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Securities Source
Summer 2013

Securities Source

A quarterly newsletter devoted to securities law and regulation updates

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4/9/13	FINRA/SEC	SEC approved amendments to FINRA Rule 6440 regarding FINRA's ability to halt trading and quotation in a particular equity security due to a foreign regulatory halt and its ability to continue such halt for 10 days or more.	5/19/13
4/10/13	CFTC/SEC	Adopted new "Identity Theft Red Flag Rules" and guidelines requiring financial institutions and creditors to establish written identity theft prevention programs.	5/19/13

Monitor Report: Key Changes and Challenges to SEC Rules

Securities Exchange Commission Clarifies Rule 144, Form S-3, Rule 403B and Regulation D

The SEC updated its compliance and disclosure interpretations, providing guidance on certain provisions of Rule 144, Form S-3, Rule 430B and Regulation D.

U.S. District Court Vacates and Remands SEC's Resource Extraction Rule

The United States District Court for the District of Columbia vacated and remanded the SEC's approval of Rule 13q-1 under the Securities Exchange Act of 1934.

U.S. District Court Upholds SEC's Conflict Mineral Disclosure Rule

The U.S. District Court for the District of Columbia upheld the SEC's rules implementing Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

New "Testing The Waters" Rules Liberalize Communications With Potential Institutional Investors in a Registered Public Offering

Section 105(c) of the JOBS Act amended Section 5 of the Securities Act of 1933 to permit an emerging growth company to engage in oral or written communications with potential investors to determine whether such investors might have an interest in the offering, either before or after the filing of a registration statement with the SEC.

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The SEC Speaks: Are You Listening?

Unregistered Public Offerings Will Now Be Permitted Under Amended Rules 144A and 506

By Michael Dunn

On September 23, 2013, amendments to Rules 144A and 506 mandated by the JOBS Act will become effective. These rule amendments will permit general advertisements and solicitations in connection with unregistered offerings that result in sales only to qualified institutional investors (Rule 144A) or accredited investors (Rule 506). Under these new rules, and for the first time since the adoption of the Securities Act of 1933, a company may conduct a public offering of its securities without having to prepare a required disclosure package that must be declared effective by the Securities and Exchange Commission ("SEC") prior to completing sales of the offered securities to the public pursuant to that disclosure package.

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During his remarks at the open meeting of the SEC at which the new amendments to Rule 506 were adopted by a divided 3-2 vote, Commissioner Luis A. Aguilar expressed his view that general solicitation will make fraud easier "by allowing fraudsters to cast a wider net for victims." The accredited investor standards under Rule 506 have been in place for more than three decades, and Commissioner Aguilar observed that "the definition of accredited investor is not limited to experienced or sophisticated investors" and the income and net worth standards set forth in Rule 506 "are not necessarily correlated with financial expertise."

Concurrent with the adoption of the final amendments to Rule 506, the SEC also proposed new rules to ameliorate the risk of fraud in Rule 506 offerings that, if adopted, would require specific disclaimers and disclosures in offering materials, advance filing of a Form D prior to any public advertisement or solicitation of a Rule 506 offering, and one-year bans from reliance on Rule 506(c) for issuers that fail to comply with the new rules, including the requirement to take reasonable steps to verify an investor's accredited investor status.

While Commissioner Aguilar supports these proposed amendments, he stated that "[i]t is reckless to create a known risk today, with just the hope of a speculative remedy tomorrow." Commissioner Aguilar points to the findings of the Investor Advisory Committee, a committee required under the Dodd-Frank Act, as a basis for the requirement to take further time to consider the risks of the new rules without concurrently adopting appropriate safeguards. The Investor Advisory Committee acted unanimously in October 2012 to adopt a series of recommendations on general solicitation seeking to balance investor protection, capital formation, and market integrity. However, only a handful of the recommendations are embodied in the proposed rules that are still being considered by the SEC while the new amendments to Rules 144A and 506 become effective on September 23, 2013.

Commissioner Aguilar concluded his remarks by stating that "I hope that the Regulation D enhancements we propose today — together with needed improvements to the definition of accredited investor — will be adopted promptly, but experience tells me I shouldn't hold my breath. The SEC has proposed many rules that linger indefinitely without going into effect."

For now, issuers may commence public advertisement and solicitations of Rule 506 offerings on September 23, 2013 subject only to the application of the general anti-fraud rules.

Why IFRS Matters in Today's U.S. Capital Markets

By Michael Dunn

At the 32nd Annual Commission and Financial Reporting Institute Conference in May, Paul Beswick, the Chief Accountant in the Office of the Chief Accountant at the SEC, delivered a keynote address discussing the status of the International Accounting Standards Board (the "IASB") and the SEC's vested interest in ensuring that the IASB "continues to function as a strong and independent accounting standard setter."

Since 2007, foreign private issuers that are reporting companies in the United States have been permitted to prepare their financial statements in accordance with the International Financial Reporting Standards ("IFRS") as adopted by the IASB without any reconciliation to U.S. GAAP. Mr. Beswick noted that there are currently over 450 foreign private issuers who use IFRS without reconciliation to U.S. GAAP whose market capitalization "is in the multiple trillions of U.S. dollars," and that U.S. investors are "heavily invested in companies that prepare their financial statements using IFRS." In addition, approximately 40% of registrants monitored by an Assistant Director group within the Division of Corporation Finance responsible for oversight of large financial institutions also file financial statements prepared in accordance with IFRS.

The SEC and its staff are actively involved in the IASB throughout the standard-setting and compliance processes. Mr. Beswick notes that the Chair of the SEC is a member of the IFRS Monitoring Board, and that the SEC staff participates in working groups of the IASB. The SEC staff also "works to promote consistent application of IFRS on a global basis…[and] reviews the filings of foreign private issuers and issues comment letters on the filings." In addition, the FASB is a member of the IASB's Accounting Standards Advisory Forum.

The SEC has yet to recommend adoption of rules allowing or requiring domestic registrants to comply with IFRS and has not committed to any timetable for adoption or convergence. However, the July 2012 report by the SEC staff provides a thorough analysis of the work that needs to be undertaken to transition the United States from GAAP to IFRS. Mr. Beswick stated that over the next 18 months, he expects the FASB and IASB "will complete some of the most fundamental [convergence] projects on their respective agendas."

While FASB, the SEC and the SEC staff all appear to remain committed to transitioning to IFRS as a global accounting standard and are working toward that goal with their international counterparts, the only thing that is clear today is that there is a great deal of work to be done, and any convergence timeline will be measured in years, not months.

SEC Announces New Enforcement Initiatives

By Chris Robertson

Building on the reorganization of the Enforcement Division into targeted enforcement areas under Director Robert Khuzami, on July 2, 2013 the Securities and Exchange Commission ("SEC") announced three new enforcement initiatives: the Financial Reporting and Audit Task Force, the Microcap Fraud Task Force, and the Center for Risk and Quantitative Analytics. According to the SEC's announcement, these initiatives are an effort to "build on its Division of Enforcement's ongoing efforts to concentrate resources on high-risk areas of the market and bring cutting-edge technology and analytical capacity to bear in its investigations." These new initiatives are among the first steps taken by new Chairman Mary Jo White, who has pledged to further strengthen the enforcement function of the SEC.

Financial Reporting and Audit Task Force

It has been reported in the press that the financial crisis that emerged in 2008, along with the widely publicized Ponzi schemes that came to light around the same time, shifted the SEC's primary focus away from financial reporting fraud such as the high-profile investigations of WorldCom, Adelphia, and Enron that had taken place in the early 2000 timeframe. Notably, at the beginning of the Obama Administration, the Enforcement Division established five specialized units focusing on particular enforcement priorities but none with a particular emphasis on accounting fraud and financial reporting issues. Now, as financial crisis and other fraud litigation wanes, the SEC is establishing a task force specifically focused on financial reporting and auditing. The Financial Reporting and Audit Task Force will concentrate on the preparation of financial statements, issuer reporting and disclosure, and audit failures with the goal of detecting fraud and increasing the prosecution of violations involving false or misleading financial statements and disclosures. The Task Force will identify issues for potential investigation by reviewing restatements, looking at industry trends, and using technology-based tools such as the SEC's proprietary Accounting Quality Model (AQM). The AQM is a model that compares registrants' filings and seeks to identify filings that are anomalous, with a particular aim at identifying instances of earnings management. The SEC has employed a similar tool, the Aberrational Performance Inquiry (API), in overseeing hedge funds. Although the Financial Reporting and Audit Task Force formalizes the SEC's renewed focus in this area, SEC administrative proceedings against auditors have increased in recent months, a trend that is likely to continue. The Financial Reporting and Audit Task Force will be led by David Woodcock, Director of the Fort Worth Regional Office, and will include Enforcement Division attorneys and accountants from across the country who will work with the Division's Office of the Chief Accountant, the SEC's Office of the Chief Accountant, the Division of Corporation Finance, and the Division of Economic and Risk Analysis.

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Microcap Fraud Task Force

The Microcap Fraud Task Force builds on the Microcap Fraud Working Group, which was created in 2010, and will investigate fraud in the issuance, marketing, and trading of "microcap" securities – low-priced stocks issued by small companies with sometimes limited financial reporting. According to the SEC, these stocks pose a high risk for fraud because there is limited reliable public information about the companies, they often are traded on over-the-counter markets with no minimum listing standards, and the issuers are often inherently risky companies with few assets, little or no operations, and low trading volume. In addition, according to the SEC, fraudulent activity in the microcap market often includes "serial violators and organized syndicates" that use social media to promote their fraudulent schemes to less sophisticated investors. The Microcap Fraud Task Force will develop and implement long-term strategies for detecting and combating fraud in the microcap market and will focus on market gatekeepers such as attorneys, auditors, broker-dealers, transfer agents, stock promoters, and purveyors of shell companies. It will be led by Elisha Frank, Assistant Regional Director of the Miami Regional Office, and Michael Paley, Assistant Regional Director in the New York Regional Office.

Center for Risk and Quantitative Analytics

The third enforcement initiative is the Center for Risk and Quantitative Analytics (CRQA). The principal role for the CRQA will be identifying and assessing risks and threats that could harm investors, as well as assisting the SEC Staff in conducting risk-based investigations. The CRQA will work closely with other SEC offices and divisions with the goal of providing guidance to the Enforcement Division's leadership on how to allocate resources strategically in light of the risks it is able to identify. The CRQA will be led by Lori Walsh, former Deputy Chief of the SEC's Office of Market Intelligence.

Fifth Circuit Narrows Dodd-Frank Whistleblower Protections

By Chris Robertson

The U.S. Court of Appeals for the Fifth Circuit recently held that potential whistleblowers are only protected from retaliation under the Dodd-Frank Act whistleblower-protection provision if they report a violation of the securities laws directly to the U.S. Securities and Exchange Commission ("SEC"). *Asadi v. G.E. Energy, LLC*, No. 12-20522 (5th Cir. July 17, 2013). Five district court decisions had concluded that the Dodd-Frank whistleblower-protection provision could also extend to individuals who made an internal report to the employer, even if they did not make a report directly to the SEC. However, the Fifth Circuit, in the first federal appellate decision to address this issue, found the reasoning of those cases unpersuasive.

Khaled Asadi, a former employee of G.E. Energy, LLC who was based in Iraq, alleged that his employer had violated the Dodd-Frank whistleblower-protection provision by terminating him after he made an internal report of a possible securities law violation. The district court dismissed Asadi's complaint with prejudice after concluding that the statute did not protect overseas whistleblowing activity. Affirming, the Fifth Circuit based its decision solely on its conclusion that Asadi did not meet the definition of a "whistleblower" under the statute because he did not provide any information to the SEC.

The question of who can qualify as a whistleblower under the Dodd-Frank Act appears straightforward from the statute itself. Subsection (a)(6) defines a "whistleblower" as "any individual who provides... information relating to a violation of the securities laws *to the Commission*." (emphasis added) This definition appears to require that an individual provide information to the SEC to qualify as a whistleblower. In subsection (h), however, which provides a private cause of action against employers who take retaliatory measures against a whistleblower, protected activity includes "making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002... and any other law, rule, or regulation subject to the jurisdiction of the [SEC]." Because subsection (h) does not contain any express requirement that a disclosure be made to the SEC, the five district court decisions to consider the issue concluded that this subsection established an exception to the general requirement that a report be made to the SEC.

The Fifth Circuit rejected this reading, explaining that because the statutory definition of a "whistleblower" is unambiguous and does not conflict with any other portion of the statute, rules of statutory construction require a literal reading of the statutory definition. That definition requires a report to the SEC. The Fifth Circuit also held that construing the Dodd-Frank whistleblower-protection provision beyond the statutory definition would render Sarbanes-Oxley's ("SOX") anti-retaliation provision moot, as it would be completely subsumed by Dodd-Frank. Finally, the Court rejected a recent regulation promulgated by the SEC which adopted the more expansive definition of a "whistleblower," concluding that the statutory language controlled.

The Fifth Circuit's ruling is important for a number of reasons. Dodd-Frank provides for awards equal to two times the whistleblower's back pay, whereas SOX provides only for single back pay. Dodd-Frank also allows an employee to proceed directly to district court, whereas SOX requires employees to first file

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a claim with OSHA. Dodd-Frank also contains a significantly longer statute of limitations. Under SOX, an employee has six months to file a claim; while Dodd-Frank allows claims to be brought within six years.

For defense counsel and company management, the Fifth Circuit's decision is a welcome reversal of a trend within the Department of Labor and district courts toward expanding whistleblower coverage under both SOX and Dodd-Frank.

Securities Law Tracker

Date	Authority	Regulation	Compliance Date
4/9/13	FINRA/SEC	SEC approved amendments to FINRA Rule 6440 regarding FINRA's ability to halt trading and quotation in a particular equity security due to a foreign regulatory halt and its ability to continue such halt for 10 days or more.	5/19/13
4/10/13	CFTC/SEC	Adopted new "Identity Theft Red Flag Rules" and guidelines requiring financial institutions and creditors to establish written identity theft prevention programs.	5/19/13
5/1/13	U.S. Dist. Ct. SDNY	U.S. District Court for the Southern District of New York held that under the whistleblower provisions of the Sarbanes-Oxley Act, a report by an employee to his supervisor (and no one else), is protected under the Act even if the supervisor is implicated in the wrongdoing. The employer failed to demonstrate that as a matter of law there was "clear and convincing" evidence that plaintiff would have been terminated in the absence of the retaliatory factor.	--
5/2/13	FINRA	†Provided guidance to firms on communications with the public concerning unlisted real estate investment programs, including unlisted real estate investment trusts and unlisted direct participation programs that invest in real estate.	--
5/7/13	U.S. House of Rep.	House Financial Services Committee passed H.R. 701 which requires the SEC to amend or adopt new SEC Regulation A to create a new category of exempt public offerings of up to $50 million, pursuant to Title IV of the JOBS Act by October 31, 2013.	10/31/13
5/10/13	SEC	Updated the Form 13F Frequently Asked Questions to clarify the definition of "Section 13(f) securities" and provide additional information about options and warrants in connection with Form 13F.	--
5/16/13	FASB and IASB	Published for comment a revised Exposure Draft outlining proposed changes to accounting for leases.	Comment period ends 9/13/13
5/16/13	SEC	*Updated its compliance and disclosure interpretations regarding Securities Act Section 5; Rule 144(a); Rule 144(e); Rule 413; Rule 430B; Rule 502; Rule 144(d); Form S-3; Form S-4; Regulation S-K Sections 118, 134, and 146; Securities Exchange Form 8-K; and Regulation S-X Section 106.	--
5/24/13	NYSE	Adopted a new set of rules governing investigations, discipline of member organizations and covered persons, sanctions, cease and desist authority, and other procedural rules that are modeled on the rules of FINRA.	7/1/13
5/30/13	SEC	*Issued frequently asked questions and answers, regarding conflict mineral disclosure and payments by resource extraction disclosure.	--
6/7/13	FASB	Issued an Accounting Standards Update that sets forth a new approach for determining whether a public or private company is an investment company.	--
6/26/13	FASB	Issued proposed Accounting Standards Update, Presentation of Financial Statements (Topic 205): Disclosure of Uncertainties about an Entity's Going Concern Presumption, related to an organization's ability to continue as a going concern.	Comment period ends 9/24/13

Date	Authority	Regulation	Compliance Date
7/2/13	U.S. Dist. Ct. D.C.	*U.S. District Court for the District of Columbia vacated and remanded the SEC's resource extraction rule (Rule 13q-1) enacted pursuant to the Dodd-Frank Act, which required resource extraction issuers listed on a US stock exchange to disclose in an annual report (on new Form SD) payments made to foreign governments or the US federal government for the commercial development of oil, natural gas or minerals.	--
7/10/13	SEC	‡Published new Rule 506(c), removing the prohibition on general solicitation or general advertising for unregistered securities offerings made under Rule 506(b) and other Section 4(a)(2) offerings, as required by the JOBS Act.	9/23/13
7/10/13	SEC	‡Published for comment proposed rules allowing the SEC to improve the content and timeliness of the Form D notice filing, to require legends and other disclosures in written materials disseminated in offerings utilizing general solicitation and to extend certain antifraud guidance to the sales literature of private funds.	Comment period ends 9/23/13
7/10/13	SEC	‡Adopted amendments, required by the Dodd-Frank Act, to Securities Act Rule 506, which bar felons and other bad actors from participating in exempt offerings.	9/23/13
7/11/13	U.S. Senate	Senators Elizabeth Warren, John McCain, Maria Cantwell and Angus King introduced the "21st Century Glass-Steagall Act", a modern version of the Banking Act of 1933 (Glass-Steagall). The bill would separate traditional commercial and retail banks that are insured by the FDIC from those financial institutions that offer services such as investment banking, insurance, swaps dealing, and hedge fund and private equity activities.	--
7/16/13	SEC	±Updated the financial reporting manual for issues related to real estate acquisitions, determining significance for equity method investees, and non-GAAP measures and issued guidance on non-traded real estate investment trusts.	--
7/18/13	GAO	Published a report, as required by the Dodd-Frank Act, on possible alternative methods for determining who is an "accredited investor." The report recommends the SEC consider alternative criteria such as an individual's liquid investments and requiring the use of a registered adviser.	--
7/23/13	U.S. Dist. Ct. D.C.	U.S. District Court for the District of Columbia held that the SEC's rules implementing the Dodd-Frank Act's conflict mineral disclosure requirements do not violate the Administrative Procedures Act. In addition, the Court summarized the rule, providing a succinct outline of how to comply with it.	--
* See more detailed article in this issue.			

† See Seyfarth Client Alert available at http://www.seyfarth.com/publications/OMMRE060613

‡ See Seyfarth Client Alert available at http://www.seyfarth.com/publications/MA071813Corp

± See Seyfarth Client Alert available at http://www.seyfarth.com/publications/MA080913

Monitor Report: Key Changes and Challenges to SEC Rules

Securities Exchange Commission Clarifies Rule 144, Form S-3, Rule 430B and Regulation D

By Georgia Quinn

On May 16, 2013 the Securities Exchange Commission ("SEC") updated its compliance and disclosure interpretations, providing guidance on certain provisions of Rule 144, Form S-3, Rule 430B and Regulation D, as follows:

Rule 144

The SEC clarified that securities involved in non-sale transfers (such as gifts or forclosures) by an affiliate that were not restricted securities in the affiliate's hands are still subject to the current public information restriction of Rule 144(c)(1) but not the holding period restriction of Rule 144(d) in the subsequent donee's or lender's hands. The SEC also confirmed that securities sold back to the issuer in a nonpublic transaction, do not need to be included in an affiliate's calculation of securities sold under Rule 144.

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Form S-3

The SEC explained that an issuer may add by post-effective amendment to a Form S-3 an additional amount of securities of the same class as those already registered under the Form S-3.

Rule 430B

The SEC clarified that if an issuer is relying on Rule 430B(b) to omit the identities of the selling security holders and the amounts they are selling under a non-automatic shelf registration statement, then the issuer must list the aggregate number of securities being registered for resale in the registration statement.

Regulation D

The SEC confirmed that an acquirer seeking shareholder consent from non-accredited shareholders in reliance on Rule 505 or Rule 506, must provide the disclosure required by Rule 502(b)(2) to such non-accredited shareholders in a reasonable amount of time *prior* to the receipt of such consents.

U.S. District Court Vacates and Remands SEC's Resource Extraction Rule

By Mary Lovely

On July 2, 2013, in *American Petroleum Institute v. Securities and Exchange Commission*, the United States District Court for the District of Columbia vacated and remanded the SEC's approval of Rule 13q-1 promulgated under the Securities Exchange Act of 1934 ("Exchange Act"), which was adopted by the SEC on August 22, 2012 to implement Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Rule 13q-1 mandated that resource extraction issuers disclose in an annual report certain payments made to the United States or foreign governments in connection with the commercial development of oil, natural gas, or minerals. The rule would have required disclosure for fiscal years ending after September 30, 2013. The Court found that the SEC misread Section 13(q) to unambiguously require disclosure of the annual reports and its decision to deny any exemption for countries that prohibit payment disclosure was arbitrary and capricious.

The American Petroleum Institute and other trade groups contended that the SEC should have allowed issuers to submit payment information confidentially to the SEC. The Court agreed with the trade groups, finding that the statute did not mean that these reports should be publicly filed and stating that the SEC may selectively omit the information from the public compilation if disclosing some of the information would compromise commercially sensitive information and impose high costs on shareholders and investors. Further, the Court held that the SEC erred by denying any exemption for foreign law prohibitions, finding that the decision was based on arbitrary and capricious reasoning and drastically increased the rule's burden on competition and cost to investors.

The SEC must decide whether to appeal the decision to the D.C. Circuit Court of Appeals or revise or rewrite the rule. In the meantime, issuers should continue to compile information related to resource extraction payments in preparation that the information may need to be reported to the SEC in some form sometime in the near future.

U.S. District Court Upholds SEC's Conflict Mineral Disclosure Rule

By Mary Lovely

On July 23, 2013, the U.S. District Court for the District of Columbia upheld the Securities and Exchange Commission's ("SEC") rules implementing Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") which require companies to publicly disclose their use of "conflict minerals" originating from the Democratic Republic of Congo and adjoining countries, including Angola, Burundi, Central African Republic, Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia ("Covered Countries").

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The conflict mineral rules apply to any issuer that files reports with the SEC under Section 13(a) or 15(d) of the Exchange Act, with no exceptions for foreign private isusers, emerging growth issuers or smaller reporting companies. Under the rules, issuers are required to disclose annually on a new Form SD whether they use "conflict minerals" that are "necessary to the functionality or production" of a product that they either "manufacture" or "contract to manufacture" and that originate from the Covered Countries. Issuers must comply with the disclosure requirements for the calendar year beginning on January 1, 2013, with the first reports due on May 31, 2014, with subsequent reports due on May 31 of each year. The report on Form SD should include a description of the measures taken by the issuer to exercise due diligence with respect to the conflict minerals' source and chain of custody, a description of the products manufactured or contracted to be manufactured that are not "DRC conflict free," the facilities used to process such conflict minerals, the country of origin of the conflict minerals, and the efforts made to determine the mine or location of origin. Further, the due diligence measures must include an independent private sector audit of the issuer's report conducted in accordance with standards established by the Comptroller General of the United States and the issuer must identify the auditor in the report and certify that the issuer obtained the required audit.

The Court found that the Dodd-Frank Act's conflict mineral disclosure requirements do not violate the Administrative Procedures Act ("APA") or the First Amendment. Further, the Court noted that the Securities Exchange Act of 1934 ("Exchange Act") does not require the type of far-reaching cost-benefit advocated by the plaintiffs and the SEC had conducted a reasoned cost-benefit analysis and did not act arbitrarily or capriciously when it decided not to include a de minimis exception to its rule. The Court held that the SEC's adoption of the "reasonable country of origin inquiry" and inclusion of issuers who "contract to manufacture" was based on reasonable and permissible standards set forth in the Dodd-Frank Act and did not contravene the APA.

For more information on the conflict mineral disclosure requirements, please see the SEC's Frequently Asked Questions published on May 30, 2013 and available at http://www.sec.gov/divisions/corpfin/guidance/conflictminerals-faq.htm and Seyfarth's Client Alert published on September 20, 2012 and available at http://www.seyfarth.com/publications/MA092012.

New "Testing the Waters" Rules Liberalize Communications With Potential Institutional Investors in a Registered Public Offering

By Mary Lovely and Matt Hafter

Section 105(c) of the JOBS Act amended Section 5 of the Securities Act of 1933 ("Securities Act") to permit an emerging growth company (or any person authorized to act on behalf of an emerging growth company, such as an investment banker), to engage in oral or written communications with potential investors to determine whether such investors might have an interest in the offering, either before or after the filing of a registration statement with the Securities Exchange Commission ("SEC"). These communications must be limited to qualified institutional investors ("QIBs") or institutions that are accredited investors as respectively defined in Securities Act Rules 144A and 501(a) and must comply with the prospectus delivery requirements of Securities Act Section 5(b)(2) related to sales of the securities.

In the past, the SEC restricted "gun jumping" - communications to potential investors when a securities offering was contemplated or in process - to prevent issuers and underwriters from attempting to offer or sell securities in the absence of available information about the issuer or the securities. Specifically, the SEC was concerned that certain communications may condition the market or arouse public interest in a particular security without providing investors adequate disclosure. Prohibited communications included press releases, interviews, Facebook postings, Twitter "tweets", and other communications on social media platforms, and no intent is required to be found guilty of violating the gun jumping restrictions. Violations of the gun jumping restrictions may have (1) resulted in the SEC imposing a "cooling off period" to delay a proposed public offering, (2) given rise to rescission rights allowing investors the statutory right to return any securities purchase in the public offering and receive a full refund of the purchase price, plus interest, or (3) caused the SEC to impose possible sanctions or fines on the issuer.

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Some very noteworthy IPOs have gotten tangled up in problems arising from pre-filing communications. For example, shortly before Google Inc. filed a registration statement for its IPO, the company's co-founders gave an interview to Playboy magazine that was published several months later. Although the SEC did not require a "cooling off" period, Google included the text of the article as an appendix to the prospectus. Because the article became part of a filed document Google had prospectus liability for the article's contents and was required to provide additional disclosure correcting what it believed were factual inaccuracies. Similarly, in anticipation of Groupon, Inc.'s 2011 IPO, the investment community commented negatively about Groupon's business model and certain accounting practices. In response, Groupon's CEO sent an email to employees defending the company, which ultimately leaked and went viral. This (among other factors) delayed Groupon's IPO and resulted in Groupon having to include the email in its prospectus (again assuming liability for statements in the email) along with a risk factor that stated, "In making an investment decision, you should not rely on an email sent by our Chief Executive Officer to certain employees that was leaked to the media without our knowledge."

Emerging growth companies should still carefully consider the timing and content of any meetings or communications to QIBs or institutions that are accredited investors. Anti-fraud provisions of the federal securities laws continue to apply to the testing-the-waters communications, and the testing-the-waters materials should be consistent with the information contained in the most recent draft of the registration statement. The SEC retains authority to request copies of written testing-the-waters communications through the comment letter process, and to request supplemental information to confirm consistency with the registration statement. It is therefore important that emerging growth companies contemplating an IPO maintain discipline in communications in all media and be prepared to respond to SEC comments, so that the informality of social media, email and the like does not lead to statements that require subsequent potentially embarrassing corrections. This may result in issuers limiting testing-the-waters activities to oral communications. In part because of such concerns, to date, few, if any, emerging growth companies have utilized the liberalized "testing the waters" rules in the context of their registered pulic offerings.

The new "testing the waters" provisions for emerging growth companies significantly liberalize the gun-jumping restrictions under the Securities Act and offer a new way for emerging growth companies and underwriters working with them to approach the market. At the same time, emerging growth companies planning for an IPO should review their policies and procedures regarding social media and designate a team tasked with monitoring and controlling communications during this critical period.

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