News Bulletin

January 26, 2012

FINRA Files Amendments to FINRA Rule 5123 on Private Placements

On January 19, 2012, the Financial Industry Regulatory Authority, Inc. ("FINRA") filed a Partial Amendment No. 1 (the "Partial Amendment") to proposed FINRA Rule 5123 (Private Placement of Securities) with the Securities and Exchange Commission (the "SEC")[1] to address concerns raised by market participants. The Partial Amendment would narrow the proposed definition of "private placement" and modify the proposed disclosure and filing requirements in private placements.

Background

FINRA proposed Rule 5123 (the "Proposed Rule") on October 5, 2011.[2] Comments were due on November 18, 2011. The SEC received 16 comment letters in response to the Proposed Rule. On November 17, 2011, FINRA extended the period for the SEC to approve the Proposed Rule to January 20, 2012. The comments expressed a broad range of concerns, including concerns regarding: the scope of the definition of private placement; the broker-dealer disclosure requirements; the filing requirements; the exemptions; and whether the Proposed Rule is consistent with FINRA's regulatory oversight and authority. FINRA responded to the comments in its Response Letter and filed the Partial Amendment to address these concerns.[3]

The Partial Amendment

The Partial Amendment:

- Clarifies that the term "private placement" in the Proposed Rule would mean a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act of 1933, as amended (the "Securities Act"), making it consistent with FINRA Rule 5122. The definition would not apply to securities offered pursuant to:
  - Sections 4(1), 4(3) and 4(4) of the Securities Act;

[1] See Notice of Filing of Partial Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as modified by Partial Amendment No. 1, to Adopt FINRA Rule 5123 (Private Placements of Securities), Exchange Act Release No. 66203 (the "SEC Release") (Jan. 20, 2012), available at http://www.sec.gov/rules/sro/finra/2012/34-66203.pdf.
[2] For a discussion of the evolution and contents of the Proposed Rule, see our client alert available at http://www.mofo.com/files/Uploads/Images/111010-FINRA-Proposes-Rule-5123-in-lieu-of-Proposed-Rule-5122.pdf.
[3] The text of Partial Amendment No. 1 and FINRA's Response Letter are available at http://www.finra.org/Industry/Regulation/RuleFilings/2011/P124600.

  - Sections 3(a)(2) (offerings by banks), 3(a)(9) (exchange transactions), 3(a)(10) (securities subject to a fairness hearing), or 3(a)(12) (securities issued by a bank or bank holding company pursuant to reorganization or similar transactions), of the Securities Act; or
  - Section 1145 of the Bankruptcy Code (securities issued in a court-approved reorganization plan that are not otherwise entitled to the exemption from registration afforded by Securities Act Section 3(a)(10)).

- Amends the filing and disclosure requirements for those private placements for which a disclosure document includes a description of the anticipated use of offering proceeds, the amount and type of offering expenses and compensation provided or to be provided to sponsors, finders, consultants, and members and their associated persons in connection with the offering. Members would be required to provide, prior to any sale, the disclosure document to each investor other than those investors in a private placement that would be subject to an exemption, as provided by the Proposed Rule, as amended.[4] Each member participating in the offering, or a member designated to make the filing on behalf of all members identified in the filing, would also be required to file such document with FINRA no later than 15 calendar days after the date of first sale.

- Amends the filing and disclosure requirements for those private placements for which there is no disclosure document to eliminate the requirement that members provide investors with the required disclosures. If no disclosure document is used, the participating member (or a designated member acting on behalf of the member) would instead be required to make a notice filing, identifying the private placement and the participating members and stating that no disclosure document was used, with FINRA no later than 15 calendar days after the date of first sale. The Proposed Rule as amended by the Partial Amendment would not prohibit a member from participating in such private placements, and would not require the member to make any additional disclosure to investors in such offerings.

- Clarifies that the Proposed Rule would not require delivery of multiple copies of a disclosure document to a single customer. Specifically, the Proposed Rule would require an affected member to deliver disclosure documents only to persons to whom it sells shares in the private placement.

What's Next?

In light of the issues raised by the Proposed Rule, the SEC determined to institute proceedings pursuant to Section 19(b)(2) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act") to determine whether to approve FINRA's Proposed Rule. In its release, the SEC stated, "Institution of such proceedings appears appropriate at this time in view of the legal and policy issues raised by the proposed rule change."[5] The SEC also stated it believes FINRA's Proposed Rule, as amended by the Partial Amendment, raises questions as to whether it is consistent with the requirements of Section 15A(b)(6) of the Exchange Act. Section 15A(b)(6) requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

It remains uncertain whether the Proposed Rule, as amended by the Partial Amendment, would be approved by the SEC. Comments on the Proposed Rule, as modified by the Partial Amendment, are due 30 days from publication in the Federal Register. In addition to general comments, the SEC specifically seeks comments on the proposed definition of "private placement"; the potential impact on investors purchasing private placement securities through a broker-dealer; the potential impact on members of having to comply with the Proposed Rule; and the potential impact on competition and capital formation, including:

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[4] For a description of the exemptions, see our client alert available at http://www.mofo.com/files/Uploads/Images/111010-FINRA-Proposes-Rule-5123-in-lieu-of-Proposed-Rule-5122.pdf.

[5] See SEC Release, available at http://www.sec.gov/rules/sro/finra/2012/34-66203.pdf.

- whether members would continue to participate in private placements subject to the Proposed Rule;
- whether the Proposed Rule would encourage issuers to use unregistered firms to effect their covered offerings; and
- whether the Proposed Rule would affect access to capital, the costs of capital raising or the cost of capital for issuers.

The future evolution of FINRA Rule 5123 will have to await another comment period.

Contacts

Gerd Thomsen
(212) 336-4335
gthomsen@mofo.com

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News Bulletin

December 20, 2011

IPO "On-Ramp"

In our November 2011 client alert,[1] we discussed many of the proposed legislative initiatives designed to ease the burdens on emerging and smaller companies and promote capital formation, particularly through exempt offerings. Regulators now have begun to focus on measures that would encourage smaller companies to pursue initial public offerings, or IPOs. One such measure was introduced in the Senate on December 1 by Senator Charles Schumer (D. NY), along with Senators Thomas Carper (D. DE), Mike Crapo (R. ID), Patrick Toomey (R. PA) and Mark Warner (D. VA).[2] The bill echoes a number of the recommendations that were included in a report entitled "Rebuilding the IPO On-Ramp" (the "Report"),[3] presented to the U.S. Department of the Treasury by the IPO Task Force in October 2011.

Background– The IPO Task Force Report

In March 2011, the U.S Treasury Department convened the Access to Capital Conference to "gather insights from capital markets participants and solicit recommendations for how to restore access to capital for emerging companies – especially public capital through the IPO market."[4] At this conference, a small group of professionals representing broad sectors of the IPO market decided to form the IPO Task Force (the "Task Force") to examine the challenges that emerging growth companies face in pursuing IPOs, and to provide recommendations for restoring effective access to the public markets for emerging growth companies.[5]

In its Report, the Task Force noted that after achieving a one-year high of 791 IPOs in 1996, the U.S. IPO Market severely declined from 2001-2008, averaging only 157 IPOs per year during that period, with a low of 45 in 2008, with IPOs by smaller companies showing the steepest declines. The Report presents a nuanced view of the causes of this decline, pointing to a series of regulatory and market structure changes. The Report notes that these changes have coalesced and as a result have had the effect of driving up costs for smaller companies looking to go public; constraining the amount of information available to investors about such companies; and shifting the economics of investment banking away from long-term investing in such companies and toward high-frequency trading of large-cap stocks, thus making the IPO process less attractive to, and more difficult for, smaller companies. The Report made four principal recommendations to the Treasury Department: providing an "on-ramp" (or phasing in of disclosure requirements) for smaller companies that complete IPOs; improving the availability and flow of information for investors before and after an IPO; lowering the capital gains tax rate for investors who purchase shares in an IPO and hold these shares for a minimum of two years; and educating issuers about how to succeed in the new capital markets environment.

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[1] See http://www.mofo.com/files/Uploads/Images/111107-Capital-Formation.pdf.
[2] See http://www.gpo.gov/fdsys/pkg/BILLS-112s1933is/pdf/BILLS-112s1933is.pdf for the full text of the bill.
[3] See the IPO Task Force Report, available at http://www.williamblair.com/Documents/IPOTaskForce.pdf.
[4] Id. at 1.
[5] See id.

The Task Force stressed that these recommendations purport only to adjust the scale of current regulations, not change the focus on investor protection.

Proposed Legislation

The legislation, entitled the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011," proposes to amend Section 2(a) of the Securities Act of 1933 (the "Securities Act") and Section 3(a) of the Securities Exchange Act of 1934 (the "Exchange Act") by creating a new category of issuer called an "emerging growth company" and exempting these emerging growth companies, at least initially, from certain requirements. Under the proposed legislation, an "emerging growth company" would be defined as an issuer that had total annual gross revenues of less than $1 billion dollars at the end of its most recent completed fiscal year. An issuer that is an emerging growth company as of the first day of that fiscal year shall remain one until the earliest of:

- the last day of the fiscal year of the issuer during which it had total annual gross revenues of $1 billion or more;
- the last day of the fiscal year of the issuer following the fifth anniversary of the date of first sale of common equity securities of the issuer pursuant to an effective Securities Act registration statement; and
- the date on which the issuer is considered to be a Large Accelerated Filer as defined by the SEC.

The bill creates a transitional on-ramp status for emerging growth companies to encourage them to go pursue IPOs by phasing in compliance measures in areas that will not compromise core investor protection. For example, the bill would exempt emerging growth companies from the requirement to hold a shareholder advisory vote on executive compensation arrangements, including golden parachutes under Section 14A(e) of the Exchange Act and from Dodd-Frank Act requirements to disclose the median of the annual total compensation of all employees under Section 953(b)(1). In addition, the legislation would require emerging growth companies to provide only two years of audited financial statements to the SEC (rather than three years), and would remove the auditor attestation requirement.

In order to promote access to information about emerging companies, the legislation would allow brokers and dealers, even if they were participating in the underwriting process, to publish research reports about emerging growth companies prior to the IPO. The bill does not remove other important protections in this area. The proposed legislation would also allow an emerging growth company to gauge preliminary interest in a potential offering by expanding the range of permissible pre-filing communications made to qualified institutional buyers or accredited investors, and filing a registration statement with the SEC on a confidential basis

Going Forward

While discussions regarding reforms in the area have been promising, and seem to attract broad bipartisan support, it is fair to predict that it will be a long and steep ramp to climb toward final measures in the area. Please see our other updates on developments related to capital formation:

"Legislative Proposals to Facilitate Capital Formation Advance," November 7, 2011

"Reg A A-Okay – House Approves the Small Company Capital Formation Act," November 4, 2011

"Legislative Proposals to Facilitate Small Business Capital Formation," October 13, 2011

"House Financial Services Committee Approves the Small Company Capital Formation Act; Regulation A Revival Closer?" June 24, 2011

"Legislative Action on Exchange Act Registration Thresholds," June 21, 2011

"U.S. Capital Raising in the Spotlight," April 20, 2011

"Small Company Capital Formation Act of 2011; Regulation A Revival?" March 30, 2011

Contacts

Michael Rosenberg
(212) 336-4447
mrosenberg@mofo.com

About Morrison & Foerster

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News Bulletin

November 7, 2011

Legislative Proposals to Facilitate Capital Formation Advance

In our October 2011 client alert,[1] we discussed various bills that had been approved by the House Committee on Financial Services, Subcommittee on Capital Markets and Government-Sponsored Enterprises (the "House Subcommittee") focusing on capital formation. Several of these were recently approved by a vote of the full House of Representatives (the "House").

Shareholder Threshold for Small Banks

On November 2, 2011, the House overwhelmingly approved H.R. 1965 without amendment by a vote of 420 to 2.[2] The bill increases the shareholder threshold under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act") from 500 to 2,000 for banks and bank holding companies and increases the threshold for total assets of an issuer required to register with the SEC from $1 million to $10 million.[3] Representative Jim Himes (D-CT), who co-sponsored the bill with Representative Steve Womack (R-AR), remarked that "this bill helps banks help growing businesses access the capital they need to expand and create jobs while maintaining important protections for investors." Representative Womack noted that "by raising the shareholder threshold from 500 to 2,000, banks will now be better positioned to increase small business lending which, in turn, will promote economic growth in communities across the country." [4]

Make Room for "Crowdfunding"

H.R. 2930, introduced in the House on September 14, 2011 by Representative Patrick McHenry (R-NC), proposes to add a "crowdfunding" exemption to Section 4 (exempt offerings) of the Securities Act and Section 12(g) of the Exchange Act. On November 3, 2011, the House approved H.R. 2930 by a vote of 407-17.[5] The bill, as approved, contains a few amendments to the version approved by the House Financial Services Committee on October 26, 2011. Amendments proposed by Representative Steven Fincher (R-TN) and by Representative Ben Quayle (R-AZ) that direct the SEC to adjust for inflation the $1,000,000 cap on "crowdfunding" transactions and $10,000 individual investment cap were added.

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[1] See http://www.mofo.com/files/Uploads/Images/111013-Small-Business-Capital.pdf.
[2] See http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=267321. The House approved a motion to suspend the rules and pass H.R. 1065, a procedural shortcut used for bills that are not controversial.
[3] This change merely incorporates into statute the current requirements of SEC rules under Section 12(g) and 15(d).
[4] See press release issued by Representative Himes' office, available at http://himes.house.gov/content/house-passes-himes%E2%80%99-bipartisan-bill-reduce-small-biz-credit-crunch.
[5] See press release issued House Financial Services Committee, available at http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=267641.

Representative McHenry also added an amendment to H.R. 2930 that requires the issuer in a "crowdfunding" transaction to state a deadline for reaching the desired offering proceeds and to notify the SEC once the offering has been completed. The notification must include the aggregate offering proceeds and number of purchasers. McHenry's amendment also revised the "bad actor" provision to disqualify issuers and intermediaries from the transaction if their predecessors, affiliates, officers, or directors have a history of committing securities fraud. This amendment was agreed upon by a voice vote of the House.

Advertising Allowed

During the same session, the House also approved H.R. 2940, without amendment, by a vote of 413 to 11.[6] This bill would allow for the use of general advertisements to solicit investors in offerings of non-publicly traded securities, so long as the privately held companies market only to accredited investors. The bill would direct the SEC to revise its rules to remove the prohibition against general solicitation or advertising for sales of non-publicly traded securities made only to accredited investors.[7]

Going Forward

H.R. 2167, the bill that would amend Section 12(g) of the Exchange Act to increase the shareholders of record threshold to 1,000 for all companies still awaits review by the House. Having been approved in the House, H.R. 1965, 2930 and 2940 were sent to the Senate for review and are still awaiting Senate Committee referrals. The strong bipartisan support for the bills and the backing of the White House suggests that there is a strong chance that these bills could become law in the near future.

Contacts

Michael J. Rosenberg
(212) 336-4447
mrosenberg@mofo.com

[6] See supra at note 10.
[7] Id.

News Bulletin

November 4, 2011

Reg A A-Okay – House Approves the Small Company Capital Formation Act

On November 2, 2011, the House of Representatives (the "House") overwhelmingly approved the Small Company Capital Formation Act of 2011, as amended (the "Small Company Capital Formation Act") by a vote of 421 to 1.[1] The Small Company Capital Formation Act increases the offering threshold from $5 million to $50 million for offerings exempt from registration under the Securities Act of 1933, as amended (the "Securities Act") pursuant to Regulation A.[2] The House also passed legislation that modifies the threshold for registration and deregistration under the Securities Exchange Act of 1934 for bank and bank holding companies.[3]

Representative David Schweikert (R-AZ), Vice Chairman of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises and sponsor of the Small Company Capital Formation Act, said: "Small businesses are the backbone of job growth in our country....This bill ... will assist them in efficiently raising funds."[4]

The Approved Legislation

The Small Company Capital Formation Act, as approved, contains a few modifications to the version approved by the House Financial Services Committee on June 22, 2011.[5] The Small Company Capital Formation Act subjects prospectus disclosures used in a Regulation A offering to the civil liability provision in section 12(a)(2) liability (not Section 11 liability).[6] In addition, the Small Company Capital Formation Act amends Section 18(b)(4) of the Securities Act to include in the definition of "covered security" (for blue sky law purposes) a security that is (i)

[1] This bill is H.R. 1070. See http://www.gpo.gov/fdsys/pkg/BILLS-112hr1070eh/pdf/BILLS-112hr1070eh.pdf. The House approved a motion to suspend the rules and pass H.R. 1070, a procedural shortcut used for bills that are not controversial.
[2] For a discussion of the background for and elements of the Small Company Capital Formation Act, see our Client Alerts "Small Company Capital Formation Act of 2011; Regulation A Revival?" dated March 30, 2011, available at http://www.mofo.com/files/Uploads/Images/110330-Small-Company-Capital-Formation-Act-2011.pdf and "House Financial Services Committee Approves the Small Company Capital Formation Act; Regulation A Revival Closer?" dated June 24, 2011, available at http://www.mofo.com/files/Uploads/Images/110624-HSFC-Approves-Small-Company.pdf.
[3] This bill is H.R. 1965. See press release issued by the House Financial Services Committee regarding both bills, available at http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=267321.
[4] See press release issued by Representative David Schweikert's office, available at http://schweikert.house.gov/News/DocumentSingle.aspx?DocumentID=267319.
[5] See Small Company Capital Formation Act as approved on June 22, 2011, by the House Financial Services Committee, available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr1070rh/pdf/BILLS-112hr1070rh.pdf and our Client Alert "House Financial Services Committee Approves the Small Company Capital Formation Act; Regulation A Revival Closer?" dated June 24, 2011, available at http://www.mofo.com/files/Uploads/Images/110624-HSFC-Approves-Small-Company.pdf.
[6] See Id.

offered or sold on a national securities exchange; or (ii) offered or sold to a qualified purchaser...,[7] but not a security offered or sold through a broker or dealer.[8] The bill mandates that the Comptroller General conduct a study on the impact of state blue sky laws on offerings made under Regulation A and report to Congress on the results of the study within three months of enactment of this legislation. State blue sky considerations clearly remain a concern.[9]

Next Steps

House approval of the Small Company Capital Formation Act is a step in the right direction. The Senate received H.R. 1070 on November 3, 2011. Senate Committee referrals are still pending. However, the strong bipartisan support on the House side bodes well for action on the Senate side.

Contacts

Gerd D. Thomsen
(212) 336-4335
gthomsen@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

[7] See Small Company Capital Formation Act of 2011, H.R. 1070, as approved by the House on November 2, 2011, available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr1070eh/pdf/BILLS-112hr1070eh.pdf.
[8] See Id.
[9] Towards the end of the debate, Mr. Peters said: "Finally, the gentleman from Arizona [Mr. Schweikert] has also worked with Democrats on the remaining issue of contention, and that was the preemption of State law. The gentleman from Arizona's substitute amendment to H.R. 1070 removes the exemption from State level review that was previously provided to an issuer using a broker-dealer to distribute and issue. Regulation A securities can be high-risk offerings that may also be susceptible to fraud, making protections provided by the State regulators an essential future." See the Congressional Record, available at http://www.gpo.gov/fdsys/pkg/CREC-2011-11-02/pdf/CREC-2011-11-02-pt1-PgH7229.pdf.

News Bulletin

October 13, 2011

Legislative Proposals to Facilitate Small Business Capital Formation

In our June 2011 client memorandum,[1] we discussed H.R. 2167, the proposed bill introduced by Representative David Schweikert (R-AZ) to increase the threshold for mandatory registration for all companies under the Securities Exchange Act of 1934 (the "Exchange Act") from 500 persons holding equity securities of record to 1,000 persons. We also discussed a related bill, H.R. 1965, introduced in the House by Representatives Jim Himes (D-CT) and Steve Womack (R-AK) to amend Section 12(g) of the Exchange Act by raising the registration threshold from 500 to 2,000 record holders if the issuer is a bank or a bank holding company. The Himes-Womack bill would also modify the threshold for deregistration under Sections 12(g) and 15(d) of the Exchange Act for banks or bank holding companies from fewer than 300 to fewer than 1,200 shareholders as well as raise the total assets threshold from $1 million to $10 million on the last day of the company's first fiscal year following the passage of the bill.[2]

The Proposed Legislation

Since June 2011, there have been a number of legislative developments to amend the mandatory registration thresholds of Section 12(g) and related provisions. On September 21, the House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises (the "House Subcommittee") held a hearing on a number of these proposals, followed, on October 5, by a House Subcommittee approval vote. The Himes-Womack bill was agreed upon by a voice vote of the House Subcommittee. The Schweikert bill, as amended, was also agreed to by a voice vote of the House Subcommittee. The amendment, offered by Representative Scott Garrett (R-NJ), removed the proposed exclusion of accredited investors from the definition of "held of record" for purposes of Section 12(g)(5). Now, the Schweikert bill excludes from the definition of "held of record" only those who receive their securities pursuant to an employee stock option or pension plan in transactions exempt from registration under Section 5 of the Securities Act of 1933 (the "Securities Act").

During the same session, the House Subcommittee also approved three other bills. H.R. 2930, introduced in the House on September 14, 2011 by Representative Patrick McHenry (R-NC), proposes to add a "crowdfunding" exemption under both Section 4 (exempt offerings) of the Securities Act and Section 12(g) of the Exchange Act. The McHenry bill defines "crowdfunding" as an offering of securities in which the aggregate annual amount raised is $5 million or less *and* individual investments in the securities are limited to an aggregate annual amount equal to the lesser of (i) $10,000 and (ii) 10% of the investor's annual income.[3] The McHenry bill would amend Section 4 of the Securities Act to exempt the offering from registration under Section 5 of the Securities Act and would

[1] See http://www.mofo.com/files/Uploads/Images/110621-Legislative-Action-on-Exchange-Act-Registration-Thresholds.pdf.
[2] Note that this change merely puts into the statute the current requirements of SEC rules under Sections 12(g) and 15(d).
[3] H.R. 2930 is available at http://financialservices.house.gov/UploadedFiles/hr2930ai.pdf.

exempt the persons acquiring securities in a "crowdfunding" offering from the calculation of holders of record under Section 12(g)(5) of the Exchange Act. The McHenry bill would also exempt holders of securities issued pursuant to the "crowdfunding" exemption from state blue sky laws and regulations. The House Subcommittee agreed to the McHenry bill by a recorded vote of 18 ayes to 14 nays.

H.R. 2940, originally introduced in the House on September 15, 2011 by Representative Kevin McCarthy (R-CA), seeks to amend Section 4(2) of the Securities Act to state specifically that general solicitation and general advertising will not affect the availability of the private placement exemption.[4] The McCarthy bill also proposes to direct the Securities and Exchange Commission (the "SEC") to remove the prohibition against general solicitation and advertising for securities issued pursuant to Rule 506 of Regulation D, provided that all purchasers of the securities are accredited investors and that the issuer took reasonable steps to ascertain that each holder is indeed an accredited investor. The House Subcommittee agreed to the McCarthy bill by a voice vote.

The Small Company Job Growth and Regulatory Relief Act of 2011[5] was originally introduced in the House by Representative Stephen Fincher (R-TN).[6] This bill seeks to amend Section 404(b) of the Sarbanes-Oxley Act of 2002, which requires accounting firms to attest to a company's internal control over financial reporting. The Fincher bill would provide that Section 404(b) no longer applies to reports issued by companies with a total public float of less than $350 million. The Fincher bill was agreed to by a recorded vote of 18 ayes to 14 nays by the House Subcommittee.

Reducing Regulatory Burden

Both the Himes-Womack bill and the Schweikert bill reflect a desire to reduce the burdens on small companies. At the September 21 hearing, Matthew H. Williams, on behalf of the American Bankers Association, testified about the need to increase registration thresholds so as not to overburden small banks with potentially excessive registration and periodic reporting costs. Reducing these costs, Mr. Williams noted, could enable smaller banks to focus on meeting the credit and loan needs of their communities, rather than devoting resources to meeting regulatory requirements that provide little incremental benefit to the banks, shareholders or the public.[7]

Small companies, not just banks, would also benefit from the proposed legislation. Schweikert's bill, which would increase the registration threshold *for all companies* from 500 to 1,000 and exempt securities issued pursuant to an employee compensation plan, would have an immediate impact on the ability of emerging companies to raise capital.

The SEC has stated that it is studying "crowdfunding." At an SEC hearing on September 15, 2011, Meredith Cross, the SEC Director of the Division of Corporation Finance, testified that one of the major areas that the SEC is looking at is "crowdfunding" in response to Chairman Shapiro's urging the SEC Staff to "take a fresh look at some of our offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection."[8] It will be interesting to see, should the McHenry bill move forward, whether any amendments will be attached to the bill that harmonize the endeavors of the SEC and Congress in relation to a "crowdfunding" exemption.

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[4] H.R. 2940 is available at http://financialservices.house.gov/UploadedFiles/hr2940ai.pdf.
[5] No bill number has been assigned yet.
[6] See http://financialservices.house.gov/UploadedFiles/fincherjobbill.pdf.
[7] See http://www.aba.com/NR/rdonlyres/222CE044-577A-11D5-AB84-00508B95258D/73516/FinalMatthewWilliamsHouseCapMkts500Shareholder9211.pdf.
[8] See http://www.sec.gov/news/testimony/2011/ts091511mbc.htm.

Next Steps

Having been agreed to by the House Subcommittee, all five bills discussed above will be sent to the House Committee on Financial Services for further review and markup before being presented to the entire House of Representatives. There has been no date scheduled as of yet for markup nor is there any indication that any or all of these bills will even make it out of Committee review. As we noted in our previous client memorandum on the subject,[9] these are not the first attempts to amend the registration thresholds. However, there does appear to be a renewed fervor, both in Congress and from the administration,[10] to find ways to help emerging companies raise capital.

Contacts

Michael J. Rosenberg
(212) 336-4447
mrosenberg@mofo.com

Nilene R. Evans
(212) 468-8088
nevans@mofo.com

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[9] See http://www.mofo.com/files/Uploads/Images/110621-Legislative-Action-on-Exchange-Act-Registration-Thresholds.pdf at page 3.
[10] See http://www.whitehouse.gov/the-press-office/2011/09/08/fact-sheet-and-overview.

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News Bulletin

October 10, 2011

The Evolution of a Rule: FINRA Proposes Rule 5123 in lieu of Proposed Rule 5122

By: Seth Chertok

Introduction

FINRA stated that it is proposing to adopt new Rule 5123 (Private Placements of Securities) to ensure that investors in private placements are provided with detailed information about the intended use of offering proceeds, the offering expenses and offering compensation. In addition, new Rule 5123 would provide FINRA, through a member "notice" filing requirement, with more timely and detailed information about the private placement activities of member firms. As a result, FINRA believes that the rule will provide important investor protections in connection with private placements without unduly restricting capital formation. In addition, FINRA believes that the proposed rule change will assist its efforts to identify problematic terms and conditions in private placements, thereby helping to detect and prevent fraud.

Disclosure

Rule 5123(a) would prohibit a member or person associated with a member from offering or selling any security conducted in reliance on an available exemption from registration under the Securities Act ("private placement"), or from participating in the preparation of a PPM, term sheet or other disclosure document for a private placement, unless the member or associated person provides a PPM or term sheet to each investor prior to sale. The information provided to the investor must describe the anticipated use of offering proceeds, the amount and type of offering expenses, and the amount and type of compensation provided or to be provided to sponsors, finders, consultants and members, and their associated persons in connection with the offering. In private placements without a PPM or term sheet, the member or associated person must prepare a document that contains these disclosures and provide it to each investor prior to sale.

Notice Filings

Proposed Rule 5123(b) would require "notice" filings of members' private placement activities. Specifically, the proposed Rule would require participating members or associated persons to file the PPM, term sheet or other disclosure document (including exhibits) with FINRA no later than 15 calendar days after the date of first sale, and to file any material amendments to such document, or any amendments to the disclosures mandated by the Rule, with FINRA no later than 15 calendar days after the date such document is provided to any investor or prospective investor.

Exemptions

Proposed Rule 5123(c) would exempt from the requirements of the Rule several types of private placements. Exemptions include offerings sold only to any one or more of the following purchasers:

- institutional accounts, as defined in NASD Rule 3110(c)(4);[1]
- qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;
- qualified institutional buyers, as defined in Securities Act Rule 144A;
- investment companies, as defined in Section 3 of the Investment Company Act;
- an entity composed exclusively of qualified institutional buyers, as defined in Securities Act Rule 144A;
- banks, as defined in Section 3(a)(2) of the Securities Act; and
- employees and affiliates of the issuer.

In addition, the Rule would exempt the following types of offerings:

- offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;
- offerings made pursuant to Securities Act Rule 144A or SEC Regulation S;
- offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;
- offerings of subordinated loans under SEA Rule 15c3-1, Appendix D (see NASD Notice to Members 02-32 (June 2002));
- offerings of "variable contracts" as defined in Rule 2320(b)(2);
- offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in Rule 5110(b)(8)(E);
- offerings of non-convertible debt or preferred securities by issuers that meet the eligibility criteria for incorporation by reference in Forms S-3 and F-3;[2]
- offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already existing investor without the need for additional consideration or investments on the part of the investor;
- offerings of securities of a commodity pool operated by a commodity pool operator as defined under Section 1a(11) of the Commodity Exchange Act; and
- offerings filed with FINRA under Rules 2310, 5110, 5121 and 5122.

These proposed exemptions are very similar to the exemptions in existing Rule 5122 (Member Private Offerings), upon which proposed Rule 5123 is based. The only differences in the exemptions are that the current proposed Rule would not exempt (1) offerings in which a member acts in a wholesaling capacity and (2) offerings of certain credit derivatives, both of which are exempted from Rule 5122.

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[1] The SEC approved SR-FINRA-2010-052, which, when it becomes effective on December 5, 2011, will transfer the definition of "institutional accounts" currently found in NASD Rule 3110(c)(4) to FINRA Rule 4512(c).

[2] FINRA noted that the SEC recently adopted amendments to remove any references to credit ratings from its rules and forms promulgated under the Securities Act of 1933 and the Securities Exchange Act of 1934. See, e.g., Security Ratings, Securities Act Release No. 9245 (July 27, 2011), 76 FR 46603 (August 3, 2011). FINRA is proposing to use the references described therein in the proposed rule change.

The basis for the wholesaling exemption in Rule 5122 was that distribution of the private placement by independent retail broker-dealers would obviate the need for the rule, which applies to private placements in which the selling member or its control entity is the issuer. However, given that the current proposed rule change applies to all private placements, the reliance upon the efforts of an "independent" broker-dealer is no longer relevant. Accordingly, the wholesaling exemption is not provided in proposed Rule 5123.

The exemption for offerings of equity and credit derivatives was intended to avoid attributing certain derivative products on unaffiliated issuers as a "member private offering." However, since proposed Rule 5123 would apply to all offerings in which a member participates, that distinction is not relevant to Rule 5123.

FINRA noted that the exemption provisions may be combined, since these exemptions are derived from those in Rule 5122. For example, if an MPO is offered to both qualified purchasers and employees or affiliates of the issuer or its control entities, as long as these purchasers qualify for exemptions under the rule, the MPO would be exempt from the rule's requirements.

Furthermore, proposed paragraph 5123(e) would provide members with a method for application of an exemption from the provisions of the Rule for good cause pursuant to the Rule 9600 Series.

Confidentiality

Proposed Rule 5123 contains provisions identical to those in current Rule 5122 regarding confidential treatment and application for exemption. Pursuant to proposed paragraph 5123(d), FINRA would accord confidential treatment to all documents and information filed pursuant to the Rule, and would use such documents and information solely for the purpose of determining compliance with FINRA rules or other applicable regulatory purposes. FINRA stated that Rule 5123 would afford confidential treatment to all comment or similar letters by FINRA, and thus they could not be discovered by a litigant through any legal action.

Relationship to Regulatory Notice 11-04

In January 2011, FINRA published Regulatory Notice 11-04 requesting comment on proposed amendments to expand Rule 5122 (the "11-04 Proposal"). The 11-04 Proposal would have extended virtually all of the existing requirements of Rule 5122, i.e., those requiring disclosure, filing and limitations on the use of offering proceeds, to all private placements in which a member participates (subject to the listed exemptions). As a result of the differences between the 11-04 Proposal (and Rule 5122) and the current proposed Rule, FINRA proposed that the rule regarding private placements be a new rule separate from Rule 5122.

Use of Offering Proceeds Limitation

The issue generating the most comments was the proposed use of offering proceeds limitation (i.e., the proposed requirement that 85 percent of the offering proceeds raised be used for the business purposes described in the disclosure document). Based in large part on the comments, FINRA amended the proposal such that it no longer included the substantive requirement that at least 85 percent of offering proceeds must be used for the disclosed business purposes and instead reoriented the provisions of the Rule towards disclosure.

While FINRA continues to believe that the manner in which offering proceeds are used is critically important in a private placement – and that offerings in which a large percentage of offering proceeds are used for other than business purposes raise regulatory concerns – FINRA believes that these concerns can be addressed through the obligations of broker-dealers, under the suitability and anti-fraud provisions of securities laws and FINRA rules, to conduct a reasonable inquiry of an issuer.[3] FINRA's expectation is that the reasonable inquiry obligations of

[3] See Regulatory Notice 10-22 (April 2010) (Regulation D Offerings).

broker-dealers will encourage reasonable limits on the use of offering proceeds for purposes other than generating a return on investment. If the rigorous application of reasonable inquiry obligations outlined in Regulatory Notice 10-22 does not achieve this result, FINRA will reconsider the imposition of numerical limitations.

Filing Requirements

The 11-04 Proposal would have required a member to file information with FINRA by the time an offering document is provided to any investor. Commenters raised concerns, among others, about potential slowdowns of offerings due to the filing requirement. In response to these comments, FINRA now proposes to require that a member file "no later than 15 calendar days after the date of first sale."

This timing requirement is the same as the filing requirement for Form D. Synchronizing these timing requirements may allow some filers to utilize operational efficiencies. Moreover, by requiring a "notice" filing, FINRA will remove any implication that the FINRA staff will provide comments on a filing; that such filing with FINRA could be a precondition to commencing an offering; or that members should expect to receive any FINRA staff input before proceeding with an offering. The proposed filing requirement would nevertheless provide FINRA staff with timely access to information about the private placement business of FINRA members.

Furthermore, FINRA stated that it is more practical, and more helpful to FINRA's need for timely access to information about the private placement business of members, to require every member that participates in a particular private placement to fulfill the notice filing requirement.

Implementation Date

FINRA will announce the implementation date of the proposed rule change no later than 90 days following SEC approval. The implementation date will be no more than 180 days following SEC approval.

Contacts

Seth Chertok
(415) 268-6531
schertok@mofo.com

Nilene Evans
(212) 468-8088
nevans@mofo.com

Anna Pinedo
(212) 468-8179
apinedo@mofo.com

Gerd Thomsen
(212) 336-4335
gthomsen@mofo.com

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News Bulletin

June 24, 2011

House Financial Services Committee Approves the Small Company Capital Formation Act; Regulation A Revival Closer?

On June 22, 2011, the House Financial Services Committee on Capital Markets and Government Sponsored Enterprises (the "House Financial Services Committee") approved the Small Company Capital Formation Act of 2011, as amended (the "Small Company Capital Formation Act").[1] Several amendments were introduced and debated by the full House Financial Services Committee.[2] Representative David Schweikert (R-AZ), Vice Chairman of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, said: "I am extremely pleased that the Financial Services Committee passed my Small Company Capital Formation Act. This common-sense proposal, passed with bipartisan support, reduces burdensome regulation on small business and creates more jobs. I am glad my colleagues stand with me in unwinding regulation and make our capital markets more vibrant and competitive."[3] On March 14, 2011, Representative Schweikert introduced the Small Company Capital Formation Act in the U.S. House of Representatives (the "House"). The bill seeks to increase the offering threshold from $5 million to $50 million for public offerings of smaller companies exempt from registration under the Securities Act of 1933, as amended (the "Securities Act") pursuant to Regulation A.[4]

The House Financial Services Committee approved amendment no. 1 offered by Representative Schweikert.[5] This amendment would amend Section 18(b)(4) of the Securities Act by including in the definition of covered security: "a rule or regulation adopted pursuant to Section 3(b)(2) and such security is (i) offered or sold through a broker or dealer; (ii) offered or sold on a national securities exchange; or (iii) sold to a qualified purchaser." Accordingly, pursuant to this amendment, certain Regulation A offerings would be preempted from state "Blue Sky" review. The North American Securities Administrators Association had objected to limitations in state authority in connection with Regulation A offerings in a comment letter to the House Financial Services Committee dated June 15, 2011, citing investor protection concerns.[6]

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[1] This is bill H.R. 1070. See http://financialservices.house.gov/UploadedFiles/HR1070_REPSUBCOM_xml.pdf. See press release issued by the House Financial Services Committee, available at http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=248319.
[2] See the overview provided by the House Financial Services Committee available at http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=247453.
[3] See press release issued by the House Financial Services Committee, available at http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=248319.
[4] See our Client Alert "Small Company Capital Formation Act of 2011; Regulation A Revival?" dated March 30, 2011, for a discussion of the background for and elements of the proposed legislation.
[5] See http://financialservices.house.gov/UploadedFiles/062211hr1070schweikertam.pdf.
[6] See http://www.nasaa.org/content/Files/NASAA_Comment_Letter_HR1070_HR1082.pdf.

Amendment no. 1a offered by Representative Gary Ackerman (D-NY) was also approved.[7] This amendment provides that the Securities and Exchange Commission (the "Commission") *shall* require an issuer to file audited financial statements with the Commission annually, aiming to put stronger investor protections in place for investors in smaller companies.

Finally, amendment no. 1b offered by Representative Barney Frank (D-MA), providing that each prospectus for securities offered in a Regulation A offering will be treated as a registration statement for purposes of liability under Section 11 of the Securities Act, was approved.[8] Currently, an exempt offering pursuant to Regulation A is excluded from Section 11 liability, while remaining subject to the antifraud provisions under the federal securities laws.

While on a fast track and subject to bipartisan support,[9] the Small Company Capital Formation Act is still in the early stages of the legislative process, and it remains to be seen whether Regulation A reform will succeed.

Contacts

Gerd D. Thomsen
(212) 336-4335
gthomsen@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

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[7] See http://financialservices.house.gov/UploadedFiles/062211hr1070ackermanam.pdf.
[8] See http://financialservices.house.gov/UploadedFiles/062211hr1070frank02am.pdf.
[9] The Small Company Capital Formation Act is currently co-sponsored by 17 representatives (of which 15 are Republicans and 2 are Democrats).

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News Bulletin

June 21, 2011

Legislative Action on Exchange Act Registration Thresholds

On June 14, 2011, Representative David Schweikert (R-AZ) introduced a bill in the U.S. House of Representatives that would raise the threshold for mandatory registration under the Securities Exchange Act of 1934 (the "Exchange Act") from 500 persons holding equity securities of record to 1,000 persons for all companies.[1] This bill would also exclude accredited investors and securities held by persons who received such securities pursuant to employee compensation plans from counting against the 1,000-record holder threshold.

Representative Jim Himes (D-Conn.) and Steve Womack (R-Ark.) introduced a related bill in the House on May 24, 2011.[2] The Himes-Womack bill is nearly identical to a bill introduced in the Senate on March 10, 2011 by Senators Kay Bailey Hutchinson (R-Texas) and Mark Pryor (D-Ark.).[3] These bills seek to amend Section 12(g) of the Exchange Act by raising the threshold that triggers registration from 500 to 2,000 record holders if the issuer is a bank or a bank holding company. The bill would also modify the threshold for deregistration under Sections 12(g) and 15(d) of the Exchange Act in the case of a bank or a bank holding company from 300 to less than 1,200 shareholders.

Background

Section 12(g) of the Exchange Act requires issuers to register a class of equity securities with the Securities Exchange Commission ("SEC") if, on the last day of the issuer's fiscal year, such class of securities is held of record by 500 or more record holders and the company has total assets of more than $10 million.[4] After a company has registered under Section 12(g), all of the reporting requirements under the Exchange Act apply; therefore, a company would need to file annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements on Schedule 14A, and certain persons would be required to report transactions on Forms 3, 4 and 5 and Schedules 13D and 13G.[5] A company can deregister a class of equity securities under Section 12(g), when such class of equity securities is held of record by less than 300 persons, or by less than 500 persons and the total assets of the issuer has not exceeded $10 million on the last day of each of the issuer's three most recent fiscal years.

[1] H.R. 2167. See http://www.gpo.gov/fdsys/pkg/BILLS-112hr2167ih/pdf/BILLS-112hr2167ih.pdf.
[2] H.R. 1965. See http://www.gpo.gov/fdsys/pkg/BILLS-112hr1965ih/pdf/BILLS-112hr1965ih.pdf.
[3] S. 556. See http://www.gpo.gov/fdsys/pkg/BILLS-112s556is/pdf/BILLS-112s556is.pdf.
[4] While section 12(g) provides for a $1 million threshold, Rule 12g-1 provides an exemption from the mandatory registration provisions of Section 12(g) for companies with assets of $10 million or less.
[5] Foreign private issuers are subject to less burdensome disclosure requirements. A foreign private issuer is required to file annual reports on Form 20-F, and quarterly and current reports on Form 6-K if such information is required to be made public in its home jurisdiction. A foreign private issuer is also exempt from the proxy solicitation requirements and its insiders are not required to report transactions on Forms 3, 4 and 5.

Prior to 1964, only listed companies were required to comply with the Exchange Act registration, reporting, proxy solicitation and other requirements. Section 12(g) of the Exchange Act was added in amendments to the Exchange Act in 1964.[6] The purpose of the amendments, as stated in the preamble, was "to extend disclosure requirements to the issuers of additional publicly traded securities."[7] The legislative history indicates that the purpose of adding this section was to extend the registration and disclosure requirements to issuers whose securities trade in the over-the-counter market were comparable to the registration and disclosure requirements of listed issuers. The amendments had the effect of increasing investor confidence in issuers whose securities trade in the over-the-counter market and allowed such companies to access the capital markets with greater ease.

In the 1980s, the SEC raised the asset threshold incrementally to $5 million and then, in 1996, it was raised to the current level of $10 million.[8] There have been no subsequent changes to the Section 12(g) registration and deregistration threshold. Consistent with congressional intent, the SEC stated that the numerical thresholds that mandate registration under Section 12(g) were directed toward issuers that had active trading markets and public interest of a level sufficient to warrant mandatory disclosure to ensure the protection of investors.[9]

The Proposed Legislation

The Schweikert bill seeks to amend Section 12(g) of the Exchange Act by raising the registration threshold to 1,000 holders of record of a class of equity securities. The bill would also exclude accredited investors and securities held by persons who received such securities pursuant to employee compensation plans from counting against the 1,000-record holder threshold.

The Himes-Womack bill would amend Section 12(g) by modifying the threshold that triggers Section 12(g) registration to 2,000 holders of record of a class of equity securities if the issuer is a bank or a bank holding company. The bill preserves the 500 holders of record threshold for all other companies, and raises the deregistration threshold for a bank or a bank holding company from 300 to 1,200 holders of record.

The Himes-Womack bill also directs the Chief Economist and the Director of the Division of Corporation Finance of the SEC to jointly conduct a study, including a cost-benefit analysis, of shareholder registration thresholds. The cost-benefit analysis must weigh the benefits to investors of the increased disclosure relative to the costs to issuers as a result of registration and examine the administrative costs to the SEC that are associated with different thresholds. In conducting the study, the Chief Economist and the Director of the Division of Corporation Finance must evaluate whether to increase the asset threshold, index the asset threshold to inflation, increase the shareholder threshold, change the shareholder threshold to be based on beneficial ownership or to create thresholds based on other criteria. The Chief Economist and the Director of the Division of Corporation Finance are required to submit a report and a recommendation to Congress within two years.

Time for Reform?

The proposed bills come at a time when there have been other attempts at amending Section 12(g). For example, the impact of regulations, including the 500 holder of record threshold in Section 12(g) of the Exchange Act, was recently put in the spotlight by correspondence between Congressman Darrell Issa (R-CA), Chairman of the House Committee on Oversight and Government Reform, and Mary Schapiro, Chairman of the SEC.[10] Subsequently, Chairman Schapiro also testified on May 10, 2011, before the U.S. House of Representatives Committee on Oversight and Government Reform on the impact of regulations, including the shareholder

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[6] Securities Acts Amendments of 1964, Pub. L. 88-467; 78 Stat. 565 (referencing Section (3), which added Exchange Act Section 12(g)).
[7] *See id*.
[8] Release No. 34-37157 (May 1, 1996).
[9] Release No. 34-23407 (July 8, 1986).
[10] Our client memorandum on this topic is available at http://www.mofo.com/files/Uploads/Images/110420-US-Capital-Raising-in-the-Spotlight.pdf.

thresholds under Section 12(g), on the future of capital formation in the U.S.[11] Chairman Schapiro also recently instructed her staff to review the impact of regulations on capital formation for small businesses, focusing on a number of areas, including the number of shareholders that trigger public reporting. Chairman Schapiro indicated that this review will include an evaluation of the recommendations of the annual SEC Government-Business Forum on Small Business Capital Formation. The SEC has also created an email box for suggestions for reform on their website located at http://www.sec.gov/spotlight/regulatoryreviewcomments.shtml. Chairman Schapiro indicated that the SEC will also consider recommendations from a new Advisory Committee on Small and Emerging Companies.

Securities markets have changed significantly since the enactment of the 1964 amendments to Section 12(g), and while the Commission has increased the asset thresholds, it has not made any corresponding changes to the holder of record thresholds under this section. Privately held companies may have less than 500 record holders but can still have actively traded securities on the secondary markets. In the case of public companies, the vast majority of securities are held in street name. Brokers, who typically own large positions in companies, are counted as one record holder. In contrast, in smaller private companies, shares are held directly and all holders are counted for purposes of Section 12(g).

Raising the registration threshold would benefit private companies and secondary trading markets. Private companies would more easily avoid the reporting requirements that come with mandatory SEC registration under Section 12(g), and some companies would stay private longer if they were not subject to the registration provisions of the Exchange Act as a result of the number of holders of record of their equity securities. The existence of more, growing private companies could potentially invigorate secondary trading markets, which provide shareholders of private companies with access to liquidity prior to going public through an IPO or due to the mandatory registration provisions of Section 12(g).

The Senate Bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs on March 10, 2011, but the Committee has not scheduled hearings on the bill.[12] The House bills were likewise referred to the House Committee on Financial Services. Similar bills amending the registration thresholds were also proposed in 2007, and the relevant committees took no action on either bill.[13] An amendment identical to the Himes-Womack Bill was introduced to the 2010 Dodd-Frank bill, but was not considered nor adopted as part of that legislation.[14] Without concerted effort by the bills' sponsors and advocates, the current bills may meet the same fate as earlier legislative attempts at addressing the Exchange Act registration threshold.

Contacts

David M. Lynn
(202) 887-1563
dlynn@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

Indira Lall
(202) 778-1446
ilall@mofo.com

[11] SEC Chairman Mary Schapiro's Testimony before the U.S. House of Representatives Committee on Oversight and Government Reform on the Future of Capital Formation. See http://sec.gov/news/testimony/2011/ts051011mls.htm.
[12] Nor has further action yet been taken on H.R. 1965, which was referred to the House Financial Services Committee on May 26, 2011, or H.R. 2167, which was referred to the same committee on June 14, 2011.
[13] The 2007 reform attempts were S. 1405 and H.R. 1869 (109th Congress).
[14] Sen. Hutchison introduced the amendment. See S. Res. 3833 (110th Congress), 156 Cong. Rec. 3262.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

News Bulletin

June 3, 2011

Dodd-Frank Update: SEC Proposes Bad Actor Disqualifications for Private Placements under Regulation D

On May 25, 2011, the Securities and Exchange Commission (the "SEC" or "Commission") proposed amendments to rules promulgated under Regulation D to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Section 926 of the Dodd-Frank Act, entitled "Disqualifying felons and other 'bad actors' from Regulation D offerings," requires the SEC to adopt rules to disqualify certain securities offerings from reliance on the private placement safe harbor provided by Rule 506 of Regulation D.

We discuss the background, the proposed amendments to Rule 506 of Regulation D, and possible future SEC rulemaking below.

Background

Rule 506 permits sales of an unlimited amount of securities, without registration, to any number of accredited investors[2] and up to 35 non-accredited investors, as long as there is no general solicitation, the appropriate resale limitations are imposed, any applicable information requirements are satisfied and the other conditions of the rule are met. Rule 506 is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D.

Unlike Rule 505 of Regulation D, Regulation E and Regulation A, Rule 506 of Regulation D does not currently have any "bad actor" disqualification provisions. "Bad actor" disqualification requirements prohibit issuers and others such as underwriters, placement agents, directors, officers, and shareholders of the issuer from participating in exempt securities offerings, if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. The SEC proposed similar amendments in 2007, but did not take final action on that proposal.[3]

Section 926 of the Dodd-Frank Act requires the SEC to adopt rules that would make the exemption available under Rule 506 unavailable for any securities offering in which certain "felons" or other "bad actors" are involved. Section 926 also requires the new rules to be substantially similar to the bad actor disqualification provisions of another limited offering exemptive rule, Rule 262, the bad actor disqualification provisions specified in Regulation A.

[1] Release No. 33-9211 (May 25, 2011) (the "Proposing Release"). The Proposing Release is available at http://www.sec.gov/rules/proposed/2011/33-9211.pdf.
[2] In a separate rulemaking required under Section 413(a) of the Dodd-Frank Act, the SEC proposed amendments to the accredited investor standards in the rules promulgated under the Securities Act of 1933. Our news bulletin on those amendments is available at http://www.mofo.com/files/Uploads/Images/110125-Net-Worth-Standard-for-Accredited-Investors.pdf.
[3] Release No. 33-8828 (August 3, 2007). That Release is available at http://www.sec.gov/rules/proposed/2007/33-8828.pdf.

Proposed Amendments

Covered Persons

Section 926(1) of the Dodd-Frank Act requires the SEC to adopt disqualification rules that are substantially similar to those of Rule 262, the bad actor disqualification provisions applicable to offerings under Regulation A. The proposed amendments would add a new Section 506(c) to Regulation D. That new section would encompass disqualification provisions that are currently codified in Rule 262 of Regulation A and in Section 926(1) of the Dodd-Frank Act. The disqualification provisions in proposed Rule 506(c) generally correspond to the persons currently covered under Rule 262 and would thus apply to the following "covered persons":

- the issuer and any predecessor of the issuer or affiliated issuer, any director, or any officer;
- any director, officer, general partner, or managing member of the issuer;
- any beneficial owner of 10 percent or more of any class of the issuer's equity securities;
- any promoter connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid, directly or indirectly, remuneration for solicitation of purchasers in a securities offering; or
- any director, officer, general partner, or managing member of any compensated solicitor.

The SEC has sought to clarify in the proposed rule that for entities organized as limited liability companies, managing members would be covered expressly, as are general partners of partnerships. In the case of financial intermediaries likely to be involved in a private placement under Rule 506, the SEC proposed to look to the current standards in Rule 505. Because Rule 505 transactions do not involve underwritten public offerings but rather the use of compensated placement agents and finders, the term "underwriters" in Rule 262 is replaced with "any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers." This Rule 505 standard would apply to transactions under Rule 506, as such transactions would also typically involve placement agents and finders.

The proposed rule also clarifies that the disqualification provisions do not apply to certain events prior to an offering. Under existing Rule 262(a)(5), orders, judgments, and decrees entered against affiliated issuers before the affiliation arose do not disqualify an offering, if the affiliated issuer is not in control of the issuer or under common control, together with the issuer, of a third party that controlled the issuer at the time that the order, decree, or judgment was entered. The proposed rule would clarify that this exclusion applies to all potentially disqualifying events that predate the affiliation.

The SEC is seeking comments on whether other categories of persons should be included in Rule 506(c), whether the term "officer" as it applies to financial intermediaries in private offerings should be reserved for "executive officers" only (i.e., those performing policy-making functions), whether the proposed coverage of 10 percent shareholders is appropriate, whether any exceptions need to apply for actions entered into prior to affiliation, and whether it would be appropriate to extend coverage to investment advisers and their directors, officers, general partners and managing members.

Disqualifying Events

The proposed rule includes seven categories of disqualifying events. They are:

- Criminal convictions;
- Court injunctions and restraining orders;
- Final orders of certain state regulators (such as securities, banking, and insurance) and federal regulators;
- Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization ("SRO");
- Commission stop orders and orders suspending a Regulation A exemption; and
- U.S. Postal Service false representation orders.

A discussion of each of these categories appears below.

Criminal Convictions

Section 926(2)(B) of the Dodd-Frank Act provides for disqualification if any covered person "has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission," similar to the current language of Rule 262(a)(3) (with respect to criminal convictions of issuers) and Rule 262(b)(1) (with respect to criminal convictions of other covered persons). Unlike Rule 262(b)(1), however, Section 926(2)(B) of the Dodd-Frank Act does not address criminal convictions "arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer or investment adviser." Given that these convictions are covered in existing Rule 262, the proposed revision to Rule 506 would cover such convictions, and includes a reference to convictions arising out of the conduct of the business of a person compensated for soliciting purchasers, as is presently provided in Rule 505(b)(2)(iii).

Proposed Rule 506 also includes a five-year look-back period for criminal convictions of issuers and a ten-year look-back period for other covered persons. Rule 262 has similar look-back periods, but Section 922(2)(B) of the Dodd-Frank Act does not include any look-back period for convictions. The SEC is seeking comments on whether a longer look-back period is appropriate. The SEC is also seeking comments on whether the inquiry should focus on the beneficial ownership structure of an entity at the time of the disqualifying event, on the application of the rule to the date of the relevant sale, on the scope of the application, and whether corresponding convictions in foreign courts should trigger disqualification.

Court Injunctions and Restraining Orders

Currently under Rule 262, issuers and other covered persons are disqualified from reliance on Regulation A if the issuer or such covered person is subject to a court injunction or restraining order against engaging in or continuing any conduct or practice in connection with the purchase or sale of securities or involving the making of a false filing with the SEC. Proposed Rule 506(c)(1)(ii) reflects the substance of Rule 262, but also includes in its application orders arising out of the conduct of business of paid solicitors of purchasers of securities.

The SEC is seeking comments on whether a look-back period of five years for injunctions and restraining orders is appropriate, and whether foreign court orders and injunctions should have any consequences when subject to disqualification.

Final Orders of Certain Regulators

Section 926(2)(A) of the Dodd-Frank Act provides that the SEC disqualification rules must apply to offerings by any covered person who is subject to a final order of a state securities commission; a state agency that regulates banks, savings associations, credit unions and insurance companies; a federal agency, or the National Credit Union Administration. The order must be final, based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct and must bar the person from association with such entity and from engaging in the business of securities, insurance, banking, savings association or credit union activities. That section also contains a ten-year look-back period. Section 926(2)(A) is identical to existing provisions in the Securities Exchange Act ("Exchange Act") and the Investment Advisers Act of 1940 ("Advisers Act")[4] that grant the Commission authority to censure, suspend or revoke the registration of brokers, dealers and investment advisers based on financial industry bars and final regulatory orders issued against them by specified regulators.

Proposed Rule 506(c)(1)(iii) codifies Section 926(2)(A) of the Dodd-Frank Act and seeks to eliminate ambiguities, as the proposed rule provides that the order must bar the person "at the time of [the] sale" from one or more of the activities, the bar must be disqualifying only for as long as it has continuing effect, and that the ten-year look-back period applies from the date of the order and not the date of the underlying conduct. The SEC is seeking comments on whether the rule should clarify what constitutes a "bar" and whether a cut-off date for permanent bars is appropriate.

The proposing release discusses each of "Final Orders," "Fraudulent, Manipulative or Deceptive Conduct," and "Orders of Other Regulators" under this subsection. A discussion of each of these subcategories appears below:

- Final Orders

Proposed Rule 501 defines "final order" to mean the final steps taken by a regulator. The proposed definition is based on the Financial Industry Regulatory Authority ("FINRA") definition. FINRA collects information regarding disciplinary actions, including relevant final orders, through its uniform registration Forms BD, U4, U5, and U6 for the purpose of registration of broker-dealers and associated persons. In that context, FINRA defines "final order" to mean "a written directive or declaratory statement issued by an appropriate federal or state agency . . . pursuant to applicable statutory authority and procedures, that constitute a final disposition or action by that federal or state agency."[5]

The SEC is seeking comments on whether the proposed definition is appropriate and whether the definition should mean an order for which all rights of appeal have been exhausted.

- Fraudulent, Manipulative, or Deceptive Conduct

Section 926(A)(ii) of the Dodd-Frank Act provides that disqualification must result from final orders of the relevant regulators that are "based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct." Proposed Rule 501 does not differentiate between technical violations, and intentional or other more egregious conduct. The SEC is seeking comments on whether to provide guidance on what constitutes fraudulent, manipulative, or deceptive conduct, and whether to distinguish between technical violations and intentional or egregious conduct for the purposes of the disqualification.

[4] See Section 15(b)(4)(H) of the Exchange Act and Section 203(e)(9) of the Advisers Act.
[5] See "Explanation of Terms" applicable to FINRA Forms U4, U5, and U6 (available at http://www.finra.org/web/groups/industry/@ip/@comp/@regi/documents/appsupportdocs/p116979.pdf).

- Orders of Other Regulators

Under Section 926 of the Dodd-Frank Act, bad actor disqualification would result from final orders issued by state and federal regulators enumerated in that section. That list does not currently include the Commission or the Commodity Futures Trading Commission ("CFTC"). Currently, some types of Commission orders are covered by bad actor disqualification rules such as Regulation A, Rule 505, and Regulation E. However, Commission orders in cease-and-desist proceedings are not disqualifying under current rules.[6] This distinction has the effect of subjecting individuals outside the securities industry to bad actor disqualification rules only if those persons are subject to court orders.

The SEC is seeking comment on whether CFTC orders are relevant for disqualification purposes, if cease-and-desist orders may be an appropriate basis for disqualification, and, if so, whether the rules should differentiate among different types of orders.

Commission Disciplinary Orders

Currently under Rule 262(b)(3), issuers and other covered persons that are subject to an SEC order entered pursuant to Section 15(b), 15B(a), or 15B(c) of the Exchange Act, or Section 203(e) or (f) of the Advisers Act, are disqualified from relying on the exemption available under Regulation A. Under the cited provisions of the Exchange Act and the Advisers Act, the SEC has the authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers, and investment advisers, including the suspension or revocation of registration, censure, placing limits on their activities, imposing civil money penalties and barring individuals from being associated with specified entities and from participating in the offering of any penny stock.

The SEC and its staff have historically required disqualification periods to run only for as long as some act is prohibited or required to be performed pursuant to an order. Therefore, censures are not disqualifying and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires. The SEC is seeking comments on whether this position should be codified, whether a look-back period should be required, and whether the reference to Section 15B(a) of the Exchange Act should be eliminated in the proposed rule. Orders issued under Section 15B(a) of the Exchange Act (the basic registration requirements for municipal securities dealers) are treated as disqualifying and the SEC believes that it is not appropriate to refer to it in the context of bad actor disqualification.

Suspension or Expulsion from SRO Membership or Association with an SRO Member

Rules 262(b)(4) imposes disqualification on an offering if any covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade. The proposed rule covers expulsion from FINRA and seeks comment on whether the rule should cover expulsion from any other organization, including foreign exchanges, and whether a look-back period is appropriate.

Stop Orders and Orders Suspending the Regulation A Exemption

Rule 262(a)(1) and (a)(2) impose disqualification on an offering if the issuer or any predecessor or affiliated issuer filed a registration statement or other Regulation A offering statement that is subject to a Commission refusal order, stop order, or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine if such an order should be issued. Paragraphs (c)(1) and (c)(2) extend disqualification to an underwriter under similar circumstances. Proposed Rule 506(c)(1)(vi) incorporates the substance of paragraphs (a)(1), (a)(2), (c)(1), and (c)(2) of Rule 262, thereby imposing disqualification on an

[6] In addition, investment company bars, civil penalties, and disgorgement under Sections 9(d) and (e) of the Investment Company Act, and censures of persons under Rule 102(e) of the Commission's Rules of Practice, are also not currently disqualifying.

offering pursuant to Regulation A under the circumstances discussed above on both issuers and underwriters. The SEC seeks comments on whether the look-back period is appropriate, and whether this provision should cover action by other regulators, including commodities and foreign regulators.

U.S. Postal Service False Representation Orders

Paragraphs (a)(5) and (b)(5) of Rule 262 impose disqualification on an offering if the issuer or another covered person is subject to a U.S. Postal Service false representation order entered within the preceding five years, or to a temporary restraining order or preliminary injunction with respect to conduct alleged to have violated the false representation statute that applies to U.S. mail. Proposed Rule 506(c)(1)(vii) incorporates the substance of these paragraphs and mirrors the current five-year look-back period.

The SEC seeks comments on whether the five-year look-back period is appropriate.

Reasonable Care Exception

Proposed Rule 506 incorporates a reasonable care exception that would apply if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person. The reasonable care exception would help preserve the intended benefits of Rule 506 and avoid creating an undue burden on capital-raising activities, while giving effect to the legislative intent to screen out felons and bad actors.[7]

In order to rely on the reasonable care exception, the issuer would need to conduct a factual inquiry, the nature of which would depend on the facts and circumstances of the issuer and the other offering participants. In such an inquiry, an issuer would need to consider various factors, such as the risk that bad actors present, the presence of screening and other compliance mechanisms, the cost and burden of the inquiry, whether other means used to obtain information about the covered persons is adequate, and whether investigating publicly available information is reasonable.

The SEC is seeking comments on whether the reasonable care exception is consistent with its goals of investor protection, how the factual inquiry differs from current practice, and whether specific steps for broker-dealers are required.

Waivers

Currently, issuers may seek waivers of disqualification under Regulation A if the issuer shows good cause. Proposed Rule 506(c)(2)(i) carries over the current waiver provisions of Regulation A. Waivers under the new rule will be issued by the Commission.

The SEC is seeking comments on whether it is appropriate for the Commission to have the authority to waive disqualification and whether such authority can be exercised in cases involving orders by state regulators.

[7] Regulation D already has a provision, Rule 508, under which "insignificant deviations" from the terms, conditions, and requirements of Regulation D will not result in the loss of the exemption if the person relying on the exemption can show that: (i) the failure to comply did not pertain to a term, condition or requirement directly intended to protect that individual or entity; (ii) the failure to comply was insignificant with respect to the offering as a whole; and (iii) a good faith and reasonable attempt was made to comply. The Commission does not believe that Rule 508 would cover circumstances in which an offering was disqualified under proposed Rule 506(c).

Transition Issues

Disqualifying Events that Predate the Rule

Under the proposal, the disqualification provisions would apply to all sales under Rule 506 after the effective date of the new provisions. Offerings made after the effective date would be subject to disqualification for all disqualifying events that had occurred within the relevant look-back periods, regardless of whether the events occurred before the enactment of the Dodd-Frank Act. This retroactive application of the disqualification provisions is the most controversial and elicited statements at the open meeting by Commissioners Kathleen Casey[8] and Troy Paredes.[9] The SEC justifies the retroactive application by referencing the language in Section 926 of the Dodd-Frank Act and by relying on the legislative history and intent of that provision.[10]

The SEC is seeking comments on whether grandfathering or other accommodations such as waivers are appropriate for events that predate the enactment of the Dodd-Frank Act. The SEC is also seeking comments on whether the retroactive application of the proposed disqualification provisions will operate in an unfair manner. For example, individuals who negotiated settlements prior to the enactment of the Dodd-Frank Act may have negotiated a different settlement had they known that it would result in disqualification from future Rule 506 offerings.

Effect on Ongoing Offerings and Timing of Implementation

The proposed bad actor disqualification provisions would apply only to sales of securities made in reliance on Rule 506 after the rule amendments go into effect. If disqualifying events occur while an offering is underway, only sales made after the event will be impacted.

The proposal does not contemplate any phase-in period or delay before issuers would be required to comply with the new disqualification rules.

The SEC is seeking comments on whether the disqualification provisions should apply after the effective date of the new rules, and whether it is appropriate to apply them to each sale of securities.

Amendment to Form D

The signature block of current Form D contains a certification that applies to transactions under Rule 505, confirming that the offering is not disqualified from reliance on Rule 505. Under the proposal, this certification would be broadened, so that issuers claiming a Rule 506 exemption would also be required to confirm that the offering is not disqualified from reliance on the Rule 506 exemption.

Possible Amendments to Increase Uniformity

Uniform Application of Bad Actor Disqualification to Regulations A, D, and E

The SEC is requesting comments on whether the bad actor disqualification standards proposed under Rule 506 should be applied uniformly to each of the other Regulation D exemptions, as well as to the exemptions under Regulations A and E. Currently, all bad actor disqualification provisions are substantially similar in language and

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[8] Commissioner Kathleen Casey's speech is available at http://www.sec.gov/news/speech/2011/spch052511tap-item1.htm.
[9] Commissioner Troy A. Paredes's speech is available at http://www.sec.gov/news/speech/2011/spch052511tap-item1.htm.
[10] The SEC reached the opposite result with respect to eligibility for being a "well known seasoned issuer." For the purposes of defining "ineligible issuer" (i.e., an issuer that is not eligible to be a "well known seasoned issuer"), ineligibility based on settlements applies only to judicial or administrative decrees or orders entered into after the effective date of the rule. See Release No. 33-8591 (July 19, 2005); available at http://www.sec.gov/rules/final/33-8591.pdf.

effect to those in Rule 262. The proposal seeks to preserve this uniformity by conforming all existing bad actor disqualification requirements to the standards proposed in Rule 506 offerings.

In order to adopt a uniform approach, the SEC will need to amend its rules to add a new paragraph (e) to Rule 502 and conform the current disqualification provisions in Regulations A and E to the new Rule 502(e), add underwriters and their directors, officers, general partners, and managing members to the categories of covered persons, add as covered persons investment advisers and the general partners, managing members, directors, and officers of investment managers of private funds and business development companies ("BDCs"); use the date of the relevant sale as the measurement date for the look-back period under Regulations A and E; and amend the certification requirements in Form D to apply to all Regulation D offerings.

The SEC is soliciting comments on possible approaches to uniformity, including whether to apply the proposed disqualification provisions uniformly to offerings under Regulations A, D, and E; whether to extend the application to Rule 504 offerings; whether to conform existing disqualification provisions of Regulations A and E to proposed Rule 506(c), and whether investment advisers of private fund issuers and BDCs should be included as covered persons.

Uniform Look-Back Periods

Currently, the Dodd-Frank Act provides for a ten-year look-back period for final orders of federal and state regulators, and for criminal convictions of covered persons other than the issuer (as provided under Rule 262), and a five year period for all other events.

The SEC is proposing to add a uniform ten-year look-back period for all disqualifying events and is soliciting comments on whether this is appropriate.

Request for Comments and Future Rulemaking

The SEC is soliciting comments, both specific and general, on each component of the proposal. Comments are due on July 14, 2011.

Contacts

David M. Lynn
(202) 887-1563
dlynn@mofo.com

Indira Lall
(202) 778-1446
ilall@mofo.com

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News Bulletin

April 20, 2011

U.S. Capital Raising in the Spotlight

The competitiveness of capital markets in the United States and the impact of regulations on capital raising activities by emerging companies have been put in the spotlight again by recent correspondence between Congressman Darrell Issa (R-CA), Chairman of the House Committee on Oversight and Government Reform, and Mary Schapiro, Chairman of the U.S. Securities and Exchange Commission. The wide-ranging inquiry from Chairman Issa elicited a thoughtful response from Chairman Schapiro, which carefully reviews the SEC's regulation of communications around initial public offerings and the viability of various private capital raising activities (including the growth of secondary markets for private company securities), as well as the broader economic and other factors behind a reduction in the number of public companies and initial public offerings in the United States. Chairman Schapiro outlined a number of new SEC initiatives in her response, including SEC staff review of (i) the restrictions on communications in initial public offerings; (ii) whether the general solicitation ban should be revisited; (iii) the number of shareholders that trigger public reporting, including questions regarding the use of Special Purpose Vehicles; and (iv) the regulatory questions posed by new capital raising strategies, such as "crowdfunding." Chairman Schapiro also indicated that the SEC is in the process of forming a new Advisory Committee on Small and Emerging Companies.

Background

On March 22, 2011, Chairman Issa sent a letter to Chairman Schapiro. The letter raised concerns about whether the current securities regulatory framework had a negative impact on capital formation which has led to the dearth of initial public offerings ("IPOs") in the U.S., as well as the extent to which SEC regulations potentially limited other capital raising activities by small and emerging companies.[1] The letter from Chairman Issa also sought specific information regarding the economic studies conducted by the SEC staff in these areas, along with information concerning the consideration of costs and benefits in connection with SEC rulemakings. In her response dated April 6, 2011, Chairman Schapiro stated that she has requested that the SEC staff take a fresh look at the agency's rules in order to develop ideas for the SEC about ways to reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection.[2] The SEC's stated mission, as Chairman Schapiro reiterated in her letter, is to facilitate capital formation, along with protecting investors and maintaining fair and orderly markets.

Congressman Issa is Chairman of the Committee on Oversight and Government Reform in the House of Representatives. The Committee on Oversight and Government Reform has broad powers to, at any time, investigate any matter. Chairman Issa's letter was not joined by the House Financial Services Committee or the Senate Committee on Banking, Housing, and Urban Affairs, which are the Committees that oversee the SEC.

[1] *See* http://www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf.
[2] *See* http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

Chairman Issa's letter to Chairman Schapiro reflects a concern that the U.S. capital markets have become less competitive, as the number of IPOs in the U.S. has plummeted from an annual average of 530 during the 1990s to about 126 since 2001, with only 38 in 2008 and 61 in 2009.[3] The number of companies listed on the major U.S. exchanges peaked at more than 7,000 in 1997, and has been declining ever since, and is currently at about 4,000.[4] Meanwhile, the value of transactions in private-company shares has grown, almost doubling in 2010 to $4.6 billion, from about $2.4 billion in 2009 and is expected increase to $6.9 billion for 2011.[5] Chairman Issa's letter discussed these statistics and raised questions about the following topics: (i) the decline of the U.S. IPO market; (ii) the communications rules in connection with securities offerings; (iii) the 499-shareholder cap under Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act"); (iv) organizational considerations; and (v) new capital raising strategies. Chairman Schapiro's letter contained a detailed response to each of these topics.

Discussion

Decline of the IPO market in the U.S.

Chairman Issa's letter cited statistics about the declining U.S. IPO market and asked if the SEC evaluated the reasons for such decline. The letter asks if the possible reasons for the decline are increasingly complex SEC regulations, costs associated with compliance with the Sarbanes-Oxley Act of 2002 ("SOX"), the uncertainty generated by the pending rulemakings under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the risk of class action lawsuits or the expansion of regulatory, legal and compliance burdens. The letter also cited examples of the IPOs of Google, Inc. and GoDaddy.com that were delayed and canceled, respectively, as evidence of overly burdensome communications rules.

In her response, Chairman Schapiro discussed various reasons for the decline in the IPO market, such as each company's own situation and market factors at the time of the contemplated IPO. She further indicated that the SEC conducts an extensive cost-benefit analysis prior to promulgating rules, and that it has minimized the costs of being a public company and maintained important investor protections to ensure that investors make responsible capital allocation decisions.

Chairman Schapiro stated that it is difficult to determine why a company decides to undertake an IPO or declines to do so. She stated that approximately 11 percent of new issuers filing registration statements for underwritten initial public offerings between January 2009 and March 2011 withdrew their registration statements and terminated their offerings. These companies cited various reasons for terminating their offerings, including unfavorable market conditions, a decision to pursue a merger/acquisition strategy or simply not conduct an IPO at that time. One issuer cited in its withdrawal request that it was withdrawing its registration statement because the benefits of being publicly traded were not sufficiently attractive to warrant proceeding with a public offering.

The costs associated with conducting an IPO and becoming a public reporting company factor into the decision as to whether to conduct an IPO. Chairman Schapiro stated that the SEC has lowered these costs in recent years and that, in 2010, approximately 40% of first-time registrants were smaller reporting companies. Similarly, in 2010, nearly half of registered offerings conducted by first-time registrants were for offerings less than $10 million. Insiders also may desire to maintain control, avoid ownership dilution and may not want to disclose vital information publicly. Chairman Schapiro cited one study that found that companies that had conducted IPOs ranked SEC reporting and SOX compliance costs as fairly low on their list of factors that affected their decision to

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[3] *See* http://www.gt.com/staticfiles//GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf.
[4] *See id.*
[5] *See* http://online.wsj.com/article/SB10001424052748704630004576249182275134552.html?KEYWORDS=%22new+stock+rules%22.

conduct an IPO.[6] Other reasons cited for the declining U.S. IPO market were the protracted decline in stock prices and deteriorating market and industry conditions.

In a discussion about the challenges faced by early stage growth companies, Chairman Schapiro pointed out that such companies have greater difficulty raising capital because of the lack of disclosure on a regular basis, smaller and more variable cash flows, a smaller asset base and a larger percentage of intangible assets.

Chairman Schapiro also stated that while there are studies that show that the number of U.S. IPOs had declined,[7] there are other studies conducted by SEC staff members which indicate that for the period 1995-2007, the U.S. market's share of global IPOs in terms of total dollar proceeds and average dollar proceeds is much higher than those of the United Kingdom and Hong Kong.[8] The other reason for companies to favor an IPO in the European markets is that the underwriters' spread is significantly lower than in the U.S. For example, the gross spread in the U.S. for an offering size between $25-$100 million is approximately 7 percent, while in Europe it would be approximately 4 percent for a similar offering.

Chairman Schapiro also cited several studies which show that the effect of SOX on a company's decision to delist is minor and that delisting from U.S. exchanges is driven by the characteristics of the issuers and not by the decrease in competitiveness of the U.S. equity markets or the enactment of SOX. She stated that several academic studies have found that companies with weak corporate governance structures are more likely to go private and go dark as a result of SOX.[9]

The Impact of the Communications Rules in Connection With Securities Offerings

In his letter, Chairman Issa indicated that the communication rules governing the offerings of securities potentially conflict with the promotion of disclosure and transparency and the First Amendment. He requested an explanation for the potential harm that may realistically result to an unaccredited investor by the receipt of an advertisement by an issuer of unregistered securities that is targeted at accredited investors or Qualified Institutional Buyers ("QIBs"). He reiterated his point that the existing communications rules governing offerings stifle IPOs in the U.S. by citing to examples of the offering of Facebook shares to non U.S. investors, the delay of Google's IPO and the cancellation of the GoDaddy.com IPO.

In her response, Chairman Schapiro described the communications rules that apply to registered and unregistered offerings. Under the Securities Act of 1933 (the "Securities Act"), for registered offerings, an issuer's ability to communicate varies depending on the three phases of the registration process called the pre-filing period, quiet period and the post-effective period.[10] During the "pre-filing period" prior to the filing a registration statement, an issuer may not offer securities.[11] During the "quiet period" or "waiting period", an issuer can make oral offers but cannot make written offers other than through a prospectus that complies with Section 10 of the Securities

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[6] *See* J. Brau and S. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, Journal of Finance 61, 399-436 (2006).
[7] *See, e.g.* D. Weild and E. Kim, *A Wake Up Call for America*, Grant Thornton LLP (2009); Committee on Capital Markets Regulation, Continued Erosion in Competitiveness of the U.S. Equity Markets (2009).
[8] *See* C. Caglio, K. Weiss Hanley and Marietta-Westberg, *Going Public Abroad: The Role of International Markets for IPOs* (February 2011).
[9] *See* L. Austen and D. Dickens, *SOX Doomsday Predictions in Hindsight: Evidence from Delisting*, Current Issues in Auditing I, 21-27 (2007); E. Engel, R. Hayes, and X. Zhang, *The Sarbanes-Oxley Act and Firms Going Private Decisions,* Journal of Accounting and Economics 44, 116-45 (2007); B. Hansen, G. Pownall, and X. Wang, *The Robustness of the Sarbanes-Oxley Effect on the U.S. Capital Market*, Review of Accounting Studies 14, 404-39 (2009); C. Leuz, A. Triantis, and T. Y. Wang, *Why do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, Journal of Accounting and Economics 45, 181-208 (2008).
[10] The Securities Act does not state when the pre-filing period begins. The SEC has stated that an issuer will be in registration at least from the time it begins preparing the related registration statement or the time it has reached an understanding with an underwriter, even if all the terms or conditions of the underwriting arrangement have not been agreed upon. *See* Release No. 33-5009, *Publication of Information Prior to or After the Filing and Effective Date of a Registration Statement Under the Securities Act of 1933* (October 7, 1969); Release No. 33-5180, *Guidelines for Release of Information by Issuers Whose Securities Are in Registration* (August 16, 1971).
[11] *See* Securities Act § 5(c).

Act.[12] In the post-effective period, an issuer can sell and deliver securities as long as a final prospectus that complies with Section 10(a) of the Securities Act accompanies or precedes the delivery of the securities.

Chairman Schapiro discussed the offering reforms adopted in 2005 that liberalized an issuer's ability to communicate during offerings.[13] The reforms included Rule 163A, which provides eligible issuers with a bright-line safe harbor for communications made more than 30 days before filing a registration statement, Rules 168 and 169 that allow issuers to continue to communicate factual business information in the ordinary course of business, Rules 405, 163, 164 and 433 that permit Free Writing Prospectuses, Rules 134 and 135 that allow issuers to communicate details about contemplated offerings and Rules 137, 138 and 139 that allow the publication of research reports. In addition, Rule 163 allows well-known seasoned issuers to make offers of securities before filing a registration statement.

Chairman Schapiro also clarified that had these rules been effective when Google and Salesforce.com conducted their IPOs, the SEC would not have imposed a cooling-off period to address gun-jumping concerns. In the case of Google, the SEC determined that the publication of the interview with the founders in Playboy did not inappropriately condition the market, given the timing of the publication and the inclusion of the text of the publication in the registration statement, and the SEC did not impose a cooling-off period. In the case of Salesforce.com, the SEC reached an opposite result, as the article in The New York Times contained significant amount of information about the company's IPO that was published while the road show was ongoing. Had the offering reforms been enacted at that time, the SEC would have required that the article be filed as a free writing prospectus. In contrast, the letter notes that Go Daddy decided to withdraw its registration statement because the chief executive officer of the company believed that he could not conduct his weekly radio show. Chairman Schapiro pointed out that the SEC's communications rules did not prohibit the chief executive officer of Go Daddy from conducting his radio show, rather the rules did not permit the chief executive officer of the company to use the weekly show as a means to promote the offering of Go Daddy's securities.

Chairman Schapiro's letter points out that with respect to offerings not registered under the Securities Act, issuers relying on Section 4(2) of the Securities Act or its safe harbor, Rule 506 of Regulation D, generally are not allowed to use a general solicitation or advertising to attract investors for its offering. In addition, the SEC adopted Rule 155, another safe harbor, that allows companies to abandon a public offering and instead raise money through a private offering. With respect to the offering of Facebook shares by Goldman Sachs that was cited in Chairman Issa's letter, Chairman Schapiro clarified that the staff did not advise or instruct Facebook or Goldman Sachs that the offering could not be conducted in the U.S.

Chairman Schapiro recognized that some view the general solicitation ban as a significant burden on capital raising and may be unnecessary as offerees who might be located through general solicitation and who might not purchase the securities would not be harmed.[14] Others, however, support the solicitation ban on the grounds that it helps prevent securities fraud by making it more difficult for fraudsters to attract investors or unscrupulous issuers to condition the market.[15] The Chairman also stated that the SEC has not yet had an occasion to consider the constitutionality of the quiet period rules under the First Amendment. Such issues have been raised in a no-action request which is still pending.

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12 *See* Securities Act § 5(b)(1).

13 *See* Release No. 33-8591, *Securities Offering Reform* (July 19, 2005), http://www.sec.gov/rules/finaI/33-8591.pdf.

14 *See*, e.g., Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (April 23, 2006), http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf; Joseph McLaughlin, *How the SEC Stifles Investment - and Speech*, The Wall Street Journal (February 3, 2011). Concerns about the scope of the Commission's rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. *See* 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (May 2010), http://www.sec.gov/info/smallbus/gbfor28.pdf.

15 *See Pinter v. Dahl*, 486 U.S. 622, 644 (1988) ("The purchase requirement clearly confines §12 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.").

The 499-Shareholder Cap Under Section 12(g) of the Exchange Act

Chairman Issa raised concerns about the 499 shareholder cap under Section 12(g) of the Exchange Act as being a fundamental roadblock to private equity capital formation. The letter went on to cite the case of the Facebook equity issuance where the 499 person threshold would have been overcome by grouping multiple shareholders into single entities. He questioned whether the use of special purpose vehicles ("SPVs") for the purposes of facilitating investments in private companies resulted in disjointed or illiquid markets and prevented price discovery.

In her letter, Chairman Schapiro stated that Rule 12(g) of the Exchange Act was enacted by Congress in 1964 and that the securities markets have changed significantly since then. Section 12(g) of the Exchange Act requires companies to register its securities with the SEC within 120 days after the last day of its fiscal year, if, at the end of the fiscal year, the securities are "held of record" by 500 or more persons and the company has "total assets" exceeding $10 million. Chairman Schapiro pointed out that today, the vast majority of shares of public companies are held in nominee or "street name" and, as a result, individual shareholders are not counted because the securities are not "held of record" by those individuals. Conversely, in private companies, shareholders generally hold their shares directly or "of record," and thus those companies may exceed the 499 shareholder limit under Rule 12(g), which would require them to commence reporting. Chairman Schapiro stated in her letter that the issue of how holders are counted and how many holders should trigger registration will need to be examined.

In his letter, Chairman Issa also raised concerns about Rule 12g5-1(b)(3) of the Exchange Act. That rule states that if an issuer knows that the form of holding securities of record is primarily used to circumvent Section 12(g), the beneficial holders will be deemed the record owners. Noting that this rule has been invoked sparingly, Chairman Schapiro stated that this rule is not meant to create uncertainty for issuers, but is rather intended to prevent issuers from circumventing the registration requirements.

Chairman Schapiro noted that Congress has provided the SEC with broad exemptive authority in Sections 12(h) and 36 of the Exchange Act with respect to the Section 12(g) registration requirements, and that Section 12(g) of the Exchange Act also allows the SEC to define the terms "held of record" and "total assets." Therefore, the SEC has the requisite authority to revise the shareholder threshold if it concludes that doing so is not inconsistent with the public interest or protection of investors.

In response to Chairman Issa's question about the use of SPVs that hold private company securities, Chairman Schapiro stated that the SEC has noted the trend of the use of SPVs, and that these vehicles raise a number of important policy issues that the SEC will consider. Chairman Schapiro also stated that the SEC is monitoring secondary trading on a number of platforms which facilitate trading of stock in private companies, noting that a balance must be struck between the benefit of increased liquidity and the investor protection concerns that can arise due to a lack of information about private companies. Chairman Schapiro noted that Rule 144A, which provides a non-exclusive safe harbor for specified resales of restricted securities to QIBs, was adopted for the primary purpose of removing uncertainties as to the legitimacy of resales to institutional buyers, may also be used by non-reporting issuers to raise capital through equity financings. She also noted that issuers using Rule 144A must be mindful of the mandatory registration threshold under Section 12(g) of the Exchange Act.

Organizational Considerations

In his letter, Chairman Issa raised concerns about the cost-benefit analysis that the SEC conducts prior to the promulgation of its regulations. In response, Chairman Schapiro stated that the SEC engages in an extensive cost-benefit analysis of every rule that it proposes and that it is a fundamental component of the process. She noted that senior staff at the agency reviews the cost-benefit analysis for each rulemaking and that such analysis is then reviewed thoroughly by each of the Commissioners prior to release for public comment. The comments and data provided by the public are carefully reviewed and taken into consideration prior to the adoption of final rules. Chairman Schapiro provided numerous examples of rules that the SEC adopted that facilitate capital formation for small businesses, including the simplification of disclosure and reporting requirements,[16] liberalizing the eligibility requirements for short-form registration statements,[17] adopting rules that allow companies to grant stock options without triggering the reporting requirements,[18] implementing electronic Regulation D filings,[19] amending Rule 144 to shorten holding periods,[20] and allowing for a phase-in period for implementation of the Say-on-Pay rules under the Dodd-Frank Act for smaller companies.[21] Chairman Schapiro also noted that the SEC recently proposed to modify the calculation of "net worth" for purposes of the "accredited investor" definition to exclude the value of an individual's primary residence when calculating net worth.[22] Chairman Schapiro noted that these examples are actions that facilitate capital formation, improve secondary market liquidity and strengthen private placement market, but nonetheless resulted in a diminished regulatory role for the agency.

New Capital Raising Strategies

The letter from Chairman Issa raised questions regarding "crowdfunding," singling that approach out as a possible new method of capital formation that has gained popularity.

Chairman Schapiro stated that she understands "crowdfunding" to be a new method of capital formation whereby groups of people pool money, typically small individual contributions, to support an effort by others to accomplish a specific goal. Initially, such arrangements did not trigger securities law issues because there was no profit participation. However, Chairman Schapiro noted that interest in offering an ownership interest in a developing business and an opportunity for a return on investment capital is growing. She provided an example of crowdfunding as described to the staff as an offering of up to a maximum of $100,000 of equity securities of a company, with individual investments capped at $100.

She noted that proponents of this approach to capital formation seek a registration exemption and the SEC has been exploring several approaches to address this.[23] In considering whether to grant an exemption from registration for such arrangements, Chairman Schapiro stated that the SEC would consider, for example, its experience with Securities Act Rule 504, which was revised in 1999 due to concerns about fraud in the market. The widespread use of the internet for capital raising presents additional challenges in this area.

Chairman Schapiro distinguished investments by venture capital firms in start-ups from investments made by financial institutions and institutional investors in typical companies, stating that venture capital firms have

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[16] *See* Release No. 33-8876, Smaller Reporting Company Regulatory Relief and Simplification (December 19, 2007), http://www.sec.gov/rules/final/2007/33-8876.pdf.

[17] *See* Release No. 33-8878, Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3 (December 19,2007), http://www.sec.gov/rules/finaI/2007/33-8878.pdf.

[18] *See* Release No. 34-56887, Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934 (December 3, 2007), http://www.sec.gov/rules/final/2007/34-56887.pdf.

[19] *See* Release No. 33-8891, *Electronic Filing and Revision of Form D* (February 6, 2008), http://www.sec.gov/rules/finaI/2008/33-8891.pdf.

[20] *See* Release No. 33-8869, *Revisions to Rules* 144 *and* 145 (December 6, 2007), http://www.sec.gov/rules/finaI/2007/33-8869.pdf.

[21] *See* Release No. 33-9178, *Shareholder Approval of Executive Compensation and Golden Parachute Compensation* (January 25, 20II), http://www.sec.gov/rules/finaI/201l/33-9178.pdf.

[22] *See* Release No. 33-9177, *Net Worth Standard for Accredited Investors* (January 25, 2011), http://www.sec.gov/rules/proposed/2011/33-9177.pdf.

[23] For example, crowdfunding was discussed at the Commission's November 2010 Forum on Small Business Capital Formation. Participants in the Forum recommended that the Commission consider implementing a new exemption from Securities Act registration for crowdfunding, which would include offerings of up to $100,000 and a cap on individual investments not to exceed $100. In January 2011, representatives from the Division of Corporation Finance's Office of Small Business Policy met with a group from the Small Business & Entrepreneurship Council, which advocates an exemption from registration requirements for crowdfunding offerings meeting specific requirements. In addition, the Office of Small Business Policy and other members of the Division of Corporation Finance staff discussed crowdfunding with representatives from the North American Securities Administrators Association, the organization of state securities regulators, at a conference held on March 28, 2011.

developed mechanisms that allow them to successfully manage risk as they vigorously monitor their investments and furnish business expertise to their portfolio companies.

A Path Toward Further Reforms

The correspondence between Chairman Issa and Chairman Schapiro comes at a time when other reforms have been suggested as a means for spurring economic growth. For example, a proposed reform that was not mentioned in the correspondence between Chairman Schapiro and Chairman Issa, but that could potentially facilitate small company capital formation, is the Small Company Capital Formation Act of 2011 ("Small Company Capital Formation Act"). This bill was recently introduced by Representative David Schweikert (R-AZ) in the U.S. House of Representatives.[24] The bill seeks to increase the offering threshold from $5 million to $50 million for public offerings of smaller companies exempt from registration under the Securities Act pursuant to Regulation A. Representative Schweikert is the Vice Chairman of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises. Regulation A's threshold of $5 million and a lack of a Blue Sky exemption have been limitations on smaller companies that want to access the capital markets. The Small Company Formation Act was introduced after hearings on the topic of capital formation were held in December 2010, during which industry representatives such as Mr. David Weild, Senior Advisor of Grant Thornton LLP, and William Hambrecht, CEO of WR Hambrecht + Co, expressed support for Regulation A reform as the beginning of a long awaited process to revive the small company IPO market. In addition to the other potential reforms discussed in Chairman Schapiro's letter, a Regulation A reform could also potentially serve to revitalize the U.S. IPO market.

Chairman Schapiro stated in her letter to Chairman Issa that she recently instructed her staff to review the impact of regulations on capital formation for small businesses, specifically focusing on the following areas:

- the restrictions on communications in IPOs;
- whether the general solicitation ban should be revisited in light of the current technologies and capital raising trends;
- the number of shareholders that trigger public reporting, including questions surrounding the use of SPVs that hold securities of private companies for groups of investors; and
- the regulatory questions posed by new capital raising strategies.

Chairman Schapiro indicated that this review will include an evaluation of the recommendations of the annual SEC Government-Business Forum on Small Business Capital Formation. The SEC has also created an email box for suggestions for reform on their website located at http://www.sec.gov/spotlight/regulatoryreviewcomments.shtml. Chairman Schapiro indicated that the SEC will also consider recommendations from a new Advisory Committee on Small and Emerging Companies.

[24] H.R. 1070, available at: http://www.gpo.gov/fdsys/pkg/BILLS-112hr1070ih/pdf/BILLS-112hr1070ih.pdf. Our News Bulletin entitled "Small Company Capital Formation Act of 2011; Regulation A Revival?" is available at: http://www.mofo.com/files/Uploads/Images/110330-Small-Company-Capital-Formation-Act-2011.pdf.

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Contacts

David Lynn
(202) 887-1563
dlynn@mofo.com

Indira Lall
(202) 778-1446
ilall@mofo.com

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News Bulletin

April 18, 2011

FINRA to Repropose Rule Addressing Participation of Broker-Dealers in Private Placements

On April 16, 2011, at the American Bar Association Business Law Section's Spring Meeting in Boston, representatives of the Financial Industry Regulatory Authority ("FINRA") announced that the Board of Governors had approved a reproposal of the recent proposal by FINRA to expand FINRA Rule 5122 to govern all private placements in which a member firm participates—not just those in which the member firm (or its control entity) is the issuer.[1] The reproposal is in response to the 35 comment letters that addressed the original proposal.[2] The most critical proposed revisions for participation of broker-dealers in offerings of unaffiliated entities are:

- Eliminating the provision that 85% of the proceeds (i) be used for the business purposes disclosed in the offering document, and (ii) not be used to pay offering costs, commissions or other compensation to participating broker-dealers and their associated persons;
- Requiring disclosure of use of proceeds;
- Changing the date of filing of the private placement memorandum ("PPM") to 15 days after either commencement or first offer (not first sale), in order to avoid affecting the capital formation process;
- Creating a new Rule 5123 to address participation of broker-dealers in offerings by unaffiliated entities, thereby leaving the provisions of current Rule 5122 in place (including the 85% use of proceeds provision) for participation in offerings by affiliated entities;
- Retaining the expanded definition of "participation" (from Rule 5110(f)(5)); and
- Possibly adding an exemption for M&A transactions.

The existing Rule 5122 would not be changed.

We will provide further analysis of the reproposal when it is filed with the Securities and Exchange Commission.

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[1] See FINRA Regulatory Notice 11-04 "Private Placements of Securities – FINRA Requests Comment on Proposed Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements" (January 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122787.pdf. See our News Bulletin, "FINRA Proposes Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements," available at http://www.mofo.com/files/Uploads/Images/110215-FINRA-Rule-5122.pdf.

[2] The comments are available on FINRA's website: http://www.finra.org/Industry/Regulation/Notices/2011/P122788.

Contacts

Nilene R. Evans
(212) 468-8088
nevans@mofo.com

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News Bulletin

March 30, 2011

Small Company Capital Formation Act of 2011; Regulation A Revival?

On March 14, 2011, Representative David Schweikert (R-AZ) introduced the Small Company Capital Formation Act of 2011 (the "Small Company Capital Formation Act") in the U.S. House of Representatives (the "House").[1] The bill seeks to increase the offering threshold from $5 million to $50 million for public offerings of smaller companies exempt from registration under the Securities Act of 1933, as amended (the "Securities Act") pursuant to Regulation A. The bill also will require the Securities and Exchange Commission (the "Commission") to review the threshold every two years.

Representative Schweikert, Vice Chairman of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, said: "Taking a small business public is an important, but expensive process that requires millions in underwriting costs.... Raising the Regulation A threshold to $50 million is one way to lower those costs and promote economic growth and job creation. At a time when so many small businesses are in need of capital, this is a common sense proposal that will make our capital markets more vibrant and competitive."[2]

Background

Regulation A was enacted during the Great Depression to help the economy by improving small businesses' access to equity capital. While the initial offering threshold of $100,000 has been increased over the years to the current $5 million set by the Commission in 1992, it has not been increased to reflect the rising costs associated with bringing a small company public over the last two decades. Due to the low offering threshold, and without a corresponding state "Blue Sky" exemption for Regulation A offerings, Regulation A has not provided a viable capital-raising vehicle for smaller companies in recent years. Amplified by increased difficulties for smaller companies resulting from the recent financial crisis, these shortcomings of Regulation A have invited renewed focus on this regulation.

The Small Company Capital Formation Act is designed to encourage small companies to access the capital markets — allowing them to invest and hire employees.[3] As part of a broader effort to tie the financial regulatory environment to U.S. job creation and economic competitiveness, the Small Company Capital Formation Act was

[1] This is bill H.R. 1070. See http://www.gpo.gov/fdsys/pkg/BILLS-112hr1070ih/pdf/BILLS-112hr1070ih.pdf.
[2] See press release issued by the House Financial Services Committee, available at http://financialservices.house.gov/press/PRArticle.aspx?NewsID=1817.
[3] See Id.

introduced — along with other legislation — to supplement, amend or repeal certain sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

On March 16, 2011, a hearing was held in the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, chaired by Representative Scott Garrett (R-NJ), regarding these legislative proposals to promote job creation, capital formation and market certainty, including the Small Company Capital Formation Act.[4] However, already during the lame-duck session of Congress in December of last year, a proposal to increase the offering threshold under Regulation A to $30 million was discussed at a hearing before the House Committee on Financial Services on December 8, 2010.[5]

Preceding these hearings and the introduction of the legislative proposal, the topic of increasing the Regulation A threshold was discussed at the Commission's Government-Business Forum on Small Business Capital Formation on November 18, 2010. Moreover, in 2009, the recommendation made it into the final report of the Government-Business Forum on Small Business Capital Formation.[6]

Regulation A

Currently, Regulation A, or the "Conditional Small Issues Exemption,"[7] provides an exemption from registration with the Commission for public offerings of up to $5 million in any 12-month period by non-reporting companies, without any restrictions on the types of investors that can participate in the offering. As with registered offerings, the securities can be offered publicly. The securities are eligible to trade freely, immediately after the offering, in the over-the-counter market.

Companies that issue securities under Regulation A must provide the Commission with an offering statement on Form 1-A, which includes a notification, an offering circular and exhibits, for its review. However, they do not have to submit audited financial statements (provided the company is not already filing reports pursuant to Sections 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")). In addition, they are not subject to periodic reporting obligations under the Exchange Act or any of the Sarbanes-Oxley Act obligations after the offering.[8] Issuers in Regulation A offerings are permitted to "test the waters" by soliciting interest in the offering before filing any offering statement with the Commission to determine if there is enough interest in the securities.

These features of Regulation A are beneficial to a smaller company considering a capital raise, including by means of a small IPO, as opposed to a more costly and time-consuming IPO process using a comprehensive Form S-1 registration statement. The fact that there are no restrictions on the type of investors also makes Regulation A advantageous compared to Regulation D offerings. The offering threshold of $5 million, however, poses a major disadvantage.

[4] See press release issued by the House Financial Services Committee summarizing the legislative proposals, available at http://financialservices.house.gov/press/PRArticle.aspx?NewsID=1810.
[5] Industry representatives at that hearing testified that a $50 million threshold would make Regulation A offerings more useful to companies engaged in capital-intensive sectors.
[6] See the final report of the 2009 SEC Government-Business Forum on Small Business Capital Formation, available at http://www.sec.gov/info/smallbus/gbfor28.pdf.
[7] Regulation A consists of Rules 251-263 and was adopted as an exemption from registration by the Commission pursuant to Section 3(b) in 1933.
[8] If an issuer subsequently grows to have more than $10 million in assets and more than 500 shareholders, it will become subject to Exchange Act registration and filing obligations pursuant to Section 12(g)(1) of the Exchange Act.

The Proposed Legislation

Increased Offering Threshold

The proposed legislation would amend Section 3(b) of the Securities Act by requiring the Commission to increase the aggregate offering amount to $50 million for exempt offerings of securities. Additionally, the proposed legislation would authorize, but not require, the Commission to adopt such other terms and conditions as it may determine necessary in the public interest and for the protection of investors, including, but not limited, to:

- a requirement to file audited financial statements with the Commission and distribute such statements to prospective investors;
- a requirement to submit the offering statement and related filings to the Commission electronically; and
- the establishment of "bad actor" disqualification provisions based on the disciplinary history of the issuer, its affiliates, officers, directors, underwriters, or other related persons.[9]

Periodic Disclosure

Under the proposed legislation, the Commission is also authorized to require an issuer to make available to investors periodic disclosures regarding the issuer, its business operations, its financial condition, its use of investor funds, and other appropriate matters. The Commission may also provide for the suspension and termination of such a requirement with respect to that issuer.

Adjustments

Within two years of the date of enactment of the Small Company Capital Formation Act, and every two years thereafter, the Commission must review the offering amount threshold and increase the amount as it determines appropriate. Note that if the Commission determines not to increase the offering amount, it must report to the House Committee on Financial Services and the Senate Committee on Banking on its reasons for not doing so.

Time for Regulation A Reform

A Regulation A reform could potentially revitalize public capital-raising opportunities for smaller companies by helping to jump-start the small IPO market, which has virtually disappeared over the last decade and a half,[10] and by providing access to capital for smaller companies — a topic that currently is attracting significant attention in Washington, D.C.[11]

By early indications, one should expect a Regulation A reform to not be "a partisan or terribly controversial one," as stated by Representative Barney Frank (D-MA) who chaired the hearing before the House Financial Services Committee in December 2010. In addition, industry representatives indicated support for a Regulation A reform at both the December 2010 and March 2011 hearings. Mr. David Weild, Senior Advisor of Grant Thornton LLP, testified at the March 16, 2011 hearing, applauding the Small Company Capital Formation Act as the beginning of a campaign to bring back the small IPO market. In addition to the cost benefits for small companies, Mr. Weild noted that an increased threshold opens up the Regulation A exemption to an offering size that will allow

[9] Rule 262 of Regulation A currently provides for certain disqualification provisions.
[10] See Market Structure is Causing the IPO Crisis (October 2009) by David Weild and Edward Kim, Grant Thornton LLP, available at http://www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20Sep%202009%20-%20FINAL.pdf.
[11] Treasury Secretary Timothy Geithner held a conference on March 22, 2011, titled "Access to Capital: Fostering Growth and Innovation for Small Companies," examining the difficulty of funding for smaller businesses. See http://www.treasury.gov/press-center/news/Pages/access-to-capital.aspx.

companies to list on the NYSE and NASDAQ and to avail themselves of the so-called "Blue Sky" exemption, thus avoiding very costly state-by-state filings. Other observers have voiced a preference for an increased Regulation A threshold combined with Congress also pre-empting state regulation for these offerings similar to Regulation D offerings.[12] Mr. Weild also noted the importance of the "test-the-waters" provision of Regulation A, citing a steady increase in IPOs that are postponed, withdrawn, priced below the low end of the IPO filing range or that have broken the IPO price within 30 days of the completion of the offering as potentially ruinous to smaller companies.

Yet, the real question may be whether a Regulation A reform would be adopted as currently proposed, or whether mandatory provisions designed to enhance investor protections associated with Regulation A offerings, such as the requirement to file audited financial statements and periodic reporting requirements, are included as the bill proceeds through the legislative process.[13] Assuming, however, that the legislation is ultimately adopted in a form similar to this initial proposal, Regulation A reform would represent an important step towards improving public capital-raising opportunities for smaller companies.

Contacts

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

Gerd D. Thomsen
(212) 336-4335
gthomsen@mofo.com

[12] Rule 506 offerings under Regulation D (used for private placements and PIPE transactions) are exempt from state registration under the National Securities Market Improvement Act of 1996.
[13] Mr. Damon A. Silvers, Policy Director and Special Counsel of American Federation of Labor and Congress of Industrial Organizations expressed concern at the March 16, 2011 hearing that the bill does not guarantee that these added protections would be imposed even as the bill sponsor requires that the Regulation A exemption be expanded.

News Bulletin

February 15, 2011

FINRA Proposes Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements

On January 11, 2011, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 11-04 (the "Notice") proposing to expand FINRA Rule 5122 to govern all private placements in which a member firm participates—not just those in which the member firm (or its control entity) is the issuer—while retaining all but one of the existing exemptions, including those for offerings sold solely to certain institutions, qualified purchasers and other sophisticated investors.[1] If the amendments were adopted, a member broker-dealer would be required to file the offering document for any private placement in which the member participates, subject to certain exemptions.

Background

FINRA Rule 5122 was adopted in 2009 in response to abuses in the sale of private placements by member broker-dealers and their control entities. Currently, FINRA Rule 5122 applies *only* to private placements of securities *issued* by member broker-dealers and certain affiliated entities. However, the vast majority of private placements remain outside the scope of the rule. FINRA seeks to expand FINRA Rule 5122 to govern all private placements in which a member participates, subject to certain exemptions.

Proposed Amendments to FINRA Rule 5122

Participation in a Private Placement

The expanded rule would incorporate the broad definition of "participation" in FINRA Rule 5110, which corresponds to the types of services typically provided by a broker-dealer in a private placement. Rule 5110(a)(5) defines "participation" as:

> "Participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to SEC Rule 13e-3."

[1] See FINRA Regulatory Notice 11-04 "Private Placements of Securities – FINRA Requests Comment on Proposed Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements" (January 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122787.pdf.

If the rule is amended, customary placement agent activities by a member broker-dealer in connection with private placements and PIPEs would generally fall under this definition and subject the broker-dealer to the requirements of FINRA Rule 5122 in connection with its participation.

Disclosure Requirements and Use of Proceeds Limitation

FINRA Rule 5122 currently requires disclosure in the offering document[2] of the use of proceeds, offering expenses and selling compensation to the member broker-dealer and its associated persons. The rule would continue to require that at least 85 percent of the proceeds (i) be used for the business purposes disclosed in the offering document, and (ii) not be used to pay offering costs, commissions or other compensation to participating broker-dealers and their associated persons. In the Notice, FINRA proposes to require additional disclosure if a participating broker-dealer is an affiliate of the issuer and the nature of the affiliation.[3] In addition, in order to capture the amount and type of *any* compensation that will be paid directly or indirectly to a participating member broker-dealer, the proposed amendments replace the term "selling compensation" with the term "compensation."

Filing with FINRA

FINRA Rule 5122 would continue to require each offering document to be submitted to FINRA at or prior to the first time it is provided to any prospective investor, in order to allow the FINRA staff to conduct *ex post* reviews. While the Notice states that the filing requirement would not impose any delay in the offering, and the offering may proceed while staff reviews the offering document, a broker-dealer may want to consider waiting for a confirmation from the FINRA staff before completing the offering, in order to avoid comments to the disclosure at a time when changes are impractical to make.[4]

Exemptions from FINRA Rule 5122

FINRA proposes to eliminate the existing exemption under FINRA Rule 5122(c) for offerings in which a member acts primarily in a wholesaling capacity, referring to recent enforcement cases involving private placements in which a broker-dealer affiliated with an issuer acted primarily as the wholesaler, as a demonstration of the need for more investor protection. Moreover, given that the proposed amendments expand the rule to reach all private placements, the reliance upon the efforts of an "independent" broker-dealer is no longer relevant.

FINRA Rule 5122 would otherwise continue to exempt offerings to institutional accounts, qualified purchasers, qualified institutional buyers (QIBs), investment companies, banks and employees and affiliates of the issuer, as well as offerings pursuant to Rule 144A and Regulation S, and offerings of specified types of securities, including commodity pool interests, unregistered investment grade rated debt and preferred securities.

FINRA requests comments to the proposed amendments by March 14, 2011.

FINRA's Focus on Abuses in the Private Placement Market

The proposed amendments to FINRA Rule 5122 would significantly expand FINRA's oversight of the private placement market. The Notice constitutes the most recent example in a trend illustrating FINRA's increased focus on the private placement market.[5] FINRA issued Regulatory Notice 10-22 in April 2010 reminding broker-dealers of their regulatory obligations under FINRA's suitability rule and the anti-fraud requirements of the federal

[2] A private placement memorandum, term sheet or other offering document.
[3] An "affiliate" would be defined as a company that controls, is controlled by or is under common control with a broker-dealer.
[4] Note this is unlike FINRA Rule 5110, which requires that completion of an offering be delayed until FINRA staff has issued a "no-objections" letter with respect to public offerings.
[5] See the Notice at footnote 4 citing examples of recent FINRA and SEC enforcement cases.

securities laws to conduct a reasonable investigation of the issuer and securities they recommend in private placements.[6]

Contacts

Gerd D. Thomsen
(212) 336-4335
gthomsen@mofo.com

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[6] See our Client Alert "FINRA Issues Regulatory Notice Reminding Broker-Dealers of their Obligation to Conduct Reasonable Investigations in Regulation D Offerings," available at http://www.mofo.com//files//Uploads/Images/100527FINRA.pdf.

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News Bulletin

January 25, 2011

SEC Proposes Amendments to Its Net Worth Standard for Accredited Investors

As anticipated, on January 25, 2011, the Securities and Exchange Commission (the "SEC") proposed amendments to the accredited investor standards in its rules under the Securities Act of 1933, as amended (the "Securities Act"), to reflect the requirements of Section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The SEC also proposed technical amendments to Form D and a number of rules to conform the language in the rules to the language of Section 413(a) and to correct cross-references to former Section 4(6) of the Securities Act, which was renumbered Section 4(5) by Section 944 of the Dodd-Frank Act.

We discuss the background, the proposed amendments to the accredited investor standards, and possible future SEC rulemaking below.

Background

The Dodd-Frank Act became law on July 21, 2010.[2] Among other things, the Dodd-Frank Act changed certain legal requirements governing private and other limited offers and sales of securities exempt from registration under the Securities Act. The Dodd-Frank Act provided that, upon enactment and for four years following enactment, the net worth threshold for accredited investor status will be $1 million, excluding the equity value (if any) of the investor's primary residence. One year after enactment, the SEC is authorized to review the definition of the term "accredited investor" (as it is applied to natural persons) and to adopt rules that adjust the definition, except for modifying the net worth threshold. Four years after enactment, and every four years thereafter, the SEC must review the "accredited investor" definition as applied to natural persons, including adjusting the threshold, although it may not be lowered below $1 million.

The SEC provided additional guidance regarding the net worth standard in a Compliance and Disclosure Interpretation (the "C&DI"). The C&DI notes that:

> "Section 413(a) of the Dodd-Frank Act does not define the term "value," nor does it address the treatment of mortgage and other indebtedness secured by the residence for purposes of the net worth calculation. As required by Section 413(a) of the Dodd-Frank Act, the Commission will issue amendments to its rules to conform them to the adjustment to the accredited investor net worth standard made by the Act. However, Section 413(a) provides that the adjustment is effective upon enactment of the Act. When determining net worth for purposes of Securities Act Rules 215 and 501(a)(5), the value of the person's primary residence must be excluded. Pending implementation of the changes to the Commission's rules required by the Act, the related amount of indebtedness secured by the primary residence up to its fair

[1] The Proposing Release is available at http://www.sec.gov/rules/proposed/2011/33-9177.pdf.
[2] Pub. L. No. 111-203, 124 Stat. 1376.

> market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth."[3]

The Dodd-Frank Act requires the SEC to promulgate rules, within one year of enactment, disqualifying persons determined to be "bad actors" from eligibility to use Rule 506 under Regulation D. A "bad actor" includes any person who is subject to a final order by a state securities, banking or insurance authority, a federal banking regulator, or the NCUA that: bars the person from (1) association with any entity regulated by such authority, (2) engaging in the business of securities, insurance, or banking, (3) engaging in savings association or credit union activities; or constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of filing of the Form D relating to the offer or sale; or who has been convicted of any felony or misdemeanor in connection with the purchase or sale of a security or involving the making of any false filing with the SEC.

Discussion of the Proposed Amendments to Net Worth

As amended, Rules 215(e) and 501(a)(5) would define as an accredited investor:

> "Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of purchase, exceeds $1,000,000, excluding the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property."

The proposed amendments would set the same standard under both Rule 501 and Rule 215 for individuals to qualify as accredited investors on the basis of net worth, either individually or with their spouses.

The amendments (as proposed) implement Section 413(a) by adding the statutory language[4] to the relevant SEC rules. In addition, the proposed amendments add the phrase "calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property." The SEC states that the purpose of adding this phrase is to clarify that net worth is calculated by excluding only the investor's net equity in the primary residence.

The SEC notes that it believes this approach is appropriate because it is consistent with, and advances the regulatory purposes of, Section 413(a). It reduces the net worth measure by the amount or "value" that the primary residence contributed to the investor's net worth before enactment of Section 413(a). The SEC also notes that some existing rules, for example Rule 701 under Regulation R, follow an approach similar to this proposal in calculating net worth.[5]

Section 413(a), the change that removed the value of the primary residence from the net worth calculation, became effective upon enactment of the Dodd-Frank Act. Thus, we expect that most issuers and agents have already made the appropriate adjustments to their subscription documents and investor questionnaires.

Requests for Comments and Future Rulemaking

The SEC is soliciting comments on its proposal and a number of questions that it raises in the proposal. Comments are due on March 11, 2011.

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[3] C&DI July 23, 2010, Question 179.01.

[4] Section 413(a) provides the phrase "excluding the value of the primary residence of such natural person."

[5] Rule 701, which provides for the exclusion of the value of a person's primary residence in applying a net worth standard, provides for the exclusion of "associated liabilities," such as mortgages on the property.

In addition, as noted above, Section 413(b) specifically authorizes the SEC to undertake a review of the definition of "accredited investor" as it applies to natural persons, and requires the SEC to undertake a review of the definition "in its entirety" every four years, beginning four years after enactment of the Dodd-Frank Act. Moreover, the SEC is authorized to engage in rulemaking to make adjustments to the definition after each such review. While the SEC states that it may consider future rulemaking, at this point in time, the SEC is not proposing to make revisions to the definitions of "accredited investor" that are not required by the Dodd-Frank Act.

Contacts

Gerd D. Thomsen
(212) 336-4335
gthomsen@mofo.com

Contact a member of MoFo's Private Equity Fund Group with any additional questions.

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News Bulletin

May 2010

FINRA Issues Regulatory Notice Reminding Broker-Dealers of their Obligation to Conduct Reasonable Investigations in Regulation D Offerings

On April 20, 2010, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 10-22 (the "Notice") reminding broker-dealers of their obligation – enforceable under federal securities laws and FINRA rules – to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made pursuant to Regulation D under the Securities Act of 1933 (the "Securities Act").[1] The Notice also reinforces the obligations of broker-dealers that recommend securities offered under Regulation D to comply with the suitability requirements of NASD Rule 2310, the advertising and supervisory rules of FINRA and the rules and regulations of the Securities and Exchange Commission (the "SEC").

The following provides a summary of the Notice, including broker-dealers' regulatory responsibilities in Regulation D offerings, and the guidance set forth regarding broker-dealers' reasonable investigation and suitability obligations, and addresses FINRA's focus on enforcement.

Background and Overview of the Notice

The Notice results from FINRA's nationwide initiative to investigate broker-dealer activities in connection with private placements, an area where recent enforcement actions have uncovered a lack of regulatory compliance.[2] While the private placement market is an important source of capital for many U.S. companies, recent problems uncovered by FINRA in Regulation D offerings have resulted in sanctions on broker-dealer firms that provide private placement memoranda and sales materials to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions. FINRA Chairman and CEO, Rick Ketchum, said that, "[a]n increase in investor complaints regarding private placements, as well as SEC actions halting sales of certain private placement offerings, led FINRA to launch a nationwide initiative that involves active examinations and investigations of broker-dealers engaged in retail sales of private placement interests. That initiative has uncovered misconduct, including fraud and sales practice abuses."[3]

Aimed at curtailing these regulatory compliance issues, the Notice reinforces and details broker-dealers' obligations in connection with Regulation D offerings. The Notice provides significant guidance to FINRA

[1] See FINRA Regulatory Notice 10-22 "Regulation D Offerings – Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings" (April 2010), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf.
[2] See FINRA news release announcing the Notice, available at http://www.finra.org/Newsroom/NewsReleases/2010/P121305.
[3] Id.

member firms regarding their duties to conduct reasonable investigations and customer suitability analyses in connecton with private placements to investors, including PIPEs, under Regulation D.

Broker-Dealers' Regulatory Responsibilities in Regulation D Offerings

Federal Antifraud Provisions and FINRA Rules – While Regulation D provides an exemption from the registration requirements under Section 5 of the Securities Act, Regulation D offerings are not exempt from the antifraud provisions, including Rule 10b-5, of applicable federal securities laws. The Notice details a broker-dealer's duty, when recommending a security, under case law and SEC interpretations, to conduct a reasonable investigation of both the securities offered and the issuer's representations about those securities. Specifically, FINRA reminds broker-dealers:

- The SEC and federal courts have long held that a broker-dealer that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it.[4]
- This duty springs from the broker-dealer's special relationship to the customer, and from the fact that in recommending the security, the broker-dealer represents to the customer "that a reasonable investigation has been made and that [its] recommendation rests on the conclusions based on such investigation."[5]
- Courts have held that the scope of investigation required depends on the particular facts and circumstances. Relevant factors include the nature of the offering recommendation, the role of the broker-dealer in the offering, its knowledge of and relationship with the issuer, the size and stability of the issuer, and the level of sophistication of the investor (e.g., institutional, accredited or retail).[6]
- Failure to comply with this duty can constitute a violation of the antifraud provisions of the federal securities laws, including Rule10b-5.[7] It also can constitute a violation of FINRA Rule 2010, which requires broker-dealers to adhere to just and equitable principles of trade, and FINRA Rule 2020, which prohibits broker-dealers from engaging in manipulative and fraudulent behaviour.

Note that a broker-dealer also must comply with the advertising and supervisory rules of FINRA and the SEC.[8]

FINRA Suitability Obligations – A broker-dealer that recommends an issuer's securities in a Regulation D offering must also satisfy the "suitability requirements" under NASD Rule 2310. This rule requires that a broker-dealer have reasonable grounds to believe that a recommendation to purchase, sell or exchange a security is suitable for the customer.

There are two components to a broker-dealer's suitability obligation. *First*, the "reasonable basis suitability" component requires that the broker-dealer have a reasonable basis to believe, based on a reasonable investigation, that the recommendation is suitable for at least some investors. This requirement relates to the specific security recommended by a broker-dealer and imposes an obligation on the broker-dealer to investigate and obtain sufficient information about the security it is recommending. *Second*, the "customer specific suitability" component requires that the broker-dealer determine whether the security is suitable for the particular investor,

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[4] See, e.g., *Hanly v. SEC*, 415 F.2d 589, at 595-96 (2d. Cir. 1969); see also Securities Act Release No. 4445, 27 Fed. Reg. 1415 (Feb. 2, 1962).
[5] See *Hanly*, supra note 4 at 597. FINRA has included a variation of this concept within its suitability rule, NASD Rule 2310, albeit without the scienter requirement of the federal antifraud provisions.
[6] See, e.g., *Hanly*, supra note 4.
[7] Particularly, Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. See generally *Hanly*, supra note 4.
[8] See NASD Rule 2210 (advertising rule), infra note 12. See also NASD Rule 3010 (supervisory rule) that requires broker-dealer firms participating in Regulation D offerings to have supervisory procedures that are reasonably designed to ensure that their personnel, including its registered representatives, conduct an investigation that is sufficiently thorough to comply with their legal and regulatory requirements.

based upon the investor's financial situation, needs and other security holdings.[9] This requirement is construed to impose a duty of inquiry on broker-dealers to obtain relevant investor information relating to their financial situation and to keep such information current.

The Notice provides guidance for broker-dealers to help ensure the fulfillment of their suitability responsibilities. Accordingly, in a Regulation D offering, a broker-dealer should, at a minimum, conduct a reasonable investigation concerning the:

- issuer and its management;
- business prospects of the issuer;
- assets held by or to be acquired by the issuer;
- representations and claims being made; and
- intended use of proceeds of the offering.

A broker-dealer must conduct a reasonable investigation in connection with *each* offering, notwithstanding that a subsequent offering may be for the same issuer.

In the context of a Regulation D offering, NASD Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non- accredited investors. This analysis must take into account the investors' knowledge and experience. The fact that an investor meets the net worth or income test for being an accredited investor is only one factor involved in a complete suitability analysis. The broker-dealer must also make reasonable efforts to gather and analyze information about the customer's other security holdings, financial situation and needs, tax status, investment objectives, and any other information that would enable the broker-dealer to make its suitability determination. In addition, a broker-dealer must satisfy itself that the customer fully understands the risks involved and is able to take those risks.

What Level of Investigation is Required?

The short answer is that the level of investigation required depends upon the facts and circumstances in each case. While there are no clear-cut rules that set forth the scope of investigation required, the Notice provides some important guidance that broker-dealers should consider in making their determination:

- a broker-dealer should not rely, without some investigation, on information provided by the company or its advisors;
- the presence of "red flags" should alert the broker to the need for further inquiry;
- a more thorough investigation is required for smaller companies of recent origin;
- a broker-dealer that lacks essential information about an issuer or its securities when making a recommendation in a Regulation D offering must disclose this fact as well as the risks associated with the lack of information;
- the fact that a broker-dealer's customers may be sophisticated and knowledgeable does not obviate the duty to investigate; and

[9] See NASD Rule 2310(a). If a broker-dealer recommends a securities transaction to an "institutional investor," the broker-dealer will be deemed to have discharged its suitability obligation under NASD Rule 2310 if the institutional investor is making an independent decision regarding the risks associated with the investment and is capable of evaluating such risk. See NASD Rule 2310(b) and NASD IM-2310-3.

- with respect to reporting companies under the Securities Exchange Act of 1934 (the "Securities Exchange Act"), in the absence of red flags, a broker-dealer that is not an underwriter typically may rely on the current registration statement and periodic reports of the public company.

Broker-dealers should retain records documenting both the process and results of their diligence investigation. A broker-dealer's reasonable investigation should be tailored to each Regulation D offering in a manner that best ensures that it meets its regulatory responsibilities. As a reference, FINRA provides a list of practices adopted by some broker-dealer firms to help them adequately discharge their responsibilities.[10] FINRA notes that the duty of inquiry under the antifraud provisions is distinguished from the "reasonable investigation" that, under Section 11(b) of the Securities Act, permits an underwriter to avoid liability for misrepresentations in a registration statement. FINRA further notes that courts have compared the Section 11 reasonable investigation requirements with the broker-dealer's general duty to investigate and concluded that somewhat more is required of an underwriter than a broker-dealer in order to discharge its obligation to the investing public.[11]

For the last two decades, we have been advising our investment banking clients of the importance of undertaking diligence exercises in private placements that are similar to what they might typically undertake in public offerings. Obviously, the depth and character of the diligence exercises will vary depending upon the facts specific to each issuer and each transaction. The Notice serves only to confirm this viewpoint.

The Notice also provides guidelines relating to specific issues that will help inform broker-dealers when making a determination of the scope of their investigation:

Broker-Dealer Affiliated with Issuer – A broker-dealer that is an affiliate of an issuer in a Regulation D offering must ensure that its affiliation does not compromise its independence as it performs its investigation. A broker-dealer must also resolve any conflict of interest that could impair its ability to conduct a thorough and independent investigation.

Broker-Dealer Involved in the Preparation of the Private Placement Memorandum – A broker-dealer that prepares a private placement memorandum or other offering document has a duty to investigate securities offered under Regulation D and representations made by the issuer in the private placement memorandum or other offering document. Broker-dealers that are involved in the preparation of offering materials should be mindful of this heightened due diligence obligation, especially in light of FINRA's recent enforcement actions. The Notice also specifies that a broker-dealer that assists in the preparation of a private placement memorandum or other offering document should expect that it would be considered a communication with the public by that broker-dealer for purposes of NASD Rule 2210, FINRA's advertising rule.[12]

Red Flags – The Notice provides that a broker-dealer must note any information that it encounters in the course of a reasonable investigation that could be considered a "red flag" that would alert a prudent person to conduct further inquiry. The broker-dealer has a duty to follow up on any red flags by doing more than relying, without inquiry, on representations made by an issuer's management, disclosure in a memorandum or even a diligence report of issuer's counsel. Thus, the presence of red flags gives rise to a duty to conduct an independent investigation. Note that an issuer's refusal to provide a broker-dealer with information that is necessary for the broker-dealer to meet its duty to investigate may itself constitute a red flag.

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[10] The list is set forth on page 8 – 10 of the Notice.

[11] See *University Hill Foundation v. Goldman, Sachs & Co.*, 422 F. Supp. 879, 898 (S.D.N.Y. 1976) at 898-99. This is because "an underwriter's relationship to the issuer is more substantial" than a broker-dealer that is only recommending a security, and the underwriter "plays a more central role in the marketing process." Id.

[12] NASD Rule 2210 provides that all member communications with the public must be based on principles of fair dealing and good faith, must be fair and balanced, and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service, and that no member may omit any material fact or qualification if the omission, in the light of the context of the material presented, would cause the communications to be misleading.

Reliance on Counsel and Syndicate Members – A broker-dealer may retain counsel or other experts to assist it in undertaking and fulfilling its reasonable investigation obligation. However, FINRA notes that this does not necessarily satisfy the broker-dealer's investigation responsibilities, insofar as such counsel's or expert's findings may identify issues or concerns that require further investigation by the broker-dealer. It is also common that a broker-dealer is a member of a syndicate or selling group. FINRA recognizes that the broker-dealer may rely upon a reasonable investigation by the syndicate manager or lead placement agent, provided the broker-dealer has reason to believe that the syndicate manager has the expertise and absence of conflicts to engage in a thorough and independent inquiry, and that it has in fact performed such an inquiry with respect to the particular Regulation D offering.

FINRA's Focus on Enforcement Actions

The Notice is an indication that FINRA intends to focus more actively on enforcement of its rules relating to Regulation D offerings against its members that are acting as placement agents. In recent months, FINRA has initiated three enforcement actions against broker-dealers. Market participants should expect this trend to continue. "While several enforcement actions have been taken and additional investigations are underway, FINRA is taking this opportunity to remind firms of their substantial duties when engaging in the sale of private placement offerings," said FINRA Chairman and CEO, Rick Ketchum.[13]

We would encourage broker-dealers to revisit their compliance procedures and practices relating to Regulation D offerings and to advise their personnel of any changes.

Contacts

Tim Cleary
(212) 336-4051
tcleary@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

James R. Tanenbaum
(212) 468-8163
jtanenbaum@mofo.com

Gerd D. Thomsen
(212) 336-4335
gthomsen@mofo.com

[13] See FINRA news release announcing the Notice, supra note 2.

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News Bulletin

February 18, 2010

Fundamental Transaction Adjustments in Warrants and Convertible Securities

Convertible debt and equity securities, such as preferred stock, convertible notes or debentures, and warrants, which we refer to collectively as "convertible securities," are financial instruments with embedded derivatives. Generally, these securities contain antidilution adjustment provisions that are intended to protect the holder or the issuer from the occurrence of a number of events that could affect the value of the instruments. "Standard" antidilution provisions, including provisions related to stock options, stock dividends, and similar transactions, are found in virtually all such instruments. Other antidilution provisions provide adjustments in connection with mergers, acquisitions, other fundamental transactions, and down-round financings. These are less common and may raise problematic accounting issues.

Standard merger adjustment provisions are provisions that simply state that if a merger, acquisition, or similar transaction occurs, the holder of the convertible security will be entitled to receive upon the exercise or conversion of the derivative security the same consideration that the holder would have received had the derivative security been exercised or converted prior to the transaction. They are intended to prevent the holder from being affected differently by the transaction when compared to other security holders of the same issuer. These provisions are features of most derivative securities and generally do not raise any accounting or other issues.

In addition to standard merger adjustment provisions, some convertible securities contain provisions designed to provide the security holder liquidity for its investment and to preserve value for the instruments if the issuer completes a fundamental transaction. We refer to such provisions as fundamental transaction provisions. Fundamental transaction provisions require that the issuer repurchase the convertible securities from the security holder for cash. The cash payment is generally based upon the Black-Scholes value of the instrument at the time the fundamental transaction occurs, but could be based on any agreed-upon valuation methodology. If an issuer with outstanding convertible securities with fundamental transaction provisions enters into a fundamental transaction, the cash payment for each convertible security often will be greater than the value of the compensation that the security holder would have been entitled to had the convertible security been exercised for, or converted into, common stock in connection with the fundamental transaction. This is a result of the Black-Scholes valuation used to calculate the cash payment. The benefit to the security holder is even greater when an issuer enters into a fundamental transaction at a lower valuation than its valuation at the time the convertible security was issued. "Down-round" antidilution provisions, provisions that require an adjustment if the issuer issues additional securities at an effective price per share that is lower than the effective price per share of the convertible security, present similar advantages to the security holder. They are designed to guarantee, to some degree, the value of the convertible securities to the holder in the event of a down-round financing by requiring a decrease in the exercise price, conversion price, or conversion rates of the convertible security.

Fundamental transaction provisions are not new. However, the overriding decline in equity values over the last two years, and a general lack of confidence among investors, have led to increased demand for such protections by investors in PIPE transactions and similar transactions. In earlier years, issuers generally were in a better position to resist.

The Financial Accounting Standard Board's Emerging Issues Task Force Issue No. 00-19, "*Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's own Stock*" (EITF 00-19), contains explicit guidance regarding the classification and measurements of warrants and instruments with embedded derivatives. EITF 00-19 has been codified as ASC 815-40 under the new codification of the Financial Accounting Standards Board. ASC 815-40-25-1 & 2 provide that generally, a contract that requires net-cash settlement must be classified as an asset or liability on an issuer's balance sheet. ASC 815-40-25-8 provides generally that if a security has a net-cash settlement requirement that is triggered by an event that is not in the issuer's control, the security must be classified as an asset or liability. ASC 815-40-55-2 indicates that an event that causes a change of control of an issuer is not within the issuer's control and, therefore, a contract that requires net-cash settlement upon a change in control must be classified as an asset or liability. Fundamental transaction provisions require cash payments upon a change of control and, therefore, embedded derivatives containing such provisions should be treated as a liability, not equity, under this guidance.

Fundamental transaction provisions may be broken down into two general categories: those that provide an absolute obligation of the issuer to repurchase the convertible security in connection with any fundamental transaction, and those that require a cash purchase of the convertible security, but only to the extent common stockholders are compensated in cash in connection with the same transaction. Based on the guidance discussed herein, issuers have begun taking the position that an absolute obligation to repurchase a convertible security will preclude equity treatment thereof, but that fundamental transaction provisions that allow the holder of the convertible security to receive the same manner of consideration payable to the common stockholders will not preclude equity treatment. This is consistent with ASC 815-40-55-3, which provides that "if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision." ASC 815-40-55-3 further explains that, with respect to any such provision, "if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract." Note that the valuation of convertible securities being purchased for cash need not be the same as the valuation of the securities purchased from the issuer's common stockholders. Rather, the focus is on the manner or type of compensation.

In structuring PIPEs, registered directs, and other similar transactions, the parties should be aware of the accounting effects of fundamental transaction provisions. Many investors that would otherwise require such a provision understand the burden that issuers face in treating convertible securities with embedded derivatives as liabilities, and may be willing to forgo such protection. However, some investors demand such provisions regardless of the accounting effects for the issuer. An issuer that would prefer not to provide such a provision but feels compelled to do so by investors may be able to avoid liability treatment for the convertible security by including a provision that only provides a cash payment for a fundamental transaction if, and to the extent that, the common stockholders are paid in cash. Issuers should also consider limiting the definition of fundamental transaction in the security. Although it may not help the accounting treatment, issuers may consider limiting the definition of fundamental transaction to include only cash-only mergers, going-private transactions, or transactions in which the stockholders are compensated in securities that are not publicly traded. In any event, an issuer should vet these issues with its external auditors or other accounting experts to ensure they understand the accounting implications before finalizing the terms of any offering of convertible securities, including those issued in PIPE transactions, registered directs, and similar transactions.

Contacts

Joseph R. Magnas	Anna T. Pinedo
(212) 336-4170	(212) 468-8179
jmagnas@mofo.com	apinedo@mofo.com

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