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News to Note

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BULLETIN

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## SEC/Corporate

### SEC Issues Guidance on the Use of Social Media to Disclose Company Information

On April 2, 2013, the SEC provided guidance on the use of social media to disclose company information in a Report of Investigation under Section 21(a). The investigation concerned Netflix's chief executive officer (CEO) posting on his individual Facebook page that the company streamed 1 billion hours of programs within a month. The post was not accompanied by a press release, a post on Netflix's own website or a Form 8-K. The SEC investigated whether this violated Regulation FD and Section 13(a) of the Exchange Act but ultimately determined not to pursue an enforcement action in this matter.

Regulation FD and Section 13(a) of the Exchange Act ban public companies from selectively disclosing material, nonpublic information to certain securities professionals or shareholders, where it is reasonably foreseeable that they will trade on that information, before it is made available to the general public. In 2008, the SEC provided guidance explaining that a company makes public disclosure when the information is published "through a recognized channel of distribution."

As a result of the Netflix investigation, the SEC realized that the 2008 guidance it previously provided did not discuss how Regulation FD and Section 13(a) of the Exchange Act applied to disclosures made through social media channels. The 2008 guidance was directed primarily at the use of issuer websites as a method of disseminating information in compliance with Regulation FD. The guidance addressed whether a company's website is a "recognized channel of distribution" and provided a non-exhaustive list of factors to be considered in evaluating whether a corporate website constitutes a recognized channel of distribution. The SEC noted that the central focus of this inquiry is whether the company has made investors, the market and the media aware of the channels of distribution it expects to use, so these parties know where to look for disclosures of material information about the company.

The post from Netflix's CEO was especially problematic because his Facebook page had not been previously used to distribute material, nonpublic information and the company had not filed the information with the SEC or provided the information on the company's actual Facebook page. The public, especially investors, were not made aware that this material, nonpublic information would be available on the CEO's Facebook page because the public instead was directed to the company's Facebook page and Twitter account, as well as the company's website.

The SEC clarified in the report that issuer communications through social media channels require careful Regulation FD analysis comparable to communications through more traditional channels. In addition, the SEC clarified that the 2008 guidance, specifically the concept that the investing public should be alerted to the channels of distribution a company will use to disseminate material information, also applies to corporate disclosure made through social media. This means companies need to alert the public about what methods of distribution the company will use to provide material information. If the company chooses not to file a Form 8-K to disclose the information, the company needs to evaluate whether the information is being disseminated in a manner that is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public."

The SEC further advises that when a company posts material, nonpublic information on social media and does not provide the public with notice of this fact, the method is not likely to qualify as "reasonably designed to provide broad, non-exclusionary distribution of the information to the public."

*http://www.sec.gov/litigation/investreport/34-69279.pdf*

## Division of Investment Management Issues Guidance on Filing Requirements of Communications Made in Social Media

On March 15, 2013, the SEC's Division of Investment Management (the "division") issued guidance on the filing requirements for electronic communications (i.e., chat rooms or social media). The division issued the guidance after receiving questions as to whether certain electronic posts should be filed under either Section 24(b) of the Investment Company Act of 1940 ("Investment Company Act") or Rule 497 of the Securities Act of 1933 ("Securities Act") if the posts are exempt from filing under Financial Industry Regulatory Authority (FINRA) Rule 2210. Section 24(b) of the Investment Company Act prohibits investment companies from sharing any "advertisement, pamphlet, circular, form letter, or other sales literature" with investors unless the communications have been filed with the SEC or are filed 10 days after the information is shared. Rule 497 of the Securities Act requires information about performance of registered investment companies be filed with the SEC or FINRA. Previously, FINRA has determined that electronic communications are exempt from the FINRA Rule 2210 filing requirement because they constitute a "public appearance." In 2010, FINRA stated that even if the communications are exempt under FINRA Rule 2210, the communications could still require filing under the Investment Company Act or the Securities Act.

The division concluded that the issue of whether electronic communications need to be filed depends on the "content, context, and presentation of the particular communication or set of communications" which needs an evaluation of the information provided, including whether the communication is a response to a question or a request from the public. The division provided several examples of electronic communications that do not generally require filing. The examples include:

- an accidental reference of a particular investment company or funds that are not related to a discussion of the fund's investment merits
- the accidental use of the word "performance" when discussing an investment company or funds, without referring to the elements of a fund's return
- a statement providing a hyperlink to the prospectus of a fund or information filed under Section 24(b) of the Investment Company Act or Rule 497 of the Securities Act
- a statement that does not relate to the discussion of investment merits of a fund that provides a hyperlink to "general financial or investment information"
- a response to a question that includes discrete information unrelated to the investment merits of the fund (which may refer the public to the fund prospectus, information filed with FINRA, or to use a different form of communication to discuss the question with the issuer)

The division also provided examples of electronic communications that generally require filing. These examples include:

- a discussion of fund performance that refers to, or promotes, some or all of a fund's return
- a communication started by the issuer that references the fund's investment merits

*http://www.sec.gov/divisions/investment/guidance/im-guidance-update-filing-requirements-for-certain-electronic-communications.pdf*

## SEC's Division of Trading and Markets Grants Relief from Broker-Dealer Registration for Online Platform that Permits Investment in Start-Up Companies

On March 26, 2013, the SEC's Division of Trading and Markets issued a no-action letter indicating that it would not recommend enforcement action under Section 15(a)(1) of the Exchange Act if a venture capital fund adviser and its management company (collectively, the "fund") operated a platform through which its members could participate in Rule 506 offerings. The no-action letter is the first relief from broker-dealer registration for a platform that provides investors with a means to invest in start-up companies following the enactment of the JOBS Act. However, the no-action letter does not in any way address the JOBS Act's crowdfunding exemption, or the ability to conduct a Rule 506 offering using general solicitation, as those final rules have not yet been adopted by the SEC.

The fund is a Delaware corporation and venture capital fund adviser that solely advises venture capital funds. The fund identifies and performs due diligence on start-up companies for which the fund may wish to form investment funds. Once the fund decides to invest in a start-up company, it enters into a non-binding agreement with that company setting a target amount of capital for which the fund will invest. The fund then posts information provided by the start-up company on its website. Such information is available online only to the fund's members, all of whom must be accredited investors as defined in Rule 501 of Regulation D.

The fund's members may submit non-binding indications of interest in an investment fund offered on the fund's website in accordance with Rule 506. The fund then reconfirms investors' interest and accredited investor status, and negotiates the final terms of the investment fund's investment with the start-up company.

Investors provide funds for their investments in the investment fund directly or indirectly to a custody account subject to the Investment Advisers Act Rule 206(4)-2 at a custodian bank or trust company. Although the money

invested by the investors may include administrative fees, the fund does not receive any compensation. The fund intends to be compensated in connection with its role in organizing and managing the investment funds at an anticipated rate of 20 percent or less of the profits of the investment fund, but never exceeding 30 percent.

**Findings**

The no-action letter does not address general solicitation issues or the crowdfunding exemption, but instead addresses whether the fund is a broker dealer. While the fund does not earn commissions on the sale of securities, it does take a carried interest. The carried interest only pays out if a fund returns its capital contributions. In addition, the fund does not propose to take a management fee. The SEC notes in the no-action letter that the fund's current activities appear to comply with Section 201 of the JOBS Act, in part because it and each person associated with it receives no compensation (or the promise of future compensation) in connection with the purchase or sale of securities. However, if the fund or persons associated with it receive compensation or the promise of future compensation, the fund will no longer be able to rely on Section 201 of the JOBS Act.

*http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf*

*Authored by Delcy P. Sweet*

# Litigation

## SOX Whistleblower Protection Expanded by a Federal Appeals Court

With the number of employee whistleblower claims brought under the Sarbanes-Oxley Act (SOX) on the rise, a recent federal appeals court case has amplified the circuit split over how rigorous a showing a claimant must make to prevail in a SOX whistleblower case. The U.S. Court of Appeals for the Third Circuit embraced an expanded scope of whistleblower protection, ruling that an employee who reports an accounting irregularity to corporate managers may be protected from retaliation by SOX, even if the complaint did not clearly relate to the kinds of securities fraud that SOX was enacted to guard against. Employers should be aware of the potential liability that they could face in dealing with employees who may not appear at first blush to be engaged in any activity related to securities laws, but could fall within SOX protection under this holding.

For additional information, see the Holland & Knight alert, "SOX Whistleblower Protection Expanded by a Federal Appeals Court," (April 5, 2013).

*Authored by Katherine Healy Marques*

## SEC Files Initial Brief in Conflict Minerals Rule Case

The SEC recently filed its initial brief in the case pending in the United States Court of Appeals for the D.C. Circuit in which the National Association of Manufacturers, United States Chamber of Commerce, and Business Roundtable (collectively, the "petitioners") are seeking to strike down the SEC's conflict minerals rule adopted on August 22, 2012.

The rule is mandated by Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added Section 13(p) to the Securities Exchange Act of 1934 and requires the SEC to issue rules requiring issuers to disclose their use of certain conflict minerals (e.g., gold, columbite-tantalite, cassiterite, wolframite and their derivatives) originating from the Democratic Republic of the Congo or an adjoining country (collectively, the "covered countries") on a new Form SD beginning May 31, 2014, and continuing on May 31 every year thereafter.

The petitioners have argued, among other things, that: (1) the SEC failed to evaluate and quantify the economic impact of the rule, which the petitioners allege is significant; (2) the SEC failed to provide a *de minimis* exception for issuers using small amounts of conflict minerals; (3) the SEC overreached by including issuers who contract to have products manufactured that might contain conflict minerals but are not manufacturers; (4) the two- and four-year transition periods for large and small issuers, respectively, are backwards; and (5) Section 1502 and the rule violate the First Amendment.

The SEC's initial brief asserts that the SEC's analysis when designing the rule was completely reasonable and responds to the petitioners' arguments regarding the depth of the SEC's analysis by arguing that:

- the SEC engaged in extensive qualitative analysis of its discretionary choices when creating the rule, which included evaluating more than 420 individual comment letters and 13,000 form letters, and accurately estimated the rule's quantitative costs
- although the SEC can estimate costs of compliance, a qualitative rather than quantitative analysis is more feasible and appropriate because the ultimate benefits of the rule are intangible and currently unquantifiable
- other federal offices, such as the State Department and comptroller general, rather than the SEC are statutorily required to examine and quantify the effectiveness of Section 1502 and the rule
- the SEC must defer to Congress' determination that humanitarian relief for the covered countries is necessary and must neither undermine the congressional mandate of Section 1502 nor unilaterally create exceptions that contradict it

With respect to the petitioners' arguments concerning the absence of a *de minimis* exception, the inclusion of issuers who contract to manufacture products (rather than solely manufacturers), and the length of the transition periods, the SEC asserts:

- adding a *de minimis* exception to the rule would contradict Congress' intent because Congress considered, but deliberately omitted, a *de minimis* exception for Section 1502
- a *de minimis* exception is also inappropriate because small, individual uses of conflict minerals can have a large impact
- Congress (and ultimately the SEC) reasonably included issuers who contract to manufacture rather than solely manufacturers because manufacturers could otherwise evade the rule by contracting around disclosure requirements
- conflict minerals are commonly used in products that are manufactured by one company and branded, marketed, and sold by other companies further down the supply chain, so requiring only the manufacturer to comply with the rule would frustrate the purpose of Section 1502
- providing a longer transition period for small issuers than large issuers (two years for small issuers, four years for large issuers) is warranted because large issuers have greater leverage over suppliers and more resources at their disposal to evaluate and refine their supply chains in a shorter period of time

Finally, the SEC seeks to refute the petitioners' assertions that Section 1502 and the rule violate the First Amendment by arguing:

- mandatory disclosures of factual information do not violate First Amendment rights
- Section 1502 is different than other laws that have been found to violate First Amendment rights, such as laws requiring a person to express or subsidize a message with which the person disagrees, laws requiring speakers to alter the content of speech, and laws infringing on rights of political association or belief
- fear of stigmatization stemming from required factual disclosures does not substantiate a First Amendment violation
- the SEC went to great lengths to avoid burdening free speech, including curtailing disclosure requirements, allowing additional disclosure, and providing the two and four year transition periods to large and small issuers, respectively

Oral arguments in the case are scheduled for May 15, 2013.

For additional information, reference the SEC's initial brief and an article in the Holland & Knight *Securities & Financial News to Note Bulletin* (August 27, 2012), which explains the rule's disclosure requirements.

*Authored by Edward Sarnowski*

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