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SEC Proposes Rules to Implement Crowdfunding Exemption: What Factors Will Affect Its Success?

The SEC has proposed long-awaited rules to implement the crowdfunding exemption under the JOBS Act. Whether an active offering market develops will depend on start-ups' and investors' assessment of the exemption's costs and benefits.

By Gregory T. Davidson, James Moloney, Blaise F. Brennan and Nicholas H.R. Dumont

On October 23, 2013, the Securities and Exchange Commission (SEC or Commission) approved the release of proposed "crowdfunding" rules[1] implementing Title III of the 2012 Jumpstart Our Business Startups Act (the JOBS Act).[2] Title III of the JOBS Act created an exemption, under Section 4(a)(6) of the Securities Act of 1933 (Securities Act), from registration for securities issued in crowdfunding transactions.[3] The comment period for the proposed rules will end February 3, 2014.

Once the SEC adopts final implementing rules, the crowdfunding exemption will allow U.S. private companies (primarily startups and small businesses) to raise up to $1 million in any continuous 12-month period from an unlimited number of investors without regard to their sophistication and without registration under the Securities Act. Those engaging in such fundraising activities will be required to conduct these offerings through a registered intermediary[4]—either a registered broker or an online "funding portal."[5] Until the SEC adopts final rules, however, issuers will not be able to rely on the crowdfunding exemption.

The extent to which issuers use the crowdfunding exemption is likely to be driven largely by their determination as to whether the exemption's benefits outweigh its limitations, requirements, and potential liabilities (including costs and burdens arising from the statutory liability of intermediaries, which is similar to that of underwriters in a registered offering). In addition, the success of the exemption will depend in part on whether potential investors in these offerings are willing to make investments that may carry high risk in securities for which there likely will be severely limited liquidity.

Limitations on Offering Size and Investment Amount

Section 4(a)(6) provides that an issuer may issue up to $1 million (including any securities issued by any predecessor issuer or any issuer controlled by or under common control with the issuer) in a continuous 12-month period in offerings pursuant to the crowdfunding exemption. Under the proposed rules, amounts raised in another type of exempt offering would not count against the $1 million cap. In addition, an exempt crowdfunding offering generally would not be integrated with an offering pursuant to another exemption, so long as all of the conditions of each exemption are satisfied. For instance, if the issuer were to engage in general solicitation in an offering pursuant to Rule 506(c) under Regulation D, the issuer would need to satisfy

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itself that the general solicitation did not constitute impermissible advertising of the crowdfunding offering. Likewise, in an offering pursuant to Rule 506(b) under Regulation D, the issuer would need to satisfy itself that any notices regarding the crowdfunding offering and the posting of the crowdfunding offering on the intermediary's platform did not constitute general solicitation with respect to the Rule 506(b) offering. Similarly, the amount that an issuer could raise under the crowdfunding exemption would not be affected by the amount of any non-securities crowdfunding (fundraising in which contributors receive something of value related to the project, such as listing donors in the credits of a film funded by such contributions), or where the amount contributed constitutes the pre-purchase of a product.

The Commission noted that taking a more restrictive approach to these issues "would be inconsistent with the goal of alleviating the funding gap faced by startups and small businesses because it would place a cap on the amount of capital startups and small business could raise." Thus, while the statutory cap on crowdfunding offerings may limit the utility of the exemption for issuers with more extensive financing needs, the proposed rules ensure that these businesses will not need to choose between engaging in crowdfunding offerings and availing themselves of other fundraising options.

Separate from the limitation on the amount an issuer can raise through crowdfunding, Section 4(a)(6) limits the amount that any investor can invest in crowdfunding offerings over a continuous 12-month period, based on an investor's annual income and net worth.[6] The maximum aggregate investment in any 12-month period under the proposed rules are as follows:

- For investors with both an annual income and net worth of less than $100,000—greater of $2,000 or 5% of such investor's annual income or net worth, whichever is greater;
- For investors with either an annual income or a net worth over $100,000—greater of 10% of such investor's annual income or net worth, not to exceed $100,000.

Notably, these limitations reflect a more permissive interpretation of the relevant provisions of the JOBS Act. The Commission has requested comment on whether the final rules should take a more restrictive reading.[7]

Recognizing that "it would be difficult for intermediaries to monitor or independently verify whether each investor remains within his or

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her investment limits for each particular offering in which he or she intends to participate," the Commission declined to propose a high standard on issuers and intermediaries for determining the amount that an investor would be permitted to invest in any crowdfunding offering. Thus, an intermediary "may rely on an investor's representations concerning compliance with investment limitation requirements based on the investor's annual income and net worth and the amount of the investor's other investments" in crowdfunding offerings. An intermediary portal, and the issuer, will be permitted to rely on such representations so long as they do not have "reason to question the reliability of the representation." For example, the intermediary likely would not be reasonable if it were to disregard the amount of other investments that the investor has made through an account with that intermediary, if such investment collectively exceed the investor's maximum annual investment amount.

Limitations on Advertising

Under the proposed rules, issuers would be permitted to post advertisements containing minimal information about their offering—similar to a "tombstone" advertisement in connection with a registered offering. The proposed rules would permit an advertisement to include only:

- a statement that the issuer is conducting an offering;
- the name of the intermediary through which the offering is being conducted and a link directing potential investors to the intermediary's platform on which additional information on the issuer and the offering may be found;
- the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period; and
- the name, address, phone number and website of the issuer, the email address of a representative of the issuer, and a brief description of the business of the issuer.

Although it is likely that these fairly stringent limitations on advertising will reduce the impact of the crowdfunding exemption on the capital raising activities of small, very early-stage businesses, the Commission has very little discretion to permit broader advertising in light of the statutory mandate that issuers not advertise the terms of the offering except for notices directing investors to the funding portal or broker.

Issuer Disclosures and On-going Reporting

Section 4(a)(6) and the proposed rules would require that issuers file with the Commission, and make available to the intermediary and to investors, certain disclosures, including financial information about the issuer for the prior two fiscal years (or for such shorter time as the issuer has been in existence), as well as certain information similar to what is required to be disclosed in a registration statement for a public offering. The financial information required of the issuer would depend on the aggregate amount of securities offered in crowdfunding transactions as measured on a rolling 12-month basis and would include:

- for offerings up to $100,000, financial statements certified by the issuer's principal executive officer, together with the issuer's income tax returns;
- for offerings over $100,000 and up to $500,000, financial statements that have been reviewed by the issuer's independent accountants; and
- for offerings over $500,000, audited financial statements.

In each case, the financial statements would be required to be prepared in accordance with U.S. GAAP.

The proposed rules would implement specific disclosure requirements contained in the statutory provisions, and would impose other disclosure requirements pursuant to the Commission's discretionary authority to require disclosures in the public interest and for the protection of investors.

The Commission added disclosure requirements not mandated by the statute.

The proposed rules implementing the disclosures mandated by the statute generally are narrower in scope, or grant the issuer greater flexibility in determining what to disclose, than comparable disclosure requirements for registered offerings. For example, with respect to the description of the issuer's business, the Commission noted that "issuers engaging in crowdfunding transactions may have businesses at various stages of development in differing industries, and therefore, we believe that the proposed rules should provide flexibility for issuers to discuss the information about their businesses" rather than prescribing specific disclosure requirements. Similarly, disclosure of the business experience of directors and officers of the issuer would be limited to three (rather than five) years.

At the same time, the Commission interpreted some of the statutorily mandated disclosures more broadly than the statute necessarily requires, and added disclosure requirements not mandated by the statute. For example, the statute requires that issuers describe their ownership and capital structure, but the proposed rules would require disclosure of the number of securities being offered and/or outstanding, whether or not such securities have voting rights, and any limitations on such voting rights. While the statute requires that issuers describe their financial condition, under the proposed rules, issuers would be expected to discuss their financial condition "in a manner similar to" the management's discussion and analysis of financial condition and results of operations (MD&A) required by Item 303 of Regulation S-K. While the proposed rules do not prescribe the content or format for this information and the Commission states that it "expect[s] that the discussion would not generally need to be as lengthy or detailed" as the MD&A of companies reporting under the Securities Exchange Act of 1934 (Exchange Act), this level of disclosure is arguably greater than that required by the statute.

In addition, the proposed rules would require disclosures that were not mandated by the statute, including, among others:

- disclosure of the amount of compensation paid to the intermediary for conducting the offering;
- disclosure of the number of employees of the issuer;
- risk factor disclosure;
- a description of the material terms of any indebtedness of the issuer;
- disclosure of exempt offerings conducted within the past three years; and
- disclosure of related-party transactions.

While all of these disclosures may be advisable for the protection of investors, they meaningfully increase the disclosure burden on crowdfunding issuers.

The net result of the proposed disclosure requirements is that issuers will be required to provide disclosure that is similar in nature, though narrower in scope, to the disclosures that would be required in a registered offering. The Commission noted that "[c]ommenters expressed concerns [in advance of its proposal] about the extent of the disclosure requirements and stated that overly burdensome rules would

make offers and sales [under the crowdfunding exemption] prohibitively expensive." The proposing release stated that the Commission had "considered [these comments] in determining the disclosure requirements that [it] should propose." Ultimately, the attractiveness to an issuer of engaging in a crowdfunding offering likely will depend in large part on the appetite of the issuer to draft the required disclosures.

These transfer restrictions will have the effect of limiting the development of secondary markets in crowdfunded securities.

In addition to the disclosure requirements in connection with a crowdfunding offering, issuers will be required to file an annual report containing information about the issuer and its financial condition similar to that required in their offering document, but excluding information about the offering itself. In order to improve compliance with the on-going reporting requirement, an issuer would not be permitted to engage in subsequent crowdfunding transactions unless it is current in its on-going disclosure obligations.

Transfer Restrictions

New Section 4A(e) of the Securities Act provides that securities issued in reliance on the crowdfunding exemption may not be transferred for a period of one year following the date of purchase, except: (1) to the issuer; (2) as part of a registered offering; (3) to an accredited investor as defined under Rule 501(a) of Regulation D; or (4) to a family member (as defined in accordance with SEC rules), or to a trust controlled by an initial purchaser or for the benefit of a family member, or in connection with the death or divorce of the purchaser or other similar circumstances.

These transfer restrictions will have the effect of limiting the development of secondary markets in crowdfunded securities. To address this limitation, third-party vendors and platforms may begin to provide accredited investor status verification services to expand the opportunities for investors in crowdfunded securities to resell such securities. Initial appetite for crowdfunded securities may temper, however, once less sophisticated investors understand that their investments cannot be freely resold. This concern may be heightened if the Commission adopts additional limitations on resale after the first year, or if resale or trading is restricted when the issuer is no longer in compliance with on-going reporting requirements or is out of business, as suggested by the Staff's questions in the proposing release.

Issuer and Intermediary Liability

Issuers and intermediaries in crowdfunding transactions are subject to liability under federal securities laws similar to registered offerings.[8] First, the antifraud and civil liability provisions of Securities Act Sections 12(a)(2) and 17 apply to crowdfunding transactions, as do the antifraud provisions of Section 10(b) and Rule 10b-5 under the Exchange Act. Second, new Section 4A(c) of the Securities Act provides for liability if the issuer (which is defined to include its directors and key executive officers and other persons who offer the securities), in the offer or sale of the securities, "makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of the untruth or omission." The issuer will have a defense against liability under Section 4(A)(c) if it establishes that it "did not know, and in the exercise of reasonable care could not have known, of the untruth or omission." This liability standard and defense are similar to Section 12(a)(2) of the Securities Act.

If an investor brings a successful action pursuant to Section 4A(c), it may be entitled to recover the amount of consideration paid for the

applicable security with interest, or damages if the investor no longer holds the security. In accordance with Sections 12(b) and 13 of the Securities Act, damages are limited to loss of value of the security resulting from material untruths or omissions if suit is brought within one year after discovery of the offending statement (or after discovery should have been made by reasonable diligence), or three years after sale of the security, as applicable. Notably, because there will likely be a limited secondary market for securities issued in crowdfunding offerings, it may be difficult to prove the amount of the loss of value.

The proposing release also notes that, under Section 4A(c)(3), funding portals and registered brokers serving as crowdfunding intermediaries are likely subject to the same potential liability as issuers, subject to a "due diligence" defense if the intermediary establishes that it did not know and in the exercise of "reasonable care" could not have known of a material misstatement or omission when offering crowdfunded securities. The proposing release suggests certain steps that intermediaries could take to exercise "reasonable care," including implementing policies and procedures designed to ensure compliance with the regulations governing crowdfunding, and review of the issuer's offering documents to identify potentially materially false or misleading information.

It may be difficult to prove the amount of the loss of value.

Market practice and further Staff guidance will inform the ultimate extent of this due diligence burden, and numerous questions remain unresolved. Will required due diligence be greater than that already applicable to registered brokers offering exempt securities under Regulation D?[9] Will crowdfunding intermediaries be prepared to spend additional time and expense on due diligence, and will issuers be prepared to compensate intermediaries for such efforts? Will intermediaries retain outside advisors, including counsel, to assist them? The answers to these and other questions may influence the feasibility of acting as a crowdfunding intermediary, and market practices over time will reveal whether the crowdfunding statutory liability regime will temper issuance activity by issuers and intermediaries.

Conclusion

The statutory framework for crowdfunding includes a number of explicit provisions and rulemaking mandates intended to protect crowdfunding investors that could ultimately dampen interest in such offerings. In addition, the SEC's proposed rules interpreted some of its statutory mandates, and included certain other provisions pursuant to its discretionary authority, in ways that may also reduce issuers' and intermediaries' interest in these offerings. These protections may ultimately be necessary, however, to establish an offering regime that investors trust will provide them with the protections that they require to enter this market. The input received from commenters on the proposed rules should have a significant influence on the rules that the SEC ultimately adopts, and it will likely take some time after adoption of any final rules before the market will judge the success of the crowdfunding exemption.

Notes

1. *Crowdfunding*, Release No. 33-9470 (Oct. 5, 2013) [78 FR 66427] (available at *http://www.sec.gov/rules/proposed/2013/33-9470.pdf*).

2. Pub. L. No. 112-106, 126 Stat. 306 (2012).

3. Although the term "crowdfunding" is often used generally to refer to securities offerings conducted online, including online offerings involving the use of general solicitation pursuant to Rule 506(c) of Regulation D under the Securities Act, we use "crowdfunding" herein to refer only to offerings pursuant to the specific crowdfunding exemption provided by Section 4(a)(6).

4. Crowdfunding intermediaries will be subject to Section 4A(a) of the Securities Act, and the proposing release includes proposed rules to implement these requirements. Under Section 4A(a) and the proposed rules, intermediaries would be required to provide investors

with educational materials and information regarding the issuer and its offering, including risks associated with crowdfunding investments. Intermediaries would also be required to take certain steps to reduce the risk of fraud and provide communication channels to permit discussions regarding an offering. Officers, directors, and partners of an intermediary would be prohibited from having any financial stake in any crowdfunding issuer using its services. The proposed rules also provide for disqualification of intermediaries in certain circumstances under conditions that are somewhat broader than Rule 262 of Regulation A under the Securities Act.

5. Funding portals may act solely as intermediaries and may not otherwise handle customer funds, offer investment advice or recommendations, solicit investments or compensate employees, agents or other persons to do so. Funding portals would be required to register as such with the SEC on Form Funding Portal, and also would be required to register with FINRA. On October 24, 2013, FINRA proposed funding portal rules and related forms. *See Jumpstart Our Business Startups (JOBS) Act, FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms*, FINRA Regulatory Notice 13-34 (Oct. 24, 2013) (available at: *http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p370743.pdf*).

6. A natural person's net worth would be calculated in accordance with the SEC's accredited investor rules, which exclude the value of the person's primary residence.

7. The Commission requested comment on whether, if either the investor's annual income or net worth is less than $100,000, the investment limitation should be calculated at the 5% threshold rather than the 10% threshold. The Commission also requested comment on whether, at either the 5% or the 10% threshold, an investor's annual investment should be calculated based on the lesser, rather than the greater, of the investor's annual income or net worth.

8. However, Section 11 of the Securities Act, which provides for registration statement liability, would not apply to crowdfunding transactions under Section 4(a)(6).

9. *See http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf*.

The *Mark Cuban* Verdict and What It Means for Misappropriation and Insider Trading Law

A Texas jury recently returned a complete verdict for Mark Cuban in the SEC's insider trading case against him. Aside from the media intrigue surrounding Cuban's fight against the SEC, the case teed up for decision a critical and open issue concerning the nature of the "duty" upon which misappropriation claims are predicated. So what does the recent verdict mean for misappropriation law, and what are its implications for the SEC and the market?

By Christopher G. Green, Matthew L. McGinnis, and John N. McClain III

On October 16, 2013, more than four years after the case began, but after only four hours of jury deliberation, a jury found Mark Cuban not liable for insider trading. Cuban, the owner of the Dallas Mavericks, had been charged with insider trading for the 2004 sale of his Mamma.com stock. The sale allegedly helped Cuban avoid losing $750,000. In defending against the SEC's charges, which were first filed in 2008, Cuban almost surely spent several times that amount.

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Those who have followed the matter over the years may recall that the rollercoaster case has been covered in INSIGHTS at various points along the way.[1] In 2009, the district court dismissed the SEC's complaint, giving Cuban a temporary victory. The U.S. Court of Appeals for the Fifth Circuit then reversed that decision and remanded for discovery. The district court subsequently denied a motion for summary judgment by Cuban, sending the matter to trial.

Cuban was plainly vindicated by the jury's verdict. But what does it mean for other investors, and what (if any) impact does it have on insider trading law? Although the case has been followed principally because of Cuban's celebrity status and his unique personality, the case is not just one of sensational sport. The case raised a critical issue in insider trading law concerning the scope of the duty underlying the misappropriation theory. Whereas many courts, practitioners, and the SEC typically have believed that misappropriation requires only that the defendant undertook a duty to maintain material nonpublic information (MNPI) in confidence, the district court in Cuban's case took that requirement one step further by also requiring that the defendant undertook a duty not to use or trade on the MNPI. But what is not yet apparent is whether other courts will adopt a similar requirement, or how the SEC will respond to the verdict.

Cuban's Four-Year War with the SEC

The *Cuban* trial was the latest—and likely last—battle in a lengthy four-plus year war between Cuban and the SEC, with each side gaining the upper hand at various points. To assess the potential significance of the verdict, one first needs to understand the phases of the litigation that preceded it.

The Facts

In 2004, Cuban owned 600,000 shares of Mamma.com (Mamma). He was its largest shareholder at the time, with a 6.3 percent stake. Mamma sought to raise capital through a private investment in public equity offering (PIPE). As the PIPE progressed, Mamma's CEO, Guy Fauré, called Cuban to inform him of the offering and invite him to participate in the investment. According to the SEC's complaint:

> The CEO prefaced the call by informing Cuban that he had confidential information to convey to him, and Cuban agreed that he would keep whatever information the CEO intended to share with him confidential. The CEO, in reliance on Cuban's agreement to keep the information confidential, proceeded to tell Cuban about the PIPE offering.

Cuban allegedly reacted angrily, saying that he did not like PIPE offerings because they diluted existing shareholders' stakes. At the end of the call, Cuban famously said: "Well, now I'm screwed. I can't sell."

A crucial issue in many misappropriation cases is the nature of the relationship between the investor and his source.

Cuban then allegedly spoke to a sales representative at the investment bank handling the PIPE offering, who provided Cuban with additional confidential details about the PIPE. One minute later, Cuban called his broker and directed him to sell all 600,000 of Cuban's shares in Mamma. Mamma publicly announced the PIPE offering after the market closed that day, and its share price dropped significantly. By selling his shares prior to the announcement, the SEC claimed that Cuban avoided a $750,000 loss.

The SEC's Allegations

The SEC filed a civil suit against Cuban in 2008 in the U.S. District Court for the Northern District of Texas. It claimed that, among other things, Cuban engaged insider trading in violation of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 under the so-called "misappropriation theory" of insider trading. The misappropriation theory holds that a person may be liable for insider trading if he or she knowingly misappropriates MNPI for securities trading purposes in breach of a duty to the source of the information, regardless of whether the investor owes a duty to the corporation whose securities are being traded.[2] In theory, the investor's undisclosed, self-serving use of the source's confidential information in order to purchase or sell securities, in breach of a duty of trust or confidence to that source, deceives the source and defrauds it of the exclusive use of the MNPI.

As one might expect, a crucial issue in many misappropriation cases—including the *Cuban* case—is the nature of the relationship between the investor and his source, including the scope of any duty that investor may owe. In many cases, the duty at issue is a preexisting one, such as a lawyer's duty to his firm and clients to maintain the confidentiality of MNPI he learns in the course of his work. In the *Cuban* case, however, the SEC did not rely on any sort of preexisting duty owed Cuban owed to anyone. Instead, it essentially claimed that Cuban owed a duty to Mamma because he orally agreed to such a duty in his conversation with Fauré.

The scope and terms of that alleged "agreement" between Cuban and Fauré became the central issue for the duration of the litigation. At the outset of the case, Cuban moved to dismiss the complaint. Cuban argued that liability under the misappropriation theory of insider trading requires a preexisting fiduciary or fiduciary-like relationship with the provider of the information,

and that a mere "agreement" between the investor and the source cannot provide a basis for liability. In response, the SEC pointed to Rule 10b5-2(b)(1), which purports to define the circumstances in which a duty of trust or confidence exists for purposes of misappropriation. According to the rule, a duty of trust or confidence is established "whenever a person agrees to maintain information in confidence." The rule is silent on the "use" of the information.

The District Court's Ruling on Cuban's Motion to Dismiss

In ruling on Cuban's motion to dismiss, Chief Judge Fitzwater held that an agreement alone can in some circumstances be the basis for a duty of trust or confidence that can give rise to insider trading liability. But the precise terms of that agreement, according to Chief Judge Fitzwater, are critical. As he explained:

> The agreement ... must consist of more than an express or implied promise merely to keep the information confidential ... it must impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain. ... although conceptually separate, both non-disclosure and non-use comprise part of the duty that arises by operation of law when a fiduciary relationship is created. Where misappropriation theory liability is predicated on an agreement, however, a person must undertake, either expressly or implicitly, both obligations. He must agree to maintain the confidentiality of the information *and* not to trade on or otherwise use it. Absent a duty not to use the information for personal benefit, there is no deception in doing so.[3]

Thus, under Chief Judge Fitzwater's reasoning, an investor's agreement to maintain the confidentiality of the MNPI is not enough; he or she must also agree not to use it.

Applying this standard to the allegations, Chief Judge Fitzwater concluded that although the SEC had alleged that Cuban agreed to keep the MNPI *confidential*, it had not adequately alleged that Cuban also agreed *not to use* the MNPI. According to the Court, Cuban's comment that he was "screwed" and could not sell his shares expressed merely "his belief, at least at that time, that it would be illegal for him to sell," but did not constitute an agreement to refrain from doing so.[4] Chief Judge Fitzwater acknowledged that Rule 10b5-2(b)(1) stated that a duty was established "[w]henever a person agrees to maintain information in confidence" without also requiring that the person agree not to use the information. But that definition of the duty was, according to Chief Judge Fitzwater, impermissibly broad and "exceed[ed] the SEC's Section 10(b) authority to proscribe conduct that is deceptive."[5] The district court accordingly granted Cuban's motion to dismiss.

An investor's agreement to maintain the confidentiality of the MNPI is not enough.

The SEC's Appeal to the Fifth Circuit

The SEC appealed Chief Judge Fitzwater's ruling to the Fifth Circuit Court of Appeals. The SEC claimed that (1) an agreement to keep MNPI confidential by its nature creates a duty to disclose or abstain from trading on that information, but that, even if it did not, and (2) the complaint adequately alleged that Cuban agreed both to keep the information he received from Fauré confidential and not to trade on it.[6]

The Fifth Circuit sidestepped the first of these arguments. In so doing, the court acknowledged the "paucity of jurisprudence on the question of what constitutes a relationship of 'trust and confidence'" for purposes of misappropriation liability, but declined to "draw [its] contours,"

including the applicability of Rule 10b5-2(b)(1).[7] Instead, the Fifth Circuit said that regardless of which standard applied, it had "a different view from our able district court brother of the allegations of the [SEC's] complaint."[8] The Fifth Circuit then highlighted the SEC's allegation that after Cuban told Fauré that he was "screwed" and couldn't sell, he contacted Mamma's investment bank and obtained details on the terms and conditions of the PIPE offering's investment bank. These allegations, according to the Fifth Circuit,

> provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement. By contacting the sales representative to obtain the pricing information, Cuban was able to evaluate his potential losses or gains from his decision to either participate or refrain from participating in the PIPE offering. It is at least plausible that each of the parties understood, if only implicitly, that Mamma.com would only provide the terms and conditions of the offering to Cuban for the purpose of evaluating whether he would participate in the offering, and that Cuban could not use the information for his own personal benefit.[9]

The Fifth Circuit thus held that the SEC's complaint stated a claim against Cuban, vacated the district court's dismissal, and remanded the case for discovery.

The jury instructions are critical.

Although the remand was obviously a loss for Cuban, there was a silver lining. The Fifth Circuit had not disturbed Judge Fitzwater's ruling that establishing a duty of trust or confidence required proof that Cuban had agreed both to keep the MNPI confidential and not to trade on it. The SEC thus could proceed in its action against Cuban, but only under a standard that was arguably inconsistent with Rule 10b5-2(b)(1). Indeed, on remand, the district court held that its prior ruling establishing the two requirements for any agreement—including non-use—was the "law of the case."[10] But in light of the Fifth Circuit's reading of the facts, the district court refused to grant summary judgment to Cuban at the end of discovery. The question was a close one, according to Chief Judge Fitzwater, but applying the Fifth Circuit's rationale, "there is evidence ... that would enable a reasonable jury to find that Cuban agreed at least implicitly not to trade on the PIPE information."[11]

The Trial

The case was tried to a jury in September 2013. In order to prove that Cuban agreed to keep the PIPE information confidential and not to trade on it, the SEC presented videotaped testimony of Mr. Fauré, who lives in Canada and refused to travel to Texas for the trial. Cuban, for his part, said he did not recall the specifics of the conversation but said he would never have agreed to refrain from selling his Mamma stock. There was no wiretap of the brief conversation—something to which jurors have perhaps grown accustomed in the post-CSI world—so evidence of the supposed "agreement" was limited to Fauré's and Cuban's recollections of a conversation that occurred more than nine years ago.

The jury instructions are critical. Before turning the case over to the jury, the Court instructed that a finding of liability for insider trading required proof of the following seven elements:

1. Cuban received MNPI concerning the impending PIPE transaction.

2. Cuban "expressly or implicitly agreed with Mamma.com to keep the material, nonpublic information confidential and not to trade on or otherwise use the information

for his own benefit. ... The express or implied agreement must include both aspects."

3. Cuban traded on the MNPI.

4. Before trading on the MNPI, Cuban did not disclose to Mamma.com that he planned to trade on it.

5. Cuban acted knowingly or with severe recklessness.

6. Cuban's conduct was in connection with the sale of a security.

7. Cuban's conduct took place in interstate commerce.[12]

Unsurprisingly, the SEC continued to fight the looming "non-use" issue and objected to the second element of the charge, claiming that "an agreement to keep material, nonpublic information confidential is sufficient" to support misappropriation liability "because an agreement to keep inside information confidential gives rise to a duty not to trade."[13]

After less than four hours of deliberation, the jury found for Cuban and rejected the SEC's misappropriation insider trading claim. Significantly, the jury found that the SEC had failed to prove any of the five disputed elements of its claim.[14]

The *Cuban* Verdict's Implications for Misappropriation Law

Since the verdict was announced in October, there has been widespread debate over its significance. Some view it as a blow to the SEC's enforcement efforts because the SEC spent substantial resources litigating the matter for the past four-plus years. For market participants, however, the case's significance turns on whether the district court's two-pronged requirement for agreements creating a duty of trust or confidence gains ground elsewhere. After the district court's ruling on the motion to dismiss in 2009, some of us wrote in INSIGHTS that "[a] wait-and-see approach may be the most prudent." That advice still holds true. *Cuban* remains the only federal court case to hold that proof of an agreement not to use or trade is required in misappropriation insider trading cases. That holding was not adopted (or rejected) by the Fifth Circuit, and it has not been followed by any other court since. And no other district judge (even one in the Northern District of Texas) is required to adopt Chief Judge Fitzwater's reasoning.

The SEC may rightly see some risk in teeing up this issue for an appellate decision yet again.

The SEC may, of course, appeal the jury verdict in order to challenge Chief Judge Fitzwater's ruling. If it does, it will likely need to file a notice of appeal by mid-December (barring any post-judgment motions). But the case is a poor candidate for appeal for several reasons. As the party with the burden of proof, the SEC faces a high—if not insurmountable—burden in order to obtain a directed verdict or new trial, especially since the jury found that the SEC failed to prove *any* of the disputed elements of its claim. Even if Chief Judge Fitzwater erred in requiring proof that Cuban agreed not to use or trade on the PIPE information, that error would not have made a difference, because the jury also found that the SEC failed to meet its burden as to the four other disputed elements. And if the prior appellate ruling in *Cuban* is any indication, the Fifth Circuit may not want to reach the question of what sort of "agreement" is required to establish the requisite duty in misappropriation cases since it does not have to.

The SEC also may prefer to avoid prompting a federal appellate decision on this issue for now. When the SEC objected to Chief Judge

Fitzwater's jury instruction on the second element, it identified several cases it claimed supported its position that a mere agreement to keep MNPI confidential is sufficient to establish a duty of trust or confidence.[15] Although these cases contain some ambiguous language supporting the SEC's position, none provides a definitive endorsement of the SEC's position and interpretation in Rule 10b5-2. As a result, the SEC may rightly see some risk in teeing up this issue for an appellate decision yet again.

As for other enforcement matters, the SEC may very well continue to pursue cases involving reasonably analogous facts where an investor agrees to maintain information "in confidence" but nevertheless trades on the information. Neither Chief Judge Fitzwater's ruling on the motion to dismiss nor the ultimate jury verdict alter the state of the law in any other jurisdiction. The SEC may, however, seek to avoid the predicament it found itself in in *Cuban* by bolstering, wherever possible, factual allegations of at least an implied agreement not to use or trade on the information in question.

Takeaways for Public Companies and Market Participants

In the end, the key question is whether the *Cuban* jury verdict will change the "rules of the road" for the market, both as to public companies and as to the buy-side. As to public companies, the decision underscores the importance of being explicit about the scope of any duty when providing information to third parties or investors. The company should be clear that the receiver of the information can neither disclose the information nor use it other than for the narrow purpose for which it was provided. NDAs, of course, have precisely that language, but clarity in all settings—including investor conferences, company meetings, and investor relations calls, among others—is warranted.

For buy-side market participants who often find themselves in Cuban's predicament due to information flow from either public companies or the sell-side, the verdict should provide cold comfort. Merely agreeing to keep information confidential, without also agreeing not to use the information, may give buy-siders a meaningful argument that the predicate duty did not attach, but buy-siders proceeding on that basis cannot be sure they will not face an enforcement action and all the collateral costs that come with that. Indeed, Cuban had the liberty to fight this battle; institutional investors often do not enjoy the same liberty, given reputational concerns and relationships with limited partners and investors.

The decision underscores the importance of being explicit about the scope of any duty when providing information to third parties or investors.

One could imagine buy-siders seizing upon Chief Judge Fitzwater's reasoning and making it explicit in written NDAs and confidentiality agreements that the buy-sider will not agree to be restricted in trading in the public company's securities. That approach is one gradation stronger than mere silence on whether the buy-sider can use the information. Of course, many market participants already have such procedures in place. But the *Cuban* verdict suggests they should sharpen that practice. If, after all, an investor discloses that it intends to *use* the information, there is no deception and thus no claim under Rule 10b-5.

Given the continuing ambiguity in the law on this issue, and the unlikelihood that it will be resolved by case law or SEC rulemaking anytime soon, prudence counsels in favor of being explicit with the source when an investor intends to trade on confidential information disclosed to it. Such a statement may, of course, prompt the

well-counseled source to refrain from providing the confidential information at all. But when it comes to insider trading law, some things are better left said.

Notes

1. *See, e.g.*, Stephen E. Older and Seth T. Goldsamt, "The *SEC v. Mark Cuban* Insider Trading Case: Does It Pay to Be a Maverick When Trading Securities?" *Insights*, February 2009, Vol. 23, No. 2; Christopher G. Green and Julie H. Jones, Misappropriation: The *Mark Cuban* Decision and Its Potential Impact on Insider Trading Law," *Insights*, August 2009, Vol. 23, No. 8.
2. *See generally United States v. O'Hagan*, 521 U.S. 642 (1997).
3. *SEC v. Cuban*, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009).
4. *Id.* at 728.
5. *Id.* at 731.
6. *SEC v. Cuban*, 620 F.3d 551, 552-53 (5th Cir. 2010).
7. *Id.* at 558.
8. *Id.* at 552.
9. *Id.* at 557.
10. *SEC v. Cuban*, Civ. A. No. 3:08-CV-2050-D, 2013 WL 791405, at *2 (N.D. Tex. March 5, 2013).
11. *Id.* at *6.
12. Court's Charge to Jury, Dkt. 278 at 9, 11, *SEC v. Cuban*, No. 3:08-cv-02050-D (N.D. Tex. filed Oct. 16, 2013).
13. Plaintiff's Trial Brief Regarding Court's Contemplated Charge to the Jury, Dkt. 272, at 5-6, *SEC v. Cuban*, No. 3:08-cv-02050-D (N.D. Tex. filed Oct. 14, 2013).
14. Court's Charge to Jury, Dkt. 278 at 13-14, *SEC v. Cuban*, No. 3:08-cv-02050-D (N.D. Tex. filed Oct. 16, 2013). There was apparently no dispute that Cuban's conduct was in connection with the sale of a security (element #6) or that his conduct took place in interstate commerce (element #7).
15. *See* Plaintiff's Trial Brief Regarding Court's Contemplated Charge to the Jury, Dkt. 272, at 6 n.3, *SEC v. Cuban*, No. 3:08-cv-02050-D (N.D. Tex. filed Oct. 14, 2013) (citing *United States v. O'Hagan*, 521 U.S. 642, 663-64 (1997); *Carpenter v. United States*, 484 U.S. 19, 27-28 (1987); *Regents of the Univ. of Calif. v. Credit Suisse First Boston*, 482 F.3d 372, 389 (5th Cir. 2007); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc); *United States v. Falcone*, 257 F.3d 226, 234 (2d Cir. 2001); *SEC v. Yun*, 327 F.3d 1263, 1273 (11th Cir. 2003)).

Going Dark: A Step-by-Step Planning Guide for Exiting the Public Company Reporting System

Preparing for an issuer's exit from the reporting system requires careful planning. An issuer going through this process retains some degree of choice but must be aware of the traps in the process.

By Keir D. Gumbs, Brian K. Rosenzweig, Ciarra Chavarria, and David Dunn

In the wake of the largest financial crisis in decades and the heightened regulatory environment that exists in its aftermath, public companies that are considering a merger, struggling financially or that are otherwise seeking relief from regulatory and other burdens have a greater incentive than ever to consider delisting and deregistering their securities, or "going dark." In a world already heavily impacted by requirements for CEO and CFO certifications, internal control over financial reporting, increased shareholder activism and increased SEC and DOJ enforcement activity, senior executive officers and members of the board of directors of an issuer that has been merged with another company,[1] come under financial distress or that has otherwise concluded that remaining a public company is not in the best interests of the corporation often are anxious to see the extinguishment of the issuer's reporting obligations as promptly as possible. Yet, the process for exiting the public reporting system is time consuming and unwieldy.

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Navigating the process by which a company delists from a national securities exchange and completes and terminates its registration and reporting obligations under the Securities Exchange Act of 1934 (Exchange Act) requires advanced planning. This article provides step-by-step instructions for completing the delisting and deregistration process, including alternative approaches that may help accelerate ending a company's Exchange Act reporting obligations. The steps are summarized in charts that accompany this article. In addition, this article briefly addresses the process and timing for winding up compliance with Section 16 insider trading regulations under the Exchange Act.

Terminating an Issuer's Exchange Listing and Reporting Obligations Under the Exchange Act

Generally, an issuer's obligation to file Exchange Act reports is derived from one or more of three provisions of the Exchange Act: Sections 12(b), 12(g), and 15(d). Section 12(b) requires the registration of any class of securities listed on a national securities exchange (*e.g.*, the New York Stock Exchange or the NASDAQ Stock Market).[2] Section 12(g) generally requires an issuer that has assets exceeding $10 million as of the end of its fiscal year to register any class of equity securities held of record by either 2,000 or more persons or 500 or more persons who are not accredited investors (as defined by the SEC).[3] Section 15(d) imposes a reporting obligation on an issuer that has sold securities pursuant to an effective registration statement under the Securities Act of 1933 (Securities Act).[4]

The reporting obligations imposed by Sections 12(b), 12(g), and 15(d) are usefully thought of as rungs on a ladder, with Section 12(b) registration

Step-by-Step Guide for Delisting and Suspending an Issuer's Reporting Obligations Outside the Context of a Merger		
Timing	**Item**	**Action**
In advance of any public announcement or SEC filing	Board Resolutions	The board (and audit committee, if appropriate) of the issuer should approve resolutions authorizing the issuer to proceed with delisting and deregistration.
Within four business days after the first definitive action to delist	Item 3.01(d) 8-K	The issuer must file a current report on Form 8-K under Item 3.01(d) upon any definitive action taken (including adoption of resolutions by the board) to delist.
At least 20 days before filing deadline for next periodic Exchange Act Report if listed on an Exchange	Notification of proposed exchange delisting	At least 10 days in advance of filing a Form 25, the issuer must publish notice of its plans to delist, along with its reasons for such withdrawal, via a press release on the issuer's website. The issuer must also notify the exchange of the proposed delisting. To avoid timing pressure in connection with an upcoming Exchange Act reporting deadline, the issuer may want to add one or more additional days into the process to ensure suspension of reporting obligations prior to the day an Exchange Act filing is due.
At least 10 days before filing deadline for next periodic Exchange Act Report	Form 25	The issuer must file the Form 25 with the Commission. The Form 25 may be filed no less than ten days after notifying the exchange of proposed delisting. To avoid timing pressure in connection with an upcoming Exchange Act reporting deadline, the issuer may want to add one or more additional days into the process to ensure suspension of reporting obligations prior to the day an Exchange Act filing is due.
Prior to filing Form 15	Suspension of reporting obligations under Section 15(d)	The issuer should withdraw any registration statements that had been filed, but under which no securities had been sold, and file post-effective amendments to any of its outstanding registration statements under the Securities Act. Issuers should build in to the timeline 3-5 days prior to the desired Form 15 filing date for any post-effective amendments terminating any registration statements on Form S-1 or S-3 to be declared effective by the SEC.
Ten days after filing Form 25	Securities Delisted	The issuer's securities listed on the Form 25 are delisted by operation of law. If the only source of an issuer's reporting obligation relates to the Section 12(b) registration covered by the Form 25 the issuer's reporting obligations under Section 13(a) are suspended immediately.

(*Continued*)

Ten days after filing Form 25	Form 15	If the issuer also has reporting obligations under Section 12(g) and/or Section 15(d), the issuer should file a Form 15. The Form 15 should be marked to reflect that the issuer is relying on Rule 12g-4(a)(i) if it has a Section 12(g) registration, and Rule 12h-3(a)(i) if it has a reporting obligation under Section 15(d) .
90 days after filing Form 25	Termination of Section 12(b) registration	Section 12(b) deregistration becomes effective
90 days after filing Form 15	Termination of Section 12(g) registration and suspension of Section 15(d) reporting obligation	Section 12(g) registration terminated and Section 15(d) reporting obligation suspended.

being the "highest," Section 12(g) being the "intermediate," and Section 15(d) being the "lowest" source of reporting obligation. An issuer that is subject to more than one of these provisions is only subject to the highest source of reporting obligation with the remaining obligations suspended until the higher source of its reporting obligation is terminated. For example, if an issuer's registration under Section 12(b) terminates, any prior registration under Section 12(g) would resume. As is the case with Section 12(b) and Section 12(g), an issuer's reporting obligation under Section 15(d) will resume when both its Section 12(b) and Section 12(g) registrations terminate. Only when an issuer has terminated its Section 12 registration and suspended its reporting obligation under Section 15(d) are all of its Exchange Act reporting obligations extinguished.

Terminating an Issuer's Exchange Listing and Registration under Section 12(b)

If an issuer's securities are listed on a national securities exchange and the issuer seeks to terminate its reporting obligations, it must first delist its securities and terminate its Section 12(b) registration under the Exchange Act. To do so, either the national securities exchange or the issuer must file a Form 25 with the Commission on EDGAR in reliance on Rule 12d2-2 notifying the Commission of the withdrawal of an issuer's securities from listing on an exchange and from registration under Section 12(b).[5] Generally, a class of securities that is the subject of a Form 25 is deemed to be delisted and the related Section 12(b) reporting obligation suspended 10 days after the Form 25 is filed (or in the case of an amendment, 10 days after the filing of an amended Form 25), and deregistered under Section 12(b) of the Exchange Act 90 days after the Form 25 is filed.

Exchange-initiated delisting. An issuer that delists in the context of a merger transaction usually does so pursuant to an exchange-initiated delisting process. In this process, the issuer notifies the exchange of the proposed closing date of the pending merger transaction and the exchange takes the next step in the process by preparing the Form 25 to be filed with the Commission. Once the merger is closed, the issuer need only notify the exchange that the merger has been closed, at which point the exchange files the Form 25 with the Commission.

Issuer-initiated delisting. Outside the context of a merger, an issuer must initiate the delisting process and file the Form 25 itself. An issuer must notify the exchange in writing, at least ten days prior to filing Form 25, of its intention to delist

its securities.[6] To conduct an issuer-initiated delisting, the issuer must have:

- complied with applicable state law and with the exchange's rules governing the voluntary withdrawal of its securities from listing;
- provided the exchange with written notice of its determination to withdraw its securities from listing at least ten days in advance of the date upon which it seeks to file the Form 25; and
- published notice of its plans to delist, along with its reasons for such withdrawal, via a press release and on its website at least ten days in advance of the date upon which it seeks to file the Form 25.[7]

Under certain circumstances, as described below, an issuer in the context of a merger transaction also may choose the issuer-initiated delisting process. However, of the two alternatives, the exchange-initiated process is most common in the merger context.

Timing considerations. If the issuer does not have any other classes of securities registered under Section 12(b), any classes of securities registered under Section 12(g) of the Exchange Act or a reporting obligation under Section 15(d) of the Exchange Act, the issuer's obligation to file current and periodic reports under Section 13(a) is suspended on the date that the issuer's securities are delisted.

However, in most cases, the filing of the Form 25 is only the first step in the process of terminating registration under the Exchange Act. Issuers that are listed on a national securities exchange may also have a class of securities registered under Section 12(g) of the Exchange Act[8] and likely have a Section 15(d) reporting obligation. For such issuers, the filing of the Form 25 must, as applicable, be followed by the termination of registration of their securities under Section 12(g) and the suspension of any reporting obligations imposed by Section 15(d). This adds time to the process, because an issuer may not terminate its Section 12(g) registration or suspend its Section 15(d) reporting obligation until the Section 12(b) registration is terminated, which, as noted above, does not occur until 90 days after the Form 25 is filed.[9]

Due to these timing considerations, an issuer looking to delist and deregister following a merger may wish to consider relying on the issuer-initiated delisting process so that it can ensure that its shares are delisted on the same date that the merger closes by filing the Form 25 ten days in advance of the merger closing and then filing the Form 15 concurrently with the merger closing. The flexibility afforded by the issuer initiated process may be of particular utility in situations where an issuer needs to be able to suspend its reporting obligations immediately upon closing the merger. This would be the case, for example, if a periodic report would be due during the ten-day period between the exchange's filing of the Form 25 and the effective date of the Form 25.[10]

The suspension of the issuer's obligation to file reports under Section 13(a) of the Exchange Act does not immediately suspend all of its public reporting requirements.

Whether an issuer relies on the exchange-initiated process or initiates the process itself, the suspension of the issuer's obligation to file reports under Section 13(a) of the Exchange Act does not immediately suspend all of its public reporting requirements. The remaining provisions of the Exchange Act, including the proxy rules, Section 16 and certain provisions of the Williams Act, continue to apply to the issuer until the expiration of 90 days from the date the Form 25 is filed.[11] This period may be accelerated or extended by the Commission.[12]

Terminating an Issuer's Registration Under Section 12(g)

Some issuers, including those with securities listed on a national securities exchange, may have a class of securities registered under Section 12(g) of the Exchange Act.[13] As discussed above, should an issuer have securities registered under Section 12(g) of the Exchange Act, this registration will have been suspended during the pendency of the issuer's registration under Section 12(b). However, once registration under Section 12(b) is terminated, the registration and related reporting obligation imposed by Section 12(g) would resume.

In order to terminate its Section 12(g) registration, an issuer may wish to rely on Rule 12g-4. Under Rule 12g-4, an issuer may terminate the registration of a class of its securities under Section 12(g) if it can certify on Form 15 that it meets one of the following conditions:

- fewer than 300 record holders; or
- fewer than 500 record holders and $10 million or less in assets as of the last day of each of the issuer's three most recent fiscal years; or
- in the case of a bank or bank holding company, fewer than 1,200 record holders.[14]

In a merger transaction, at the effective time of a typical merger, the common stock of the target is converted into the right to receive the merger consideration and the issuer becomes a wholly-owned subsidiary of the acquirer. In this scenario, it will have only one shareholder (*i.e.*, the acquirer), and should be able to certify on Form 15 that it has fewer than 300 record holders (or 1,200 record holders, in the case of a bank or bank holding company).

Outside the context of a merger, the determination of the number of record holders of a company requires additional consideration. Rule 12g5-1 under the Exchange Act defines a company's record holders, for purposes of determining whether an issuer is subject to the provisions of Sections 12(g) and 15(d) of the Exchange Act, as each person who is identified as the owner of the company's securities on the record of security holders maintained by or on behalf of the company (typically, by the company's transfer agent). Where a portion of a company's shares are held in book-entry form in the facilities of the Depository Trust Company through the institutional custodian Cede & Co., each DTC member who holds the company's securities will be treated as one record holder (the company will need to obtain a DTC participants list in order to ascertain this number). In contrast, securities held in street name by a broker-dealer will be treated as held of record only by the broker-dealer and no look-through to the beneficial owners of the street-name securities is necessary for Section 12(g) and Section 15(d) purposes.[15]

An issuer will have a reporting obligation under Section 15(d) of the Exchange Act if it has ever registered securities for sale under the Securities Act.

Unlike Section 12(b) deregistration under Rule 12d2-2, there is no lapse in time between the filing of a Form 15 under Rule 12g-4 and the suspension of an issuer's obligation to file periodic reports under Section 13(a) of the Exchange Act. Once a Form 15 is filed, assuming an issuer does not have a reporting obligation under Section 15(d), an issuer's obligation to file periodic reports with the Commission under Section 13(a) is suspended immediately. As with Form 25, however, an issuer remains registered under Section 12(g) of the Exchange Act, and thus subject to the remaining provisions of the Exchange Act, including the proxy rules, Section 16, and certain provisions of the Williams Act, until the expiration of 90 days from the date upon which the Form 15 is filed.[16]

Step-by-Step Guide for Delisting and Suspending an Issuer's Reporting Obligations in Connection with a Merger			
		Exchange-Initiated Process—Exit Completed 10-15 Days After Merger Closing	**Issuer-Initiated Process—Potential to Exit Promptly Following Merger Closing or Prior to Upcoming Periodic Report Filing Deadline**
Timing	**Item**	**Action**	**Action**
At the same time or after the board of directors approves the merger agreement, but in any event, in advance of the merger closing	Board Resolutions	The board (and audit committee, if appropriate) of the target should approve resolutions authorizing the issuer to proceed with delisting and deregistration. The board (and compensation committee if appropriate) of the target should approve resolutions that: (i) identify the insiders whose dispositions are to be exempted, (ii) identify the number of securities to be disposed of by such insiders, and (iii) express the general exemptive purpose of the resolutions under Rule 16b-3. The board of the acquirer should approve resolutions, contingent upon the merger closing, authorizing persons to sign post-closing SEC filings on behalf of the target upon the closing of the merger.	The board (and audit committee, if appropriate) of the issuer should approve resolutions authorizing the issuer to proceed with delisting and deregistration. Consideration should be given to the risks of unexpected delay in the merger closing. The board (and compensation committee, if appropriate) of the issuer also should approve resolutions that: (i) identify the insiders whose dispositions are to be exempted, (ii) identify the number of securities to be disposed of by such insiders, and (iii) express the general exemptive purpose of the resolutions under Rule 16b-3. The board of the acquirer should approve resolutions, contingent upon the merger closing, authorizing persons to sign post-closing SEC filings on behalf of the target upon the closing of the merger.
20 days before the merger closing	Exchange Delisting	--	The issuer should publish notice of its plans to delist, along with its reasons for such withdrawal, via a press release on the issuer's website. The issuer also should notify the exchange of the proposed delisting.
Ten days before the merger closing	Exchange Delisting	The issuer should notify the exchange of the proposed closing date of the merger. Depending on the exchange upon which it is listed, the issuer should notify the exchange of the proposed closing date several days in advance of the closing. Five to ten business days is advisable.	The issuer should file the Form 25 with the exchange. The Form 25 may be filed no less than ten days after notifying the exchange of proposed delisting.

(*Continued*)

Four days in advance of the merger closing	Section 16(a) Compliance	Prepare Forms 4 for officers and directors reflecting exchange of issuer's securities in receipt for merger consideration.	Prepare Forms 4 for officers and directors reflecting exchange of issuer's securities in receipt for merger consideration.
Merger Closing			
Date of the merger closing	Exchange Delisting	The issuer should notify the exchange of the merger closing. The exchange then should file the Form 25 with the SEC.	The issuer's securities listed on the Form 25 are delisted by operation of law. If the only source of an issuer's reporting obligation relates to the Section 12(b) registration covered by the Form 25 the issuer's reporting obligations under Section 13(a) are suspended immediately.
Date of the merger closing	Suspension of reporting obligations under Section 15(d)	The issuer should withdraw any registration statements that had been filed, but under which no securities had been sold, and file post-effective amendments to any of its outstanding registration statements under the Securities Act. Consider pre-closing filings of any post-effective amendments to terminate any registration statements on Form S-1 or S-3.	The issuer should withdraw any registration statements that had been filed, but under which no securities had been sold, and file post-effective amendments to any of its outstanding registration statements under the Securities Act. Consider pre-closing filings of any post-effective amendments to terminate any registration statements on Form S-1 or S-3.
Date of the merger closing	Suspension of Periodic and Current Reporting Obligations	--	The issuer should file a Form 15 marked to reflect that the issuer is relying on Rule 12g-4(a)(i) if it has a Section 12(g) registration, and Rule 12h-3(a)(i) if it also has a reporting obligation under Section 15(d) of the Exchange Act.
Two days after the merger closing	Section 16(a) Compliance	File Forms 4 for officers and directors reflecting exchange of issuer's securities in receipt for merger consideration.	File Forms 4 for officers and directors reflecting exchange of issuer's securities in receipt for merger consideration.
Four business days after the merger closing	Item 5.01 Form 8-K	Must be filed within four business days of the closing of the merger.	None required since Section 13(a) reporting obligations already have been suspended.
10 days after the date of the merger closing	Exchange Delisting	The issuer's securities listed on the Form 25 are delisted by operation of law. If the only source of an issuer's reporting obligation relates to the Section 12(b) registration covered by the Form 25 the issuer's reporting obligations under Section 13(a) are suspended immediately.	Already delisted.

(*Continued*)

10 days after the date of the merger closing	Suspension of Periodic and Current Reporting Obligations.	The issuer should file a Form 15 marked to reflect that the issuer is relying on Rule 12g-4(a)(i) if it has a Section 12(g) registration, and Rule 12h-3(a)(i) if it also has a reporting obligation under Section 15(d) of the Exchange Act.	Section 13(a) reporting obligations already suspended.
90 days after the date of the merger closing	Termination of Section 12(g) registration and suspension of Section 15(d) reporting obligation	--	Section 12(g) registration terminated and Section 15(d) reporting obligation suspended.
100 days after the date of the merger closing	Termination of Section 12(g) registration and suspension of Section 15(d) reporting obligation	Section 12(g) registration terminated and Section 15(d) reporting obligation suspended.	Section 12(g) registration already terminated and Section 15(d) reporting obligation already suspended.

Suspending an Issuer's Reporting Obligation Under Section 15(d)

As a general matter, an issuer will have a reporting obligation under Section 15(d) of the Exchange Act if it has ever registered securities for sale under the Securities Act. Most public companies have a reporting obligation under Section 15(d) in connection with the registration of their securities on a Form S-8 relating to employee stock purchase and similar employee benefit plans, or from having sold (or exchanged) registered equity or debt securities under the Securities Act. Regardless of how the Section 15(d) reporting obligation was created, an issuer must consider how it may suspend such reporting obligation once the registration of the issuer's securities under Section 12 has been terminated.[17]

Section 15(d) suspends the reporting obligations associated with a class of registered securities that is held by fewer than 300 record holders (or by fewer than 1,200 record holders in the case of a bank or bank holding company) as of the beginning of the current fiscal year.[18] Although this suspension is effective without any action by the issuer, Rule 15d-6 requires the issuer to notify the Commission of such suspension within 30 days of its occurrence by filing a Form 15. If an issuer cannot rely on Section 15(d) because it has 300 or more (or 1,200 or more in the case of a bank or bank holding company) record holders of a class of equity securities on the first day of a fiscal year but fewer than 300 (or 1,200 in the case of a bank or bank holding company) security holders on a date after the first day of a fiscal year (as would most often be the case in a merger transaction), it must rely on Rule 12h-3.

Rule 12h-3 permits an issuer to suspend its Section 15(d) reporting obligation with respect to a class of securities at any time that such securities are held by fewer than 300 record holders (or by fewer than 500 record holders if the issuer's total assets have not exceeded $10 million on the last day of each of its three most recent fiscal years).[19] To rely on Rule 12h-3, an issuer must certify to the Commission that it has filed all required reports for the most recent three fiscal years and the portion of the current year preceding reliance on the rule.

If an issuer had a registration statement declared effective or deemed to have been declared effective (*e.g.*, through the filing of a Form 10-K) in its most recently completed fiscal year, Section 15(d) will not suspend the issuer's obligation to file a Form 10-K for such completed fiscal year even if the issuer's equity securities are held by fewer than 300 record holders (or by fewer than 1,200 record holders in the case of a bank or bank holding company) as of the beginning of its current fiscal year.[20] Such an issuer must instead file a Form 15 in reliance on Rule 12h-3 prior to the date on which a Form 10-K for the preceding fiscal year would be due to suspend its obligation to file such Form 10-K.[21]

Continued Exchange Act reporting no longer serves the purposes underlying Section 15(d) and Rule 12h-3 where there were never any public shareholders, or there are no longer any public shareholders.

In many cases, issuers who are parties to a merger transaction or are otherwise pursuing delisting and deregistration that seek to rely on Rule 12h-3 technically cannot do so based on paragraph (c) of Rule 12h-3. Rule 12h-3(c) provides that Rule 12h-3 is not available for any class of securities for a fiscal year in which a registration statement for that class of securities became effective under the Securities Act. On its face, this provision is problematic for an issuer that wishes to file a Form 15 in the same fiscal year in which it filed a new registration statement or had an already-filed registration statement updated through the filing of a Form 10-K.[22]

In a 2010 staff legal bulletin, however, the Division of Corporation Finance indicated that issuers involved in an abandoned initial public offering or that have been acquired and no longer have shares outstanding may rely on Rule 12h-3, notwithstanding the application of paragraph (c). Despite technically having a new Securities Act registration statement go effective directly or indirectly through a Section 10(a)(3) update during the same fiscal year, Staff Legal Bulletin No. 18 states that issuers in these enumerated situations may rely on Rule 12h-3 to deregister under Section 15(d).[23] The Division of Corporation Finance stated its belief that continued Exchange Act reporting no longer serves the purposes underlying Section 15(d) and Rule 12h-3 where there were never any public shareholders, as in the case of an abandoned initial public offering, or there are no longer any public shareholders, in the case of certain merger transactions. In order to avail themselves of the Section 15(d) reporting suspension provided by Rule 12h-3, issuers in the situations enumerated by Staff Legal Bulletin No. 18 must:

- not have a class of securities registered under Section 12 of the Exchange Act;
- comply with the other requirements of Rule 12h-3;
- deregister any unsold securities from Securities Act registration statements and withdraw any registration statements if there were no sales; and
- not otherwise file Exchange Act reports during the time period in which such issuer seeks to avail itself of the suspension provided by Rule 12h-3.

Based on the foregoing, an issuer that finds itself in the situations addressed by Staff Legal Bulletin No. 18 and that wishes to suspend its reporting obligations under Section 15(d) must withdraw any previously-filed registration statements under which no securities had been sold,[24] and file terminating post-effective amendments to any outstanding registration statements. While

EDGAR will not reject a Form 15 that is filed by an issuer that has not filed post-effective terminating amendments to its outstanding registration statements, an issuer that fails to follow the protocols established in Staff Legal Bulletin No. 18 would not be able to avail itself of the interpretive positions taken by the staff of the Division of Corporation Finance. It thus would not be able to rely on Rule 12h-3 to suspend its reporting obligations under Section 15(d) of the Exchange Act.[25]

Good corporate governance practices call for board approval.

The application of Rule 12h-3(c) creates a quandary for an issuer that hopes to suspend its Section 15(d) reporting obligations unless its only outstanding registration statements are on Form S-8. A post-effective amendment to a registration statement on Form S-8 is effective immediately. A post-effective amendment to a Form S-3 or S-1 registration statement, however, generally must be declared effective by the staff, creating additional timing considerations for an issuer that is eager to suspend its reporting obligations because all registration statements must be terminated before an issuer can file an effective Form 15. In addition, if an issuer has filed a registration statement, but has made no sales pursuant to the registration statement, the issuer must file an application to withdraw the registration statement and the staff must consent to applications to withdraw registration statements.[26] To alleviate these timing constraints, an issuer could prepare and file post-effective amendments to any outstanding registration statements on Form S-3 or Form S-1 and applications to withdraw any registration statements under which no securities were sold at least three to four business days in advance of the proposed filing date of the Form 15.[27]

As a technical matter, an issuer may not file a Form 15 to suspend its Section 15(d) reporting obligation until its Section 12 registration has been terminated. As is the case for an issuer who has filed a Form 25 but not terminated its Section 12(b) registration, however, the staff will not object if an issuer files a Form 15 suspending its Section 15(d) reporting obligations prior to the expiration of 90 days from the date that it filed a Form 15 terminating its Section 12(g) registration. In fact, in most cases, issuers avail themselves of Rules 12g-4 and 12h-3 at the same time and on the same Form 15. Once this Form 15 is filed, an issuer will no longer be required to file any periodic or current reports due on or after the filing of the Form 15. As noted above, however, an issuer remains registered under Section 12(g) and subject to Section 15(d) until the expiration of 90 days from the date that the Form 15 is filed. In the case of an issuer whose only reporting obligation prior to the merger was under Section 15(d), it only would continue to be subject to the issuer tender offer, going private and antifraud provisions of the Exchange Act, but not the proxy rules or third-party tender offer rules, which only apply to issuers of equity securities that are registered under Section 12 of the Exchange Act.

Board Involvement

An issuer that anticipates exiting the public company reporting system as a result of a merger or otherwise should involve its board of directors, and as appropriate, its audit committee early in the delisting and deregistration process. While this is required for companies listed on the NYSE, most practitioners would agree that good corporate governance practices call for board approval. With this in mind, in the context of a merger, the general resolutions submitted to a board of directors in connection with a proposed merger should include resolutions that specifically contemplate the delisting and deregistration process. In addition, both within and outside the context of a merger, given that the delisting and deregistration process can take several months, to avoid a last minute scramble, the resolutions that the board approves should designate a number of

authorized persons who may sign the Form 25 and the Form 15 on behalf of the issuer and take whatever other steps are necessary in connection with the delisting and deregistration process.

Section 16 Considerations for Directors and Officers of the Exiting Company

As noted above, an issuer that has filed a Form 25 or Form 15 continues to be registered under the Exchange Act until the expiration of 90 days from the date that the later of those forms is filed. Outside the context of a merger transaction, this means that officers and directors will be required to continue reporting changes in beneficial ownership of the issuer's securities on Form 4 at a minimum up to 90 days following the first exit report filed with the SEC. In the context of a merger transaction, this means that in most cases, Section 16(a) would require the filing of a Form 4 by any officer or director who owned shares of the issuer prior to the merger transaction and disposed of such securities in the transaction, even if the issuer already has filed a Form 25 or a Form 15.[28] No Form 4 is required if a director or officer does not own any of the issuer's securities at the time of the merger. This is because the director or officer likely will not have a Section 16 acquisition or disposition to report, but instead a change in status as a result of the merger—the termination of the insider's status as an insider of the issuer or the termination of the registration of the issuer's securities under Section 12 of the Exchange Act.[29]

In addition to Section 16(a), an insider who participates in a merger transaction may be deemed to sell his or her target securities upon the effectiveness of the merger for the purposes of the short-swing recovery rules imposed by Section 16(b).[30] In order to avoid the application of Section 16(b), both the target and the acquirer can take steps to rely on Rule 16b-3, which exempts an officer or director's disposition of his or her securities in a merger transaction from the application of Section 16(b) if any of the following conditions are met:

- the disposition is approved by either the board of directors of the issuer or a committee of the board composed solely of two or more "non-employee directors";
- the disposition is approved by the issuer's stockholders; or
- the insider holds such securities for at least six months before disposing of them.[31]

In most cases, issuers prefer to seek the approval of the board or non-employee directors in lieu of seeking stockholder approval. This preference likely is due to the possible negative perception that stockholders may have of such a solicitation, the expense that may be incurred in connection with such a solicitation and, of course, the possibility that shareholders may not approve the disposition. As a result, this alternative may be best thought of as an approach of last resort.[32]

Other Disclosure Requirements

In addition to the actions described above, an issuer that determines to delist its securities from a national securities exchange must file a current report on Form 8-K under Item 3.01(d) within four business days of the date that the board takes any definitive action to delist.

Issuers prefer to seek the approval of the board or non-employee directors in lieu of seeking stockholder approval.

An issuer that plans to exit the reporting system after the completion of a merger may have to file a current report on Form 8-K under Item 5.01, to report the change in control resulting from the merger. There are two instances where the non-surviving participant in the merger transaction will not be required to file an Item 5.01

Form 8-K. First, if the issuer's securities were not listed on a national securities exchange, it will not be required to file an Item 5.01 Form 8-K if it files a Form 15 under Rule 12g-4 and Rule 12h-3, as applicable, before the close of the fourth business day after the closing of the merger. Second, the issuer will not be required to file an Item 5.01 Form 8-K if it was listed on a national securities exchange, filed a Form 25 ten days in advance of the proposed closing date of the merger and filed a Form 15 under Rule 12g-4 and Rule 12h-3, as applicable, before the close of the fourth business day after the closing of the merger.

An issuer also should be aware of other potential Form 8-K items that might require disclosure, such as Item 1.01 (Entry into a Material Definitive Agreement), Item 2.05 (Costs Associated with Exit or Disposal Activities), Item 3.03 (Material Modification to Rights of Security Holders), Item 5.01 (Changes in Control of Registrant), Item 5.02 (Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers), Item 5.03 (Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year) and Item 5.07 (Submission of Matters to a Vote of Security Holders).

Conclusion

Preparing for an issuer's exit from the reporting system requires careful planning. It requires early board involvement, communication with the national securities exchange where the issuer's securities are listed and thoughtful consideration of the precise timeline for when the issuer wishes to suspend its reporting obligations. While the rules governing the process are highly regimented, an issuer that is going through this process retains some degree of choice. For example, to the extent the issuer is listed on a national securities exchange, it has a choice between the exchange-initiated or issuer-initiated delisting process. Choosing the issuer-initiated process allows the issuer to ensure that its reporting obligations are suspended at a point in time it chooses, which could be contemporaneously with a merger closing or otherwise prior to the time a periodic report would be required to be filed under the Exchange Act. However, in the context of a merger, the issuer-initiated process also subjects the issuer to the risk that its delisting may be effective in advance of the proposed closing of the merger, if the merger closes at all.

The process of exiting the reporting system also involves a few traps for the unwary. As discussed above, there is a ten-day delay between the filing of a deregistration form and the suspension of an issuer's reporting obligations and a 90-day delay between such filing and the termination of an issuer's Section 12 registration and the suspension of an issuer's Section 15(d) reporting obligation. Further, the requirement that an issuer withdraw or file post-effective amendments to its outstanding registration statements may inject additional uncertainty into the deregistration process. This is particularly the case if the issuer has any outstanding registration statements on Form S-1 or S-3 or any registration statements under which no securities have been sold, all of which require staff action to terminate or withdraw.

The process of exiting the reporting system involves a few traps for the unwary.

One cannot help but wonder, however, how well this process serves the Commission's investor protection mandate. It is doubtful that investors are best served by the timing and order in which an issuer must proceed in order to terminate its registration and suspend its reporting obligations—particularly in the context of a merger transaction, where the issuer has no more public shareholders and has reached a merger closing only following a regulated proxy solicitation or tender offer. The Commission currently is addressing the deregistration process for foreign private issuers and one can hope that this will

inspire it to re-examine the deregistration process for domestic issuers as well. Current and future boards of directors and executive officers of public companies would welcome a more streamlined process of ensuring that a public company can "go dark" upon the closing of a merger or otherwise when it has determined that delisting and deregistration is in the best interests of the company.

Notes

1. The merger discussion in this article focuses on merger transactions involving two public companies that result in one of the parties being merged out of existence or becoming a wholly-owned subsidiary of the other party. The party being merged out of existence (or that will become a wholly-owned subsidiary of the other party) is described as "exiting" the reporting system. Although many of the procedures described in this article apply to transactions such as going private transactions and tender offers, such transactions raise additional regulatory and governance issues that are not the subject of, nor specifically addressed by, this article.

2. An issuer that has a class of securities that is registered under Section 12 of the Exchange Act is required to file reports with the Commission under Section 13(a) of the Exchange Act. Section 13(a) of the Exchange Act is the source from which reporting companies generally derive the obligation to file current and periodic reports. It imposes periodic and current reporting obligations on any company with a class of securities registered under Section 12.

3. For banks and bank holding companies, as defined in Section 2 of the Bank Holding Company Act of 1956, the relevant thresholds are total assets exceeding $10 million and 2,000 or more record holders of a class of equity security (*i.e.*, the lower threshold of 500 record holders who are not accredited investors does not apply to banks or bank holding companies). Section 12(g) of the Exchange Act also permits issuers to register a class of securities voluntarily under the Exchange Act.

4. Section 15(d) of the Exchange Act requires that each issuer that has filed a registration statement that has become effective pursuant to the Securities Act file with the Commission "such supplementary and periodic information, documents, and reports as may be required pursuant to Section 13 of this title in respect of a security registered pursuant to Section 12 of this title." Proposed Suspension of Periodic Reporting Obligation, SEC Rel. No. 34-20263 (October 5, 1983).

5. An issuer may file one Form 25 for multiple classes of securities listed on the same exchange. However if an issuer's securities are listed on more than one exchange, a separate Form 25 must be filed for each exchange.

6. The written notice must set forth a description of the security involved, together with a statement of all material facts relating to the reasons for delisting such security. Rule 12d2-2(c)(2)(ii).

7. When the Form 25 is filed, the issuer must check a box on the cover page of the Form 25 representing that the Company has complied with each of these requirements. The issuer also makes these representations in the notice it provides to the exchange on which its securities are listed in advance of filing the Form 25.

8. This is particularly relevant for NASDAQ-listed companies. The NASDAQ Stock Market LLC became a national securities exchange in August 2006. Prior to that time, most companies listed with NASDAQ had their listed securities registered pursuant to Section 12(g). At the time NASDAQ transitioned to a national securities exchange, all prior-listed NASDAQ securities became registered under Section 12(b). However, unless affirmative steps were taken to terminate the prior 12(g) registration, NASDAQ-listed securities that were listed prior to August 2006 will still be registered under Section 12(g). As a result, following deregistration under Section 12(b), the prior registration under Section 12(g) will kick back in and will then also need to be terminated as part of the "going dark" process. *See* In the Matter of the Application of The Nasdaq Stock Market, Inc. and The NASDAQ Stock Market LLC For Section 12(b) Registration On Behalf of Certain Issuers, SEC Rel. No. 34-54240 (July 31, 2006).

9. *See* Exchange Act Forms Compliance and Disclosure Interpretation 111.01 (Sept. 30, 2008) and Exchange Act Rules Compliance and Disclosure Interpretation 144.01 (September 30, 2008). The staff of the Commission's Division of Corporation Finance does not allow an issuer to file a Form 15 to terminate its Section 12(g) registration and to suspend its Section 15(d) reporting obligation before the effective date of the delisting pursuant to a Form 25, but it does allow a Form 15 filing upon the date that an issuer is delisted from an Exchange, rather than requiring that the issuer wait until the expiration of the 90-day period. Even this accommodation, however, may result in a gap between the date of the merger closing and the date upon which an issuer may terminate its reporting obligations.

10. The SEC does not allow an issuer to withdraw a Form 25 once it has been filed. For post-merger issuers, this results in the risk that the Form 25 may become effective even if the merger transaction does not close. *See* Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, SEC Rel. No. 34-52029 (July 14, 2005). Due to this risk, such an issuer may have to be ready to file a registration statement on Form 8-A with the exchange on or before the expected delisting date to make sure that its securities are not delisted if the transaction does not close as scheduled. Further, an issuer that is contemplating this approach is well-advised to wait until

all significant conditions to closing, such as any requisite shareholder approval or regulatory approval, have been satisfied.

11. While technically an issuer remains subject to the Williams Act, in the context of a merger, this may have no practical significance since the issuer, once acquired in the merger, generally will not be exposed to transactions regulated by the Williams Act.

12. In the event that the Commission delays the termination of an issuer's Section 12(b) registration, the issuer will be required to file with the Commission any periodic or current reports that would have been required had the Form 25 not been filed. From a review of no-action letters and Commission orders, we could not find examples of the Commission having accelerated the 90-day period. Members of the Office of Chief Counsel of the SEC's Division of Corporation Finance indicated that the staff does not, as a general matter accelerate this period.

13. *See* note 8, above.

14. Rule 12g-4 has not yet been amended to incorporate the new 1,200 record holder deregistration threshold for banks and bank holding companies created by the Jumpstart Our Business Startups Act. A bank or bank holding company that has fewer than 1,200 record holders, but that does not satisfy the asset or record holder thresholds of Rule 12g-4, can still terminate the registration of a class of its securities under Section 12(g), but it must do so in reliance on Section 12(g)(4) rather than in reliance on Rule 12g-4. As a result, banks and bank holding companies will remain obligated to file periodic reports under Section 13(a) of the Exchange Act until 90 days after the bank or bank holding company files a Form 15. *See* Jumpstart Our Business Startups Act Frequently Asked Questions, Changes to the Requirements for Exchange Act Registration and Deregistration (April 11, 2012), available at: *http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-12g.htm*.

15. *See* Exchange Act Rules Compliance and Disclosure Interpretation 152.01 (Sept. 30, 2008).

16. During this 90-day period, the Commission has the right to object and request the withdrawal of this certification, at which time the issuer would have to resume filing reports with the SEC. From a review of SEC proceedings, it does not appear that the Commission has exercised this authority other than in instances in which an issuer has failed to satisfy a procedural element of the deregistration rules, such as for example, when the issuer failed to certify that the class of securities was held by fewer than 500 record holders. *See, e.g.*, *In the Matter of AirCharter Express, Inc.*, SEC Rel. No. 34-53048 (January 3, 2006).

17. An issuer that has a reporting obligation under Section 15(d) of the Exchange Act can never fully terminate that reporting obligation. At best, an issuer that is not a bank or a bank holding company can "suspend" its reporting obligations at such time that the securities to which the Section 15(d) reporting obligations attach are held by fewer than 300 record holders. However, its reporting obligations will resume as of the first day of any subsequent fiscal year that such securities are held by more than 300 record holders. Interestingly, the SEC has taken steps to address this issue in the context of foreign private issuers in response to complaints about the effects of these provisions on foreign issuers that wish to exit the reporting system due to the burdens of Sarbanes-Oxley compliance. In 2007, the SEC adopted Rule 12h-6, which permits a foreign private issuer to terminate the registration of a class of securities under Section 12(g) and to terminate its reporting obligation under Section 15(d) under certain circumstances. *See* Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, SEC Rel. No. 34-55540 (Mar. 27, 2007). No similar rulemaking has been proposed for domestic issuers.

18. Under Rule 15d-6, an issuer is required to notify the Commission that its reporting obligations under Section 15(d) have been suspended within 30 days of the beginning of the fiscal year in which such suspension takes place.

19. It is not clear at this point whether the SEC will amend Rule 12h-3 to implement the new 1,200 record holder threshold for suspension of the Section 15(d) reporting obligation of a bank or bank holding company.

20. Section 15(d) provides that, if an issuer's equity securities are held by fewer than 300 record holders (or 1,200 record holders in the case of a bank or bank holding company), the issuer's reporting obligations for such securities will be suspended "as to any fiscal year, *other than the fiscal year within which such registration statement became effective*." Exchange Act Section 15(d) (emphasis added). Because the obligation to file a Form 10-K pertains to the preceding fiscal year, within which the issuer's registration statement became effective or was deemed to have become effective, Section 15(d) does not suspend the obligation to file the Form 10-K.

21. Rule 12h-3(a) provides that the Section 15(d) reporting obligations will be suspended "immediately upon filing" a Form 15. Thus, an issuer that can satisfy the requirements of Rule 12h-3 may immediately suspend its Section 15(d) reporting obligations by filing a Form 15. As long as the issuer files a Form 15 prior to the date on which a Form 10-K for the preceding fiscal year would be due, the issuer can suspend its obligation to file such Form 10-K.

22. The filing of an annual report on Form 10-K acts as a post-effective amendment to any registration statement on Form S-3 or S-8 that is on file on such date. For the purposes of Rule 12h-3, this post-effective amendment has the same effect as having a registration statement declared effective: it restarts the statute of limitations for Section 11 liability under the Securities Act, requires reconsideration of the issuer's eligibility to use Form S-3 and further extends an issuer's reporting

obligations under Section 15(d). *See generally* Securities Offering Reform, SEC Rel. No. 33-8591 (July 19, 2005).

23. *See* Staff Legal Bulletin No. 18 (March 15, 2010).

24. This includes registration statements that were never declared effective. *See* Staff Legal Bulletin No. 18 (March 15, 2010).

25. It bears noting that issuers that have continuing reporting obligations, such as pursuant to debt covenants, may not rely on Staff Legal Bulletin No. 18.

26. *See* Securities Act Rule 477.

27. The requirement to file a post-effective amendment to deregister unsold securities does not apply to registration statements that have expired under Securities Act Rule 415(a)(5). Under Rule 415(a)(5), if three years have elapsed since the initial effective date of the registration statement under which securities were being offered and sold, and a new registration statement has not been filed under Rule 415(a)(6), the offering of securities on the original registration statement has expired and will not need to be post-effectively amended to deregister unsold securities. *See* Staff Legal Bulletin No. 18 (March 14, 2010).

28. The Form 4 should reflect the insiders' receipt of the merger consideration in exchange for any outstanding common stock and any derivative securities based on the target company's common stock. In addition, insiders should indicate that they have exited the reporting system by checking the appropriate box in the upper left corner of the form. Peter J. Romeo & Alan L. Dye, *Romeo & Dye's Section 16 Treatise and Reporting Guide*, 648 (4th ed., August 2012). Generally, entry into an agreement to vote in favor of the transaction is not treated as the purchase of a derivative security or a sale of the issuer's common stock for purposes of Section 16 reporting, and thus is not required to be reported on Form 4.

29. Romeo & Dye at 615. Many practitioners advise insiders in this situation to file a so-called "exit filing" that essentially notifies investors that they no longer are insiders for the purposes of Section 16. An exit filing would appear to be of only marginal utility in the context of a merger of two public companies—the documents that participants in a merger file with the Commission should provide the market with ample notice that the merger participant intends to exit the reporting system upon completion of the merger and that the insiders will no longer be insiders once the merger transaction is completed.

30. *Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982). In the same vein, an insider's acquisition of the Section 12 registered equity of the acquirer as merger consideration may be deemed to be a purchase under Section 16 if the insider becomes an insider of the acquirer upon completion of the merger. Steven Mark Levy, *Regulation of Securities: SEC Answer Book* (4th ed. Supp. 2013-2).

31. *See* Skadden, Arps, Slate, Meagher and Flom, LLP, SEC No-Action Letter (January 12, 1999) (the Skadden No-Action Letter). If stockholder approval is to be the condition relied upon for the exemption, (i) both the proxy card and proxy statement should provide that a vote to approve the merger also will constitute a vote to approve the insiders exempt dispositions of the target company's securities, and (ii) the proxy statement should describe the security holdings of each officer and director as to which approval of an exempt disposition is solicited. *See generally* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, SEC Rel. No. 34-37260 (May 31, 1996). An insider of the target in a merger transaction who becomes an insider of the acquirer may rely on any of the same three alternatives discussed above to exempt the acquisition of the acquirer's securities from being matched with any subsequent transactions in the acquirer's securities within six months of the date of the merger. In this case shareholder approval may be obtained *after* the transaction.

32. *See* Skadden No-Action Letter. One condition included in the Skadden No-Action Letter was that the resolutions express the general exemptive purpose of the transaction. This condition was later renounced by the Commission in an amicus curae brief. *See Brief of the Securities and Exchange Comission, Amicus Curiae* (June 21, 2011), *Gryl v. Shire Pharmaceuticals Group, PLC,* 298 F.3d 136 (2d Cir. 2002). If board or non-employee director approval is to be the condition relied upon under Rule 16b-3, the resolutions to be approved generally should identify (i) the insiders whose dispositions are to be exempted, (ii) the number of securities (including any derivative securities) to be disposed of by such insiders, and (iii) the general nature of the transaction. These resolutions may be included in the same set of resolutions that approve the proposed merger transaction, but should not precede the board's approval of the merger transaction. An issuer must approve each specific transaction that will take place in a merger transaction and may not rely on the board's approval of a plan in its entirety with one exception. An officer or director may rely on Rule 16b-3 where the board or non-employee directors approved a plan pursuant to which the terms and conditions of each transaction are fixed in advance. *See* Note 3 to Rule 16b-3.

STATE CORNER

The U.S. Court of Appeals for the Third Circuit Strikes Down Delaware's Confidential Arbitration Program

By John P. DiTomo

On October 23, 2013, a three-judge panel of the U.S. Court of Appeals for the Third Circuit—issuing three opinions—a majority, concurrence, and dissent—affirmed a District Court ruling enjoining the Delaware Court of Chancery's arbitration program. In 2009, the Delaware General Assembly enacted legislation empowering sitting judges of the Court of Chancery to arbitrate private business disputes (Chancery Arbitrations). Delaware's decision to offer businesses a forum for arbitrations was meant to promote the state's goals of (1) addressing businesses' increasing demand for alternatives to civil litigation as a means of resolving commercial disputes, and (2) making the state's expert judiciary available to satisfy that demand with well-reasoned results and savings of time and expense.[1] To qualify for a Chancery Arbitration, at least one party had to be a Delaware entity, no party could be a consumer, and the dispute had to involve an amount-in-controversy of at least one million dollars. Like most private arbitrations, Chancery Arbitrations were intended to remain confidential. The proceeding would only become public if a party sought judicial review of the arbitrator's determination.

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The Complaint and Response

On October 25, 2011, the Delaware Coalition for Open Government (Coalition), filed a complaint under 42 U.S.C. § 1983, naming as defendants the State of Delaware, the Delaware Court of Chancery and the Court's five current members. The case was filed in the Federal District Court for the District of Delaware, but was reassigned to Judge Mary A. McLaughlin of the Eastern District of Pennsylvania. The Coalition alleged that because Chancery Arbitrations were conducted in private, the program violated the First and Fourteenth Amendments of the U.S. Constitution, which guarantee a qualified right of public access to certain government proceedings. The defendants answered the complaint, and the parties both moved for judgment on the pleadings.

Defendants argued no right of public access existed under the "experience and logic" test, which was adopted by the United States Supreme Court in *Press–Enter. Co. v. Superior Court*.[2] Under the experience and logic test, a government proceeding carries a right of public access if (1) there has been a tradition of accessibility to that kind of proceeding, and (2) access plays a significant positive role in the functioning of that particular process. Defendants argued that the history of openness with respect to arbitrations was most relevant. In that regard, Defendants highlighted that Chancery Arbitrations were different than civil trials in key respects; most notably, the proceedings are conducted with the parties' consent, not under the auspices of coercive state power; the procedures are flexible, subject to the parties' design; and the arbitration decision lacks precedential value, subject only to limited review. Because Chancery Arbitrations were like other forms of private arbitration, and

because arbitrations historically were closed to the public, experience shows that there was no history of openness. As a matter of logic, defendants argued that Chancery Arbitrations fulfill an important societal function, but if they were open to the public, the program would fall into disuse thereby defeating the fundamental rationale of arbitration.

The Coalition argued that Chancery Arbitrations were simply a bench trial under a different name. More specifically, the arbitrator is a sitting judge acting pursuant to power granted by the State (and not merely by private contract); the arbitration fee is paid into a court; the proceedings take place in a courthouse on government time (and government salary); the proceedings are conducted pursuant to court rules, under which the arbitrator functions as a judge; and the arbitral award is effective and enforceable without bringing a legal action to confirm it. Citing *Publicker Indus., Inc. v. Cohen*,[3] in which the Third Circuit extended the right of access to civil trials, the Coalition argued that because a Chancery Arbitration was no different than a civil trial, Chancery Arbitrations should be open to the public.

The District Court Decision

On August 20, 2012, Judge McLaughlin issued an opinion holding that a right of access extended to Chancery Arbitrations and that "the portions of [10 *Del. C.* § 349] and Chancery Court Rules 96, 97, and 98, which make the proceeding confidential, violate that right."[4] In so holding, Judge McLaughlin asked a threshold question: "Has Delaware implemented a form of commercial arbitration to which the Court must apply the logic and experience test, or has it created a procedure 'sufficiently like a trial' such that *Publicker Industries* governs?"[5] In answering that question, the District Court observed that Chancery Arbitrations are conducted by "a sitting judge of the Chancery Court, acting pursuant to state authority," in which the judge "hears evidence, finds facts, and issues an enforceable order dictating the obligations of the parties."[6] In contrast, the District Court observed, "[a]rbitration differs from litigation because it occurs outside of the judicial process. The arbitrator is not a judicial official."[7] In addition, the District Court was troubled by the fact that Chancery Arbitrations were conducted by sitting judges because a judge bears "a special responsibility to serve the public interest,"[8] "judges in this country do not take on the role of arbitrators"[9] and "the public role of that job[] is undermined when a judge acts as an arbitrator bound only by the parties' agreement."[10] The District Court concluded that it was unnecessary "to reiterate the thorough analysis of the experience and logic test performed by the Court of Appeals in *Publicker Industries*."[11] Rather, because Chancery Arbitrations function "essentially as a non-jury trial before a Chancery Court judge"[12] a qualified right of access existed.

The Third Circuit Decision

The District Court's decision was appealed, and the case was assigned to a three-judge panel of the U.S. Court of Appeals for the Third Circuit. On October 23, 2013, the Court of Appeals affirmed the District Court's holding 2 to 1.[13] Writing for the majority, Judge Sloviter rejected the District Court's decision to forego the experience and logic test, noting that "[a]lthough Delaware's arbitration proceeding shares a number of features with a civil trial, the two are not so identical"[14] that it was appropriate for the District Court to forego the experience and logic test. The Court also rejected the parties' "either/or" approach, concluding that "an exploration of both civil trials and arbitrations is appropriate."[15]

Under the experience prong of the test, Judge Sloviter first focused on the history of openness for civil trials, recounting the analysis undertaken in *Publicker Industries*. Going back as far as 1267, the Court tracked the history of public access to civil trials and reaffirmed that "civil trials and the court filings associated with them generally are

open to the public"[16] because "[t]he courthouse, courtroom, and trial remain essential to the way the public conceives of and interacts with the judicial system."[17]

Turning to arbitrations, Judge Sloviter observed "a mixed record of openness."[18] Again citing examples dating back to the 13th century, Judge Sloviter observed that "although proceedings labeled arbitrations have sometimes been accessible to the public, they have often been closed, especially in the twentieth century."[19] Judge Sloviter noted that confidentiality was a "natural outgrowth of the status of arbitrations as private alternatives to government-sponsored proceedings."[20]

In contrast, "proceedings in front of judges in courthouses have been presumptively open to the public for centuries."[21] Based on those observations, Judge Sloviter concluded that "history teaches us not that all arbitrations must be closed, but that arbitrations with non-state action in private venues tend to be closed to the public."[22] "Understood in this way, the closure of private arbitrations is only of questionable relevance."[23] Judge Sloviter then observed that "[w]hen we properly account for the type of proceeding that Delaware has instituted—a binding arbitration before a judge that takes place in a courtroom—the history of openness is comparable to" other proceedings that have been found to include the right of access.[24] Thus, for both civil trials, as well as arbitrations, history demonstrated "a strong tradition of openness for proceedings like Delaware's government-sponsored arbitrations."[25]

Applying logic, Judge Sloviter determined that allowing public access to state-sponsored arbitrations would serve the public's interest in a number of respects: (1) giving "stockholders and the public a better understanding of how Delaware resolves major business disputes";[26] (2) allaying "the public's concerns about a process only accessible to litigants in business disputes who are able to afford the expense of arbitration";[27] (3) exposing "litigants, lawyers, and the Chancery Court judge alike to scrutiny from peers and the press";[28] and (4) "discouraging perjury and ensur[ing] that companies could not misrepresent their activities to competitors and the public."[29]

The Court then determined that there would be little if any corresponding harm to the public's interest if Chancery Arbitrations were conducted openly. First, confidentiality concerns that arise in litigation could be addressed through application of the Court of Chancery's existing rules, and that the risk of "loss of prestige or goodwill," though perhaps unpleasant, was not a sufficient enough interest to trump the public's right of access.[30] Judge Sloviter similarly rejected the argument that privacy fostered a less hostile, more conciliatory approach to dispute resolution, noting that private arbitrations are often still contentious and any collegiately was just as likely to be attributable to the procedural flexibility of the arbitration as it was to the privacy of the proceeding.[31] Finally, the Court rejected the argument that opening Chancery Arbitrations to the public would end the program. In that regard, Judge Sloviter was skeptical that confidentiality was the sole advantage of Chancery Arbitrations. Rather, "disputants might still opt for arbitration if they would like access to Chancery Court judges in a proceeding that can be faster and more flexible than regular Chancery Court trials."[32] Thus, having considered both the positive role that access plays, and the extent to which openness impairs the public good, Judge Sloviter concluded that "[t]he benefits of openness weigh strongly in favor of granting access to Delaware's arbitration proceedings."[33]

In a short opinion, Judge Fuentes concurred with Judge Sloviter's analysis but wrote separately to make clear his view that the "crux of [the] holding is that the proceedings […] violate the First Amendment because they are conducted outside the public view, not because of any problem otherwise inherent in a Judge-run arbitration

scheme."[34] Judge Fuentes also took occasion to note that Chancery Arbitrations would pass constitutional muster if Rules 97(a)(4) and 98(b) (the rules establishing the confidential nature of the proceedings) were "excised from the law."[35] The defendants had made a more limited severance argument, indicating that the Court could uphold the statute and rules implementing Chancery Arbitrations if Rule 98(f)(3) was excised. That provision enabled the arbitrator to confirm the arbitration award without a separate court proceeding, and arguably was the only aspect of the program that invoked the coercive power of the state. Judge Fuentes rejected the argument noting that "the mere formality of filing that award in Court, which Rule 98(f)(3) skirts, does not alone alter the First Amendment right of access calculus one way or another," and therefore severance "would not be enough to cure any constitutional infirmity."[36] Judge Fuentes concluded with the observation that "it is likely that the Delaware Legislature has at its disposal several alternatives should it wish to continue to pursue a scheme of Judge-run arbitrations."[37]

In her dissent, Judge Roth acknowledged Delaware's legitimate interest in preventing the diversion elsewhere of complex business and corporate cases and stated that Chancery Arbitrations create "a perfect model for commercial arbitration."[38] Judge Roth expressed her view that Judge Sloviter appeared to misapprehend "the difference between adjudication and arbitration, *i.e.*, that a judge in a judicial proceeding derives her authority from the coercive power of the state while a judge serving as an arbitrator derives her authority from the consent of the parties."[39] Judge Roth also challenged the majority's conclusion that the history of arbitration reveals a mixed record of openness. Instead, an examination of confidentiality in arbitration should not extend back to medieval times but should begin in colonial times.[40] There, "[t]he tradition of arbitration in England and the American colonies reveals a focus on privacy."[41] Thus, as a rule "arbitration has not 'historically been open to the press and the general public'";[42] rather, experience shows that, "historically, arbitration has been private and confidential."[43]

Finally, Judge Roth observed that logically "the resolution of complex business disputes, involving sensitive financial information, trade secrets, and technological developments, needs to be confidential so that the parties do not suffer the ill effects of this information being set out for the public—and especially competitors—to misappropriate."[44] Judge Roth acknowledged that Delaware's initiative was meant "to provide arbitration in Delaware to businesses that consented to arbitration—and that would go elsewhere if Delaware did not offer arbitration before experienced arbitrators in a confidential setting."[45] Accordingly, Judge Roth would have reversed "the judgment of the District Court and [upheld] the statute and rules which establish the Delaware arbitration system."[46]

Conclusion

The opinions issued in this case could be read as a debate about whether sitting judges should act as private arbitrators. Indeed, the District Court's decision stood on the view that judges should not arbitrate private disputes. Judge Sloviter's opinion, albeit not directly, echoed that concern, for despite a centuries-old history of arbitrations being conducted in private, that history was only of questionable relevance to Judge Sloviter because Delaware's arbitration program involved proceedings in front of judges conducted in courthouses. The concurrence and dissent disagreed. Judge Fuentes stressed his view that there was nothing wrong with sitting Judges of the Court of Chancery engaging in arbitrations, and his opinion left room for an alternative confidential arbitration scheme sufficiently devoid of the air of an official State-run proceeding. Judge Roth would have upheld Delaware's arbitration program as currently implemented, noting that other countries have already begun to adopt government-sponsored

arbitration programs having acknowledged the importance of arbitration to their economies and to their position in today's world of global commerce. In all events, it remains to be seen whether there will be a further appeal. But, the decision to strike down Delaware's arbitration program is a significant setback to Delaware's creative attempt to enter the ADR market, leveraging its well-developed business law and expert judiciary through a program that addressed its businesses citizens' increasing demand for private ADR services, both in the United States and internationally.

Notes

1. Del. H.R. 49, syn.
2. 478 U.S. 1, 10, 106 S. Ct. 2735, 92 L. Ed. 2d 1 (1986).
3. 733 F.2d 1059 (3d Cir. 1984).
4. Delaware Coalition for Open Government v. Honorable Leo E. Strine, Jr., *et al.*, 894 F. Supp. 2d 493, 504 (D. Del. 2012).
5. *Id.* at 500.
6. *Id.* at 503.
7. *Id.* at 501.
8. *Id.* at 501.
9. *Id.* at 502.
10. *Id.*
11. *Id.* at 503-504.
12. *Id.* at 494.
13. Delaware Coalition for Open Government v. Honorable Leo E. Strine, Jr., et al., C.A. No. 12–3859 (3d Cir. Oct. 23, 2013).
14. *Id.* at 10.
15. *Id.* at 12.
16. *Id.* at 13.
17. *Id.*
18. *Id.* at 16.
19. *Id.* at 16.
20. *Id.*
21. *Id.* at 17.
22. *Id.*
23. *Id.* at 17n.2.
24. *Id.* at 17.
25. *Id.*
26. *Id.* at 19.
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.* at 19-20.
31. *Id.* at 20.
32. *Id.* at 21.
33. *Id.* at 19.
34. *Delaware Coalition for Open Government v. Honorable Leo E. Strine, Jr., et al.*, C.A. No. 12–3859 (3d Cir. Oct. 23, 2013) at 3 (Fuentes, J. concurring).
35. *Id.*
36. *Id.* at 5.
37. *Id.*
38. *Delaware Coalition for Open Government v. Honorable Leo E. Strine, Jr., et al.*, C.A. No. 12–3859 (3d Cir. Oct. 23, 2013) at 4 (Roth, J. dissenting).
39. *Id.* at 4n.2.
40. *Id.* at 6.
41. *Id.*
42. *Id.* at 7.
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.* at 8.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Arnold & Porter LLP
Washington, DC (202-942-5000)

Implications of Recent Developments in SEC Enforcement: A Six Month Review of Chairman Mary Jo White's Tenure (October 2013)

A discussion of the SEC's approach to enforcement under new SEC Chairman Mary Jo White, including increased emphasis on individual and gatekeeper accountability, tougher conditions for settlement and the leveraging of new enforcement tools and technologies.

Bingham McCutchen LLP
Boston, MA (617-951-8000)

FINRA Publishes Report on Conflicts of Interest and Provides Guidance to Broker-Dealers about Managing and Mitigating Conflicts (October 25, 2013)

A discussion of the issuance of FINRA's "Report on Conflicts of Interest," which is intended to assist broker-dealers to effectively "manage and mitigate conflicts of interest in their businesses." The report captures the results of a targeted exam initiative that FINRA began in July 2012 to identify firms' conflict of interest practices.

Dorsey & Whitney LLP
Minneapolis, MN (612-340-2600)

Capital Markets Tip: Ensure Your Company Isn't Shut Out of Rule 506 Offerings Under the SEC's "Bad Actor" Disqualification Rules (October 16, 2013)

A discussion of new SEC rules that make the exemption provided by Rule 506 of Regulation D unavailable if the issuer, selling broker-dealer or certain related persons have been the subject of certain "bad actor" disqualifying events. The memorandum provides recommendations to issuers and broker-dealers to ensure they remain eligible to offer and sell securities in reliance on Rule 506.

Greenberg Traurig LLP
Washington, DC (202-331-3100)

Implications of the Elimination of the Restriction on General Solicitation for Cross-Border Equity Offerings under Rule 144A by Foreign Private Issuers (October 2013)

A discussion of the implications of the SEC's amendments to its rules to permit general solicitation of investors in certain private securities transactions for cross-border offerings of securities of non-U.S. companies.

Latham & Watkins LLP
Los Angeles, CA (202-637-2200)

Recent SEC Enforcement Actions Put Spotlight on Prohibited Short Selling (October 4, 2013)

A discussion of recent enforcement actions demonstrating the SEC's increased focus on violations of Regulation M, which generally prohibits short selling of equity securities during a

restricted period and then purchasing the same securities in follow-on and secondary offerings.

Will Award-Seeking Whistleblower Lawyers Be Caught Between Conflicting SEC and State Ethics Rules? (October 21, 2013)

A discussion of challenges to the SEC's whistleblower rules in the context of lawyers seeking monetary awards for disclosing confidential information to the SEC without client consent, with particular focus on a recent New York challenge.

Expanding FIRREA Liability for Financial Institutions: Southern District of New York Developments (October 28, 2013)

A discussion of Southern District of New York decisions strengthening the Department of Justice's expanding application of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 to bring civil cases against financial institutions.

Lowenstein Sandler LLP
Roseland, NJ (973-597-2500)

SEC's Demand for "Admissions" Simplifies Recoveries for Professional Investors (October 15, 2013)

A discussion of why the SEC's amendment of its "neither admit nor deny" settlement policy—requiring some defendants to admit wrongdoing when settling enforcement actions—could be advantageous to professional investors bringing private actions for securities fraud.

Mayer Brown LLP
Chicago, IL (312-782-0600)

Reporting on Executive Pay—The U.K. New Regime at a Glance (October 2013)

A discussion of the recent changes to the rules on reporting directors' pay in the U.K. that are now in effect.

Neal Gerber Eisenberg LLP
Chicago, IL (312-269-8000)

Perils of Using Unregistered Finders in Securities Transactions (October 14, 2013)

A discussion of an otherwise successful company that was forced into bankruptcy due to significant potential rescission liability for the securities it sold in connection with an unregistered broker-dealer—a so-called "finder."

Paul, Weiss, Rifkind, Wharton & Garrison LLP
New York, NY (212-373-3000)

Delaware Court of Chancery Holds That Board Did Not Breach Fiduciary Duties or Create an Unfair Election in Proxy Contest (October 29, 2013)

A discussion of a Delaware Court of Chancery decision, *Red Oak Fund, L.P. v. Digirad Corp.*, holding that a board of directors did not breach its fiduciary duties or create an unfair election process.

Perkins Coie LLP
Seattle, WA (206-359-8000)

Recent Changes in SEC Enforcement Policy Require Renewed Attention to Directors' and Officers' Insurance Terms (October 17, 2013)

A discussion of SEC policy shifts that could compromise the availability of directors' and officers' insurance coverage for entities and individuals, specifically: (1) changes in its "no admit, no deny policy" in cases involving "widespread harm to investors" or "egregious intentional misconduct"; and (2) more enforcement actions against individuals.

Pillsbury Winthrop Shaw Pittman LLP
New York, NY (212-858-1000)

Looking Forward: Practical Implications of the JOBS Act Changes to Private Placements (October 14, 2013)

A discussion of the potential under the JOBS Act for an entirely new category of "publicly offered private offerings" that are largely exempt from substantive regulation at either the federal or state level, by issuers that will be able to avoid becoming public companies, for practical purposes, as long as they wish.

Schulte Roth & Zabel LLP
New York, NY (212-756-2000)

SEC Confirmation that Fixed-Income Commissions Can Satisfy the Section 28(e) "Soft Dollars" Safe Harbor (October 29, 2013)

A discussion of a no-action letter issued by the SEC division of Trading and Markets confirming that institutional asset managers, in reliance on the safe harbor of Section 28(e) of the Securities Exchange Act of 1934, may purchase eligible third-party brokerage and research services with commissions generated by qualifying transactions in fixed-income securities.

Sidley Austin LLP
Chicago, IL (312-853-7000)

The SEC's Final, Permanent Registration Regime for Municipal Advisors (October 4, 2013)

A discussion of the SEC's final and permanent rules governing the registration and regulation of "municipal advisers" as required by the Dodd-Frank Act. While the final rules are more narrow and focused than what had been proposed, the process of determining whether the rules apply to a particular entity remains complicated and highly facts and circumstances specific.

Troutman Sanders LLP
Atlanta, GA (404-885-3000)

FINRA Enhances Its Public Offering Review Programs (October 14, 2013)

A discussion of enhancements to the FINRA public offering review program, including introduction of an immediate clearance process for certain shelf offerings and a limited review process for certain non-shelf offerings of exchange-listed securities.

INSIDE THE SEC

SEC Issues Supervisory Liability Guidance

By Anitra T. Cassas, Louis D. Greenstein, David H. Pankey and Samantha E. Thompson

On September 30, the staff of the SEC's Division of Trading and Markets published answers to eight Frequently Asked Questions (FAQs) concerning supervisory liability for compliance and legal personnel at broker-dealers. The FAQs follow a speech last year by Commissioner Daniel Gallagher concerning the *Urban* case, discussed below, in which he acknowledged the need for the SEC to offer guidance so that those overseeing compliance "won't be afraid to be zealous because they'll be tagged as a supervisor."[1]

The FAQs, in attempting to clarify when compliance and legal personnel function as supervisors and thereby become subject to potential liability for failure to supervise, reiterate the familiar refrain for determining supervisory status:

> Whether, under the facts and circumstances of a particular case, that person has the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.

The FAQs further clarify that five fact patterns, by themselves, do not create supervisor status. These fact situations are discussed below.

Broker-dealer (BD) firms may wish to review their compliance procedures in light of the suggestions in the FAQs and make sure that compliance and legal functions are clearly delineated from business line and management functions. Where compliance or legal personnel serve on management committees, BD firms may wish to provide that they serve ex officio or in a nonvoting capacity.

Background

Sections 15(b)(4) and 15(b)(6) of the Securities Exchange Act of 1934 (Exchange Act), authorize the SEC to take action against an individual at a broker-dealer for failure to supervise someone who has violated the federal securities laws, the Commodity Exchange Act, the rules or regulations under those statutes, or the rules of the Municipal Securities Rulemaking Board. The FAQs discuss the circumstances that can lead to finding compliance or legal personnel are acting in a supervisory role and, therefore, have the potential for supervisory liability.

The standard by which an individual is deemed to be a supervisor was articulated in 1992 in *In re Gutfreund*.[2] In that matter, the SEC brought three separate actions against the chairman and CEO of a broker-dealer firm, John Gutfreund; the president; and the vice chairman for failing to take action to prevent the misconduct of a trader who was known by the three men to have submitted false bids in a U.S. Treasury auction. The SEC sanctioned each executive for failure to supervise, stating that supervisory liability attaches where a person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee.

In 2012, the SEC revisited its supervisory liability theory in a case against Theodore Urban, then-general counsel of a former brokerage

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and investment bank. In the initial decision, the Administrative Law Judge (ALJ) found that the general counsel had none of the traditional authority associated with a person supervising brokers but was still a supervisor because as general counsel, his opinions on legal and compliance issues were considered authoritative and his recommendations were generally followed.[3] Nonetheless, the ALJ ultimately found the general counsel acted reasonably, and the Commission later dismissed the proceeding without an opinion.[4]

Recently in the *Johns* case,[5] the SEC sanctioned a trader for deceiving the compliance officer but has not pursued an action against the compliance personnel in the *SAC/Stephen Cohen case*. The SEC published the FAQs in the context of these developments and to attempt to clarify some of the ambiguity surrounding the potential liability associated with the compliance and legal roles.

Certain Facts Alone Are Not Sufficient to Create Supervisor Status

Supervisor status in a particular case will always be a facts and circumstances test. Nevertheless, a key takeaway from the FAQs is that certain facts, standing alone, are not sufficient to turn legal or compliance personnel into supervisors. These facts include:

- Holding a compliance or legal position.
- Providing advice or counsel to business line personnel concerning compliance or legal issues.
- Assisting in the remediation of a business line issue.
- Providing advice to, or consulting with, senior management.
- Participating in, providing advice to or consulting with management or other committees.

The SEC staff noted that all of these functions are important parts of the day-to-day responsibilities of legal and compliance personnel and help broker-dealers establish a compliance program that is reasonably designed to ensure compliance with applicable laws and regulations.

What Is the Requisite Degree of Responsibility, Ability, or Authority to Affect Conduct?

As noted below, it is critical for firms to separate out the functions of compliance personnel from the functions of business line personnel in compliance manuals and written supervisory procedures. The SEC however, will, look beyond policies and procedures to the person's actual responsibilities and authorities. The answer to FAQ No. 2 sets forth questions to be considered in determining whether a person is a "supervisor" for purposes of the Exchange Act:

- Has the person clearly been given, or otherwise assumed, supervisory authority or responsibility for particular business activities or situations?
- Did the person have the power to affect another's conduct, such as the ability to hire, reward or punish that person?
- Did the person otherwise have authority and responsibility such that he or she could have prevented the violation from continuing, even if he or she did not have the power to fire, demote or reduce the pay of the person in question?
- Did the person know that he or she was responsible for the actions of another, and that he or she could have taken effective action to fulfill that responsibility?
- Should the person nonetheless reasonably have known in light of all the facts and circumstances that he or she had the authority

or responsibility within the administrative structure to exercise control to prevent the underlying violation?

Establishing an Effective Compliance System Without Creating Supervisory Liability

One of the most critical components of an effective compliance system is a clear delegation of supervisory responsibilities to business line supervisors. The compliance policies should specifically define the duties of compliance personnel and designate responsibility to business line personnel for supervision of functions and persons.

The SEC staff also suggested firms consider implementing (1) robust compliance monitoring systems, (2) processes to escalate identified instances of noncompliance to business line personnel for remediation, and (3) a system to follow up in situations where misconduct may have taken place, to help ensure that the direct supervisor implements a proper response. Compliance and legal personnel may need to escalate situations to persons at a higher level of authority in the business if they determine that concerns have not been addressed.

Participation in Management and Other Committees

In light of the *Gutfreund* and *Urban* cases, many CCOs have wondered whether their membership on or attendance at meetings of management committees will result in supervisory responsibility and an increased liability profile. The SEC staff recommends that compliance and legal personnel participate in committees in an ex officio or nonvoting capacity because this type of role is more consistent with an advisory function.

Unresolved Issues

Because of the intensely factual nature of the determination of supervisor status, there will be situations that present significant ambiguity. For example, where the CCO or internal legal counsel has more than one role in the firm, it may be hard to determine when actions are limited to a compliance or legal function. In this situation, it could be very important to have a protocol or other mechanism to clearly distinguish business from compliance and legal functions. Other areas that may present significant issues include decisions by management not to implement compliance or legal recommendations, or failure by management to make a timely decision on a recommendation. In addition, as the FAQs involve guidance provided by the SEC staff, it is not clear whether FINRA or other regulators will take a similar approach.

Notes

1. Remarks at "The SEC Speaks in 2012" (Feb. 24, 2012).
2. SEC Rel. No. 34-31554, 51 SEC 93 (Dec. 3, 1992).
3. Initial Decision, Administrative Proceeding No. 3-13655 (September 8, 2010).
4. Rel. No. 34 - 66259 (Jan. 26, 2012).
5. SEC Rel. No. IA - 3655 (Aug. 27, 2013).

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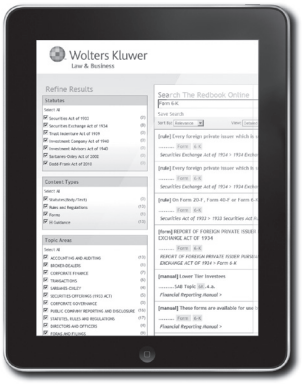

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