risks associated with each type of security, including the risk of having limited voting power as a result of dilution.
- The restrictions on the resale of securities offered and sold in a crowdfunding offering.

- The types of information that an issuer is required to provide in annual reports, the frequency of the delivery of that information, and the possibility that the issuer' s obligation to file annual reports may terminate in the future.

- The limits on the amounts investors may invest.

- The circumstances in which the issuer may cancel an investment commitment.

- The limitations on an investor's right to cancel an investment commitment;

- The need for the investor to consider whether investing in a security offered and sold in a crowdfunding offering is appropriate for him or her.

- That following completion of an offering, there may or may not be any ongoing relationship between the issuer and portal.

10. What must a portal do to reduce the risk of fraud?

A funding portal must have a reasonable basis for believing that a company seeking to conduct a crowdfunding offering through the funding portal's platform:

- Complies with the applicable statutes and SEC rules.

- Has established means to keep accurate records of its securities, both with respect to the initial crowdfunding offering and subsequent transfers.

A funding portal is permitted to reasonably rely on representations of the company, absent knowledge or other indications that the representations are not true.

A portal must deny a company access to its platform if the portal has a reasonable basis for believing that the company, any of its officers, directors, or any holder of 20 percent of the company's equity is subject to a disqualification under SEC rules. To do this, the portal must conduct a background check on the company, as well as on each of the company's officers, directors and 20 percent equity holders.

More generally, a portal must deny access if it believes that the company or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection.

11. How can a portal be paid for its service?

A funding portal, when opening an account for an investor, must clearly disclose the manner in which the portal will be compensated in connection with crowdfunding offerings. A funding portal can charge a straight fee for its services. However, the rules prohibit certain forms of compensation that could give rise to

conflicts of interest when the persons facilitating a crowdfunding transaction have a financial stake in its successful outcome.

A funding portal and its directors, officers or partners are specifically prohibited from receiving a financial interest in the company as compensation for services provided to the company in connection with a crowdfunding offering.

In addition, a funding portal and its directors, officers or partners are prohibited from having any financial interest in a company using the portal's services. "Any financial interest in a company" means direct or indirect ownership of, or economic interest in, any class of the company's securities.

12. What are a company's ongoing filing obligations after completing a crowdfunding offering?

A company that has sold securities in a crowdfunding offering must file an annual report with the SEC and post the report on its website, no later than 120 days after the end of the fiscal year covered by the report.

The company will be required to file the annual report until the earliest of the following events occurs:

- The company is required to file SEC reports under Securities Exchange Act.
- The company has filed at least one annual report and has fewer than 300 holders of record.
- The company has filed at least three annual reports and has total assets that do not exceed $10 million.
- The company or another party purchases or repurchases all of the securities issued pursuant to the crowdfunding exemption.
- The company liquidates or dissolves in accordance with state law.

The final rules require the annual report to include financial statements of the company, certified by its principal executive officer to be true and complete in all material respects. However, companies that have available financial statements that have been reviewed or audited by an independent certified public accountant because they prepare them for other purposes must provide them and will not be required to have the principal executive officer certification.

As of September 1, 2016, twenty-six states and the District of Columbia had enacted statutes or adopted regulations authorizing companies to raise capital within the state by selling equity securities through crowdfunding. This report summarizes the different approaches the states have taken to address key issues involved in equity crowdfunding.

SUMMARIZING THE CURRENT STATE OF EQUITY CROWDFUNDING IN THE UNITED STATES

INTRODUCTION

Crowdfunding is a new and evolving method to use the internet to raise money to finance a business or a cause. Typically, an entity or individual raising funds through crowdfunding seeks small individual contributions from a large number of people. However, selling a profit-sharing interest in a business over the Internet, referred to as "equity crowdfunding," involves the sale of a security and must meet the conditions for an exemption from registration under federal and state securities laws.

Crowdfunding originally became popular through websites like Kickstarter.com and Indiegogo.com. These crowdfunding websites provided a platform to raise capital by offering rewards – like copies of an album, DVD, or pre-orders of a product the company is raising money to produce – to potential "backers" who help the company reach its funding goals. Because they were not selling stock or other forms of equity securities, they avoided the need to comply with federal and state securities laws. However, anything considered an "investment" – offering a financial return rather than a reward – was, until recently, strictly off-limits.

"Rewards-based" crowdfunding has been a critical resource for many aspiring filmmakers and other start-ups that don't have access to large amounts of funding. In the film industry, there may be no greater crowdfunding success-story than the recently closed campaign for the long-awaited sequel to the 2001 cult comedy "Super Troopers 2." On April 24, 2015, the Broken Lizard film raised nearly $4.5 million and became the highest funded film and creative project in Indiegogo's history – all by giving away "rewards" rather than a financial stake in the project. Along with t-shirts and tickets to the films, fans could buy private comedy shows from Broken Lizard or props that were used in the upcoming film.

While the rewards-based model worked for "Super Troopers 2," independent filmmakers without a loyal following may find that prospective backers have much less of an interest in getting a free t-shirt or access to the "behind-the-scenes" action of a film that they have never heard of. So imagine a new film financing world, where average investors – not movie moguls and financiers – can buy a stake in a future film, and then enjoy a portion of that project's success. Thanks to recent crowdfunding legislation in many States, that vision could become a reality.

Equity crowdfunding on a national scale was authorized by the federal JOBS Act in 2012. However, interstate equity crowdfunding remained on hold until the Securities and Exchange Commission adopted final rules, which became effective in May 2016. During that interval, twenty-six states and the District of Columbia enacted legislation or adopted regulations permitting businesses domiciled in the state to sell profit-sharing interests through crowdfunding solely to residents of the state.

This Report compares the key provisions of state crowdfunding legislation adopted through September 1, 2016. It also shows the comparable crowdfunding provisions of the federal JOBS Act and Regulation Crowdfunding enacted by the Securities Exchange Commission on October 2015, which became effective in May 2016.

HOW MUCH CAN I RAISE?

The states have taken a variety of approaches to setting an amount that can be raised through equity crowdfunding. A majority of the crowdfunding states have adopted a two-tiered system that allows companies to raise substantially more if they provide audited (or sometimes reviewed) financial statements to prospective investors, but a maximum of $1 million without them. Several states have a maximum limit of $1 million.

Summary:

- Illinois allows $4 million with audited financials, $1 million without.
- Arizona allows $2.5 million with audited financials, $1 million without.
- Eight states allow up to $2 million with audited financials, $1 million without.
- Four states allow up to $2 million with reviewed or audited financials, $1 million without.
- Idaho allows for $2 million, with GAAP financial statements.
- Nine states allow up to $1 million. Two of these states require financials to be reviewed for offerings from $500,000 to $1 million and certified for offerings less than $500,000, as does federal Regulation Crowdfunding.
- Oregon allows a maximum of $250,000.
- A majority of states exclude amounts sold to certain types of investors – such as management, controlling shareholders, or accredited investors – from the maximum offering amount.

"The more recent trend has been a two-tiered system that allows companies to raise up to $2 million or more if they provide audited financial statements to prospective investors, but only $1 million without them."

Federal Regulation Crowdfunding:

The company may raise up to $1 million through equity crowdfunding in any rolling twelve-month period. Financial statements must be reviewed by an accounting firm for offerings from $500,000 to $1 million, but may be certified by officers for offerings less than $500,000.

CAN I RAISE CAPITAL FROM OTHER SOURCES, SUCH AS ANGEL INVESTORS, SEPARATELY FROM MY ONGOING CROWDFUNDING OFFERING?

If "integration" applies, two offerings by a company that are similar and conducted close in time to one another will be treated as a single offering for purposes of compliance of the specific conditions for an exemption, such as the maximum amount that can be raised, the maximum number of permitted investors, the prohibition on general solicitation, or whether the offering was limited to accredited investors. If two offerings are integrated, there is a heightened chance that the securities exemption will be blown, which could result in a number of unpleasant and expensive consequences for the company.

The states have taken different positions on whether all other capital raising must be suspended during an equity crowdfunding offering.

The federal Rule 506 exemption pre-empts any state conditions. Therefore, private placements relying on Rule 506 would not be integrated with an intrastate crowdfunding offering.

Summary:

- Fourteen states limit alternative capital raising in reliance on other state exemptions before, during and after an ongoing crowdfunding offering. Most provide exceptions for offers and sales to accredited investors, insiders and controlling shareholders. Two states only allow offers and sales of a different class or series of securities from that offered by crowdfunding.

- Ten states integrate only crowdfunding offerings.

- Three states don't address integration.

Federal Regulation Crowdfunding:

Crowdfunding offerings are not integrated with other capital raising relying on different federal exemptions. Any capital raised in compliance with a separate exemption from registration, such as a Rule 506 offering to accredited investors, would not count toward that $1 million limit.

HOW IS A CROWDFUNDING OFFERING CONDUCTED?

A narrow majority of the crowdfunding states require that the offering be conducted exclusively through either a registered broker-dealer or an internet portal registered and authorized to do business in the state. States that require portals be organized under state law and domiciled in the state limit the utility of their crowdfunding exemptions since there appears to be little financial incentive for brokerage firms to sponsor crowdfunding offerings or for others to operate a funding portal in a single state. It would be more efficient to use the federal exemption and a federally registered funding portal. This might be remedied by allowing a federally registered portal domiciled outside the state to be the crowdfunding intermediary for an intrastate offering. States with a limited offering exemption that permits general solicitation and limits the amount an individual can invest may be the optimal model for raising capital through intrastate crowdfunding. Using one's own website as the crowdfunding forum and filing general solicitation materials with a state regulator appears more workable.

Summary:

As of September 1, 2016:

- Fourteen states required that companies conduct their crowdfunding offerings exclusively through an internet funding portal. Two of these states required the issuer to register as a portal if using its own website for the offering.

- Seven states made use of a funding portal optional, but required all offering materials to be filed prior to use with the state securities regulator.

- Five states allow issuer to offer securities through crowdfunding without restriction. Two of these states allow crowdfunding under a broader limited offering exemption that permits general solicitation.

Federal Regulation Crowdfunding:

The federal JOBS Act and the SEC's Regulation Crowdfunding require that crowdfunding offerings be conducted exclusively on the Internet (or similar electronic media) through a single platform operated by either a registered broker or funding portal. The use of a registered broker or portal is intended to (i) help ensure that the offering is accessible to the public; (ii) facilitate the sharing of information that will allow the crowd to decide whether or not to fund the idea or business; and (iii) to provide safeguards to potential investors. A funding portal is a new type of securities intermediary that would be subject to similar but more limited regulation than a broker, reflecting the limitations on the activities in which funding portals may engage.

WHAT MUST I FILE FOR A CROWDFUNDING OFFERING?

The majority of states require that a minimum of three pieces of information be provided when filing for a crowdfunding exemption: 1) an express statement of the company's intent to rely on the crowdfunding exemption; 2) the identity of the company and those involved in the sale; and 3) the name of the bank where investors' funds will be deposited. A minority of states require more detailed information, such as a copy of all

offering documents provided to potential investors, financial information, future business plans, advertising materials, and compensation information.

When does the filing need to be made?

- In eleven states, the required information must be filed ten or more days before the offering begins.
- In eight states, the required information may be filed fewer than ten days before the offering begins.
- Four states provide an option. The information must either be filed a specified number of days before general solicitation of the offering can begin OR within a specified number of days after a sale prior to general solicitation.
- Two states require that a filing within a specific number of days after the first sale.

Federal Regulation Crowdfunding:

A company must file a Form C: Offering Statement with the SEC and post it on the funding portal's website at least twenty-one days before the commencement of the offering and provide copies to the intermediary and investors. The Offering Statement must remain on the portal's website until the offering is completed or cancelled. The company can provide issuers access to that information by directing the investors to the intermediary's platform.

WHAT DO I HAVE TO DISCLOSE TO INVESTORS?

A vast majority of states require companies to disclose material information about themselves and the offering. In addition, a minority of states require companies to continue to deliver reports after the offering is completed.

What information must be included in an offering disclosure?

A majority of states require companies to disclose material information about themselves and the offering, such as:

- Statement that the securities have not been registered and are subject to restrictions on resale – twenty states
- Risks associated with purchasing the securities – eighteen states
- Identifying information about the company – eleven states
- Description of the company's business – eleven states
- Purpose and intended use of the proceeds – nine states
- Target offering amount and deadline – six states

- Description of the financial condition of the company – six states
- Price of the securities – five states

Federal Regulation Crowdfunding:

The Offering Statement must include the following information:

- The name, legal status, physical address and website address of the company;
- The names of the company's directors and officers (and any persons of similar status and function), and each person holding more than a 20 percent interest in the company;
- A description of the business and the anticipated business plan of the company;
- A description of the financial condition of the company;
- The target offering amount, the deadline to reach such amount and regular updates about the progress of the company in meeting the target offering amount;
- A description of the stated purpose and intended use of the proceeds of the offering, based on the target offering amount sought by the company;
- The price of the securities offered or the method for determining the price;
- A description of the ownership and capital structure of the company; and
- Financial statements of the company.

The SEC may require additional disclosures as it deems necessary for the protection of investors and in the public interest.

What information must be included in post-offering reports?

In addition to providing offering disclosure, a minority of the crowdfunding states also require companies to provide investors with free reports. Specifically, the reports must present analysis of the company's business operations and financial condition as well as compensation to officers and directors. Of these states, nearly all require quarterly reports for so long as any securities issued under the exemption are outstanding. The District of Columbia, an outlier within the minority, requires companies to provide investors with free annual reports for each of the three fiscal years following the offering. In summary:

- Five states require companies to provide investors with free quarterly reports for so long as any securities issued under the exemption are outstanding.
- D.C. requires companies to provide investors with free annual reports for each of the three fiscal years following the offering.

"A vast majority of states require companies to disclose material information about their business and the offering. A minority of states require companies to continue to deliver reports after the offering is completed."

Federal Regulation Crowdfunding:

The company must file annual reports with the SEC no later than 120 days after the end of the fiscal year and provide those reports to investors by posting the reports on the company's website.

The company must continue to file an annual report until the earliest of the following events occurs:

- The company is required to file SEC reports under Securities Exchange Act;
- The company has filed at least one annual report and has fewer than 300 holders of record;
- The company has filed at least three annual reports and has total assets that do not exceed $10 million;
- The company or another party purchases or repurchases all of the securities issued pursuant to the crowdfunding exemption; or
- The company liquidates or dissolves in accordance with state law.

The final rules require the annual report to include financial statements of the company certified by its principal executive officer to be true and complete in all material respects. However, companies that have available financial statements that have been reviewed or audited by an independent certified public accountant because they prepare them for other purposes must provide them and will not be required to have the principal executive officer certification.

HOW OFTEN DO I NEED TO PROVIDE INFORMATION TO INVESTORS?

States are divided over whether crowdfunding companies must report to their investors following the offering. Half of the states do not require any post-offering reporting. The vast majority of the states that require post-offering reporting require that reports are sent to investors quarterly. A minority of states that require post-offering reporting require that reports are sent annually or semi-annually.

What does the post-offering report include?

- Of the twelve states that require post-offering reporting, eleven require disclosure of officer and director compensation.
- Ten states require that management include in the post-offering report an analysis of the business operations and financial condition of the company.

- Similarly, five states require that the company include the results of business operations and financial statements in the post-offering report.

- The District of Columbia requires that the report include a statement explaining how the proceeds from the offering were used.

- Ten of the twelve states that require post-offering reporting expressly permit the report to be published online. The other two states are silent.

Federal Regulation Crowdfunding:

The company must file annual reports with the SEC no later than 120 days after the end of the fiscal year and provide those reports to investors by posting the reports on the company's website.

HOW CAN I ADVERTISE MY OFFERING?

General solicitation – the ability to offer securities to the public without a pre-existing relationship with investors – is the central principle of crowdfunding. However, while broad advertising is permitted, it must be directed only at residents of the crowdfunding company's state, and purchases by residents of other states are not permitted.

A narrow majority of the crowdfunding states require that the issuer conduct the internet offering through an unrelated funding portal, which will generally have a degree of responsibility for the content of the offering materials on its website. Several other states don't require the use of a funding portal, but require that solicitation materials be filed with the state regulator before use. A few states rely upon a limited offering exemption that permits general solicitation but limits the amount of individual investment.

Can a company advertise the offering on a portal or website?

Yes. Importantly, the advertisements must be directed to in-state residents only. Advertisements can be limited by including a disclaimer that the offering is for in-state residents only or by restricting information about the offering to persons that confirm they are residents of the state by providing their address.

Can a company use social media to advertise an offering?

Yes, but the company must be careful not to make an offering to residents of different states. Companies can use technology to limit online information to individuals whose IP addresses originate in-state. Additionally, a company should include disclaimers that make clear the offering is limited to in-state residents. If the social media platform limits the amount of text (*e.g.* Twitter), a hyperlink to further information and the required statements is allowed.

Federal Regulation Crowdfunding:

The company may only publish a notice that advertises the terms of the offering if it directs investors to the portal where an investor can obtain more information about the issuer. These notices are similar to "tombstone ads" where the issuer may include only general information about the offering but the company is not restricted from advertising

information unrelated to the terms of the offering. There are no limits on an investor's state of residence.

HOW MUCH MONEY CAN AN INVESTOR INVEST?

All states limit how much a single investor may annually invest in intrastate crowdfunding securities. Most states explicitly exempt accredited investors, who meet either a $1,000,000 net worth or a $200,000 annual income threshold. states typically utilize flat dollar-amount limits, ranging from $100 to $10,000 per investor. More recent crowdfunding legislation has introduced new, two-tiered investment limits, most of which allow individuals with a net worth or annual income over $100,000 to invest more than those with a lower income or net worth.

Investment Limitations:

- Eight states limit each non-accredited investor to $10,000.
- Eight states limit each non-accredited investor to $5,000.
- Three states limit each non-accredited investor to less than $5,000.
- Five states utilize a two-tiered investment limit based on a percentage of the investor's net worth or annual income.

"Recent crowdfunding legislation has introduced new, two-tiered investment limits, most of which allow individuals with a net worth or annual income over $100,000 to invest more than those with a lower income or net worth."

Federal Regulation Crowdfunding:

The maximum investment is calculated based on the investor's annual income and net worth in any rolling twelve-month period. If either the investor's annual income or net worth is less than $100,000, the investment is limited to 5 percent of the investor's net worth or $2,000, whichever is greater. Alternatively, if either the investor's annual income or net worth is greater than or equal to $100,000, the investment is limited to 10 percent of the annual income or net worth, up to $100,000.

Note that even Warren Buffett can invest no more $100,000 in crowdfunding offerings over a twelve-month period.

HOW MUST INVESTORS' MONEY BE HANDLED DURING THE OFFERING?

A large majority of the crowdfunding sates require that companies enter into some form of escrow agreement with investors, whereby a third party takes custody of investors' money until a specified condition is met. The most common requirements, shared by twenty states, are (1) investors' money be held by a bank or depository institution which (2) is authorized to transact business within the state and (3) investors' money is only released to the company after the minimum offering amount has been attained.

Escrow Requirements:

- Twenty states require that companies hold investors' money in escrow.
- Seven states require the escrow institution be located within the state.
- Four states require the escrow institution be FDIC-insured.
- Four states require the escrow institution be chartered within the state.

"A large majority of States require that companies enter into some form of escrow agreement with investors, whereby a third party takes custody of investors' money until a specified condition is met."

Federal Regulation Crowdfunding:

A bank must hold the investor funds in escrow until the target offering amount is met, at which time funds can be released to the issuer. The funds must be held in escrow for at least twenty-one days from the day on which the intermediary makes the information about the issuer publicly available and until investors have a reasonable opportunity to rescind their investment commitment.

WHAT IS A FUNDING PORTAL'S ROLE IN A CROWDFUNDING OFFERING?

A funding portal is a new type of securities intermediary whose activities are limited to facilitating crowdfunding offerings.

The participation of a funding portal in a crowdfunding offering is intended to (i) help ensure that the offering is accessible to the public; (ii) facilitate the sharing of information that will allow the crowd to decide whether or not to fund the idea or business; and (iii) provide safeguards for potential investors.

Federal Regulation Crowdfunding:

A funding portal is required to:

- Provide investors with educational materials;
- Take measures to reduce the risk of fraud;
- Make available information about the issuer and the offering;
- Provide communication channels to permit discussions about offerings on the Internet platform; and
- Facilitate the offer and sale of crowdfunded securities.

WHAT IS REQUIRED TO OPERATE A CROWDFUNDING PORTAL?

In general, states that require or allow for the use of funding portals require the portals to register with the state securities regulator. A small number of states do not require registration as long as the portal does not:

- Offer investment advice or recommendations;
- Solicit purchases, sales or offers to buy the securities offered or displayed on its website;
- Compensate employees or other persons for solicitation or based on the sale of securities displayed on its website;
- Is not compensated based on the amount of securities sold; and
- Does not hold or handle investor funds or securities.

Federal Regulation Crowdfunding:

A funding portal will be required to register with the SEC and to be a member of The Financial Institution Regulatory Authority (FINRA), the self-regulatory agency that oversees the securities industry. The SEC and FINRA have each adopted rules expressly for funding portals, which are a streamlined version of the rules applicable to brokers.

- The funding portal and its associates (other than ministerial and clerical personnel) will be subject to FINRA licensing and standards of conduct.
- The funding portal must establish and maintain a system to supervise the activities of funding portal associates reasonably designed to achieve compliance with applicable laws.
- The funding portal will be subject to examinations and sanctions for non-compliance.
- Unlike brokers, a funding portal would not be required to maintain a written anti-money laundering program or maintain minimum fidelity bond coverage.

WHAT EDUCATIONAL INFORMATION MUST A PORTAL PROVIDE TO INVESTORS?

Federal Regulation Crowdfunding:

The portal must provide the following educational materials to an investor when the investor opens an account with the portal:

- The process for the offer, purchase and issuance of securities through the portal;
- Risks associated with investing in crowdfunding securities;

- Risks associated with each type of security that may be offered on the portal's platform;

- Restrictions on the resale of crowdfunding securities;

- The limitations on the amounts investors may invest;

- The circumstances in which the issuer may cancel an investment commitment;

- The reports the issuer must provide following completion of an offering, including the frequency of delivery of and information to be included in annual reports, plus the possibility that the issuer's obligation to file annual reports may terminate in the future; and

- There may or may not be any ongoing relationship between the issuer and intermediary following completion of an offering.

WHAT MEASURES MUST A PORTAL TAKE TO REDUCE THE RISK OF FRAUD?

Federal Regulation Crowdfunding:

An intermediary must have a reasonable basis for believing that an issuer seeking to conduct a crowdfunding offering through the intermediary's platform:

- Complies with the statute and related SEC rules; and

- Has established means to keep accurate records of its securities, both with respect to the initial crowdfunding offering and subsequent transfers.

A funding portal would be permitted to reasonably rely on representations of the issuer, absent knowledge or other indications that the representations are not true.

A portal must deny an issuer access to its platform if the portal has a reasonable basis for believing that an issuer, any of its officers, directors, or any holder of 20 percent of the issuer's equity is subject to a disqualification under SEC rules. This would require the portal to conduct a background check on each issuer, as well as on each of the issuer's officers, directors and 20 percent equity holders.

More generally, a portal must deny access if it believes that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection.

WHAT IS A PORTAL PROHIBITED FROM DOING?

Federal Regulation Crowdfunding:

Funding portals are prohibited from:

- Offering investment advice or making recommendations.

- Soliciting purchases, sales or offers to buy securities offered or displayed on its website.

- Imposing certain restrictions on compensating people for solicitations.

- Holding, possessing, or handling investor funds or securities.

The Regulation Crowdfunding would provide a safe harbor under which funding portals can engage in certain activities consistent with these restrictions.

HOW CAN A PORTAL BE COMPENSATED?

Federal Regulation Crowdfunding:

A funding portal, when establishing an account for an investor, must clearly disclose the manner in which it will be compensated in connection with crowdfunding offerings.

However, a funding portal and its directors, officers or partners are specifically prohibited from receiving a financial interest in the issuer as compensation for services provided to the issuer, in connection with the offer and sale of the issuer's securities. The prohibition is designed to protect investors from the conflicts of interest that may arise when the persons facilitating a crowdfunding transaction have a financial stake in its successful outcome.

CAN A PORTAL OWN A FINANCIAL INTEREST IN A COMPANY USING ITS PLATFORM?

Federal Regulation Crowdfunding:

The JOBS Act and Regulation Crowdfunding prohibit a funding portal and its directors, officers or partners from having any financial interest in an issuer using its services. "Any financial interest in an issuer" means direct or indirect ownership of, or economic interest in, any class of the issuer's securities. Again, this is intended to avoid conflicts of interest that may arise when the persons facilitating a crowdfunding transaction have a financial stake in its successful outcome.

WHERE THERE'S A SECURITIES MARKET, THERE'S FRAUD (AND OTHER MISCONDUCT): HOT TOPICS IN FEDERAL SECURITIES LITIGATION

Professor Joan MacLeod Heminway

I. THE ROLE OF SECURITIES LITIGATION IN THE SCHEME OF SECURITIES REGULATION

A. Policies Underlying Securities Regulation

1. Protect investors.

2. Maintain market integrity.

3. Encourage capital formation.

B. Key Securities Regulation Tools

1. Mandatory disclosure.

2. Antifraud, misstatements/omissions, and other liability.

3. Substantive regulation (players and processes).

II. KEY TYPES OF SECURITIES LITIGATION

A. Antifraud

1. Section 17 of the 1933 Act.

2. Section 10(b) of/Rule 10b-5 under the 1934 Act (including insider trading).

3. Rule 13e-3 under the 1934 Act.

4. Rule 14a-9 under the 1934 Act.

B. Misstatements/Omissions

1. Section 11 of the 1933 Act.

2. Section 12(a)(2) of the 1933 Act.

C. Other Liability

1. Section 12(a)(1) of the 1933 Act.

2. Foreign Corrupt Practices Act (FCPA).

3. Section 16(b).

D. SEC Administrative Actions

III. CURRENT TRENDS/OVERALL DATA (FIRST HALF OF 2016)

A. Above Average Projected Volume of Securities Class Actions

B. Many Securities Class Actions in Healthcare, Finance, and Technology Sectors

C. Merger Objection Securities Class Actions More Prevalent

D. Filings of Securities Class Actions against S&P 500 Firms Rebounding

E. Increase in Securities Class Action Filings against Foreign Issuers

F. Median Settlements in Securities Class Action Litigation Slightly Higher

G. Foreign Corrupt Practices Act (FCPA) Enforcement Actions Higher

IV. AREAS OF EMPHASIS AND INTEREST IN SECURITIES LITIGATION

A. Fallout from Omnicare (statements of opinion)

B. Fallout from Halliburton II (price impact)

C. Class Certification Questions

D. Salman and Other Insider Trading Actions Involving Personal Relationships (Family, Friends, Etc.)

E. FCPA Pilot Program

F. FCPA and the Panama Papers

G. Fédération Internationale de Football Association ("FIFA") FCPA Corruption Cases

H. FCPA Disgorgement Remedy Developments

V. RESOURCES

A. Donna M. Nagy *et al.*, Securities Litigation and Enforcement, Cases and Materials (West, 3d Ed. 2012)

B. Marc I. Steinberg *et al.*, Securities Litigation, Law, Policy, and Practice (Carolina Academic Press 2016)

C. Cornerstone Research, https://www.cornerstone.com/Practices/Capabilities/Securities (especially reports on securities class action filings)

D. NERA, http://www.nera.com/practice-areas/class-actions-and-class-certification/securities-class-actions.html (especially the Mid-Year and Year-End Securities Litigation Updates available there)

E. Business Law Prof Blog, http://lawprofessors.typepad.com/business_law/

F. California Corporate and Securities Law blog, http://calcorporatelaw.com

G. Kentucky Business Entity Law blog, http://kentuckybusinessentitylaw.blogspot.com

H. The 10b-5 Daily blog, https://10b5daily.com

CORNERSTONE RESEARCH: FIRST HALF SECURITIES SUIT FILINGS AT HIGHEST LEVEL IN YEARS

Kevin LaCroix

Reprinted from The D&O Diary, July 26, 2016.

Securities class action lawsuit filings in the first half of 2016 leapt to their highest level in years, according to a recent report from Cornerstone Research. According to the report, which is entitled "Securities Class Action Filings: 2016 Midyear Assessment," both the number of lawsuit filings and the rate of litigation were well above long-term historical semiannual averages in the first six months of 2016. The increases are attributable in part to the increase in federal court M&A-related securities litigation, as discussed below. The report can be found here.[1] Cornerstone Research's July 26, 2016, press release about the report can be found here.[2] Cornerstone Research's analysis is largely consistent with my own review of the first half securities suit filings, which can be found here.[3]

The Number of First Half Securities Suit Filings: According to the report, there were 119 securities class action lawsuit filings in the first half of 2016. The 119 filings in the year's first half represent the highest number of semiannual filings since the first half of 1999. This semiannual filing tally is well above the eighty-seven securities suits that were filed in the first half of 2015 and the 102 that were filed in the second half of 2015. The 119 securities suit filings in the year's first six months is 27 percent above the historical semiannual average of ninety-four between 1997 and 2015.

If the number of filings in the year's first half were to continue for the rest of the year, the year's projected total of 238 securities suits would be the second-highest number of filings in the last twenty years. The projected annualized number of securities suit filings would represent an increase of 27 percent over the 1997-2015 historical average of 188 annual filings. As discussed below, the increase in the number of filings in the first half of the year is largely due to a substantial increase in the number of federal court M&A-related securities suit filings.

The First Half Litigation Rate: Assuming the filing activity in the second half of 2016 turns out to be the same as the first half, 5 percent of U.S. exchange-listed companies will be subject to filings this year, which would be the highest annual litigation rate since 1997. A 5 percent litigation rate would not only be well above the 4.0 percent rate in 2015 (which was itself the highest annual litigation rate in the period 1997-2015), but it would also be well above the historical annual average litigation rate during the period 1997-2015 of 3.0 percent. A 5 percent litigation rate would be the highest annual rate since 1997.

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[1] https://www.cornerstone.com/GetAttachment/39af392a-52b0-414c-96a6-58fdec13629d/Securities-Class-Action-Filings-2016-Midyear-Assessment.pdf.

[2] https://www.cornerstone.com/Publications/Press-Releases/Number-of-Securities-Class-Action-Filings-Rises.

[3] http://www.dandodiary.com/2016/07/articles/securities-litigation/securities-class-action-law-suit-filings-continue-at-elevated-pace-in-the-years-first-half/.

M&A-Related Litigation Activity: Much of the increase in the number of securities suit filings in the year's first half is attributable to the increase in the number of federal court M&A-related lawsuits filings. The number of federal M&A-related securities class action lawsuits increased to twenty-four in the first half of 2016, compared to a range of five to nine per semiannual period during the period 2012 through 2015. The number of merger-related filings increased by 167 percent from the second half of 2015 and the merger suit filings were the highest they have been since the second half of 2010.

The report notes that in January 2016, the Delaware Court of Chancery rejected the disclosure-only settlement in the lawsuit relating to Zillow's acquisition of Trulia (about which refer here[4]). The report speculates that this Delaware Chancery Court development "may have resulted in some venue shifting of merger objection lawsuits," which in turn would explain the increase in the number of federal court M&A-related lawsuit filings in the first six months of 2016.

Litigation Involving S&P 500 Companies: Historically, securities litigation activity has been concentrated on the larger companies. This pattern reversed itself in 2015, when the rate of litigation activity involving S&P 500 companies was below the rate for all listed companies. However, in the first half of 2016 the traditional filings activity patterns returned, as filings against larger companies increased. In the year's first six months, filings against S&P 500 companies were more frequent than the historical average and at the highest annualized average since 2008. Assuming filings in the second half of 2016 equal the pace of the first half, more than 6 percent of S&P 500 companies will be sued in 2016. A 6 percent litigation rate would be greater than the rate during all of the years 2009 through 2015.

Litigation Against Foreign Issuers: Filings against foreign issuers increased in the first half of 2016 compared to 2015 levels in spite of the absence of filings against Chinese issuers, which in recent years has been the most common foreign companies targeted by class actions. Based on the number of foreign issuers on the U.S. exchanges, the litigation rate against foreign issuers increased in the first half of the year from 3.7 percent in 2015 to an annualized rate of 4.5 percent, which is the highest foreign issuer litigation rate since 1997. Figures 10 and 12 in the report show that over the period 1997 through 2016, both the number of filings against foreign issuers and the rate of foreign issuer litigation has steadily increased.

Disclosure Dollar Loss: Disclosure Dollar Loss (DDL) is the dollar value change in a company's market capitalization between the trading day immediately preceding the end of the class period and the trading day immediately following the end of the class period. In contrast to the increase in the number of filings in the year's first six months, the DDL declined to $43 billion in the first half of 2016, 28 percent below the historical semiannual average of $60 billion (largely due to the absence in the year's first six months of large "mega" filings).

[4] http://www.dandodiary.com/2016/01/articles/shareholders-derivative-litigation/delaware-chancellor-rejects-disclosure-only-settlement-signals-whats-next-for-merger-objection-suits/.

Maximum Dollar Loss: Maximum Dollar Loss (MDL) is the dollar value change in a company's market capitalization between the trading day during the class period with the highest market capitalization and the trading day immediately following the end of the class period. The first half MDL of $331 billion represented a 24 percent increase from $266 billion in the second half of 2015. The first half MDL was 11 percent higher than the 1997-2015 semiannual average of $297 billion.

Industry Sector: The industry sector with the most securities class action lawsuits in the first six months of 2016 was Consumer Non-Cyclical, which had 43 lawsuits (36 percent). This sector is predominately composed of biotechnology, pharmaceutical, and healthcare companies. Collectively, there were thirty-two lawsuits against companies in these areas, representing 26.8 percent of all first half filings.

GIBSON DUNN

July 5, 2016

2016 MID-YEAR FCPA UPDATE

To Our Clients and Friends:

From the pilot program to the Panama Papers, the first six months of 2016 brought with them a number of important anti-corruption-related developments, including a reinvigorated level of enforcement under the U.S. Foreign Corrupt Practices Act ("FCPA") that already has equaled the total from 2015. Enforcement actions arising out of multinationals' China operations continue to dominate the landscape. It is against this backdrop that we are thrilled to announce the addition of Patrick Stokes, the most recent head of DOJ's FCPA Unit, to Gibson Dunn's team of FCPA specialists.

This client update provides an overview of the FCPA as well as domestic and international anti-corruption enforcement, litigation, and policy developments from the first half of 2016.

FCPA OVERVIEW

The FCPA's anti-bribery provisions make it illegal to corruptly offer or provide money or anything of value to officials of foreign governments, foreign political parties, or public international organizations with the intent to obtain or retain business. These provisions apply to "issuers," "domestic concerns," and "agents" acting on behalf of issuers and domestic concerns, as well as to "any person" that violates the FCPA while in the territory of the United States. The term "issuer" covers any business entity that is registered under 15 U.S.C. §78l or that is required to file reports under 15 U.S.C. §78o(d). In this context, foreign issuers whose American Depository Receipts ("ADRs") are listed on a U.S. exchange are "issuers" for purposes of the FCPA. The term "domestic concern" is even broader and includes any U.S. citizen, national, or resident, as well as any business entity that is organized under the laws of a state or that has its principal place of business in the United States.

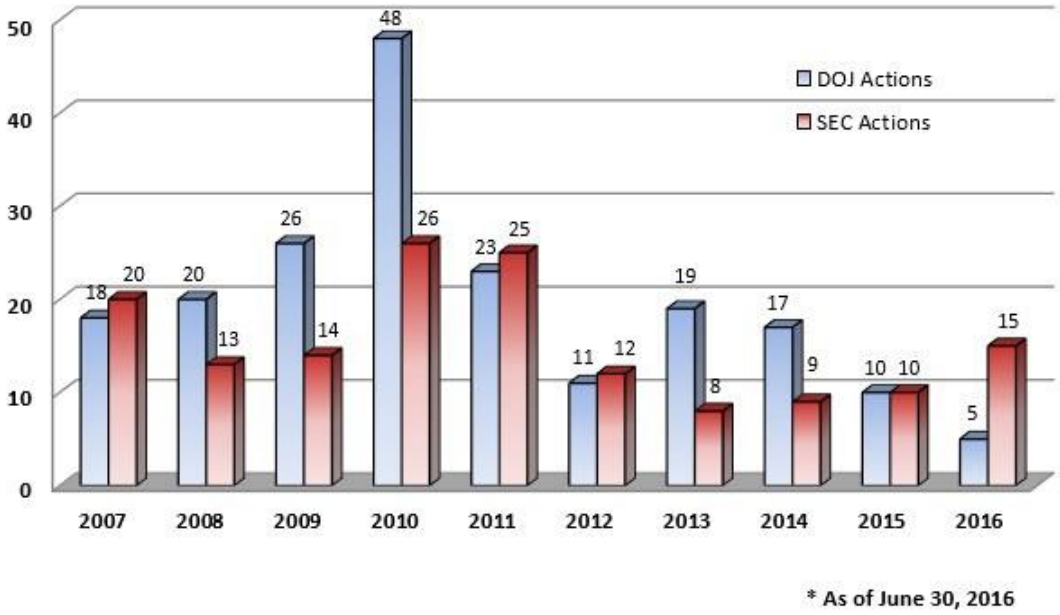
In addition to the anti-bribery provisions, the FCPA also has "accounting provisions" that apply to issuers and their agents. First, there is the books-and-records provision, which requires issuers to make and keep accurate books, records, and accounts, that in reasonable detail, accurately and fairly reflect the issuer's transactions and disposition of assets. Second, the FCPA's internal controls provision requires that issuers devise and maintain reasonable internal accounting controls aimed at preventing and detecting FCPA violations. Prosecutors and regulators frequently invoke these latter two sections when they cannot establish the elements for an anti-bribery prosecution or as a mechanism for compromise in settlement negotiations. Because there is no requirement that a false record or deficient control be linked to an improper payment, even a payment that does not constitute a violation of the anti-bribery provisions can lead to prosecution

under the accounting provisions if inaccurately recorded or attributable to an internal controls deficiency.

2016 MID-YEAR FCPA ENFORCEMENT STATISTICS

The following table and graph detail the number of FCPA enforcement actions initiated by the statute's dual enforcers, the U.S. Department of Justice ("DOJ") and the U.S. Securities and Exchange Commission ("SEC"), during each of the past ten years.

2007		2009		2009		2010		2011		2012		2013		2014		2015		2016	
DOJ	SEC	DOJ	SEC	DOJ	SEC	DOJ	SEC	DOJ	SEC	DOJ	SEC	DOJ	SEC	DOJ	SEC	DOJ	SEC	DOJ	SEC
18	20	20	13	26	14	48	26	23	25	11	12	19	8	17	9	10	10	5	15



2016 MID-YEAR FCPA ENFORCEMENT ACTIONS

FCPA enforcement actions were filed at a rapid clip during the first half of 2016, with the SEC leading the way. In fact, the SEC already has brought more FCPA enforcement actions in the first six months of this year than it has in any full year since 2011. Of the twelve corporate enforcement actions, eight were brought by the SEC alone, three were brought jointly by DOJ and the SEC, and one was prosecuted only by DOJ. Four of the five enforcement actions against individual defendants were brought by the SEC, with DOJ filing only one case (publicly) against an individual in 2016. Finally, although the total mix of enforcement actions cover a wide variety of industries and geographies, China – figuring in roughly half of them – continues to stand out as an FCPA enforcement hotspot.

A description of the first half of 2016 in FCPA enforcement actions follows.

Corporate Enforcement Actions

SAP SE

In our 2015 Year-End FCPA Update, we covered the August 2015 joint DOJ-SEC FCPA enforcement actions against Vincente Eduardo Garcia, the former Vice President of Global and Strategic Accounts for Germany-based software manufacturer and ADR-issuer ***SAP***. On February 1, 2016, the SEC filed FCPA charges against Garcia's former employer arising out of the same alleged misconduct.

The SEC's case against SAP was premised upon Garcia's alleged offer and payment of bribes to Panamanian government officials in order to secure software contracts. Specifically, the SEC alleged that between 2009 and 2013, SAP's internal controls failed to prevent Garcia from scheming with a local partner to pay $145,000 in bribes to a senior Panamanian government official and offer bribes to two others, leading to four contracts that generated $3.7 million in profits for SAP. According to the charging document, Garcia arranged for SAP's local partner to receive a steep discount, thereby enabling the partner to earn a significant margin, a portion of which was used to create a pool of funds from which bribes were paid. The SEC alleged that SAP's internal controls were inadequate to ensure that large discounts provided to third parties – frequently a legitimate and pro-competitive sales tactic – were not misused as a vehicle for third-party bribery.

Without admitting or denying the SEC's charges, SAP consented to the resolution of an administrative cease-and-desist proceeding alleging violations of the FCPA's accounting provisions and agreed to pay more than $3.8 million in disgorgement and prejudgment interest. The SEC did not impose a post-resolution reporting requirement upon SAP and acknowledged the company's cooperation and remedial actions, which included conducting a thorough internal investigation after learning about the conduct as a result of the SEC's inquiry, firing Garcia, and auditing all of its recent public-sector business in Latin America. Garcia was previously sentenced to twenty-two months in prison for his misconduct.

SciClone Pharmaceuticals, Inc.

Three days later, on February 4, 2016, the SEC announced another settled FCPA cease-and-desist proceeding, this time against California-based ***SciClone Pharmaceuticals***. The SEC alleged that employees of SciClone subsidiaries drove sales by providing improper benefits to Chinese health care professionals between 2007 and 2012, particularly by providing money, gifts, and travel benefits. In one instance, while SciClone had license applications pending in China, "a well-connected regulatory affairs specialist" hired to facilitate their approvals allegedly arranged for two licensing officials to attend an academic conference in Greece at the company's expense. But when the officials could not get visas for the trip, the specialist instead gave them more than $8,000 in "lavish gifts." Although SciClone fired the specialist and conducted an internal investigation after learning about this, the SEC faulted the company's response for "not look[ing] more broadly at sales and marketing practices in China" or leading to further remediation. Indeed, according to the SEC, trips were subsequently provided to Chinese health care providers to attend various conferences in the United States, Japan, and elsewhere that featured extensive sightseeing and recreational activities and little legitimate business purpose.

Without admitting or denying the SEC's allegations, SciClone consented to an administrative cease-and-desist order alleging violations of the FCPA's anti-bribery, books-and-records, and internal controls provisions. The company agreed to pay more than $12.8 million in disgorgement, prejudgment interest, and penalties, and to self-report on the status of its FCPA remediation efforts over a three-year period following the resolution. The SEC acknowledged that SciClone ultimately engaged in significant remediation, including a comprehensive review of historical promotional expenses.

The SEC's civil anti-bribery charge against SciClone serves as a reminder of one of the ways that, according to the SEC's interpretation of the FCPA, a parent issuer can be held liable for the corrupt acts of its foreign subsidiary even absent direct involvement by the parent. Although there was no allegation that the parent company directed or participated in the misconduct, the SEC charged the parent with bribery for the foreign subsidiary's behavior on the theory that the foreign subsidiary was acting as an "agent" of the parent. Specifically, to show an agency relationship, the SEC alleged that SciClone "direct[ed] the relevant operations of [the subsidiary] and overs[aw] [the subsidiary's] operations through various means including through the appointment of directors and officers . . . , review and approval of its annual budget, business and financial goals, and oversight of its legal, audit, and compliance functions"; "review[ed] and approve[d] annual marketing and promotion budgets of [the subsidiary]"; and had certain corporate officers who "also served as officers and/or directors of [the subsidiary], traveled frequently to China to participate in the management of [the subsidiary], and were responsible for negotiating its contracts with its Chinese distributors."

PTC Inc.

On February 16, 2016, DOJ and the SEC jointly announced another travel-and-entertainment-related FCPA resolution involving Massachusetts-based software company ***PTC*** and its Hong Kong- and Shanghai-based subsidiaries. Between 2006 and 2011, the subsidiaries allegedly provided more than $250,000 in gifts and entertainment and trips worth more than $1 million – ostensibly to visit PTC's U.S. headquarters in Needham, but then including extensive recreational travel to places like Hawaii, Las Vegas, Los Angeles, New York, and San Diego – to customers employed by Chinese state-owned enterprises. Funding for the trips was obtained in part by building the costs into commissions to third parties, who then paid for the trips. According to the SEC, PTC realized more than $11.8 million in profits from business with the state-owned enterprises whose officials participated in these trips.

To resolve the DOJ investigation, the two implicated PTC subsidiaries jointly entered into a single non-prosecution agreement and agreed to pay a $14.5 million criminal fine. To resolve the SEC proceeding, without admitting or denying the allegations, PTC consented to an administrative cease-and-desist order alleging FCPA bribery and accounting violations and agreed to pay $13.6 million in disgorgement and prejudgment interest. Like its action against SciClone discussed above, the SEC's anti-bribery charge against PTC relied on an agency theory of liability.

Of interest, the non-prosecution agreement binds only the two implicated subsidiaries – and not the parent company, PTC – to the standard compliance undertakings included in these agreements, including the obligation to self-report to DOJ on the state of their compliance program for a three-year period. Further, although both the DOJ and SEC

resolutions acknowledge PTC's self-disclosure following an internal investigation in 2011, PTC did not receive full credit for this disclosure because the company allegedly failed to disclose all of its relevant findings from the investigation until after DOJ and the SEC independently became aware of them. Finally, the SEC's first ever deferred prosecution agreement with an individual defendant in an FCPA case, reached with an employee of one of PTC's Chinese subsidiaries, ***Yu Kai Yuan***, is discussed below.

VimpelCom Ltd.

On February 18, 2016, Dutch telecom company and ADR-issuer ***VimpelCom*** and its Uzbek subsidiary, Unitel, entered into a $795 million resolution with DOJ, the SEC, and Dutch regulators arising from allegations that the companies made more than $110 million in improper payments to an Uzbek government official to facilitate market entry and secure preferential treatment in the country. The DOJ/SEC component of the resolution, comprising $397.6 million, marks the sixth-largest monetary settlement in the history of the FCPA.

According to the charging documents, to facilitate entry into the Uzbek market, certain VimpelCom executives acquired a local telecom company in which the official held an interest – Buztel – but without disclosing her ownership stake to VimpelCom's board as part of the approval process. After VimpelCom merged Buztel with another acquired Uzbek telecom, the official secured an ownership stake in that company that VimpelCom later repurchased at a nearly $40 million profit. VimpelCom also allegedly paid the official tens of millions of dollars through a Gibraltar-based shell corporation.

To resolve the criminal investigation, VimpelCom entered into a deferred prosecution agreement on charges of conspiracy to violate the FCPA's anti-bribery and books-and-records provisions and a substantive violation of the internal controls provision, and Unitel pleaded guilty to one count of conspiracy to violate the anti-bribery provisions. To resolve the SEC's investigation, VimpelCom consented to the entry of judgment on a civil complaint charging FCPA bribery and accounting violations. VimpelCom also reached a parallel resolution with the Public Prosecution Service of the Netherlands (Openbaar Ministrie, or "OM"). After netting out a series of financial credits and offsets between the resolutions, VimpelCom agreed to pay $397.5 million to the OM, $230.2 million to DOJ, and $167.5 million to the SEC. VimpelCom also agreed to retain an independent compliance monitor for a three-year term.

In addition to the charges against VimpelCom and Unitel, DOJ simultaneously brought two complaints under its Kleptocracy Asset Recovery Initiative seeking forfeiture of a combined $850 million in allegedly tainted funds paid to the Uzbek official that are currently held in Swiss banks and other European countries. In June, DOJ obtained seizure orders for assets held in banks in Belgium, Ireland, and Luxembourg. With regard to this parallel enforcement action, DOJ Assistant Attorney General Leslie Caldwell remarked, "The Criminal Division's FCPA enforcement program and our Kleptocracy Initiative are two sides of the same anti-corruption coin."

Qualcomm Incorporated

On March 1, 2016, the SEC announced a settlement with California-based telecom company ***Qualcomm*** relating to alleged FCPA bribery and accounting violations arising from purportedly corrupt hiring practices in China. According to the SEC, between 2002

and 2012 Qualcomm provided or offered full-time employment and paid internship opportunities to relatives and acquaintances of Chinese government officials, in some cases despite reservations about the applicants' skills or qualifications and even after the normal hiring process resulted in their rejection. Qualcomm also allegedly provided Chinese officials and their family members with meals, lavish gifts, and travel, including sightseeing tours, golf outings, and hospitality packages at major sporting events, all of which lacked a valid business purpose. These benefits were allegedly provided to influence officials of the Chinese government and state-owned enterprises to adopt Qualcomm's mobile-network technologies, and allegedly caused in part by the company's failure to provide regular FCPA compliance training to employees in the human resources and hospitality planning functions.

Without admitting or denying the findings, Qualcomm consented to an SEC cease-and-desist order, agreeing to pay a $7.5 million civil penalty and to self-report on the state of its compliance program to the SEC for a two-year term. Significantly, despite the "billions in revenue" that Qualcomm allegedly gained by inducing foreign officials and state-owned enterprise executives to license and adopt Qualcomm technologies, the settlement did not include a disgorgement component. It would appear that the SEC had difficulty tying the alleged improper benefits to specific contracts with profits that could be disgorged.

This settlement, like the August 2015 resolution with BNY Mellon discussed in our 2015 Year-End FCPA Update, demonstrates the risk involved in hiring so-called "princelings," or relatives of well-connected foreign officials. While the FCPA does not strictly prohibit hiring a relative of a foreign official, these cases show that decision whether to do so often benefits from close FCPA scrutiny.

Olympus Latin America, Inc.

On March 1, 2016, DOJ announced a deferred prosecution agreement with medical equipment distributor ***Olympus Latin America***, a subsidiary of Olympus Corporation of the Americas, based on alleged corrupt payments in Argentina, Bolivia, Brazil, Colombia, Costa Rica, and Mexico. According to DOJ, between 2006 and 2011 Olympus Latin America used regional training centers as a means to provide health care practitioners working in government-owned hospitals with money and gifts in order to induce them to purchase Olympus equipment. In particular, Olympus Latin America allegedly identified health care practitioners who could influence purchasing decisions and paid them $65,000 per year to manage the training centers, as well as providing a 50 percent discount on Olympus equipment and a $130,000 budget for so-called "VIP Management." Olympus Latin America also allegedly established a "miles program" through which it offered the health care practitioners operating the training centers thousands of "miles" (worth thousands of dollars) that could be used for personal travel, without any pre-approval or review. According to DOJ, the illicit payments totaled nearly $3 million and generated more than $7.5 million in profits.

To resolve the FCPA bribery and conspiracy to commit bribery charges, Olympus Latin America agreed to pay a $22.8 million criminal penalty and to engage an independent compliance monitor for a three-year term. But the FCPA resolution was only a modest part of a much larger picture. On the same day, DOJ announced that parent company Olympus Corporation of the Americas had entered into a separate deferred prosecution agreement with DOJ, agreeing to pay more than $623 million to resolve alleged

violations of the domestic Anti-Kickback Statute and federal and state false claims acts based on providing kickbacks to doctors and hospitals in the United States. The deferred prosecution agreement similarly requires Olympus Corporation of the Americas to engage a compliance monitor, and the same person reportedly will serve as monitor under both agreements. This settlement also resolves a *qui tam* suit by Olympus Corporation of America's former-chief-compliance-officer-turned-whistleblower, who reportedly will receive a more than $50 million payout under the U.S. False Claims Act. Together, these resolutions serve as a keen reminder that the FCPA risks in dealing with government-employed physicians abroad are similar to those under the Anti-Kickback Statute when operating (and receiving payments from federal health care programs) in the United States.

Nordion (Canada) Inc.

On March 3, 2016, the SEC announced a settled administrative proceeding against global health science company ***Nordion (Canada)***. According to the charging document, which the company neither admitted nor denied, between 2004 and 2011 Nordion allegedly violated the FCPA's books-and-records and internal controls provisions in connection with payments to a third-party agent to obtain Russian government approval for a medical treatment. In particular, the SEC alleged that upon the recommendation of engineer ***Mikhail Gourevitch*** (whose individual FCPA resolution is discussed below), Nordion engaged Gourevitch's childhood friend and one of the friend's companies to help it obtain government approval for, register, license, and distribute a liver cancer treatment. Gourevitch and the agent allegedly schemed to use a portion of the agent's fees to bribe Russian officials to approve the treatment, as well as to pay kickbacks to Gourevitch.

To resolve the allegations, Nordion consented to an administrative cease-and-desist order and agreed to pay a $375,000 civil penalty – marking the lowest monetary resolution in a corporate FCPA enforcement action in five years. Because Nordion's agent was unsuccessful in securing regulatory approval for the distribution of Nordion's liver cancer treatment in Russia, Nordion realized no profits on the sale of the product in Russia and therefore did not pay disgorgement. The SEC acknowledged Nordion's self-reporting to authorities in the United States and Canada, internal investigation, and "extensive remedial measures," which included hiring a new corporate compliance director and enhancing its policies and procedures for hiring third parties.

Notably, despite being a defendant in an SEC enforcement action, Nordion is no longer an SEC issuer. In 2014, Nordion was taken private as part of a corporate acquisition. Nevertheless, because the conduct occurred prior to the delisting, Nordion's FCPA liability survived the transaction.

Novartis AG

On March 23, 2016, the SEC announced another FCPA settlement with a pharmaceutical company based on allegedly improper payments to Chinese physicians, with Swiss-based ADR-issuer ***Novartis*** agreeing to pay $25 million to resolve allegations that between 2009 and 2013, employees of its Chinese subsidiaries engaged in "pay-to-prescribe" schemes by providing gifts, travel, and other benefits to Chinese health care professionals. Funding for the benefits was allegedly obtained through false expense reports, by arranging "education events" through local travel companies with

more recreation than educational content, and by commissioning studies that rewarded doctors who prescribed Novartis medications to treat their patients.

Without admitting or denying the allegations in the SEC's administrative cease-and-desist order, Novartis agreed to pay disgorgement and prejudgment interest of just over $23 million and a civil penalty of $2 million, and to self-report to the SEC on its compliance program for a two-year period. The SEC credited the steps Novartis took after learning of the SEC's investigation into the scheme, which included reviewing its relationships in China with travel and event planners, disciplining the employees involved, strengthening the subsidiaries' anti-corruption controls, and reevaluating the company's use of Chinese vendors.

Las Vegas Sands Corp.

On April 7, 2016, the SEC announced an FCPA settlement with Nevada-based resort and casino company ***Las Vegas Sands***, arising from allegations that the company failed to properly authorize or document payments to a Chinese consultant who had been hired purportedly to mask the company's involvement in certain transactions in China and Macao. According to the SEC, Las Vegas Sands used the consultant, who claimed to be a well-connected former Chinese official, to indirectly purchase a Chinese Basketball Association team in order to circumvent the Association's prohibition against a gaming company doing so. Las Vegas Sands also allegedly used the consultant to purchase a government-owned building in Beijing. Among other alleged record-keeping irregularities, almost $1 million in payments to the consultant were recorded as payments for "property management services" that the SEC contended were never provided. Further, in connection with its Macao operations, Las Vegas Sands allegedly failed to properly monitor expense reimbursement programs. As a result, Las Vegas Sands was unable to identify whether expenses were being used to make payments to foreign officials.

Without admitting or denying the SEC's findings, Las Vegas Sands consented to a cease-and-desist order, agreed to pay a $9 million civil penalty, and retained an independent compliance consultant for a two-year period. Like the settlement with Qualcomm discussed above, the resolution did not include a disgorgement component but included a civil penalty. The charging documents do not allege bribery, but contend that Las Vegas Sands' internal controls could not account for significant sums paid to the consultant and through expense reimbursements "in an environment where significant bribery risks were present."

Akamai Technologies Inc. and Nortek Inc.

In the first six years following the announcement of its Cooperation Initiative in 2010, the SEC resolved one FCPA case via a non-prosecution agreement (Ralph Lauren Corporation, covered in our 2013 Mid-Year FCPA Update). On June 7, 2016, the SEC resolved two FCPA cases in this manner, reaching its second- and third-ever FCPA non-prosecution agreements with ***Akamai Technologies***, a Massachusetts-based internet services provider, and ***Nortek***, a Rhode Island-based building products manufacturer, respectively.

According to its non-prosecution agreement, between 2013 and 2015 the regional sales manager of Akamai's Chinese subsidiary paid more than $150,000 in cash and gifts –

while other employees provided more than $30,000 in improper gifts and entertainment – to officials of state-owned customers to induce the award of contracts to their employer. In the Nortek matter, the SEC's allegations were that between 2009 and 2014 employees of Nortek's Chinese subsidiary made more than 400 payments totaling nearly $300,000 to Chinese officials. Both companies immediately initiated an investigation after learning of the improper conduct and quickly disclosed its matter to DOJ and the SEC, providing "comprehensive, organized, and real-time cooperation." Of the resolutions, SEC Director of the Enforcement Andrew Ceresney said that "[w]hen companies self-report and lay all their cards on the table, non-prosecution agreements are an effective way to get the money back and save the government substantial time and resources while crediting extensive cooperation." Each company was required to disgorge the illicit profits earned via this alleged misconduct, with Akamai paying just over $670,000 in disgorgement plus prejudgment interest and Nortek paying more than $320,000 in disgorgement plus prejudgment interest.

Notably, DOJ released publicly its declination letters to Akamai and Nortek. The increased transparency on these matters is consistent with DOJ's efforts to encourage voluntary disclosures as part of its FCPA Pilot Program (discussed below), as is the result in these matters. Nevertheless, the facts alleged in the SEC's non-prosecution agreement do suggest that DOJ may have had difficulty in obtaining jurisdiction in this matter, given the apparent lack of knowledge or involvement of the U.S. issuer parent companies.

Analogic Corp.

On June 21, 2016, the SEC and DOJ announced a joint FCPA resolution with Massachusetts-based medical devices company ***Analogic*** and its Denmark-based subsidiary BK Medical ApS, respectively. According to the charging documents, between 2001 and 2011 BK Medical engaged in a scheme whereby it allowed its largest global distributor to over-invoice BK Medical and then took direction from this distributor on making payments of the excess amounts to third-party accounts that were unknown to BK Medical. In total, BK Medical allegedly made at least 180 payments worth more than $16 million to this distributor for sales in Russia, as well as at least 80 similar payments totaling more than $3 million to distributors in Ghana, Israel, Kazakhstan, Ukraine, and Vietnam.

To avoid criminal charges, BK Medical entered into a three-year non-prosecution agreement with DOJ and agreed to pay a $3.4 million penalty. In a settled administrative cease-and-desist proceeding against Analogic, the SEC imposed $11.48 million in disgorgement and prejudgment interest and also resolved charges against BK Medical's former CFO, ***Lars Frost*** (discussed further below). BK Medical (but not Analogic) will self-report on the progress of its compliance program for a three-year period.

Individual Enforcement Actions

Moisés Abraham Millán Escobar

On January 7, 2016, DOJ filed a criminal information charging ***Moisés Abraham Millán Escobar***, the former employee of a third-party engaged by Texas-based oil services company Tradequip Services & Marine, Inc., with one count of conspiring to violate the FCPA's anti-bribery provisions. According to the charging document, Millán Escobar

assisted an official of Venezuela's state-owned oil company, Petróleos de Venezuela SA ("PDVSA"), in opening a bank account in Panama in order to receive bribe payments outside of Venezuela, and thereafter participated in e-mail discussions about improper payments to be provided to PDVSA officials. Millán Escobar has pleaded guilty and is awaiting a September 2016 sentencing date, but the paperwork associated with his plea remains under seal.

This case is related to those we reported in our 2015 Year-End FCPA Update against ***Roberto Enrique Rincón Fernandez*** and ***Abraham José Shiera Bastidas***, respectively the president and a third-party agent of Tradequip Services & Marine, who were charged in December 2015 with conspiring to corruptly obtain PDVSA contracts. More on these developments in these cases, as well as related cases against three PDVSA officials, is contained below.

Notably, the charges against Millán Escobar were initially filed under seal, with DOJ citing concerns relating to the safety of the defendant's family in Venezuela – as well as relating to the integrity of its investigation – if news of his cooperation were to become public. Although the case was subsequently unsealed, this demonstrates the difficulty of tracking DOJ FCPA enforcement actions in real time given that many such actions do not become public until long after they are filed.

Ignacio Cueto Plaza

On February 4, 2016, the SEC announced an administrative cease-and-desist settlement with ***Ignacio Cueto Plaza***, the CEO of Chile-based LAN Airlines S.A., for alleged violations of the FCPA's books-and-records and internal controls provisions. According to the charging document, upon entering the Argentine market in 2005, LAN encountered work stoppages and slowdowns from unions representing many of its employees, who threatened to enforce certain provisions of their collective bargaining agreement if LAN did not agree to substantial wage increases. In 2006 and 2007, Cueto allegedly approved the retention of, and $1.15 million in payments to, a consultant to negotiate agreements with the unions, even as he understood that it was possible that the consultant might pay union officials.

Without admitting or denying the SEC's allegations, Cueto agreed to pay a $75,000 civil penalty, certify compliance with the company's code of conduct and other compliance policies, and attend all anti-corruption training sessions required for LAN senior executives. Cueto also agreed to cooperate with the SEC's ongoing investigation of the company relating to these activities. Gibson Dunn represented Cueto in his settlement with the SEC.

Yu Kai Yuan

As noted above, on February 16, 2016 the SEC announced its first ever deferred prosecution agreement with an individual in an FCPA case, a former sales executive of PTC's Chinese subsidiaries, ***Yu Kai Yuan***. Interestingly, other than recounting the allegations against the company as described above, and alleging generically that Yuan caused these violations, the SEC made no specific allegations with respect to his purported misconduct.

Yuan received no monetary sanction, and the FCPA books-and-records and internal controls charges will be deferred for a three-year period. According to the SEC's press release announcing the resolution: "DPAs facilitate and reward cooperation in SEC investigations by foregoing an enforcement action against an individual who agrees to cooperate fully and truthfully through the period of deferred prosecution. FCPA changes[sic] will be deferred for three years against Yu Kai Yuan . . . as a result of significant cooperation he has provided during the SEC's investigation."

Mikhail Gourevitch

Coincident with its FCPA enforcement action against Nordion, on March 3, 2016 the SEC announced a settlement with ***Mikhail Gourevitch***, a Canadian-Israeli citizen of Russian extraction and former engineer of Nordion. As discussed above, the SEC alleged that Gourevitch facilitated the company's hiring of his childhood friend as a consultant to help the company obtain regulatory approvals from the Russian government, and thereafter engaged in repeated discussions with the agent concerning the payment of bribes to Russian officials and the need to conceal them from Nordion. Gourevitch was further alleged to have pocketed more than $100,000 in kickbacks from the invoices to his friend's company for his own benefit, a fact he did not disclose to Nordion.

Without admitting or denying the alleged FCPA bribery and books-and-records violations, Gourevitch consented to a cease-and-desist order and agreed to pay $100,000 in disgorgement, $12,950 in prejudgment interest, and a civil penalty of $66,000 (for a total of more than $175,000).

Lars Frost

As part of its June 21, 2016 FCPA resolution with Analogic, the SEC also charged the former CFO of its BK Medical subsidiary, Danish citizen ***Lars Frost***, with causing the parent company's violations of the FCPA's accounting provisions, as well as himself knowingly circumventing the company's internal controls and falsifying its books and records. According to the SEC, between 2008 and 2011 Frost personally approved approximately 150 of the questionable payments to unknown third parties despite knowing that they did not comply with the company's accounts payable procedures. Frost also allegedly applied his initials to invoices describing services these third parties never performed, and failed to note these questionable transactions in his quarterly SOX sub-certifications. To resolve the allegations, Frost agreed to pay a $20,000 civil penalty.

2016 MID-YEAR FCPA-RELATED DEVELOPMENTS

In addition to the robust pursuit of individual FCPA cases by DOJ and the SEC, the first six months of 2016 also saw important programmatic changes in how DOJ administers its FCPA enforcement program, as well as significant anti-corruption-related developments prominent in the public sphere.

DOJ's FCPA Pilot Program

On April 5, 2016, DOJ Fraud Section Chief Andrew Weissmann penned a nine-page memorandum highlighting a three-step plan for enhancing FCPA enforcement: (1) adding prosecutors to the FCPA Unit and creating three dedicated squads of FBI special

agents to support these investigations; increased efforts to collaborate with foreign anti-corruption prosecutors; and (3) a new one-year "pilot program" to provide greater transparency on expectations for mitigation credit for voluntary self-disclosure, cooperation, and remediation in FCPA investigations. The first two steps are formal announcements of developments that have been in the works – and which we have been reporting on – for years. The third step relating to the pilot program is significant and deserves further attention.

Under the pilot program, if a company voluntarily self-discloses FCPA-related misconduct, cooperates fully in the ensuing investigation, and appropriately remediates the misconduct, it may receive "up to a 50% reduction" off of the bottom of the applicable U.S. Sentencing Guidelines fine range, and DOJ also "will consider" declining prosecution altogether. For companies that do not self-disclose, but otherwise cooperate and undertake appropriate remediation, DOJ will provide "at most a 25% reduction" off the bottom of the Guidelines range. In all events, companies will be expected to disgorge ill-gotten profits earned as a result of the misconduct, which in the case of issuers will frequently be covered in parallel SEC enforcement actions, but in the case of domestic concerns may take the form of civil forfeiture actions.

With respect to cooperation, the pilot program memorandum provides a detailed list of 11 "threshold requirements" that must be met to receive full credit. These requirements emphasize proactive engagement with DOJ and include providing "all relevant facts known to [the company], including all relevant facts about the individuals involved in any FCPA violation." Regarding remediation, DOJ identifies several elements that "will generally be required" for a company to receive credit, including the implementation of an effective compliance program, appropriate discipline of employees, and "[a]ny additional steps that demonstrate recognition of the seriousness of the corporation's misconduct." However, no credit will be awarded for remediation unless the company fully cooperated. DOJ has indicated that it will be assisted by Hui Chen, its dedicated compliance expert hired in November 2015, in evaluating a company's remedial actions.

DOJ's one-year FCPA pilot program expires in early April 2017, at which point DOJ will evaluate whether to extend, jettison, or modify its provisions. It is yet too soon to evaluate the effectiveness of this program, but we will report on its impact in our forthcoming 2016 Year-End FCPA Update.

FIFA Update

We have been covering the corruption scandal that has engulfed the Fédération Internationale de Football Association ("FIFA") since the May 2015 pre-dawn raid at a luxury Swiss hotel made waves last year. To date, more than forty individuals and companies have been publicly charged with (non-FCPA) corruption-related offenses for their roles in a decades-long scheme that saw FIFA officials allegedly award lucrative marketing contracts in exchange for hundreds of millions of dollars in bribes. More than a dozen defendants have pleaded guilty, including in 2016:

- ***Rafael Callejas*** – former President of Honduras and former president of the country's soccer federation, pleaded guilty in March 2016 in U.S. federal court to racketeering and wire fraud conspiracy for taking bribes in exchange for awarding media rights for FIFA World Cup qualifier matches;

- ***Alfredo Hawit*** – FIFA's former vice president and an executive committee member, pleaded guilty in April 2016 to one count of racketeering conspiracy, two counts of wire fraud conspiracy, and one count of conspiracy to obstruct justice for a similar scheme; and

- ***Miguel Trujillo*** – a FIFA match agent, pleaded guilty to one count of money laundering conspiracy, two counts of wire fraud conspiracy, and one count of filing a false tax return for his role in schemes to bribe FIFA officials.

Panama Papers

Since the news first broke on April 3, 2016, the massive leak of information relating to hundreds of thousands of offshore entities – collectively known as the "Panama Papers" – has taken the corporate and legal communities by storm. In total, the leak extends to 11.6 million documents (2.6 terabytes of information) from Panama-based law firm Mossack Fonseca, including internal e-mails, financial spreadsheets, passports, and corporate records reflecting the owners of various offshore bank accounts and companies and institutions.

An anonymous source reportedly obtained the documents and leaked them to the International Consortium of Investigative Journalists, which, in turn, worked with more than 100 media organizations to analyze the trove of information. In April, a fraction of the data was publicly released, followed by a May 9 release of a larger set of information. We anticipate additional releases in the future.

Although uncertainties abound with respect to the ability to use this information in light of the questionable nature of the publication of arguably privileged documents, U.S. law enforcement officials have signaled their interest in using the documents to investigate potential FCPA violations. SEC FCPA Unit Chief Kara Brockmeyer said recently that the SEC will be reviewing the Panama Papers for indications of potential corruption. Another, unnamed senior law enforcement official is reported as remarking that prosecutors are "chomping at the bit" to "exploit" the Panama Papers "bonanza," which "will keep a lot of agents very busy for a very long time."

Unaoil

Another major corruption-related story from early 2016 involves a series of articles published in February based on tens of thousands of leaked e-mails and documents that make sweeping allegations that Monaco-based Unaoil bribed officials in the Middle East, Central Asia, and North Africa for many years to secure lucrative oil contracts on behalf of a client base that reads like a who's who of multinationals. On the heels of these provocative articles, authorities in the United States, Australia, Iraq, and the UK have launched a large-scale bribery investigation, which, upon the request of the Serious Fraud Office ("SFO"), prompted raids by Monaco authorities at Unaoil's head office and at the residences of certain executives. For its part, Unaoil has stridently denied the allegations, claiming to be a victim of extortion, and has pledged to take legal action against the media for the reputational harm caused by the reporting.

Disgorgement Developments

Any follower of FCPA enforcement knows that disgorgement is frequently the key driver in determining the cost of an FCPA settlement with the SEC. The first six months of 2016 saw two key developments in this area.

First, on May 6, 2016, the IRS released a Chief Counsel Advice Memorandum (CCA 201619008) in which it concluded that a taxpayer could not claim a U.S. federal income tax deduction for a disgorgement payment made to the SEC for FCPA violations. Although U.S. tax rules generally permit taxpayers to deduct ordinary and necessary business expenses, Section 162(f) of the Internal Revenue Code prohibits a deduction for any fine or similar penalty paid to a government for a law violation. The majority of authorities in non-tax contexts have recognized that disgorgement is remedial and not punitive in nature, and thus it has been standard practice for companies resolving FCPA matters to claim a deduction for the disgorgement portion of the settlement (but not portions relating to criminal or civil fines or penalties). In this CCA, the IRS appears to be signaling its litigation position that tax deductions for disgorgement payments in FCPA cases may not always be appropriate. The CCA is not, however, binding legal precedent and it will be for the courts to determine whether disgorgement constitutes a non-deductible fine or penalty.

Second, on May 26, 2016, the Eleventh Circuit in SEC v. Graham held that claims by the SEC for disgorgement and declaratory relief are subject to the five-year statute of limitations set forth in 28 U.S.C. §2462. This decision, discussed fully in our separate client alert Eleventh Circuit Limits SEC Power to Seek Disgorgement and Declaratory Relief, is significant because it would limit the ability to seek disgorgement for FCPA violations to five years from the time of the claim's accrual. While the decision represents a significant victory for securities market participants, it remains to be seen whether the Eleventh Circuit's interpretation of §2462 will be adopted by other circuits.

2016 MID-YEAR CHECK-IN ON ENFORCEMENT LITIGATION

PDVSA Defendants

We reported in our 2015 Year-End FCPA Update on the FCPA charges against ***Roberto Enrique***, ***Rincón Fernandez***, and ***Abraham José Shiera Bastidas*** for allegedly conspiring to corruptly obtain PDVSA contracts. Shiera, a Venezuelan national who resides in Florida, pleaded guilty on March 22, 2016 to one count of violating the FCPA and one count of conspiracy to violate the FCPA and commit wire fraud. Rincón, a U.S. permanent resident of Venezuelan origin, initially pleaded not guilty to all counts but, on June 16, 2016 – days before his jury trial was set to begin – pleaded guilty to a revised criminal information charging one count of conspiracy to violate the FCPA, one count of violating the FCPA, and one count of fraud and false statements in connection with his 2010 U.S. federal income tax return.

Four others charged in the case also have pleaded guilty to charges unsealed on March 22, including ***Moisés Abraham Millán Escobar*** (whose FCPA plea is discussed above) and three former PDVSA officials. The former PDVSA employees – ***José Luis Ramos Castillo***, ***Christian Javier Maldonado Barillas***, and ***Alfonzo Eliezer Gravina Munoz*** – pleaded guilty to conspiracy to commit money laundering, admitting to accepting bribes from Shiera and Rincón in exchange for help securing PDVSA contracts, and to

conspiring with Shiera and Rincón to launder the bribes. Gravina also pleaded guilty to making false statements on his 2010 U.S. federal income tax return, for failing to report the bribe payments he received. As foreign government officials, the former PDVSA employees are not subject to the FCPA, but as has been repeatedly demonstrated in recent years, DOJ aggressively pursues bribe recipients under other U.S. statutes such as money laundering.

All defendants are currently scheduled to be sentenced on September 30, 2016.

BANDES Defendants

We have been following for several years now the prosecution of numerous employees of Wall Street broker-dealer Direct Access Partners LLC for their payment of kickbacks to a former official of the Venezuelan state-owned economic development bank, Banco de Desarrollo Económico y Social de Venezuela ("BANDES"). On January 15, 2016, the beneficiary of this pay-to-play scheme – ***Maria de los Angeles Gonzalez de Hernandez*** – was sentenced to time served after spending nearly seventeen months in prison during the course of the investigation, and ordered to forfeit $8.3 million. At the sentencing hearing, prosecutors detailed extensively Gonzalez's cooperation, which "enabled [them] to get all the way up to the c-suite," while U.S. District Judge Denise Cote of the Southern District of New York acknowledged Gonzalez's apparent remorse and individual circumstances.

On April 6 and 7, 2016, U.S. District Judge Jesse Furman of the Southern District of New York entered final judgments against each of the Direct Access Partners defendants from the SEC's 2013 civil suit, based on consent agreements entered into with the SEC. The defendants were ordered to pay a combined total of $42.5 million in disgorgement and prejudgment interest, which was deemed satisfied by the forfeiture orders previously entered in the parallel criminal cases.

Dmitrij Harder

When we last reported on the FCPA prosecution of ***Dmitrij Harder*** in our 2015 Year-End FCPA Update, Harder had filed motions to dismiss the January 2015 indictment arguing, among other things, that the provision of the FCPA that renders employees of "public international organizations" "foreign officials" is unconstitutional both under the non-delegation doctrine and because it is unconstitutionally vague. On March 2, 2016, the Honorable Paul S. Diamond of the U.S. District Court for the Eastern District of Pennsylvania denied Harder's motions to dismiss, rejecting both constitutional arguments. With respect to the non-delegation argument, the Court held that it is permissible for Congress to delegate to the Executive Branch the ability to designate "public international organizations" (and thus their employees "foreign officials" for purposes of the FCPA) because the FCPA provides a clear legislative goal of promoting foreign commerce by American businesses, clearly confers the authority to the President, and narrowly tailors this authority by requiring congressional involvement (in the form of ratifying treaties) in the process. With respect to the vagueness argument, Judge Diamond held that a person of ordinary intelligence would have no difficulty identifying the relevant organization (European Bank for Reconstruction and Development) as a public international organization within the FCPA's ambit.

Following the resolution of the motions to dismiss, a flurry of pre-trial motions were filed by both sides relating to, among other issues, the availability of Rule 15 depositions of foreign-based witnesses, the preclusion of certain arguments from trial, and the admissibility of certain evidence. Significantly, on April 15, 2016, the Court denied Harder's motion to suppress statements he gave during a border control interview at JFK International Airport, finding that the interview was non-custodial. Five days later, Harder pleaded guilty to two counts of violating the FCPA.

On June 2, 2016, Harder filed a motion in the U.S. Court of Appeals for the Third Circuit seeking his release from custody pending sentence; the appellate court denied bail on June 22, 2016. Harder's sentencing before the district court – originally scheduled for July 21 – has now been postponed to November 3, 2016.

Lawrence Hoskins

As discussed in our 2015 Year-End FCPA Update, DOJ submitted a motion for reconsideration on August 27, 2015 after the Honorable Janet Bond Arterton of the U.S. District Court for the District of Connecticut partially granted former Alstom S.A. executive ***Lawrence Hoskins***'s motion to dismiss certain charges pending against him. The Court previously held that Hoskins could not be criminally liable for conspiring to violate or aiding and abetting a violation of the FCPA, pursuant to the Gebardi principle, unless the government establishes that he was acting as an "agent" of a "domestic concern" (here, Alstom's U.S. subsidiary) in connection with the alleged bribery scheme.

On March 16, 2016, Judge Arterton denied the Government's motion for reconsideration. Two weeks later, in a relatively rare move that underscores the programmatic importance of this issue to the Department, DOJ filed an interlocutory notice of appeal to the U.S. Court of Appeals for the Second Circuit. DOJ's brief to the Second Circuit is due on August 15, 2016.

Biomet, Inc. Deferred Prosecution Agreement Extended (Again)

We reported in our 2015 Mid-Year FCPA Update on the rare extension of ***Biomet***'s reporting obligations pursuant to its 2012 FCPA-related deferred prosecution agreement with DOJ and civil settlement with the SEC. These obligations, which originally were set to expire in March 2015, were extended just before the expiration of their term due to an investigation into new whistleblower complaints in Brazil and Mexico. In March 2016, Biomet disclosed that DOJ and the SEC were continuing to evaluate the situation and that the obligations of the 2012 agreements would remain in force until the new investigations were resolved. Then, in a June 6, 2016 status report filed in the U.S. District Court for the District of Columbia, DOJ stated that it has determined that Biomet breached its deferred prosecution agreement based on the conduct in Mexico and Brazil and the company's alleged failure to implement an adequate compliance program. According to the status report, discussions between Biomet and the government are ongoing and Biomet remains committed to cooperating with DOJ and the SEC.

2016 MID-YEAR FCPA-RELATED PRIVATE CIVIL LITIGATION

Our readership is well aware that the FCPA provides no private right of action, yet plaintiffs' attorneys continue to employ other causes of action to seek recompense for

losses allegedly associated with purported FCPA-related misconduct. A selection of matters that saw developments in the first half of 2016 follows.

Shareholder Lawsuits

Cobalt International Energy, Inc.

In our 2014 Year-End FCPA Update, we reported on the November 30, 2014 securities fraud lawsuit brought by a putative class of shareholders in the U.S. District Court for the Southern District of Texas alleging that ***Cobalt*** lost billions of dollars because it "misrepresented, and failed to disclose, the corrupted nature of its business in Angola and the true value of the Company's Angolan oil wells." This came after Cobalt announced that it had received a "Wells Notice" indicating that the SEC Staff were prepared to recommend charges against the company for alleged FCPA violations in Angola. Since then, two additional shareholder suits (one securities fraud, the other shareholder derivative) have been brought against Cobalt arising from similar allegations. Notably, on January 28, 2015, the SEC Staff advised the company that it was declining to recommend any enforcement action relating to Angola, although DOJ's investigation reportedly remains ongoing.

All three cases are currently assigned to the Honorable Nancy F. Atlas. On January 19, 2016, Judge Atlas dismissed the claims in the consolidated securities fraud action against the securities underwriters, but the suit continues with respect to the remaining defendants. Meanwhile, in the derivative case, Judge Atlas granted the Cobalt directors' motion to dismiss on November 25, 2015, citing the plaintiff's failure to allege the relevant dates of his acquisition and retention of his shares and failure to allege why presenting the demand to the Board of Directors would have been futile. The motion was granted with leave to file a second amended complaint, but the plaintiff neither filed an amended complaint nor requested an extension of the January 8, 2016 deadline, and, as a result, the derivative case was dismissed and terminated on February 2, 2016.

Freeport-McMoRan Inc.

On January 26, 2016, shareholders filed a securities fraud class-action suit against ***Freeport-McMoRan Inc.*** in the U.S. District Court for the District of Arizona, alleging that the NYSE-listed natural resources company failed to disclose that the head of the company's Indonesian subsidiary bribed Indonesian government officials in exchange for an extension of the company's right to operate in the country, in violation of the FCPA. The suit follows testimony that the president-director of Freeport Indonesia gave to an ethics tribunal of the Indonesian House of Representatives last December, in which he stated that the speaker of the House of Representatives had solicited a bribe constituting a 20 percent interest in the company in exchange for contract renewal. It is unclear whether DOJ and the SEC are investigating this matter.

Key Energy Services, Inc.

As described in our 2014 Year-End FCPA Update, on August 15, 2014 a putative class of ***Key Energy Services, Inc.*** shareholders filed a securities fraud complaint in the U.S. District Court for the Southern District of Texas, alleging that Key Energy fraudulently concealed that it had engaged in corrupt practices in Russia. After multiple judicial recusal orders and reassignments, Key Energy filed a motion to dismiss the complaint in

2015. On March 31, 2016, the Honorable Melinda Harmon granted the motion to dismiss, focusing on the plaintiff's failure to plead adequately the elements of their fraud claims, and specifically holding that plaintiff did not plead specific facts to show that key management personnel knowingly made false statements. The defendant chose not to file any subsequent motions, and the case was terminated on April 26, 2016. Key Energy has reported that DOJ has closed its investigation of the company, and that the company is in discussions with the SEC to resolve the matter.

RICO Actions

Yahoo! Inc.

In our 2014 Year-End FCPA Update, we reported that two private Mexican companies – ***Worldwide Directories, S.A. de C.V.*** and ***Ideas Interactivas, S.A. de C.V.*** – initiated a RICO suit in the U.S. District Court for the Southern District of New York against ***Yahoo! Inc.***, Yahoo!'s Mexican subsidiary, and the companies' law firm, Baker & McKenzie LLP. The plaintiffs alleged that the defendants corruptly influenced members of the Mexican judiciary in order to overturn an unprecedented $2.7 billion judgment in the plaintiffs' favor. The defendants moved to dismiss the RICO suit in March 2015, noting that, by that time, multiple Mexican courts had ruled in the plaintiffs' favor.

On March 31, 2016, the Honorable Alison J. Nathan dismissed the RICO suit with prejudice. The Court noted that the plaintiffs failed to plausibly allege Yahoo!'s involvement. The RICO claims against Baker & McKenzie were also dismissed for the plaintiffs' failure to plead a predicate act. Gibson Dunn represents Yahoo! in this matter.

Siemens FOIA Litigation

As reported in our 2014 Year-End FCPA Update, non-profit news media organization ***100Reporters LLC*** has filed a Freedom of Information Act ("FOIA") lawsuit in the U.S. District Court for the District of Columbia against DOJ seeking the release of records related to its 2008 FCPA resolution with ***Siemens AG*** and the monitorship that followed. Siemens and its former compliance monitor, Dr. Theo Waigel, were allowed to intervene in the lawsuit and assert their interests.

On March 22, 2016, DOJ, Siemens, and Dr. Waigel filed motions for summary judgment, arguing that the materials sought by 100Reporters are exempt from disclosure under four FOIA exemptions. Supporting the motions were extensive declarations from an Assistant Chief in DOJ's FCPA Unit, a former DOJ Fraud Section attorney, an Assistant Director of SEC Enforcement involved in the monitorship, independent U.S. counsel to Dr. Waigel during the monitorship, Siemens' Associate General Counsel and Head of Compliance Regulatory Case Handling for the Americas, and an information specialist in the DOJ FOIA/Privacy Act Unit. On April 22, 2016, 100Reporters filed a consolidated opposition and cross-motion for summary judgment, arguing that the exemptions do not apply and challenging DOJ's Vaughn Index justifying the FOIA bases for withholding the documents in question. According to the most recent scheduling order, reply briefs are due in the second half of 2016. Gibson Dunn represents Dr. Waigel in this matter, as it did during the monitorship itself.

Although the underlying FOIA litigation has not been resolved, the Court's opinion on intervention recognizes an independent monitor's confidentiality interests and the

importance of disclosure protections to ensure that a monitor can access the books, records, employees, and facilities of a monitored entity. While the Court has not reached the ultimate merits of the monitor's position, it has recognized the importance of his interest in preserving confidentiality by granting him the opportunity to intervene and advocate for nondisclosure.

2016 MID-YEAR INTERNATIONAL ANTI-CORRUPTION DEVELOPMENTS

World Bank Enforcement

Perhaps the most important development over the past six months for the increasingly robust enforcement role played by the World Bank Integrity Vice Presidency ("INT") was the decision of the Canadian Supreme Court in the closely watched case of World Bank Group v. Wallace. As discussed in our 2015 Year-End FCPA Update, former employees of ***SNC-Lavalin Group Inc.*** were charged with Corruption of Foreign Public Officials Act violations in Canada after INT provided information to Canadian prosecutors arising from its own investigation and the Canadian prosecutors then obtained wiretaps based on INT's lead. The defendants challenged the wiretap authorizations and sought an order requiring INT to produce certain investigative records. INT claimed sovereign immunity as is its normal practice, but this time the trial court held that the World Bank had waived its immunity by voluntarily providing evidence to prosecutors. While the case was on appeal, INT suspended its standard practice of making referrals to national authorities, in Canada and elsewhere.

On April 29, 2016, the Canadian high court upheld the Bank's asserted privileges and immunities. While lauding the World Bank's place "at the frontlines of international anti-corruption efforts" and suggesting that an implied waiver of immunity would "have a chilling effect on collaboration with domestic law enforcement," the Court also determined that the defendants had not established that the records sought would have even been relevant to their wiretap challenge – perhaps sidestepping a showdown between the Bank's privileges and immunities and issues of fundamental fairness and due process.

Bank personnel have indicated that they are considering refinements to their referral practices in light of the decision. Members of the defense bar, meanwhile, have expressed concern that immunity for the Bank in similar circumstances could result in concomitant reductions in due process protections for criminal defendants.

Europe

United Kingdom

After a flurry of concluded enforcements at the end of 2015, the first half of 2016 saw one individual convicted of foreign bribery, two companies receive sentences related to alleged corruption, and one company enter into a civil settlement.

Enforcement

As we reported in our 2014 Year-End FCPA Update, on December 22, 2014, ***Smith & Ouzman Limited*** was found guilty of three counts of corruptly agreeing to make payments in violation of Section 1(1) of the Prevention of Corruption Act 1906, the

Bribery Act's predecessor statute. On January 8, 2016, the company was sentenced and ordered to pay a total of £2.2 million, which includes a confiscation order of £881,158. The confiscated funds will be sent to Kenya.

Following its December 18, 2015 guilty plea to a Section 7 offense for failing to prevent its subsidiary from paying bribes to win a hotel construction contract in Dubai (covered in our 2015 Year-End FCPA Update and 2015 Year-End United Kingdom White Collar Crime Update), ***Sweett Group PLC*** was sentenced on February 19, 2016 and ordered to pay a fine of £1.4 million, disgorge more than £850,000 in profits, and pay approximately £95,000 in costs.

Following on the Brand-Rex settlement (covered in our separate client alert Serious Fraud Office v Standard Bank Plc: Deferred Prosecution Agreement), in April, ***Braid Logistics (UK) Limited*** became the latest company to enter into a civil settlement with Scotland's Civil Recovery Unit under the amnesty program run by the Crown Office and Procurator Fiscal Service. After becoming aware of potential improper activities related to two freight forwarding contracts in 2012, Braid conducted an investigation and voluntarily self-reported to the Crown Office. Limited information has been reported to date regarding the underlying conduct as the authorities are considering whether to prosecute the individuals involved, but on one of the contracts, a Braid employee appears to have schemed to pay for benefits, including personal travel, gifts, and cash for a customer employee, funded by submitting inflated invoices to the customer. During the investigation of this contract, separate concerns were identified relating to a profit sharing arrangement with a director of a second customer. Under the terms of the agreement, which includes Section 1 and Section 7 offenses, Braid will pay £2.2 million, representing profits resulting from the unlawful conduct.

On May 11, following a joint investigation by the SFO and Australian Federal Police and a five-week trial, ***Peter Chapman***, a former manager of Securency PTY Ltd., was convicted of four counts of making corrupt payments to a foreign official in violation of the Prevention of Corruption Act 1906, while being acquitted of two other counts. In particular, Chapman was alleged to have paid bribes of $205,000 to an agent of Nigerian Security Printing and Minting PLC, in order to secure orders for the purchase of products from his former employer. Following the conviction, Chapman was sentenced to 30 months in prison on each count, to be served concurrently.

Legislation

On May 20, 2016, the Bermudan Attorney General announced plans to introduce new legislation to modernize the country's laws on bribery and corruption. The new act will be based on the U.K. Bribery Act 2010, creating four new offenses modelled on Sections 1, 2, 6 and 7 of the Bribery Act. The proposed act also will contain the "adequate procedures" defense available under the Bribery Act. As reported in our 2012 Year-End FCPA Update, this announcement follows the Isle of Man enacting its Bribery Act in May 2013, as well as publication of a white paper in June 2012 through which the U.K. government stated that it "expected" the British overseas territories, including Bermuda, to implement anti-corruption legislation reflecting the OECD Convention. Feedback on the proposed law was requested by May 31, and we will continue to monitor related developments.

France

Enforcement

We noted in our 2015 Year-End FCPA Update the July 2013 acquittal of French oil company ***Total S.A.*** and Swiss energy trading company ***Vitol*** of foreign corruption charges arising out of the U.N. Oil-for-Food Program by a Paris regional criminal court. On February 26, 2016, the Paris appeals court overturned the acquittals, and ruled that Total and Vitol had to pay €750,000 and €300,000, respectively. The appeals court found Total guilty of corrupting foreign officials, based on French prosecutors' accusations that Total had bypassed a designated U.N. escrow account when purchasing oil from Iraq between 2000 and 2002, which allowed it to make extra payments to the Iraqi government through its suppliers. Total has challenged the Paris appeals court's decision before the French *Cour de cassation*.

Legislation

We also covered in our 2015 Year-End FCPA Update *Loi Sapin II*, the anti-corruption legislation proposed by French Finance Minister Michel Sapin in July 2015 that, if passed, would create a new administrative anti-corruption agency, a legal basis for the implementation of independent compliance monitors, and a new requirement that French businesses implement internal anti-corruption compliance programs. In January 2016, draft legislation was amended to include provisions for a new settlement tool similar to deferred prosecution agreements – the "*convention de compensation d'intérêt public*" ("CCIP") – that would allow companies to pay fines and engage in remediation in exchange for suspension of charges against them. On March 24, however, the *Conseil d'État* – France's highest administrative court, which is tasked with reviewing draft legislation sponsored by non-members of Parliament – issued an advisory opinion critical of the CCIP, leading this provision to be omitted from the version of the bill later submitted to the French Parliament's National Assembly. A settlement mechanism was reinserted during the parliamentary process, in the form of a "*convention judiciaire d'intérêt public*," a procedure that requires a judge to oversee a public and adversarial proceeding before approving a settlement proposed by the prosecutor. On June 14, 2016, the National Assembly adopted Loi Sapin II, which is now proceeding through the other legislative chamber, the Senate, according to an accelerated process (which requires only one reading of the bill in each chamber of Parliament). As of June 22, 2016, the bill has emerged from a Senate committee with the settlement procedure intact – subject to some editorial modifications, and now styled as a "*transaction judiciaire*." The Senate is scheduled to discuss *Loi Sapin II* during public sessions the week of July 4, 2016, and we will continue to monitor its status.

Germany

Introduction of Section 335a to the German Criminal Code

On November 26, 2015, the Act to Combat Corruption entered into force. The Act added Section 335a to the German Criminal Code (*Strafgesetzbuch – StGB*), which was among other things designed to implement the Criminal Law Convention on Corruption of the Council of Europe of January 27, 1999, as well as the Additional Protocol of May 15, 2003 appended thereto. The new Section 335a references Sections 331 *et seq.* of the German Criminal Code, which sanction offenses committed in public office and also

contain substantial anti-corruption legislation governing German public officials. Section 335a broadens the applicability of Sections 331 *et seq.* to certain foreign and international judges, certain staff members who are associated with foreign public service or international organizations, and certain members of the armed forces. Our clients should be aware that the parity of foreign public officials with German public officials under Section 335a applies even outside of German territory if there is a nexus to Germany. As a consequence, German anti-corruption standards, for example, for presents and invitations, must be observed in this case when interacting with foreign public officials abroad.

Sections 299a and 299b to the German Criminal Code

On June 4, 2016, the German Act to Combat Corruption in the Healthcare Sector (*Gesetz zur Bekämpfung von Korruption im Gesundheitswesen*) entered into force. The Act's major element is the addition of Sections 299a and 299b to the German Criminal Code (*Strafgesetzbuch – StGB*), which sanctions passive and active bribery in the healthcare sector, respectively. A legislative reaction to a 2012 ruling by the Federal High Court of Justice (*Bundesgerichtshof*) holding that resident medical practitioners are not to be treated as public officials under German anti-corruption legislation, Sections 299a and 299b now apply to all healthcare professionals whose profession requires a state-recognized, vocational education, and penalize corrupt conduct related to medical prescriptions, the supply of certain medical products, and referral of patients with imprisonment of up to three years or a fine.

German Federal Constitutional Court on Extradition to the United States

A recent decision by the German Federal Constitutional Court (*Bundesverfassungsgericht*) may be of crucial importance for future extraditions between Germany and the United States in multi-jurisdictional matters. In March 2016, the court remanded a 2015 ruling by the Higher Regional Court of Frankfurt and thereby stopped the deportation by German authorities of a Swiss national to the United States. The Federal Constitutional Court's ruling took issue with a 2015 decision by the U.S. Court of Appeals for the Second Circuit in United States v. Suarez[1] regarding the contours of the Principle of Specialty under international law. For the sake of international comity, the Principle of Specialty generally requires a country seeking extradition to adhere to any limitations placed on prosecution by the surrendering country. In interpreting this principle, the Suarez court held that an extradited person lacks standing to challenge the requesting nation's adherence to the doctrine absent an official protest by the extraditing nation. Because German law requires courts to assess whether a requesting nation adheres to the Principle of Specialty before extraditing a person in German custody to that nation, the Federal Constitutional Court noted its disapproval with the Suarez decision in holding that the complainant could not be extradited to the United States. Specifically, it held that the mere reference to the opportunity of requesting the extraditing nation to raise an official protest generally violates the Right to Personal Freedom guaranteed by Article 2 subsection 2 of the German Constitution, and, in any case, violates the General Freedom of Action guaranteed by Article 2 subsection 1.

[1] 791 F.3d 363 (2d Cir. 2015).

The Netherlands and Norway

As discussed above, a global settlement was reached with Dutch-based ***VimpelCom Ltd.*** in February 2016 involving DOJ, the SEC, and the Dutch Public Prosecution Service. The penalties imposed by the Dutch Public Prosecution Service totaled approximately $397.5 million. At the time of the settlement, the Prosecution Service announced that it is investigating several individuals in connection with the case.

A related investigation by the National Authority for Investigation and Prosecution of Economic and Environmental Crime in Norway (ØKOKRIM) reportedly remains ongoing. Norwegian authorities have not yet withdrawn charges against former CEO ***Jo Lunder***, who was arrested in November 2015 on suspicion of corruption relating to business in Uzbekistan. Lunder denies the charges.

Russia

Documents leaked as part of the Panama Papers name one of President Putin's childhood friends – renowned cellist Sergei Roldugin, who continuously denies having any business dealings – as the owner of several offshore entities that entered into transactions with state-run companies. The Panama Papers also have prompted inquiries about commercially questionable transactions involving some of President Putin's other close associates. President Putin's administration has responded by stating that these allegations constitute yet another attempt to attack personally Russia's president and to destabilize the Russian government.

In other developments, Vladivostok mayor ***Igor Pushkarev*** has been charged with commercial bribery and is being held without bail. Prosecutors contend that between 2009 and 2014, Pushkarev used his position to facilitate an arrangement whereby his friend's construction company purchased supplies at inflated prices from another company controlled by Pushkarev's close relatives, and, as a result, Pushkarev received kickbacks in excess of $2.4 million. Pushkarev denies involvement in this scheme and has expressed willingness to cooperate with the investigation.

Ukraine

Investigative Developments

During the first half of 2016, the newly established National Anti-Corruption Bureau of Ukraine initiated a few high-profile anti-corruption investigations, including an investigation into Ukraine's largest commercial airline, and an investigation into natural gas sales by Ukraine's national natural gas exploration company. The latter investigation has led to several high-profile arrests and the Ukrainian Parliament's approval of the arrest of a member of Parliament. Nevertheless, Ukrainian enforcement agencies still experience challenges in securing convictions in anti-corruption matters, a trend that many hope the judicial reform and the creation of a specialized anti-corruption court will address.

In other Panama Papers developments, documents leaked name President Petro Poroshenko as an indirect owner of a British Virgin Islands entity. President Poroshenko and his advisors have claimed that the entity was created to facilitate the transfer of President Poroshenko's confectionary business to a revocable trust to be run by an

international investment firm. President Poroshenko's advisors also have claimed that no tax laws were violated because this entity, and its subsidiaries in Cyprus and the Netherlands, did not engage in any transfers of funds. Many in Ukraine believe that President Poroshenko may have violated his obligation to declare assets, but the National Anti-Corruption Bureau of Ukraine has stated that it has no jurisdiction over the President, and the Parliament is still to decide whether and how to investigate the matter.

Legislative Developments

The first half of 2016 saw the passing of two key pieces of legislation aimed at combatting corruption in Ukraine: first, a measure requiring public officials and government employees to declare their full income and assets; and second, a constitutional reform seeking to curtail the incidence of bribery within Ukraine's judicial branch. Both laws were enacted – at least in part – to satisfy Ukraine's obligations under the European Union's Action Plan on Visa Liberalization.

The first law encountered some difficulties and was vetoed by President Poroshenko in its initial iteration, which did not create liability for providing false information in the declarations submitted by public officials and government employees. This earlier draft mandated the declaration of income, real estate, and vehicles, the value of which exceeds a minimal government salary by factors specified in the legislation; however, the draft postponed the criminalization of false declarations until 2017. In its final form, by contrast, the law instituted criminal liability – fines or even prison time – for submitting egregiously false declarations, effective April 1, 2016.

The second legislative action, the judicial constitutional reform, increases the accountability of judges, limits judicial immunity, creates an anticorruption court, and reinstates the three-level judicial system with a Supreme Court at the top. The latter provision abolishes the additional specialized courts, established by former president Victor Yanukovych in what many viewed as his effort to dilute the judiciary's independence by appointing judges beholden to him to courts not subject to the Supreme Court's appellate jurisdiction.

The Americas

Argentina

Investigations into alleged corruption in the administrations of now-deceased President Néstor Kirchner and his wife and successor, ***Cristina Fernández de Kirchner***, have intensified since the latter left office in December 2015. The two former presidents, as well as members of their governments, have been implicated in a variety of schemes.

One of the accusations made against Fernández involves the Central Bank of Argentina's decision to sell up to $17 billion of dollar futures contracts at artificially low prices, allegedly in an effort to make the country's finances appear stronger ahead of the November 2015 presidential election (which Fernández's party lost). The undervalued dollar futures contracts lost Argentina roughly $5.5 billion. On May 13, 2016, Fernández and more than a dozen others – including ***Axel Kicillof***, the former economy minister, and ***Alejandro Vanoli***, the former head of the Central Bank – were indicted in

connection with the scheme on charges of "unfaithful administration to the detriment of public administration."

Fernández also is the subject of two other criminal investigations. The first relates to accusations that the Kirchner family was involved in a large-scale international money laundering scheme, in which millions of dollars were funneled to a Swiss bank via offshore companies owned by the Kirchners' business partner, ***Lázaro Báez***. Báez and his employee ***Leonardo Fariña*** were arrested this spring in connection with the investigation.

Other members of the Kirchner and Fernández administrations are also under investigation, including former Minister of Planning and Public Investment ***Julio de Vido*** and ***José Francisco López***, the former Secretary of Public Works. On June 14, 2016, López was arrested while attempting to bury more than $8 million in various currencies and several luxury watches in the garden of a monastery outside Buenos Aires.

The Bahamas

In another sign of the increasingly global nature of anti-corruption enforcement and the far-reaching effects that resolutions in one jurisdiction can have on another, ***Freddie Ramsey***, a former member of the board of the Bahamas Electricity Company ("BEC"), was convicted of fourteen bribery-related counts in a Bahamian court in May for a scheme involving Alstom S.A. that was identified by DOJ during its investigation of the French power company.

As first laid out in Alstom's December 2014 guilty plea, Alstom's subsidiary retained "Consultant 1," who was a close personal friend of "Official 8," a board member of BEC, to pay more than $300,000 to the official in exchange for his assistance in winning upcoming tenders. The revelations sparked a separate investigation in the Bahamas. The Office of the Attorney General of the Bahamas made two Mutual Legal Assistance Treaty requests to DOJ in January and April 2015 and received a tranche of documents. In October 2015, charges were brought against Ramsey for his role as "Official 8" in the scheme laid out in the plea agreement. During Ramsey's trial, the Crown Prosecutors used documents obtained from DOJ as well as testimony from Mark Smith – revealed to be "Consultant 1" – to demonstrate how Alstom bribed Ramsey to obtain inside information related to Phase Three of BEC's New Providence Energy Project, and to use his influence to have the Prime Minister and Deputy Prime Minister reconsider the initial decision to award the contract to a Korean firm.

Brazil

Brazil's recent anti-corruption efforts have captivated a global audience. Operation Car Wash, the investigation focusing on an alleged kickback and bribery scheme involving contracts with state oil company Petróleo Brasileiro S.A. – Petrobras ("Petrobras") and other state-owned companies has moved into its third year and shows no signs of slowing down. To date, more than 100 defendants have been convicted and sentenced to a total of more than 1,100 years in prison.

Since January 2016, Brazilian authorities have carried out ten new phases of Operation Car Wash, focusing largely on their investigations into politicians and political parties, and have obtained a number of high-profile convictions. In March, ***Marcelo Odebrecht***,

the former CEO of Brazilian conglomerate Odebrecht, was sentenced to nineteen years in prison for corruption, money laundering, and criminal association. In May, ***José Dirceu***, who served as Chief of Staff to former President Luiz Inácio Lula da Silva, was convicted and sentenced to twenty-three years in prison – the longest sentence to date resulting from Operation Car Wash. Also in May, ***Eduardo Cunha***, formerly third in the line of presidential succession, was suspended from his position as president of Brazil's lower house. Cunha, who faces charges of money laundering and tax evasion as a result of his alleged receipt of bribes related to Operation Car Wash, was removed from his post due to concerns that he was using his position to obstruct the investigation.

Brazilian authorities have relied heavily on plea bargain testimony from more than fifty individuals, including recent testimony from Senator Delcídio do Amaral, whose collaboration statement implicated thirty-seven politicians. Most notably, Amaral alleged that President Dilma Rousseff – who is currently suspended from office pending an impeachment trial in the Senate – and former President da Silva both were aware of the corruption scheme while it was ongoing and attempted to obstruct Operation Car Wash. In May 2016, Brazil's Prosecutor General presented an indictment accusing da Silva of obstructing the investigation by buying the silence of former Petrobras executive Nestor Cerveró, who has himself signed a plea bargain agreement with Brazilian authorities.

Operation Car Wash has had profound effects in Brazil's political arena, contributing to the ongoing impeachment proceedings against President Rousseff. Although Acting President Michel Temer has pledged to support the investigation, his interim government has also been linked to the scandal. Three of Temer's ministers, Fabiano Silveira, Romero Jucá, and Henrique Eduardo Alves, resigned after audio recordings linking them to Operation Car Wash were released. Notably, Silveira – who was tied to efforts to block the investigation – had recently been named the Minister of Transparency, Supervision, and Control, a ministry that Temer created on May 12, 2016, to replace the Comptroller-General's Office ("CGU"), Brazil's federal anti-corruption regulator that had been responsible for enforcing the Clean Company Act. At this time, it is unclear whether the new ministry's powers will differ from those of the CGU.

Guatemala

Guatemala has continued to investigate and prosecute alleged corruption within the administration of former ***President Otto Pérez Molina***, with the help of the International Commission Against Impunity in Guatemala (known by its Spanish acronym, "CICIG"), an independent U.N.-supported body of international prosecutors and investigators. In April 2016, President Jimmy Morales asked the United Nations to extend the CICIG's mandate an additional two years, which would allow it to continue assisting Guatemalan authorities until September 2019.

Pérez Molina and his former vice president, ***Roxana Baldetti***, have been jailed pending trial since last fall due to their alleged participation in a tax-evasion and bribery scheme known as "La Linea" ("The Line"), in which importers were offered reduced tariffs in exchange for illicit payments. The scheme is named after the "hotline" importers could call to contact the government officials with whom they colluded. At least sixty individuals, including employees of the Superintendence of Tax Administration, are being prosecuted as a result of their involvement. In April 2016, the Guatemalan Public Prosecutor's Office reiterated its intent to try Pérez Molina, noting that a member of the

La Linea group had provided testimony about the former president and vice president's roles in the scandal.

Since Pérez Molina and Baldetti's arrests, the Guatemalan authorities and CICIG have uncovered additional evidence of corruption in the country, most notably concerning an illegal campaign finance network begun by Pérez Molina in 2007 after he lost his first presidential race. In early June, the Guatemalan Attorney General's Office ordered more than fifty individuals arrested in connection with this scandal. According to the authorities' announcement, from 2008 to 2011, Pérez Molina and Baldetti allegedly used a network of companies to launder illicit campaign donations from businesses and individuals, and then rewarded those donors with favors and public contracts after the two assumed office in 2012. To date, authorities have identified at least 450 government contracts and tens of millions in illicit donations linked to the scheme.

The former president and vice president also have been implicated in other corrupt acts, such as receiving gifts – including beach houses, a helicopter, and a boat – allegedly purchased by several former government ministers with public funds. The Guatemalan Attorney General's Office in mid-June ordered the arrest of five ex-ministers from Pérez Molina's administration in connection with the scheme. Further, in April, Pérez Molina and Baldetti were accused of accepting millions of dollars in bribes in connection with a contract to build and manage a new terminal at Guatemala's Quetzal Port. Guatemalan prosecutors contend that the former president and vice president each received approximately $4.2 million from Spanish company ***Terminal de Contenedores Quetzal***, which allegedly agreed to pay up to $30 million in bribes to secure a twenty-five-year operating concession worth $255 million.

Honduras

As first discussed in our 2015 Year-End FCPA Update, the fall of Pérez Molina and Baldetti in Guatemala have bolstered anti-corruption efforts in neighboring Honduras. Buoyed by the example set by the CICIG in Guatemala, the government of Honduras and the Organization of American States ("OAS") formally agreed to create the Mission to Support the Fight against Corruption and Impunity in Honduras ("MACCIH") in January 2016. The MACCIH has a four-year mandate and comprises judges, prosecutors, and experts from around the world. It is tasked with providing technical support to local investigators and prosecutors, overseeing their work, and working to strengthen Honduras's governmental institutions.

The MACCIH has been criticized for not being sufficiently independent from Honduran institutions that are seen as being plagued by corruption. Nevertheless, the MACCIH has taken some positive steps. In May, it worked with the newly formed Special Police Purification Commission (*Comisión Especial de Depuración Policial*) to urge the agency responsible for managing state resources (*Tribunal Superior de Cuentas*) to publish audits undertaken of twenty-seven police officers suspected of illicitly enriching themselves. And MACCIH is now working with the Supreme Electoral Tribunal (*Tribunal Supremo Electoral*) on a proposal to reform Honduras's campaign finance system.

Mexico

There have been a number of changes to the Mexican anti-corruption legal landscape in the past six months. Most significantly, in April 2016 the Mexican Chamber of Deputies

approved a reform package that amends ten separate criminal laws, including the Federal Code of Penal Procedures to establish direct criminal liability for corporations for various crimes, including bribery. Further, following several other changes to the laws governing public access to information, the Federal Law of Transparency and Public Access to Information went into effect in May, abrogating an older 2002 transparency law. The new law requires several federal institutions and state-owned entities, including the National Commission on Hydrocarbons, which has overseen the partial privatization of Mexico's energy market, to disclose numerous different types of information regarding their operations, including procurement.

Nevertheless, other anti-corruption efforts have stalled. For example, as discussed in our 2015 Mid-Year FCPA Update, Mexico passed sweeping changes to its federal Constitution that sought to create a new framework for prosecuting corruption. The changes included the establishment of a new, centralized National Anti-Corruption System. Though the amendments were approved by both legislative bodies, the President, and a majority of Mexican states, the Mexican legislature failed to pass the necessary implementing legislation prior to the May 28, 2016 deadline. One of the more significant pieces of implementing legislation being advocated by civil society organizations and under debate in the legislature was the so-called "3 out of 3" law, which would require public officials to disclose their assets, tax filings, and potential conflicts of interest. During a special session held from June 13 through June 17, 2016, the Mexican legislature passed the secondary laws, including, most controversially, an amended version of the "3 out of 3" law. The revised "3 out of 3" measure – which required entities receiving government funding to disclose their assets, while also making certain disclosures by politicians voluntary – met with widespread opposition from Mexico's business community and civil society groups. On June 23, 2016, in a surprise move, President Enrique Peña Nieto vetoed the package of secondary anti-corruption legislation, sending it back to the Senate for further consideration.

Asia

China

The first half of 2016 saw several noteworthy developments in China anti-corruption laws and regulations.

In February, China released for public review and comment a set of draft amendments to the Anti-Unfair Competition Law, the country's primary civil statute regulating commercial bribery. The proposed amendments would clarify that economic benefits not accurately reflected in contracts and accounting records are deemed commercial bribes, explicitly prohibit commercial bribery through third parties, prohibit promising to offer – and agreeing to accept – commercial bribes even where bribes are not actually given or accepted, set penalties for commercial bribery as 10-30 percent of illegal revenue, and add penalties for obstructing investigations.

In March, the Supreme People's Procuratorate issued Whistleblower Protection and Reward Regulations. The regulations provide for confidential treatment of whistleblowers, criminalize retaliation against whistleblowers and their close relatives, offer law enforcement protection to whistleblowers and their close relatives, and establish rewards of ¥200,000 RMB or more, depending on the significance of the whistleblower's contributions to a prosecution. While the Regulations' provisions cover

whistleblowing generally, they may have significant impact in bribery- and graft-related reporting, where whistleblowing is on the rise.

In April, China's Supreme People's Court and Supreme People's Procuratorate issued their much-anticipated joint interpretation regarding the handling of corruption and bribery cases under the recently amended Criminal Law. The interpretations expand the definition of bribes to include intangible benefits with monetary value, clarify the scope of bribes to include payments made *after* benefits have been received, raise the monetary threshold for most official bribery and corruption prosecutions to ¥30,000 RMB, and set the monetary thresholds for commercial bribery prosecutions to double those established for official bribery.

And, perhaps spurred by the Panama Papers' revelations about several politically powerful families' ties to off-shore companies, the Chinese Communist Party leadership expanded a pilot program aimed at curbing corruption through officials' relatives. The program, first rolled out in Shanghai in May 2015, bans senior officials' spouses from holding top positions in private companies or senior appointed positions in foreign-invested enterprises, and restricts officials' spouses, children, and children's spouses from establishing or investing in businesses or offshore companies. Officials are required to report the business dealings of their spouses, children, and children's spouses, and may be disciplined for false reporting. In April 2016, the program was expanded to Guangdong, Xinjiang, Beijing and Chongqing.

On the enforcement front, President Xi Jinping's anti-corruption campaign garnered renewed public attention with the indictment of former presidential aide ***Ling Jihua*** and former top general ***Guo Boxiong***, two of the highest-ranking officials ensnared in the corruption sweep. Ling, previously a top adviser to former President Hu Jingtao, was charged with graft, illegally obtaining state secrets, and abuse of power. Guo Boxiong, the former vice chairman of China's Central Military Commission, allegedly took $12.3 million in bribes to facilitate others' promotion and relocation. Investigations into family members and associates of both Ling and Guo are ongoing.

India

The first half of 2016 saw significant developments in the ***AgustaWestland*** bribery scandal. As covered in our 2014 Year-End FCPA Update, in 2014 Italian courts acquitted former ***Finmeccanica S.p.a.*** CEO ***Giuseppe Orsi*** and former AgustaWestland CEO ***Bruno Spagnolini*** of corruption charges related to a $712 million deal to sell twelve helicopters to India in 2010, although both were sentenced to two years in prison for false bookkeeping in connection with the deal. On April 8, 2016, the Milan Court of Appeals overturned the lower courts verdict and sentence as to Orsi, and sentenced him to four years in prison. The reversal was followed by a request from India's Central Bureau of Investigation, which continues to conduct its own investigation into the allegations, for a copy of the judgment and a request to the United Kingdom to extradite ***Christian Michel James***, a third-party intermediary thought to be involved in the scandal.

India's Central Vigilance Commission recently requested permission to prosecute 149 employees of both private and public-sector banks on corruption charges. The Commission likely was emboldened by a recent Supreme Court of India case, Central Bureau of Investigation v. Ramesh Gelli and Others, which held that officers of private

banks in India are "public servants" for the purposes of the Prevention of Corruption Act. These actions come as a number of Indian banks – both private and public – have recently been scrutinized as the amount of non-performing assets has dramatically increased in the last few years. However, some concern remains regarding the slow pace of action against corrupt officials in various parts of the country.

India also joined with forty other nations in signing a Europe-led initiative against tax evasion and corruption. The UK Treasury announced on June 8, 2016, that the signatories committed to "automatically exchange information about beneficial ownership," with the next stage to be "the development of a global standard for this exchange." The signatories are primarily European countries, but India joins Afghanistan, Mexico, Nigeria, and the UAE in the attempt to create greater global cohesion.

Korea

The latest in South Korea's string of high-profile corruption scandals has ensnared ***Lotte Group***, one of the country's largest conglomerates. Korean and international media have recently reported that several Lotte Group executives, including members of the company's controlling Shin family, are under investigation for alleged corrupt conduct. Shortly after the news broke, Lotte Group announced that it was postponing the IPO of its hotel unit. At $4.9 billion, the IPO was anticipated to be Korea's largest ever.

On the legislative front, as reported in our 2015 Year-End FCPA Update, South Korea's new Improper Solicitation and Graft Act is due to take effect this September. The law, which contains restrictions on lobbying and gift-giving, has been criticized as too harsh by some commentators, who worry that the cap on receipt of meals or gifts – $25 – will erode traditional Korean social norms and stem a useful flow of cash for restaurant owners and retailers. The National Agricultural Cooperation Federation, for example, released a statement in early May complaining that the price cap will harm sales of traditional gifts such as fruit, dried beef and dried fish sets. President Geun-Hye Park has agreed to review the price limits contained within the proposed act.

Middle East and Africa

Algeria

In February 2016, an Algerian court sentenced several people to prison and fined two companies following trial on an array of corruption-related charges involving contracts with Algerian state-owned hydrocarbon firm ***Sonatrach***. The trial followed an investigation initiated by Algerian authorities several years ago into the award of Sonatrach contracts.

Among those convicted were former Sonatrach vice president ***Belkacem Boumediene*** (sentenced to five years in prison), former Sonatrach CEO ***Mohamed Meziane*** (five years' probation and a fine of approximately $18,000), and Meziane's sons, ***Bachir Fawzi Meziane*** and ***Mohamed Reda Meziane*** (five and six years in prison, respectively). The former CEO of the Algerian bank Credit Populaire d'Algerie, ***Meghaoui Hashemi***, received a five-year sentence for money laundering, while his son, ***Yazid Meghaoui***, received a six-year sentence. ***Mohamed Reda al-Ismail***, head of Algerian-German firm ***Contel Funkwerk***, was sentenced to six years in prison. The

court also fined Contel Funkwerk and ***Saipem Contracting Algeria*** each approximately $38,000.

Israel

We reported in our 2015 Mid-Year FCPA Update that the Israel Securities Authority was reportedly seeking to question current and former ***Siemens AG*** officials in connection with a corruption investigation at state-owned Israel Electric Corporation ("IEC"). The Israel Securities Authority alleged that Siemens and its Israeli subsidiary bribed IEC executives several years ago to win the Israeli company's tender for a power station turbine project. In May 2016, Israel's Justice Ministry announced that Siemens would pay approximately $43 million to resolve the investigation. Siemens also reportedly will appoint an external monitor for its operations in Israel. Six former IEC officials, who originally were detained by Israeli authorities in December 2014 on suspicion of their roles in alleged corruption offenses, have been indicted by the Tel Aviv District Attorney.

South Africa

In March 2016, South Africa's high court ruled that President ***Jacob Zuma*** contravened the country's constitution in connection with his use of public funds to pay for millions of dollars of home improvements, which reportedly included a swimming pool, helipad, and chicken coop. Mr. Zuma has said that he will abide by the court ruling and pay back the funds.

The embattled president was dealt another blow in June when South Africa's high court rejected his appeal from an April order that the National Prosecuting Authority should reinstitute more than 780 corruption-related charges that were dropped in 2009 shortly before he took office.

CONCLUSION

As has become our semi-annual tradition, over the following two weeks Gibson Dunn will be publishing a series of enforcement updates for the benefit of our clients and friends as follows:

- Wednesday, July 6 – 2016 Mid-Year Update on Corporate NPAs and DPAs;
- Thursday, July 7 – 2016 Mid-Year False Claims Act Update;
- Monday, July 11 – 2016 Mid-Year Criminal Antitrust and Competition Law Update;
- Tuesday, July 12 – 2016 Mid-Year Securities Enforcement Update;
- Wednesday, July 13 – 2016 Mid-Year Securities Litigation Update;
- Monday, July 18 – 2016 Mid-Year FDA and Health Care Compliance and Enforcement Update – Drugs and Devices;
- Tuesday, July 19 – 2016 Mid-Year Government Contracts Litigation Update;

- Wednesday, July 20 – 2016 Mid-Year M&A and Activism Update;
- Thursday, July 21 – 2016 Mid-Year Health Care Compliance and Enforcement Update – Providers; and
- Friday, July 22 – 2016 Mid-Year E-Discovery Update.

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2016 MID-YEAR SECURITIES LITIGATION UPDATE

Posted by Monica K. Loseman, Gibson, Dunn & Crutcher LLP*

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The first half of 2016 yielded several important developments in securities litigation, including federal appellate decisions applying Omnicare and Halliburton II, as well as Delaware court opinions regarding the application of collateral estoppel to parallel cases previously dismissed based on demand futility, a price-increase for dissenting stockholders in a management-led buyout, and yet further developments on disclosure-only settlements. This post highlights what you most need to know in securities litigation developments and trends for the first half of 2016:

- We highlight the Second Circuit's opinion in Tongue v. Sanofi, which offers the most extensive appellate analysis of Omnicare to date.

- In a similar vein, we analyze post-Halliburton II opinions, including the Eighth Circuit's decertification of a class of Best Buy stockholders. We also highlight significant cases pending in the Second Circuit and notable district court opinions.

- A recent Sixth Circuit decision has deepened the circuit split over whether the American Pipe class action tolling doctrine of[sic] applies to statutes of repose for claims under the Securities Act.

- A pending petition for *certiorari* asks the U.S. Supreme Court to determine whether a privately held corporation trading in its own stock has an Exchange Act duty to disclose all material information to potential sellers or else refrain from trading.

- We also highlight important developments in Delaware courts, including the Chancery Court twice applying collateral estoppel to bar relitigation of parallel cases dismissed based on demand futility.

- The Chancery Court also awarded a 28 percent price increase to stockholders who dissented from the 2013 management-led buyout of Dell, Inc.

- The Delaware Supreme Court upheld the Zales-Signet merger, confirming in the process that a fully informed, uncoerced[sic] vote of disinterested stockholders will generally serve to shield directors and advisors from post-closing damages claims.

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* Editor's Note: Monica K. Loseman is a partner at Gibson, Dunn & Crutcher LLP. This post is based on a Gibson Dunn publication by Ms. Loseman, Jonathan C. Dickey, and Mark A. Perry and is part of the Delaware law series; links to other posts in the series are available at https://corpgov.law.harvard.edu/the-delaware-law-series/.

- The Chancery Court also approved a disclosure-only settlement, demonstrating that the door to such settlements is not entirely closed post-Trulia.

We highlight these and other notable developments in securities litigation in our post below.

FILING AND SETTLEMENT TRENDS

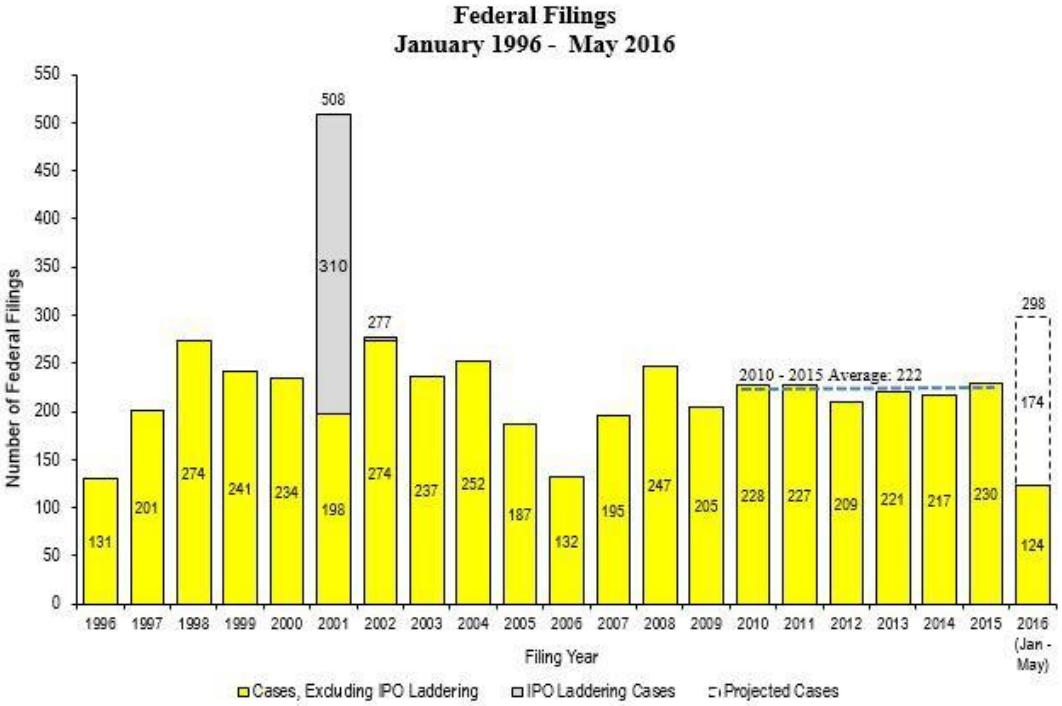
Through the first five months of 2016, new securities class actions are on pace to exceed the annual filing rates of every year in the last two decades (except for 2001, when several hundred so-called "IPO laddering cases" were filed). According to a newly-released study by NERA Economic Consulting ("NERA"), 298 class actions are projected to be filed in 2016, compared to the five year average of 222 cases. The industry sectors most frequently sued in 2016 have been healthcare (21 percent of all cases filed), finance (19 percent), and tech (16 percent). Of these three sectors, cases filed against tech companies actually dropped significantly year-over-year, from 23 percent of cases down to 16 percent. NERA also projects that the number of "merger objection" cases filed in federal court in 2016 will be significantly greater than 2015, and will represent approximately 18 percent of all securities cases filed in the federal courts in 2016.

With respect to settlement trends, median settlements in the first half of 2016 are up slightly from 2015, while average settlement amounts also increased slightly. A wide range of cases, both big and small, comprised the population of settled cases: over 50 percent of settlements in the first half of 2016 were under $10 million, while roughly 20 percent were over $50 million. Most significantly, median settlement amounts as a percentage of investor losses continue to reflect a pattern that has persisted for decades. In the last fifteen years, median settlement amounts have never exceeded about 3 percent of total alleged investor losses, and the percentage has dropped each year for the last three years. In the first half of 2016, the percentage declined once again to 1.4 percent.

Filing Trends

Overall filing rates for the first half of 2016 are reflected in Figure 1 below (all charts courtesy of NERA). One hundred twenty-four cases have been filed so far this year, annualizing to 298 cases. This figure does not include the many class suits filed in state courts or the increasing number of state court derivative suits, including many such suits filed in the Delaware Court of Chancery. Those state court cases, however, represent a "force multiplier" of sorts in the dynamics of securities litigation in the United States today.

Figure 1:

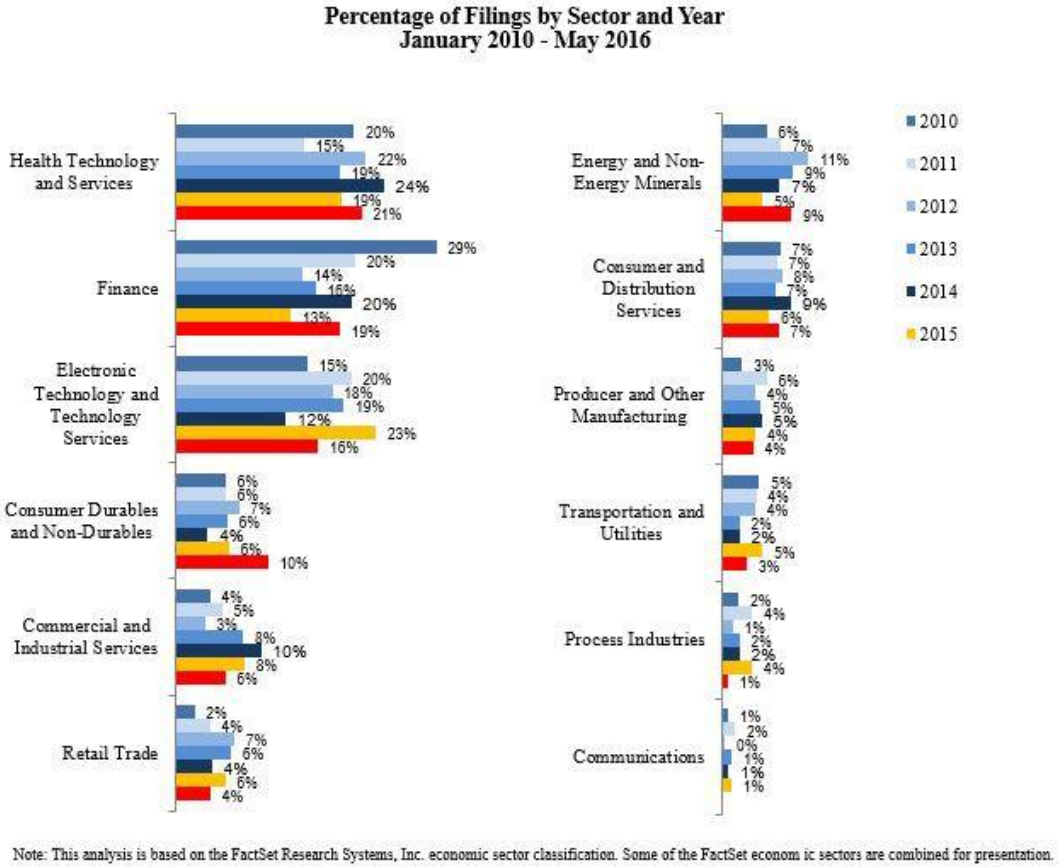


Mix of Cases Filed in First Half of 2016

Filings by Industry Sector

New case filings in the first half of 2016 reflect an increase in the percentage of cases filed against healthcare and finance companies, while the percentage of cases filed against tech companies declined. The biggest percentage increases in new case filings in the first half of 2016 were against companies in the consumer goods and energy sectors. *See Figure 2 below*.

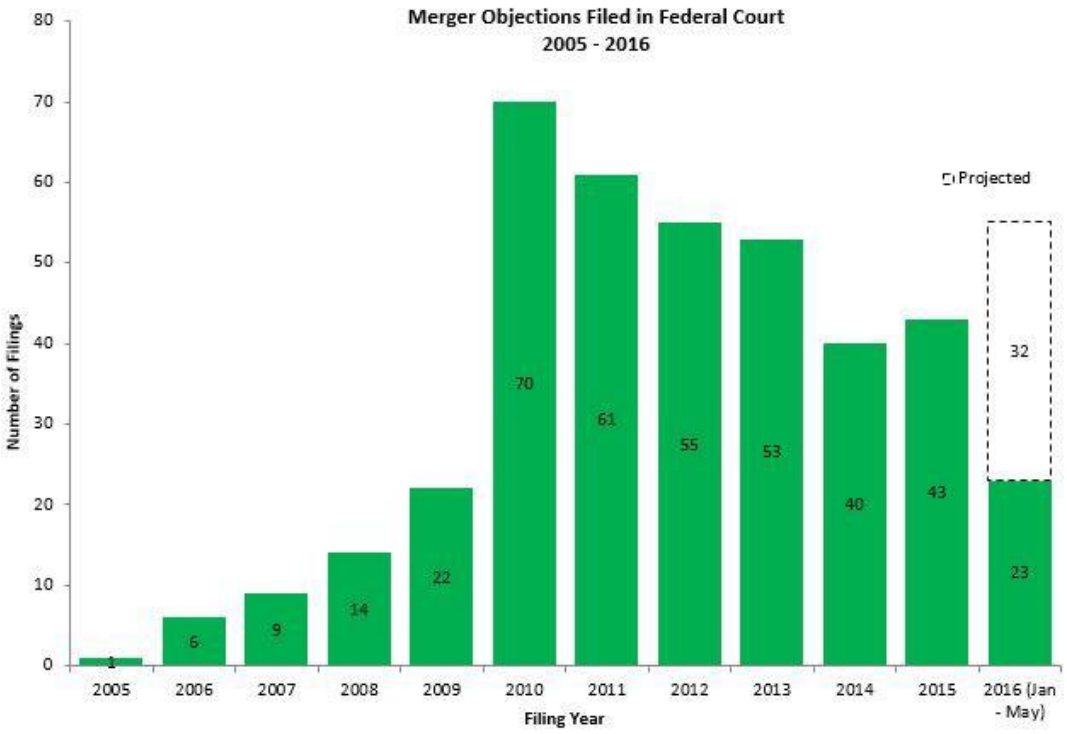
Figure 2:



Merger Cases

As shown in Figure 3 below, 23 "merger objection" cases were filed in federal court in the first half of 2016, which annualizes to 55 cases for the year. This would be a significant increase over 2015. Note, also, that this statistic only tracks cases filed in federal courts. The *real* action in M&A litigation is in state court, particular[sic] the Delaware Chancery Court. But as discussed below in our discussion of "Delaware/Derivative Litigation Developments," the Delaware Court of Chancery recently announced that the much-abused practice of filing an M&A case followed shortly by an agreement on "disclosure only" settlement is just about at an end, and with it, we anticipate a decline in the total number of M&A suits filed in the Chancery Court.

Figure 3:

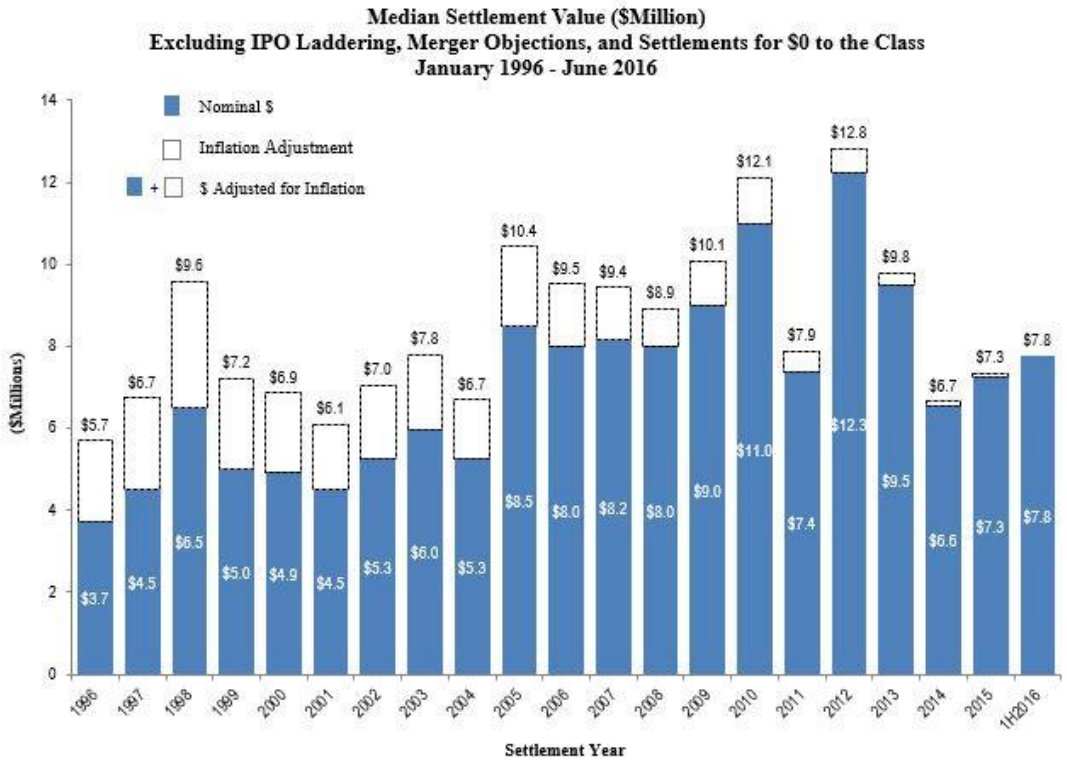


Note: Includes cases alleging either a violation of federal securities laws or a breach of fiduciary duty, as long as they were filed in federal court.

Settlement Trends

As Figure 4 shows, median settlements were $7.8 million in the first half of 2016, slightly higher than full year 2015, but still much lower than median amounts in nearly the last dozen years. One can speculate about what may account for the up-and-down trend in median settlements in the last few years. In any given year, of course, the statistics can mask a number of important factors that contribute to settlement value, such as (i) the amount of D&O insurance; (ii) the presence of parallel proceedings, including government investigations and enforcement actions; (iii) the nature of the events that triggered the suit, such as the announcement of a major restatement; (iv) the range of provable damages in the case; and (v) whether the suit is brought under Section 10(b) of the Exchange Act or Section 11 of the Securities Act. Median settlement statistics also can be influenced by the timing of one or more large settlements, any one of which can skew the numbers. In the first half of 2016, for example, the number of settlements above $100 million increased from 13 percent to 17 percent of all settlements. At the same time, the number of settlements below $10 million remained flat.

Figure 4:



Perhaps all that can be said of overall settlement trends is that plaintiffs' lawyers continue to thrive. According to NERA, total attorneys' fee awards in 2015 were in excess of $1 billion, representing a big increase from 2014's total of $672 million. These astronomical amounts have become the "new normal," as total fees over the last decade have ranged from a low of $671 million to a high of $1.7 billion, with the amounts in seven out of ten years exceeding $1 billion.

OMNICARE: THE SECOND CIRCUIT WEIGHS IN

As we described in our 2015 Mid-Year and Year-End Securities Litigation Updates, the Supreme Court's landmark decision in Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund, 135 S.Ct. 1318 (2015), has had a significant impact on cases brought under the federal securities laws. The effects were felt first in the district courts, and now appellate courts have begun to join in. We focus below on Tongue v. Sanofi, 816 F.3d 199 (2d Cir. 2016), the Second Circuit's first published opinion interpreting Omnicare and the most extensive appellate analysis of Omnicare to date.

In Omnicare, the Supreme Court resolved a circuit split regarding the scope of liability for false statements of opinion under Section 11 of the Securities Act of 1933. Section 11 imposes liability where a registration statement "[1] contained an untrue statement of a material fact or [2] omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. §77k(a). The Court decided in Omnicare that "a sincere statement of pure opinion is not an untrue statement of material fact, regardless of whether an investor can ultimately prove the belief wrong."

135 S.Ct. at 1327 (quotation omitted). The Court also held that an omission makes an opinion statement actionable where the omitted facts "conflict with what a reasonable investor would take away from the opinion itself." *Id.* at 1329. In other words, an opinion statement becomes misleading "if the real facts are otherwise, but not provided." *Id.* at 1328.

District courts have wrestled with Omnicare's holdings. Despite predictions that Omnicare might make it easier for plaintiffs to bring Section 11 claims against issuers, the early decisions have been mixed. For example, in Federal Housing Finance Agency v. Nomura Holding America, Inc., 104 F.Supp.3d 441 (S.D.N.Y. 2015), the court found that an alleged omission was actionable because a defendant's statement about its belief "implied that defendants knew facts sufficient to justify forming the opinion [it] expressed" but the record contained "evidence that [defendant] lacked the basis for making those statements that a reasonable investor would expect." *Id.* at 555-56 (quotations omitted). The FHFA decision is currently under appeal to the Second Circuit. Plaintiffs did not fare as well in Medina v. Tremor Video, Inc., No. 13-cv-8364, 2015 WL 3540809 (S.D.N.Y. Jun. 5, 2015). In this case, the court found that "[d]efendants' registration statement contained hedges, disclaimers, and qualifications addressing the risks associated with each statement of opinion used, specifically cautioning investors." *Id.* at *2 (quotation omitted). Accordingly, there was no actionable misrepresentation. The Second Circuit agreed on February 8, 2016, in a non-precedential summary order, holding that the complaint did not adequately allege that defendants knew of additional material that should have been, but was not, disclosed. Medina v. Tremor Video, Inc., No. 15- 2178-CV, 2016 WL 482160, at *2 (2d Cir. Feb. 8, 2016).[1]

On March 4, 2016, the Second Circuit issued its opinion in Tongue v. Sanofi, its first published decision interpreting Omnicare. The defendant, a global pharmaceuticals company, had allegedly violated federal and state securities laws by failing to disclose material information about its drug Lemtrada, which is used to treat multiple sclerosis. Specifically, the plaintiffs alleged that Sanofi had made multiple public statements about the high likelihood that Lemtrada would be approved by the FDA and the short timeline for the expected approval. Sanofi allegedly did not disclose that the FDA stated on multiple occasions that it was concerned about Sanofi's use of so-called "single-blind" drug trials for Lemtrada instead of more widely accepted "double-blind" trials. Sanofi did not obtain FDA approval for Lemtrada on the expected timeline, but the drug was ultimately approved a short time later.

In the district court, Sanofi and the other defendants moved to dismiss on the grounds that the alleged misrepresentations were statements of opinion, and there was no showing that defendants did not genuinely believe those opinions or that the statements were objectively false. Plaintiffs argued in response that Sanofi's disclosures omitted facts about the FDA's feedback on "single-blind" trials and that feedback was necessary to make Sanofi's optimistic statements about FDA approval not misleading. The district

[1] Just two months later, on April 8, 2016, the Second Circuit addressed Omnicare in another summary order, but this time in the context of a claim under Section 18 of the Exchange Act. Special Situations Fund III QP, L.P. v. Deloitte Touche Tohmatsu CPA, Ltd., No. 15-1813-CV, 2016 WL 1392280 (2d Cir. Apr. 8, 2016). The appellate court upheld the dismissal of plaintiffs' Section 18 claims on the grounds that the complaint failed to adequately allege facts supporting the claims of misrepresentations under Omnicare.

court agreed with defendants, dismissed the federal claims, and refused to exercise discretionary jurisdiction over the state claims.

The Second Circuit affirmed the district court's decision, agreeing with both its "reasoning and holding." Sanofi, 816 F.3d at 203. However, because the district court had decided the case before Omnicare was issued, the Second Circuit took the opportunity to engage in a lengthy analysis of the Supreme Court's decision.

The Second Circuit held in Sanofi that the principal effect of Omnicare was to modify Fait v. Regions Financial Corp., 655 F.3d 105 (2d Cir. 2011), which had held that an opinion was actionable only if it was both "objectively false *and* disbelieved by the defendant at the time it was expressed." Sanofi, 816 F.3d at 209-10 (emphasis added). In Sanofi, the Second Circuit ruled that under Omnicare, only one of these two predicates – *i.e.*, "the speaker did not hold the belief she professed" or "the supporting fact she supplied [for the opinion] w[as] untrue" – was required. *Id.* (quotations and citations omitted).

Sanofi may indicate that the Second Circuit is taking a narrow view of what factual statements and omissions will be actionable under Omnicare. Although the FDA had warned Sanofi that approval of Lemtrada would be difficult without the use of double-blind trials, Sanofi did not disclose these warnings. It publicly opined that it was confident in the FDA's approval of Lemtrada and that it was 90 percent probable that Lemtrada would be approved on the expected timeline. The Second Circuit found that Sanofi's failure to disclose the warnings was immaterial even in the context of Sanofi's "exceptional optimism." 816 F.3d at 211. In doing so, the court of appeals placed great weight on the principle that "an issuer is not liable [for a statement of opinion] merely because it 'knows, but fails to disclose some fact cutting the other way.'" *Id.* at 214 (*quoting* Omnicare, 135 S.Ct. at 1329). The FDA warnings here were simply facts that "would have potentially undermined Defendants' optimistic projections." *Id.* at 212. "Omnicare does not impose liability merely because an issuer failed to disclose information that ran counter to an opinion expressed in the registration statement." *Id.* at 213.

Significantly, the Second Circuit also relied on the sophistication of securities investors in denying the class plaintiffs' claims. According to the Circuit, the FDA's partiality towards double-blind trials was well known, and "[s]ophisticated investors, aware of the FDA's strong preference for double-blind trials, cannot claim surprise when it is revealed that the FDA meant what it said." *Id.* at 212-13. The plaintiffs were also charged with the knowledge that Sanofi was involved in a "continuous dialogue" with the FDA concerning Lemtrada, which would necessarily include "the sufficiency of various aspects of the clinical trials," and that Sanofi's projections "[we]re synthesized from a wide variety of information," including this dialogue. *Id.* at 211-12.

Other circuits will weigh in on Omnicare during the coming months, and we will continue to monitor their progress. In particular, we expect that future decisions will address whether to extend Omnicare's holdings to other provisions of the Exchange and Securities Acts, continuing a trend from the Tenth Circuit's decision in Nakkhumpun v. Taylor, 782 F.3d 1142 (10th Cir. 2015), which applied Omnicare to Section 10(b). At this point, however, Sanofi represents the most extensive explication of Omnicare from any court of appeals.

STANDARD FOR ESTABLISHING PRICE IMPACT AFTER HALLIBURTON II

In the two years since the Supreme Court held that defendants could rebut the presumption of reliance established in Basic v. Levinson (the "Basic presumption") at the class certification stage in Halliburton Co. v. Erica P. John Fund, Inc. ("Halliburton II"), courts have grappled with the implications of that decision. Recently, we have seen increased focus on three unresolved questions. First, what evidence is sufficient to rebut the Basic presumption? Second, beyond expert evidence that a price movement was not statistically significant, what evidence is appropriate for consideration at the class certification stage? And finally, when defendants present evidence rebutting the Basic presumption, does the burden of persuasion then shift to the plaintiffs to show that the alleged misrepresentations did, in fact, impact the stock price? In the past six months, district court decisions generally have continued to favor certification, but cases are beginning to reach the appellate courts, and a decision by the Eighth Circuit to decertify a class of Best Buy stockholders sets a different tone.

Eighth Circuit Reverses Class Certification in Best Buy Case

In April, the Eighth Circuit addressed whether a defendant had produced evidence sufficient to rebut the Basic presumption of reliance. As we discussed in our April 15, 2016 client alert, the Eighth Circuit reversed class certification in IBEW Local 98 Pension Fund v. Best Buy Co., Inc., holding that the district court "misapplied the price analysis mandated by Halliburton II." 818 F.3d 775, 777 (8th Cir. 2016). In Best Buy, plaintiffs moved to certify a class based on two purportedly misleading statements made during a post-market-opening conference call, which the parties agreed were "virtually the same" as non-actionable pre-market-opening statements. *Id.* at 778, 782. The district court certified the class, despite plaintiffs' expert's opinion that the conference call statements caused no price movement on the day they were made beyond that already caused by the earlier, dismissed statements. *Id.* at 782. In ruling that the district court had abused its discretion in certifying the class, a majority of the Eighth Circuit panel concluded that Best Buy had presented "strong evidence" – the opinion of plaintiffs' own expert – that the conference call statements' lack of impact on the price of Best Buy stock "severed any link between the alleged conference call misrepresentations and the stock price at which plaintiffs purchased." *Id.* at 782-83. Because the plaintiffs did not present any contrary evidence, they failed to satisfy the predominance requirement of Fed. R. Civ. P. 23(b)(3). *Id.* at 783.

Best Buy has several major implications for securities fraud class actions, particularly those based on the "price maintenance" theory – specifically, that a misrepresentation is actionable if it prevents the price of the stock from dropping until a corrective disclosure. Most significantly, the Eighth Circuit reversed certification *despite* evidence that Best Buy's stock price had dropped after a corrective disclosure three months after the conference call, noting that the price maintenance theory alone was insufficient to refute "defendants' overwhelming evidence of no price impact." *Id.* Further, the Eighth Circuit cited Federal Rule of Evidence 301 in discussing the parties' relative burdens. *See id.* Applying Rule 301 burden shifting to the Halliburton II analysis would allow defendants to place reliance at issue by producing evidence of a lack of price impact and, thus, shift the burden of persuasion back to plaintiffs. On June 1, 2016, the Eighth Circuit denied rehearing *en banc*.

Halliburton Remand Set for Argument

As we discussed in our 2015 Year-End Securities Litigation Update, the Fifth Circuit granted Halliburton leave to appeal the district court's class certification as to one of six alleged corrective disclosures. The merits have been fully briefed, and oral argument is currently set for the week of August 29.

The main issue before the Fifth Circuit is the propriety of the district court's decision (on remand from the Supreme Court) that "the issue of whether disclosures are corrective is not a proper inquiry at the certification stage," as the court would otherwise be required to conduct a premature inquiry into the merits of the action. Erica P. John Fund, Inc. v. Halliburton Co., 309 F.R.D. 251, 261-62 (N.D. Tex. 2015) (*citing* Halliburton II, 134 S.Ct. at 2416). Halliburton has argued that Halliburton II permits class certification only after full consideration of *all* price-impact evidence. And, where plaintiffs' only evidence that the alleged misstatements had a price impact is a subsequent price drop, the court must consider whether the price drop is associated with negative company news *that actually corrects the alleged misstatement.* Brief of Appellant at 27-28, Erica P. John Fund, Inc. v. Halliburton Co., No. 15-11096 (5th Cir. Feb. 8, 2016).

Even if the determination of whether a disclosure was corrective is highly relevant to the merits of the case, price impact is fundamental to evaluating the predominance requirement of Fed. R. Civ. P. 23(b)(3), and thus the corrective disclosure must be evaluated by the court at the certification stage. *Id.* at 36; *see also* Comcast Corp. v. Behrend, 133 S.Ct. 1426, 1432 (2013) (noting that the Court's precedents "requir[e] a determination that Rule 23 is satisfied, even when that requires inquiry into the merits of the claim"). Otherwise, as the plaintiffs' argument suggests, price impact could be shown by any price drop on a day when negative information was announced about a defendant so long as the announcement followed an alleged misstatement, regardless of any connection between the alleged misstatement and the subsequent announcement, leading to absurd results. Reply Brief of Appellant at 1, Erica P. John Fund, Inc. v. Halliburton Co., No. 15-11096 (5th Cir. Apr. 21, 2016).

Should Halliburton prevail, the Fifth Circuit will be the first to affirmatively hold that if an alleged disclosure is not corrective of an alleged misrepresentation, it cannot be evidence of price impact. Further, Halliburton has argued that on remand, FRE 301 and Basic require the plaintiffs to bear the burden of persuasion once the defendants have produced evidence demonstrating a lack of price impact. *See* Brief of Appellant at 52-60.

Second Circuit Arguments to Watch

Two notable appeals are pending in the Second Circuit. First, on January 26, 2016, the Second Circuit granted leave to appeal from a decision certifying a class in In re Goldman Sachs Group, Inc. Sec. Litig., 2015 WL 5613150. The defendants have asked the Second Circuit to review, among other things, whether the district court created a "virtually insurmountable legal standard" by ruling that to rebut the Basic presumption, defendants must "demonstrate a complete absence of price impact" with "conclusive evidence." Brief of Appellant at 24, Ark. Teachers Retirement Sys. v. Goldman Sachs, Inc. et al., No. 16-250 (2d Cir. Apr. 27, 2016). Further, the defendants also argue that the district court erred in refusing to consider "unrebutted evidence that (a) Goldman Sachs' stock price did not increase when the challenged statements were made, and (b) the information alleged by Plaintiffs to be corrective … was both already disclosed … and

caused no statistically significant price reaction on the earlier disclosure dates" simply because this evidence also bore on the ultimate determination of materiality. *Id.* at 25.

In addition, the Second Circuit recently granted leave to appeal certification of a class in Strougo v. Barclays PLC, 312 F.R.D. 307. In their motion for leave to appeal, the defendants argued that the district court improperly placed the burden on them to prove, by a preponderance of the evidence, that the price of Barclays' American Depositary Shares *could not have been impacted* by the alleged misstatements. Defs.' Pet. for Permission to Appeal Pursuant to Fed. R. Civ. P. 23(f) at 10-11, Strougo v. Barclays PLC, No. 16-450 (2d Cir. Feb. 16, 2016). The defendants further argued that the district court entirely failed to consider evidence that there was no statistically significant impact on the stock price at the time of the alleged misstatements, instead concluding that because plaintiffs had "asserted a tenable theory of price maintenance" by demonstrating a price drop on the date of a corrective disclosure, defendants' evidence had not "foreclose[d] plaintiffs' reliance on the price maintenance theory." *Id.* at 10-12. These two cases should prompt the Second Circuit to reach conclusions regarding the burden of proof and price maintenance evidence, either joining the Eighth Circuit or, potentially, creating a split in the circuits.

Notable District Court Opinions

District courts have continued to issue opinions applying Halliburton over the last six months, mostly favoring certification. Most arguments are similar to those that have begun percolating up to the appellate courts. For example, the U.S. District Court for the Middle District of Tennessee concluded that the defendants had failed to rebut the Basic presumption by only producing evidence of a lack of price impact at the time of the alleged misstatements. *See* Burges v. Bancorpsouth, Inc., No. 3-14-1564, 2016 WL 1701956, at *3 (M.D. Ten. Apr. 28, 2016). In their motion for leave to appeal to the Sixth Circuit, defendants argue that the court erred in that holding, and in failing to consider unrebutted evidence that the market showed no interest in the alleged misstatements, found in SEC filings but "*not* reviewed or commented on by analysts or other significant market participants." Defs.' Pet. for Permission to Appeal Pursuant to Fed. R. Civ. P. 23(f) at 17, Burges v. Bancorpsouth, Inc., No. 16-505 (6th Cir. May 12, 2016) (emphasis in original). The defendants in Burges further urge the Sixth Circuit to rule that FRE 301 requires the burden of persuasion to remain with the plaintiffs once evidence rebutting the Basic presumption is produced. *Id.* at 19. Likewise, the U.S. District Court for the Northern District of California rejected defendants' similar attempts to show a lack of price impact for the majority of alleged misstatements by only analyzing "front-end" price impact where there was no dispute that the stock price dropped on all of the alleged corrective disclosure dates. *See* Hatamian v. Advanced Micro Devices, Inc., No 14-cv-00226, 2016 WL 1042502 (N.D. Cal. Mar. 16, 2016). The court there declined to address the issue of whether FRE 301 applies. *Id.* at *7 n.5.

* * *

We will continue to monitor developments in all courts throughout the remainder of the year.

SIXTH CIRCUIT WEIGHS IN ON CIRCUIT SPLIT CONCERNING AMERICAN PIPE TOLLING QUESTION, FOLLOWS SECOND CIRCUIT OPINION IN INDYMAC

As we described in our 2014 Year-End Securities Litigation Update, the U.S. Supreme Court has left unresolved whether the class action tolling doctrine of American Pipe & Construction Co. v. Utah, 414 U.S. 538 (1974), applies to statutes of repose for claims under the Securities Act of 1933. Circuits have split over the question, with the Second Circuit holding that the filing of a class action does not toll the 1933 Act's statute of repose, rendering belated individual claims untimely. Police & Fire Ret. Sys. of City of Detroit v. IndyMac MBS, Inc., 721 F.3d 95, 106-09 (2d Cir. 2013). The Tenth Circuit, in contrast, concluded that American Pipe applies to the Securities Act statute of repose. Joseph v. Wiles, 223 F.3d 1155, 1166-68 (10th Cir. 2000).

Siding with the Second Circuit, the Sixth Circuit in May ruled that the tolling doctrine established by American Pipe does not apply to the three-year statute of repose governing claims under the Securities Act of 1933 or to the five-year statute of repose governing claims under the Securities Exchange Act of 1934. In Stein v. Regions Morgan Keegan Select High Income Fund, Inc., Nos. 15-5903, 15-905, 2016 WL 2909333 (6th Cir. May 19, 2016), plaintiffs alleged that defendants had violated Sections 11, 12(a)(2), and 15 of the Securities Act and Sections 10(b) and 20(a) of the Exchange Act by misrepresenting risks related to certain investment funds. The Sixth Circuit held that plaintiffs' claims were time-barred by the statutes of repose contained in the Securities Act and the Exchange Act. The court's holding hinged on the distinction between a statute of *limitations*, which creates a time limit for filing a civil claim that ordinarily commences when the claim accrues (usually when injured or when the plaintiff discovers the injury), and a statute of *repose*, which creates a time limit for filing a civil claim that ordinarily commences when the defendant commits its last culpable act or omission, and that functions as a substantive outer limit on the period within which the plaintiff may sue.

The Sixth Circuit's decision in Stein deepens the split among the federal courts of appeals. However, Stein is the first circuit court decision to consider the issue after the U.S. Supreme Court decision in CTS Corp. v. Waldburger, 134 S.Ct. 2175 (2014), which explored the distinction between statutes of limitations and statutes of repose in a different context. Although CTS concerned preemption of a state statute of repose and therefore at least arguably is not directly applicable to the question presented in Stein, the Supreme Court emphasized that statutes of repose "effect a legislative judgment that a defendant should 'be free from liability after the legislatively determined period of time'" and are "in essence an 'absolute bar' on a defendant's temporal liability." CTS, 134 S.Ct. at 2183 (alteration and citations omitted). The Sixth Circuit concluded that the CTS principle supports the view that statutes of repose affect substantive rights for purposes of the Rules Enabling Act, and therefore cannot be altered by a doctrine founded on a Federal Rule of Civil Procedure.

The Third Circuit is also poised to weigh in on the applicability of American Pipe tolling to statutes of repose. In North Sound Capital LLC v. Merck & Co., the District of New Jersey held that American Pipe tolling applied to the statute of repose for Exchange Act claims by a group of plaintiffs who were class members in a suit filed in 2008 but who then opted out in 2013. North Sound Capital LLC v. Merck & Co., Nos. 3:13-cv-7240 (FLW), 3:14-cv-7241 (FLW), 3:13-cv-242 (FLW), 3:14-cv-241 (FLW), 2015 WL 5055769,

at *11 (D.N.J. Aug. 26, 2015). The district court certified the issue for interlocutory appeal and briefing in the Third Circuit is now complete.

FEDERAL SECURITIES LAWS AND UNICORNS

"Unicorns" – private companies valued at or above $1 billion – are in the securities spotlight in 2016. On March 31, SEC Chair Mary Jo White focused her keynote address at the SEC-Rock Center Silicon Valley Initiative on the disclosure obligations of large private companies, citing the increasing number of unicorns and unicorn financings. Chair White cautioned such companies about the perils of disregarding investor interests, noting that "being a private company comes with serious obligations to investors and the markets. Whether the source of the obligation is the federal securities laws or the fiduciary duty that is owed to shareholders, the resulting candor and fair dealing should be fundamentally the same." Mary Jo White, Chair, Sec. & Exch. Comm'n, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (March 31, 2016), *available at* https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html (and discussed on the Forum here).

On the litigation front, the plaintiff in Fried v. Stiefel Labs., Inc. is now asking the U.S. Supreme Court to define and expand the scope of those legal and fiduciary obligations by determining whether a privately held corporation purchasing its own stock has an Exchange Act duty to disclose all material information to potential sellers or else refrain from trading with those sellers. Petition for Writ of *Certiorari*, Fried v. Stiefel Labs., Inc., 2016 WL 3136684 (2016) (No. 15-1458).

Plaintiff Richard Fried is a former CFO of Stiefel Laboratories, Inc. ("SLI") who sold his shares in the then-private company back to SLI in January 2009 for roughly $16,500 a share – shortly before GlaxoSmithKline LLC agreed to buy SLI for approximately $70,000 per share in April 2009. Fried sued SLI and its President, Charles Stiefel, for, among other things, securities fraud under Section 10(b) and Rule 10b-5 because SLI purchased Fried's stock without disclosing that the company was in negotiations for a potential sale.

At trial, Fried asked the court to incorporate into a pattern jury instruction for a Rule 10b-5(b) claim the statement "Defendants had a duty to disclose all material information to Mr. Fried." Fried v. Stiefel Labs., Inc., 814 F.3d 1288, 1292 (11th Cir. 2016). The U.S. District Court for the Southern District of Florida refused and the Eleventh Circuit affirmed, holding that Rule 10b-5(b) only prohibits omissions necessary to prevent previous affirmative representations from becoming misleading: "An insider who makes no affirmative misrepresentation but trades on nonpublic information may violate Rule 10b-5(a) or (c), but not rule 10b-5(b)." *Id.* at 1294-95.

On May 31, 2016, Fried petitioned the Supreme Court for review, asserting that the Eleventh Circuit decision created a circuit split. According to Fried, "the Eleventh Circuit's strict insistence that a claim resting on this relationship-based duty to disclose must proceed under subsection (a) or (c) of Rule 10b-5 and satisfy the elements of a classical insider trading claims … and cannot proceed as a typical omission-based securities fraud claim [under Rule 10b-5(b)], conflicts with the Second, Ninth, and Tenth Circuits' less formalistic approach to §10(b) and Rule 10b-5." Petition for Writ of *Certiorari*, Fried v. Stiefel, 2016 WL 3136684 at *3.

As noted in our previous updates, the Supreme Court has been actively taking up important securities laws issues in recent terms. Accordingly, and in light of the SEC's recent focus on large private companies and their transition to public ownership, there is an increased likelihood that the Court will take the opportunity to further define this important area of law. For unicorns such as Snapchat, Pinterest, and Intarcia Therapeutics, as well as the many private companies that aspire to be, this issue deserves particular attention.

DELAWARE/DERIVATIVE LITIGATION DEVELOPMENTS

In the past six months, the Delaware Court of Chancery and Delaware Supreme Court have had occasion to expand upon several seminal rulings, in the areas of claim preclusion for stockholder derivative actions, appraisal actions, challenges to mergers, and disclosure-only settlements. These opinions apply and give meaning to the broad principles articulated in prior rulings, and should be of interest to counsel and companies alike.

Following Pyott, Delaware Chancery Court Twice Applies Collateral Estoppel to Prior Judgments of Demand Futility

In developments that are significant for defendants faced with parallel actions across multiple jurisdictions, two recent Court of Chancery decisions applied and expanded upon the Delaware Supreme Court's landmark decision in Pyott v. LAMPERS, 74 A.3d 612, 618 (Del. 2013) to hold that a federal stockholder derivative plaintiff's election not to use books and procedures under Delaware law (a "Section 220" action) did not bar the application of preclusion doctrines in subsequent derivative suits.

As background, the Delaware Supreme Court in Pyott rejected a "'fast filer' irrebuttable presumption" of inadequate representation, which would have allowed stockholder derivative plaintiffs to circumvent the preclusive effect of a demand futility ruling rendered in virtually any parallel case in which the first derivative plaintiff opted not to use the books and records tools available under Section 220. The arguments for the presumption had been based on the notion that quick-filing plaintiffs who seek to plead demand futility without the benefit of books and records *must* be motivated by their own desire to control derivative litigation, rather than a desire to do what is best for the corporation. The Delaware Supreme Court recognized these concerns, but rejected a bright-line presumption of inadequacy.

Two notable recent cases have followed Pyott. First, in May 2016, Chancellor Bouchard dismissed a derivative action on the basis that a prior Rule 23.1 dismissal rendered in a parallel Arkansas federal action collaterally estopped the plaintiffs from asserting demand futility in Delaware. In re Wal-Mart Stores, Inc. Delaware Deriv. Litig., 2016 WL 2908344 (Del. Ch. May 13, 2016). The Delaware plaintiffs argued that the federal plaintiffs were inadequate representatives – and thus collateral estoppel should not apply to bar relitigation of the issue of demand futility – because the federal plaintiffs' decision not to pursue books and records evidenced either a conflict of interest or grossly deficient representation of such magnitude as to violate due process. *Id.* at *18-20.

Referencing Pyott and Restatement (Second) of Judgments §42, Chancellor Bouchard stated that the failure to file a Section 220 action "could serve as meaningful evidence of

inadequate representation in some cases," but cautioned that "it does not follow that plaintiffs are necessarily inadequate representatives because their counsel chose not to follow a recommended strategy in a different action," even if that strategy had been recommended by leading jurists of the Delaware courts. *Id.* At *20.

Chancellor Bouchard then rejected the Delaware plaintiffs' argument that the federal plaintiffs were inadequate because the Delaware complaint pleaded more or different facts garnered from a Section 220 action. The court noted that while it might have been "advantageous for the [federal] plaintiffs to seek additional factual support through a books-and-records action," the federal plaintiffs still had access to many of the core documents and publicly available articles that formed the basis of the Delaware complaint, and the claims and legal theories were, at bottom, the same. *Id.* at *21-22. Thus, the court held, the federal plaintiffs' decision not "to use 'the tools at hand' to investigate their claims" through a books and records action at most "[fell] into the category of an imperfect legal strategy and does not rise to the level of litigation management that was so grossly deficient as to render them inadequate representatives." *Id.* at *21.

One month later, Chancellor Bouchard dismissed another shareholder derivative action on similar grounds. *See* Laborers' Dist. Council Constr. Indus. Pension Fund v. Bensoussan, 2016 WL 3407708 (Del. Ch. Jun. 14, 2016). Stockholder plaintiffs filed a derivative complaint in Delaware in July 2015 after completing a books and records action, and more than a year after a New York federal court had dismissed a nearly identical federal derivative complaint – filed without the benefit of books and records – for failure to adequately plead demand futility. *Id.* at *1. Chancellor Bouchard again rejected the argument that the federal plaintiffs' counsel were inexperienced, and found there was a "lack of a substantive difference in the key factual allegations" and claims presented in the federal and Delaware complaints. *Id.* at *12. Chancellor Bouchard thus concluded that the federal plaintiffs' failure to seek books and records was another "imperfect legal strategy" rather than representation so deficient as to bar application of collateral estoppel or *res judicata*. *Id.* at *12 & n.70 (*citing* Wal-Mart, 2016 WL 2908344, at *22).

Court of Chancery Awards 28 percent Price Increase to Stockholders Who Dissented from 2013 Management-Led Buyout of Dell Inc.

On May 31, 2016, Vice Chancellor Laster issued an important merits opinion in In re: Appraisal of Dell Inc., C.A. No. 9322- VCL, where he appraised Dell Inc.'s fair value in a 2013 management-led buyout as $17.62 per share – approximately 28 percent higher than the $13.75 per share transaction price approved by Dell Inc.'s stockholders.

This decision should not be read as a rejection of judicial consideration of – or even deference to – the transaction price in appraisal proceedings. Indeed, Vice Chancellor Laster acknowledged that the Court of Chancery repeatedly "has found the deal price to be the most reliable indicator of the company's fair value, particularly when other evidence of fair value was weak." *Id.* at 50. However, the Court went to great lengths to distinguish the Dell Inc. transaction from those in which the Court of Chancery deferred to the deal price in subsequent appraisal proceedings. In the Court's view, distinguishing factors included (i) the use of a leveraged buyout pricing model to determine the transaction price, "which had the effect in this case of undervaluing the Company"; (ii) the evidence of a "valuation gap" between the trading price of Dell Inc.'s stock and the

Company's operative reality, "driven by the market's short-term focus"; and (iii) the lack of meaningful competition among bidders before the merger agreement was signed. *Id.* at 62. The Court further noted that, although Dell Inc. conducted a go-shop after the merger agreement was signed, it was not sufficient to ensure that the transaction price provided fair value because (i) the go-shop ultimately resulted in only a 2 percent price increase for Dell Inc.'s stockholders; (ii) Dell's large size – approximately 25 times larger than any other "jumped" deal – made a topping bid unlikely; and (ii) Michael Dell's superior knowledge of and unique value to the Company created information asymmetries and other potential impediments to competing bidders.

This decision has conflicting implications for the growing appraisal arbitrage trend. On one hand, the decision will probably further encourage appraisal arbitrage in the context of management-led buyouts, which are more likely to involve the circumstances the Court concluded undercut the reliability of the transaction price as an indicator of fair value. On the other hand, the decision should serve as a warning to appraisal petitioners who – as the Court recognized in its opinion – frequently submit expert testimony that the subject company is worth more than double the transaction price. The Court agreed with Dell Inc. that it was "counterintuitive and illogical – to the point of being incredible – to think that another party would not have topped [the buyout group] if the Company was actually worth" petitioners' asserted value of $28.61. *Id.* at 83-84. Rather, where a transaction results from a credible process free from any fiduciary breaches, the evidence likely will not support a valuation gap of the magnitude typically proffered by petitioners in appraisal proceedings.

The decision has implications for dealmakers, as well. Given the Court's conclusion that the use of a leveraged buyout pricing model to determine the transaction price "had the effect in this case of undervaluing the company," boards, special committees, and their advisors faced with bids from financial sponsors should take care to consider multiple valuation methodologies and determine the fairness of the proposed transaction independent of any leveraged buyout analysis. *Id.* a t 62. Additionally, the decision serves as a reminder that go-shops will not necessarily provide a sufficient market check to justify deference to the transaction price in a subsequent appraisal proceeding. Even though the Court noted that Dell Inc.'s go-shop was "relatively open" and "flexible," he nonetheless concluded that other factors precluded a finding that the go-shop "in fact generated a price that persuasively established the Company's fair value." *Id.* at 88, 91.

Delaware Supreme Court Upholds Zales-Signet Merger

On May 6, 2016, the Delaware Supreme Court, sitting *en banc*, affirmed the Chancery Court's dismissal of claims challenging Signet's $690 million acquisition of Zales Corporation in Singh v. Attenborough, No. 645. The Court held that the Signet-Zales deal withstood scrutiny under the business judgment rule and affirmed dismissal of claims of breach of fiduciary duty against Zales' former directors. In doing so, the Court reaffirmed its holding in Corwin v. KKR Financial Holdings LLC, 125 A.3d 304 (Del. 2015), that the deferential business judgment rule – and not Revlon's "enhanced scrutiny" standard – applies where the transaction is approved by a fully-informed, uncoerced vote of disinterested stockholders. In those circumstances, the only claims that survive are those for "waste," but "because the vestigial waste exception has long had little real-world relevance," when a claim is governed by business judgment review, "dismissal is typically the result." *Id.* at 2-3.

Additionally, while the Court also affirmed dismissal of the aiding and abetting claim against Zales' financial advisor – finding it "skeptical" that the supposed wrongdoing produced a rational basis to infer *scienter* – it took issue with the Chancery Court's suggestion that an advisor can only be liable if it aids and abets a non-exculpated breach of fiduciary duty. *Id.* at 3. Citing its holding in RBC Capital Mkts., LLC v. Jervis, 129 A.3d 816, 862 (Del. 2015) ("Rural Metro"), the Court emphasized that "an advisor whose bad-faith actions cause its board clients to breach their situational fiduciary duties (*e.g.,* the duties Revlon imposes in a change-of-control transaction) is liable for aiding and abetting." *Id.* at 4.

The Singh decision thus confirms that a fully informed, uncoerced vote of disinterested stockholders will generally serve to shield directors and advisors from post-closing damages claims. It also reaffirms the Supreme Court's ruling in Rural Metro that advisors are not immune from liability even though there is no finding of gross negligence by the directors, while recognizing that standard still provides advisors with a "high degree of insulation from liability." *Id.*

Disclosure-Only Settlement Approved After Trulia

As we discussed in a prior update, the Delaware Court of Chancery has strongly signaled of late that stockholder class actions attacking mergers may no longer be resolved by a corporate defendant providing additional disclosures to stockholders (and payment to plaintiffs' attorneys) in exchange for a broad release of claims against all defendants. Notably, in his opinion earlier this year in In re Trulia, Inc. Stockholder Litigation, C.A. No. 10020-CB (Del. Ch. Jan. 22, 2016), which was interpreted by many as the end of routine disclosure-only settlements in Delaware, Chancellor Bouchard warned that the Chancery Court "will be increasingly vigilant in scrutinizing the 'give' and 'get' of such settlements to ensure that they are genuinely fair and reasonable to absent class members." *Id.* at 2. In so doing, Chancellor Bouchard suggested that, going forward, the Chancery Court would not approve disclosure-only settlements unless (i) the supplemental disclosures are "plainly material" and (ii) the releases provided to the defendants are narrowly crafted. *Id.* at 24.

Several weeks later, however, in In re BTU International, Inc. Stockholders Litigation, C.A. No. 10310-CB (Del. Ch. Feb. 18, 2016) (Transcript), Chancellor Bouchard approved a nonmonetary settlement on the grounds that it met the heightened standards articulated in Trulia. In particular, Chancellor Bouchard found that the supplemental disclosures at issue, which included projections used in the financial advisors' analyses, satisfied the "plainly material" standard articulated in Trulia. Chancellor Bouchard similarly found that the scope of the release provided to defendants "would pass muster under Trulia" because it excluded "unknown claims" and was limited only to disclosure claims and fiduciary duty claims relating to the decision to enter the merger. Nonetheless, Chancellor Bouchard again emphasized the Chancery Court's preference that such disclosure issues "be resolved in an adversarial process, either through actual litigation or in connection with a mootness fee application." Chancellor Bouchard also noted that while the BTU settlement predated Trulia, future litigants "would be wise" to pursue mootness fee applications in similar situations.

SLUSA TO BE CLARIFIED FOR SECURITIES ACT CLASS ACTIONS IN STATE COURT?

An important jurisdictional issue that has long divided the lower courts may be getting attention from the U.S. Supreme Court this coming term. That issue is whether state courts retain jurisdiction to hear class actions invoking the federal Securities Act of 1933 following the reforms Congress enacted in the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). After plaintiffs began end-running the procedural reforms in the Private Securities Litigation Reform Act of 1995 by filing in state court, SLUSA preempted and provided for removal of certain class actions alleging securities fraud under state law, but courts have been unable to agree about whether (as would seem logical) SLUSA also precludes state court jurisdiction for Securities Act class actions. The question is important because unlike the Securities Exchange Act of 1934, the Securities Act contains a bar to removal for claims arising under its provisions, rendering SLUSA an important potential avenue to federal court apart from the federal-question removal statute (28 U.S.C. §1331). In 2011, the California Court of Appeal held that SLUSA did not apply to federal claims, *see* Luther v. Countrywide Fin. Corp., 195 Cal.App.4th 789 (2011), which caused a tremendous proliferation of Securities Act class actions to be filed and litigated in the California state courts.

Now, the defendants in one such action have sought *certiorari*. Cyan, Inc. v. Beaver County Employees Retirement Fund, No. 15-1439 (U.S. 2016). The U.S. Chamber of Commerce has filed an *amicus* brief in support of the *cert.* petition, and after the plaintiff failed to timely respond, the Supreme Court ordered it to do so (by August 1).

ETHICS RULES COMPLIANCE + PRACTICE HYGIENE = GOOD RISK MANAGEMENT

Escum L. ("Trey") Moore, III and Shannon A. ("A.J.") Singleton

It's a simple equation: compliance with the Rules of Professional Conduct, plus good practice hygiene, equals good risk management. This presentation will address recent trends in the sources of legal malpractice actions and will provide some practice pointers along the way to minimize the associated risks. The presentation will stress, for example, the importance of understanding the conflict rules and navigating them more successfully by clarifying, early in the representation, who is (and is not) the client and addressing the scope of the representation of the client. It will also address being mindful of the attorneys' duty to communicate with the client and to consult with the client throughout the representation. Finally, it will stress the importance of being diligent in that representation.

I. SOURCES OF MALPRACTICE CLAIMS – THE NUMBERS DON'T LIE

Knowing what prompts legal malpractice claims provides a good basis from which to address such claims and how to prevent them. Both Lawyers Mutual Insurance Company of Kentucky ("LMICK") and the American Bar Association ("ABA") have conducted studies to analyze legal malpractice claims. LMICK and the ABA have identified the following areas of law as those most likely to generate a malpractice claim:

Area of Law	LMICK[1] 2015	LMICK[2] 2014	LMICK[3] 2013	ABA 2011[4]
Personal injury (for plaintiff)	17%	23%	28%	15.59%
Real estate	26%	28%	30%	20.33%
Collection & bankruptcy	7%	11%	8%	9.2%
Workers' comp	7%	7%	5%	2.02%
Estate, trust & probate	22%	9%	6%	10.67%
Family law	6%	8%	5%	12.14%
Criminal law	2%	2%	3%	5.65%
Corporate & business org.	2%	2%	1%	6.79%
Labor law	1%	1%	1%	2.19%
Personal injury (for defendant)	3%	5%	2%	3.26%

[1] Lawyers Mutual Insurance Company of Kentucky ("LMICK"). LMICK survey data and other materials have been used with the express permission of LMICK.

[2] Lawyers Mutual Insurance Company of Kentucky.

[3] Lawyers Mutual Insurance Company of Kentucky.

[4] American Bar Association ("ABA") Profile of Legal Malpractice Claims: 2008-2011 (hereafter "ABA 2011"), as reported in "What We Learned about Legal Malpractice in Kentucky in 25 Years," The Risk Manager, LMICK (Winter 2013).

The ABA has also studied the stage at which an error is most likely to occur during the representation:

Stage of Case	ABA 2011	ABA 2003[5]	ABA 1999[6]
Prepare/file documents	28.86%	23.08%	25.24%
Pre-trial, pre-hearing advice	8.55%	19.47%	8.18%
Commencement of action	17.31%	15.59%	15.66%
Advice	20.19%	15.07%	6.79%
Settlement/negotiation	6.79%	8.20%	6.38%
Trial or hearing	5.33%	5.07%	5.10%
Title opinion	4.46%	4.03%	13.01%
Investigation/other than litigation	3.25%	2.19%	16.26%
Appeal activities	1.60%	2.15%	1.11%

Based on its records, LMICK identified the following activities as generating legal malpractice claims during 2013, 2014, and 2015:

Activity	2013 % Total	2014 % Total	2015 % Total
Commencement of action or proceeding	18.94%	21.31%	13.21%
Pre-trial or pre-hearing	16.67%	16.39%	11.32%
Consultation or advice	3.79%	4.10%	6.60%
Settlement and negotiation	6.06%	9.84%	13.21%
Title opinion	13.64%	12.30%	13.21%
Prepare/transmit/file document (non-pleading)	15.91%	16.39%	7.55%
Trial or hearing	3.79%	3.28%	2.83%
Written opinion (other than title)	0.00%	0.00%	0.00%
Tax reporting or payment	2.27%	1.64%	0.00%
Post-trial or hearing	7.58%	8.20%	9.43%

Likewise, LMICK has identified the following types of errors alleged in the malpractice claims presented to LMICK during 2013, 2014 and 2015:

Alleged error	2013 % Total	2014 % Total	2015 % Total
Failure to know or properly apply the law	11.36%	4.92%	16.98%
Failure to obtain the client's consent	1.52%	0.82%	0.00%
Error in public record search	12.88%	11.48%	13.21%

[5] American Bar Association ("ABA") Profile of Legal Malpractice Claims: 2000-2003 (hereafter "ABA 2003"), as reported in Del O'Roark and Pete Gullett, "Legal Malpractice in Kentucky," KBA Bench & Bar (January 2007).

[6] American Bar Association ("ABA") Legal Malpractice Claims study from 1999 (hereafter "ABA 1999"), as reported in Del O'Roark and Pete Gullett, "Legal Malpractice in Kentucky," KBA Bench & Bar (January 2007).

Failure to know or ascertain deadline correctly	7.58%	4.10%	2.83%
Procrastination/lack of follow-up	2.27%	7.38%	2.83%
Failure to calendar properly	10.61%	14.75%	6.60%
Inadequate discovery of facts/ inadequate investigation	9.85%	9.02%	7.55%
Failure to react to calendar	0.76%	0.00%	1.89%
Planning error in choice of procedure	18.18%	23.77%	12.26%
Conflict of interest	3.03%	3.28%	3.77%
Fraud	5.30%	2.46%	13.21%
Failure to file a document, where no deadline involved	1.52%	0.82%	0.94%
Failure to understand or anticipate tax	0.76%	1.64%	1.89%
Clerical error	1.52%	3.28%	0.94%
Failure to follow client's instructions	3.03%	8.20%	3.77%
Improper withdrawal from representation	1.52%	1.64%	2.83%
Libel or slander	0.76%	0.00%	0.00%
Lost file, document or evidence	2.27%	0.82%	0.00%
Malicious prosecution or abuse of process	5.30%	1.64%	8.49%

Other categories (and subcategories) of errors identified by LMICK and the ABA include:

Administrative Errors	**LMICK 2013**	**LMICK 2014**	**LMICK 2015**	**ABA 2011**
Procrastination	2.27%	7.38%	2.83%	9.68%
Failure to calendar properly	10.61%	14.75%	6.60%	4.34%
Failure to react to calendar	0.76%	0.00%	1.89%	2.34%
Failure to file document – no deadline	1.52%	0.82%	0.94%	3.17%
Clerical error	1.52%	3.28%	0.94%	3.54%
Lost file – document evidence	2.27%	0.82%	0.00%	7.05%
Total	18.94%	27.05%	13.21%	30.13%

Substantive Errors	**LMICK 2013**	**LMICK 2014**	**LMICK 2015**	**ABA 2011**
Failure to know law	11.36%	4.92%	16.98%	13.57%
Planning error – procedure choice	18.18%	23.77%	12.26%	7.39%
Inadequate discovery/ investigation	9.85%	9.02%	7.55%	7.82%
Failure to know or ascertain deadline	7.58%	4.10%	2.83%	6.91%
Conflict of interest	3.03%	3.28%	3.77%	4.28%
Failure to understand or anticipate tax	0.76%	1.64%	1.89%	1.37%

Public record error search	12.88%	11.48%	13.21%	3.03%
Error in math calculation	0.00%	0.00%	0.00%	0.69%
Total	63.64%	58.20%	58.49%	45.07%

Client Relations Errors	**LMICK 2013**	**LMICK 2014**	**LMICK 2015**	**ABA 2011**
Failure to obtain client consent	1.52%	0.82%	0.00%	7.02%
Failure to follow client instruction	3.03%	8.20%	3.77%	5.71%
Improper withdrawal of representation	1.52%	1.64%	2.83%	1.87%
Total	6.06%	10.66%	6.60%	14.6%

Intentionally Wrongful Acts	**LMICK 2013**	**LMICK 2014**	**LMICK 2015**	**ABA 2011**
Malicious prosecution	5.30%	1.64%	8.49%	3.43%
Fraud	5.30%	2.46%	13.21%	4.53%
Violations of Civil Acts	0.00%	0.00%	0.00%	1.27%
Libel or slander	0.76%	0.00%	0.00%	0.96%
Total	11.36%	4.10%	21.70%	10.19%

Deadline Errors	**LMICK 2013**	**LMICK 2014**	**LMICK 2015**	**ABA 2011**
Failure to know deadline	7.58%	6.01%	2.83%	6.38%
Failure to calendar	10.61%	8.60%	6.60%	7.44%
Failure to react to calendar	0.76%	2.93%	1.89%	3.57%
Total	18.95%	17.54%	11.32%	17.39%

Legal malpractice claims are not the only consequence of errors or poor practice hygiene. Often the same conduct is a violation of the Rules of Professional Conduct, which prompts the aggrieved client (or others) to file a Bar Complaint. Based on LMICK's experience, the lack of diligence, lack of competence and conflicts of interest are the three most commonly violated Rules of Professional Conduct for the Bar Complaints:

Type of alleged professional misconduct	Rule(s) potentially violated	% of total
Lack of diligence	1.3	31%
Lack of competence	1.1	26%
Conflict of interest	1.7-1.9	11%
Fraud or misrepresentation	8.4(c)	7%
Inadequate communication	1.4	6%
Excessive or improper attorney's fee	1.5	4%
Misappropriation of client funds	1.15	3%
Failure to follow client directives	1.2	2%
Criminal conduct	8.4(b)	2%
Respect for rights of third person	4.4	2%
Duties on termination of employment	1.16	2%
Fairness to opposing party & counsel	3.4	2%
Candor toward the tribunal	3.3	1%
Unauthorized practice of law	5.5	1%
Confidentiality	1.6	1%

These statistics are sobering. However, they also stand as a reminder to attorneys about the types of actions (or inaction) that prompts clients to file malpractice lawsuits and/or Bar Complaints. Knowing the most common risks allows attorneys to hone and improve their practices to not only minimize or avoid these risks, but to provide better service to their clients.

II. LACK OF DILIGENCE

Based on the above statistics, "Lack of Diligence" was the number one source of Bar Complaints in Kentucky as reported to LMICK. Attorneys often forget that, while a particular client's case or matter is just one of many that the attorney is handling, to the client, it is the most important matter in the world. The client also may not appreciate all of the work that is involved in a matter and the time it will take to address a matter.

Rule 1.3 of the Kentucky Rules of Professional Conduct specifically addresses diligence and states: "A lawyer shall act with reasonable diligence and promptness in representing a client." Granted, the attorney's diligence and promptness need only be "reasonable" under the circumstances, but "reasonableness" should not be an excuse for procrastination or undertaking more representations than the attorney can handle. *See* Rule 1.3, Commentary 2 ("A lawyer's work load must be controlled so that each matter can be handled competently."). Commentary 3 to Rule 1.3 specifically addresses this notion of reasonableness and the dangers of procrastination:

> Perhaps no professional shortcoming is more widely resented than procrastination. A client's interests often can be adversely affected by the passage of time or the change of conditions; in extreme instances, as when a lawyer overlooks a statute of limitations, the client's legal position may be destroyed. Even when the client's interests are not affected in substance, however, unreasonable delay can cause a client needless anxiety and

> undermine confidence in the lawyer's trustworthiness. A lawyer's duty to act with reasonable promptness, however, does not preclude the lawyer from agreeing to a reasonable request for a postponement that will not prejudice the lawyer's client.

One of the most dangerous files in an attorney's office is the one the attorney hates to work on because of a difficult client. But those are often the clients and files that warrant the most attention. It is critical for the attorney to keep every client, but especially those more difficult clients, reasonably informed as to what is going on with their representation and, whenever possible, to document those conversations. Commentaries 3 and 4 to Rule 1.4, regarding communication with a client, help to define some of the situations in which an attorney must reasonably consult with a client and – most notably – the importance of promptly responding to a client's phone calls:

> (3) Paragraph (a)(2) requires the lawyer to reasonably consult with the client about the means to be used to accomplish the client's objectives. In some situations – depending on both the importance of the action under consideration and the feasibility of consulting with the client – this duty will require consultation prior to taking action. In other circumstances, such as during a trial when an immediate decision must be made, the exigency of the situation may require the lawyer to act without prior consultation. In such cases the lawyer must nonetheless act reasonably to inform the client of actions the lawyer has taken on the client's behalf. Additionally, paragraph (a)(3) requires that the lawyer keep the client reasonably informed about the status of the matter, such as significant developments affecting the timing or the substance of the representation.
>
> (4) A lawyer's regular communication with clients will minimize the occasions on which a client will need to request information concerning the representation. When a client makes a reasonable request for information, however, paragraph (a)(4) requires prompt compliance with the request, or if a prompt response is not feasible, that the lawyer, or a member of the lawyer's staff, acknowledge receipt of the request and advise the client when a response may be expected. Client telephone calls should be promptly returned or acknowledged.

To put it simply, when clients reach out to attorneys seeking legal advice or answers to their questions, they have needs and they want to be heard. They want things done. Sometimes the attorney might not be able to respond at all immediately, or may not be able to respond immediately with any substance. But it behooves the attorney – regardless of practice area – to respond in some way as soon as practical and to share with the client a realistic deadline for a substantive response. By doing so, the attorney has not only attempted to control the client's expectations, but has also recognized the client's issue or need.

III. LACK OF COMPETENCE

Based again on the above-cited statistics, "Lack of Competence" is the second leading violation of the Rules of Professional Conduct as reflected by Bar Complaints reported to LMICK. Rule 1.1 of the Kentucky Rules of Professional Conduct provides: "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

One of the greatest dangers that Rule 1.1 poses is to an attorney dealing with a specialized area of the law for which the attorney lacks the requisite knowledge or expertise to be talking with the client in definitive terms of "success." Sometimes compounding the problem is the attorney who does not disclose to the client the attorney's lack of expertise in the area or who does not condition or qualify their early assessments. It behooves attorneys to understand the limits of their background in specialized fields of law and to be willing to share those limitations with the client. As Commentary 1 to Rule 1.1 recognizes:

> In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances.

Again, from an ethical compliance standpoint – and a risk management standpoint – it is critically important for the attorney to communicate with the client or potential client about the attorney's experience and expertise with the pertinent area of the law. Moreover, an attorney needs to recognize that once he/she has created an expectation in the client's mind about "how easy" something will be or "how inexpensive" a representation will be, the attorney is going to find him/herself in a difficult situation when the attorney has underestimated the complexity of the matter or the cost associated with such a complex matter.

Commentary 5 to Rule 1.1 addresses another aspect of competence, namely adequate preparation:

> Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners. It also includes adequate preparation. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence.

> An agreement between the lawyer and the client regarding the scope of the representation may limit the matters for which the lawyer is responsible. *See* Rule 1.2(c).

The old adage – "if you fail to prepare, prepare to fail" – is not only good practical advice in law and in life, it is also part of an attorney's ethical obligation in the representation of a client. An attorney's level of preparation must be commensurate with the issue at hand. Failure to adequately prepare may not only be a violation of the attorney's ethical obligations under the Rules of Professional Conduct, but it also increases the likelihood that a frustrated client will pursue a legal malpractice claim if the lack of preparation results in harm to the client's interests.

IV. CONFLICTS OF INTEREST

Conflicts of interest have been, and remain, a recurring issue for attorneys. Many of these conflict of interest issues can be remedied – or even avoided altogether – with effective practice management. To address these issues, a refresher of the conflict-related Rules of Professional Conduct is in order.

Rule 1.7 is the basic concurrent client conflict rule. Rule 1.7(a) provides:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
>
> > (1) the representation of one client will be directly adverse to another client; or
> >
> > (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

As such, an attorney has a concurrent conflict of interest if the attorney is representing one client directly adverse to the legal rights or interests of another current client of the attorney (or of the attorney's law firm), even if the adverse matter is totally unrelated to the other representation. The attorney also has a concurrent conflict of interest if there is a significant risk that the attorney's representation of a client will be materially limited (*i.e.*, the attorney cannot or will not advocate the client's position as zealously as the attorney otherwise would) because of some other interest, including the attorney's own interest. The only way to remedy a concurrent conflict of interest is to secure the informed consent, confirmed in writing, of each affected client, *i.e.*, no amount of screening will cure the conflict for the attorney or the attorney's law firm. *See* Rule 1.7(b)(4).

The conflict rules change when one begins dealing with matters adverse to a former client. Under Rule 1.9:

> (a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a

> substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client gives informed consent, confirmed in writing.
>
> (b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client
>
> > (1) whose interests are materially adverse to that person; and
> >
> > (2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter; unless the former client gives informed consent, confirmed in writing.

Thus, when dealing with a former client conflict situation, the relatedness of the two matters is relevant. If the new matter adverse to the former client is not the same or a substantially related matter for which the attorney represented the former client, and/or the attorney did not acquire non-public confidential information from the prior representation of the former client that can now be used against the former client in the new matter, there is no conflict.

Moreover, under Rule 1.10(a), conflicts of interest affecting one attorney in a law firm are generally imputed to the law firm as a whole:

> While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9, unless the prohibition is based on a personal interest of the prohibited lawyer and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm.

That being said, Kentucky has a very favorable "screening rule," specifically Rule 1.10(d), that allows law firms to screen specific attorneys tainted by an otherwise disqualifying former client conflict and thereby prevent any such disqualification from being imputed to the entire firm:

> (d) A firm is not disqualified from representation of a client if the only basis for disqualification is representation of a former client by a lawyer presently associated with the firm, sufficient to cause that lawyer to be disqualified pursuant to Rule 1.9 and:
>
> > (1) the disqualified lawyer is screened from any participation in the matter and is apportioned no specific part of the fee therefrom; and
> >
> > (2) written notice is given to the former client.

In other words, if the only basis for disqualification of the entire law firm is that one or more attorneys are disqualified because of a former client conflict of interest, imputation of that disqualification can be prevented through timely screening of the tainted attorney(s) and notice of those screening procedures to the former client, usually through the former client's current attorney.

A. The Engagement Letter

Key to applying the conflict rules is the answer to the following fundamental question: who is the client? The existence of an attorney-client relationship is not dependent upon an engagement letter. The test for whether a would-be client is actually a client, including for conflict of interest analysis purposes, is the subjective reasonable belief of the client. *See* Lovell v. Winchester, 941 S.W.2d 466, 468 (Ky. 1997), *overruled on other grounds by* Marcum v. Scorsone, 457 S.W.3d 710 (Ky. 2015). However, having an engagement letter in place helps clarify any confusion as to the existence of an attorney-client relationship. Moreover, the engagement letter can specify who the attorney is, and is not, representing. For example, if the attorney is representing a company or other organization, the attorney can specify in the engagement letter that he/she is not representing any officer, director or employee of the company/organization unless otherwise agreed. Likewise, the attorney can specify that he/she is not representing any subsidiary or affiliate within the company's/organization's corporate family. By doing so, the lawyer through a well-crafted engagement letter can effectively eliminate the subjective belief of such an officer or director, or company affiliate, that the attorney is also representing his/her/its interests and/or the belief that the attorney will not undertake representations adverse to those persons or entities absent a waiver.

Additionally, the engagement letter can be used to limit the scope of the representation by identifying therein what the attorney has been retained to do. Probably more importantly, the engagement letter can specify what is not within the scope of the representation, making the engagement letter a useful tool in managing the client's expectations. It would be difficult for a client to complain about not receiving tax advice related to a securities representation if the scope of representation section of the engagement letter specifically says that the attorney will not provide tax advice.

Finally, if the attorney will be representing more than one client in the same matter, the engagement letter is a perfect opportunity to address the advantages and risks of having one attorney represent multiple clients and to secure from those clients the informed consent, confirmed in writing, to the joint representation. For example, the clients should consent to the fact that, if one client shares with the attorney information in confidence that is material to the joint representation, the attorney must be able to share that information with the other clients. Thus, while the attorney may still be able to protect such communications from third parties, there will be no secrets as between or among the jointly represented clients. Also, because the attorney representing multiple

clients has a duty of loyalty to each, the attorney will not be able to advocate on behalf of one client (or provide legal advice to one client) that would be directly adverse to the other jointly represented client(s).

B. The Disengagement Letter and the "I'm Not Your Lawyer" Letter

As shown above, the Rules of Professional Conduct's conflict rules treat former client conflicts very differently than they do current client conflicts. Therefore, if the representation of a client is over, or if a matter is concluded, it behooves the attorney to make sure the client knows that the representation is concluded. Admittedly, Commentary 4 to Rule 1.3 provides that "[i]f a lawyer's employment is limited to a specific matter, the relationship terminates when the matter is resolved." However, Commentary 4 also says: "If a lawyer has served a client over a substantial period in a variety of matters, the client sometimes may assume that the lawyer will continue to serve on a continuing basis unless the lawyer gives notice of withdrawal." It may well be that the latter sentence of Commentary 4 is a recognition that the test for whether a client is still a current client, as opposed to a former client, for conflict of interest purposes is the client's subjective reasonable belief that he/she/it is *still* a client.

While most attorneys are loath to send disengagement letters for fear that the client who receives a disengagement letter will never come back to the attorney for additional work, the important effect of the disengagement letter is unmistakable. It eliminates the notion of an ongoing representation. Granted, one can see how – with an institutional client – disengagement letters may be of less importance, though still possibly helpful from a file retention and practice hygiene standpoint. But for those clients who are not institutional clients, the disengagement letter can be invaluable. It provides a definitive point in time when the matter for which the attorney has been engaged is over. Moreover, the disengagement letter can be drafted in such a way that is not off-putting, but rather, shows that the work for which the attorney was retained is done, is complimentary of the client, and leaves open the possibility of future work. On the flip-side, failure to send such a letter may allow the should-be former client to maintain a subjective reasonable belief that he/she/it remains a client, the results of which could be (a) inability to undertake new representations adverse to the should-be former client; (b) unanticipated disqualification motions when having undertaken a representation adverse to a should-be former client; and/or (c) the accompanying malpractice lawsuit and/or Bar Complaint based on the adverse representation.

In addition, akin to the provision in an engagement letter that disavows any representation of a company's/organization's officers or directors, or corporate affiliates, an "I'm Not Your Lawyer" letter is a useful tool to prevent a would-be client from believing that the attorney is representing him/her/it and/or looking out for the would-be client's interests. When working with multiple persons or parties, many if not most being unrepresented, it is critically important to specify who is a client and who

is not a client. If the attorney has, in writing, sent the non-client a letter saying that the attorney is not representing the non-client or the non-client's interests, it will be hard for the non-client to claim otherwise.

V. CONCLUDING THOUGHTS AND PRACTICAL TAKEAWAYS

The practice of law is fraught with many potential dangers, many of which could lead to legal malpractice claims or Bar Complaints. But knowledge of and compliance with the Rules of Professional Conduct and good practice hygiene can minimize the risk of malpractice actions. Practical planning – and checklists – can also help minimize some of the more frequent malpractice risks.

Pete Gullett of LMICK has identified in his "Ethics and Malpractice Avoidance Guide" a "Legal Malpractice Avoidance Checklist" that Lawyer's Mutual Insurance Company of California has developed. With some embellishments, here is that checklist, which you may find helpful in any practice area:

A. Calendar every case, not just those in litigation.

As noted above, missed deadlines are a recurring problem. Establishing a routine for the calendaring of those deadlines – even internal deadlines – will help eliminate or mitigate that risk.

B. Confirm in writing your decision to accept a case or your decision to withdraw or decline representation.

For every new client – and every new matter – make sure you have an engagement letter in the file that specifically identifies the client and the scope of work. If the new matter goes beyond the previous engagement letter's scope of work, send a new engagement letter.

C. Do not sue clients for fees.

They will most certainly counter sue you for malpractice.

D. Take only those matters in which you have experience or associate with someone who does have experience or knowledge about a specific case.

Know your limitations and be willing to explain those limitations to your client.

E. Maintain good client relations.

Communicate regularly with your clients, to keep them updated, and to get their input on critical decisions. Know when to confirm those discussions with the client in writing.

F. Do not have a personal or a financial involvement with your clients.

Business dealings with clients create special – and delicate – conflict situations that can raise questions about the lawyer's independence of professional judgment and the potential for competing loyalties.

G. Research potential conflicts of interest before you take the case.

Have a robust conflict checking system to identify actual and potential conflicts, and keep that system updated with information about new parties. If there is a concurrent conflict, secure the informed consent, confirmed in writing, of the effected clients.

H. Document everything leaving a paper trail understandable by third parties.

Memories fade, but contemporaneous writings do not.

I. Know when to reject potential clients or matters.

Conduct due diligence on your potential client, client representatives, and/or adverse parties to know what you are dealing with. If the potential client is coming to you because he/she is firing his/her attorney, ask the potential client for permission to speak with that attorney.

J. Know what to do upon receipt of a malpractice claim.

Know what triggers your obligation under your policy to report a matter to your malpractice insurance carrier, and keep internal email traffic about the matter to a minimum.

K. Obtain client consent before proceeding in a vital area of the case.

And for your own protection, have the client's consent confirmed in writing, if only in an email to the client.