Ole Miss Business Law Reporter

THE UNIVERSITY of MISSISSIPPI
School of Law
Business Law Network

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THE REPORTER

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Features

2 Letter From the Editors

4 Mississippi Secretary of State's 2014 Business Legislation Update
Delbert Hoseman

10 The New Regulator In Town:
The Financial Stability Oversight Council

16 S.E.C v. Pentago Capital Mgmt:
Recent Late Trading Case and Its Implication for Securities Lawyers

20 The Jobs Act:
An Essential Guide

27 Network Announcements

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From the Left: 3L Nader Jarun, Professor John Czarnetzky, Professor Mercer Bullard, 3L Cory Ferraez

Letter from the Editors

Welcome to the Ole Miss Business Law Reporter

Thank you all for the positive feedback after yet another successful Reporter edition. Also we would like to thank all guests that were able to attend the First Annual Business Law Conference in Jackson. We look forward to seeing you all at the second annual conference next spring.

We are excited to bring you the third and final publication of our inaugural year. It has been a journey filled with many obstacles, but we continue to get better. We will continue to deliver current business related articles that you can put to use in your day to day practice. With exception to a few, each article is co-written with a practicing attorney who offers his or her own expertise.

In this special April edition Secretary of State Delbert Hosemann gives an update on the business legistaltion in Mississippi. Furthermore, we discuss the Financial Stability Oversight Council and the latest case for securities lawyers. Finally, we dicuss the Jobs Act.

We dedicate this third issue to attorneys practicing in the financial services industry. With such a complex practice, you must continually stay ahead of the changing legal and regulatory climate in Congress and federal or state agencies. We thank you for your attention to detail.

The Reporter members are off for the summer and will return in the August. Our staff will be growing this fall with the addition of 15 new members. We look forward to another successful year and delivering the latest business law issues to our readership.

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As always, thank you for reading!

Nader Jarun & Cory Ferraez

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Mississippi Secretary of State's 2014 Business Legislation Update

By: Delbert Hoseman, Mississippi Secretary of State

When you hired me as Secretary of State, one of our main goals was to create a more business-friendly Mississippi. To promote economic development and growth through common-sense business proposals, the Secretary of State's Office has collaborated with state lawmakers, attorneys, business professionals, CPAs, and other subject matter experts to recommend, review, and draft improvements to Mississippi's business laws. Since 2008, the Legislature has adopted nearly 30 business-related legislative proposals developed through the Secretary of State's Office. The proposals included changes to Mississippi's corporate, LLC, nonprofit, trademark, and securities laws.

The 2014 Regular Session of the Mississippi Legislature was a productive session for business reform and refinement. The Legislature passed seven business-related bills from the Secretary of State's legislative agenda. Here is a look at these new laws.

I. Encouraging Economic Growth and Development

1. Headquarters Relocation (HB 785)

HB 785 is intended to encourage companies to relocate their national or regional headquarters to Mississippi. Under the proposal, a company relocating its corporate headquarters to Mississippi, and creating at least 20 jobs, may apply with the Department of Revenue for a tax credit. If the Department of Revenue finds the business meets the requirements it will allow a tax credit for actual relocation expenses against the company's state income tax liability for the taxable year in which the relocation costs are paid.

The Mississippi Department of Revenue determines relocation costs, which the bill defines as non-depreciable expenses that are necessary to relocate headquarters employees to the headquarters in conjunction with the initial establishment of the headquarters facility. These relocation costs may include typical moving expenses to relocate furnishings, household goods, and personal property of the employee and members of their household, as well as travel expenses to and from Mississippi in search of a new home.

The maximum cumulative amount of the credit claimed against the State in any one year is capped at $1,000,000. The credit is non-refundable but excess may be carried forward and used for a period of five-year period. Representative Jeff Smith sponsored HB 785, which takes effect on July 1, 2014. Senator Joey Fillingane sponsored the counterpart bill in the Senate.

2. Tax-Forfeited Properties (SB 2394)

Corporations now will be allowed to purchase tax-forfeited lands from the state, increasing the pool of potential purchasers for these properties. A corporation can purchase up to one-quarter section of public land (160 acres).

Senator David Blount sponsored SB2394, which takes effect on July 1, 2014. Representative Tom Weathersby sponsored the counterpart bill in the House.

II. Modernizing Mississippi's Business Laws

1. Amendments to Agricultural Cooperative Marketing Associations Law (HB 914)

Mississippi's Agricultural Cooperative Marketing Associations Law (§§79-19-1, et seq.) was first adopted in the 1930s and has not been updated to take advantage of changes to antitrust laws.

HB 914 provides a much-needed update. The legislation allows a cooperative to do business with nonmembers not to exceed the amount of business it does for members and it also streamlines the adoption of changes to the bylaws. Previously, it was very difficult for a cooperative to reach a quorum. Under the new law if a vote is scheduled but no quorum is present, the meeting will be adjourned and rescheduled for the specific purpose of voting on that amendment.

The bill also allows perpetual existence of the cooperative (previously 99 years), and clarifies that Mississippi's non-profit corporation laws apply to Agricultural Marketing Cooperatives, to the extent not covered by the cooperative statute.

The updates to Mississippi's marketing cooperative law are intended to broaden Mississippi's appeal as a legal situs for marketing cooperatives currently in Mississippi or in other states.

Representative Bobby Howell sponsored HB 914, which goes into effect on July 1, 2014. Senator Buck Clarke sponsored the Senate counterpart bill.

2. Mississippi Entity Domestication and Conversion Act (SB 2322)

On March 19, 2014, Governor Phil Bryant signed into law the Mississippi Entity Domestication and Conversion Act. This Act allows business entities to change their legal form (known as conversion) or change their state of incorporation (known as domestication) through a filing with the Mississippi Secretary of State's Office.

The frequent number of calls the Secretary of State's Business Service Division received from callers wishing to convert their businesses from one form to another led the Secretary of State's Office to form a study group to consider whether a law authorizing domestication and conversion was needed. After receiving a favorable study group recommendation in 2012, the Secretary of State's Office worked with a sub-committee to draft the proposal later introduced in the Legislature.

The Act is intended to give business entities a simple, efficient, and inexpensive procedure to change their business form or location. Previously, a business faced several cumbersome steps if it wanted to change from one entity form to another. Under the new law, a plan of conversion must be approved by interest holders in the pre-existing entity. The plan describes the conversion and its effect in detail. The plan is required to include: the name and type of the current entity; the name, jurisdiction of organization, and type of the new converted entity; the manner for converting the interests in the pre-existing entity; the proposed public organic document of the new converted entity if it will be a filing entity; and the private organic rules of the converted entity. After approval of the plan by the interest holders, a statement of conversion must be filed with the Secretary of State's Office. A form for this is under development and will be available when the Act becomes effective on January 1, 2015. The filing makes the transaction a matter of public record. It becomes effective upon the date and time of filing, unless a later date or time is specified.

The process for domestication is similar. Over the years, many companies in the state were formed under the laws of another state such as Delaware or Nevada. This may have been done due to perceived advantages in forming a business using

statutes of those states. Recent changes in the laws governing corporations and LLCs in Mississippi make it now more advantageous to be domesticated in Mississippi. This Act will allow those companies to become Mississippi entities by filing only a single form with the Secretary of State.

The language in the bill was based heavily on the Model Entity Transaction Act (META), a model act promulgated in 2004 by the National Conference of Commissioners on Uniform State Laws, a group of volunteer lawyers appointed by the Governors or Legislatures of their respective states to draft model states laws.One notable difference between the Mississippi and the model act is Mississippi did not adopt META's provisions on mergers and interest exchanges. Those transactions will be governed by existing law.

Senator Sally Doty sponsored SB2322. Representative Mark Baker sponsored the counterpart bill in the House.

3. Name Reservation Provisions (SB2511)

The Legislature also passed a bill harmonizing the name reservation procedure for Business Corporations, Nonprofit Corporations, Limited Partnerships, and Limited Liability Companies. The reservation of a business name occurs prior to the formation of the actual business entity. It allows for the entity to reserve the name the entity plans to use in the future for a set period of time. This prohibits any other entity from forming using that same name.

Previously, name reservation procedures were inconsistent across business entity forms. For example, limited liability companies and limited partnerships were allowed to reserve a name for six months, then had to wait 60 days after the expiration to reserve it again for another six months. Corporations, on the other hand, were allowed to renew their name reservation immediately upon expiration. Foreign corporations, on the other hand, were allowed to register their name in the state for a year with unlimited renewals.

The new act treats all entity types the same. A name may now be reserved for six months with one additional six-month renewal. This prevents foreign companies from "parking" unused names in the Secretary of State's database. If a foreign company wishes to keep its name from being used in the state, it can register with the Secretary of State.

Senator Sally Doty sponsored SB2511, which goes into effect on July 1, 2014. Representative Mark Baker sponsored the counterpart bill in the House.

III. Making Mississippi More Competitive For Trust Business

Trusts are important estate planning tools and may be a strong economic driver for a state. Mississippi has limited trust laws. Through some law exists, much of the current trust law is scattered and sparse, leading to uncertainty for both practitioners and citizens wishing to form a trust in Mississippi.

Trusts are easily established in any jurisdiction, regardless of the settlor's or beneficiary's state of residence, and many practitioners and trust professionals are under a fiduciary obligation to recommend the best location for the trust. Due to the updated trust laws in Tennessee and other states, some Mississippi citizens are taking their trust business elsewhere. At a trust conference in November 2013, a presenter (only half-jokingly) referred to Mississippi's trust law as a great job-creator for the State of Tennessee.

In March 2013, the Mississippi Secretary of State's office assembled a group of accountants, attorneys, financial planners, bankers, insurance professionals, and trust officers to review and

consider trust legislation, with the goal of making Mississippi's trust laws current, competitive, progressive, and attractive for individuals and business. The Legislature adopted two major proposals recommended by the study group – the Mississippi Uniform Trust Code and the Mississippi Qualified Disposition in Trust Act. Both take effect on July 1, 2014.

1. The Mississippi Uniform Trust Code (SB 2727)

On March 24, 2014, Governor Bryant signed the Mississippi Uniform Trust Code. The new law provides a much-needed update to Mississippi's default rule on trusts. It is intended to reduce uncertainly, suppress costly and needless litigation, and help grow the trust industry. The law provide guidelines where none currently exist, while also permitting the settlor maximum flexibility in setting up the trust. The Mississippi Uniform Trust Code is based on the Uniform Trust Code, a uniform act approved in 2000 by the National Conference of Commissioners on Uniform State Laws. The UTC has been adopted in 27 states and the District of Columbia.While the Mississippi Uniform Trust Code is based on a uniform act, it has a number of non-uniform provisions. A Task Force on the UTC met for several months, going line-by-line through the act and considering improvements to the uniform language.

The Mississippi Uniform Trust Code generally follows the format of the UTC.It includes an article addressing trust advisors and trust protectors which was not part of the uniform law, and leaves out the article on creditors' rights, opting instead to use existing Mississippi law in this area.

Article 1 contains general provisions and definitions.

Article 2 provides guidance on judicial proceedings, and clarifies a court in the trust's principal place of administration has jurisdiction over both the trustee and beneficiaries regarding matters related to the trust. The code does not attempt to address most issues surrounding jurisdiction or procedure.

Article 3 governs representation, both by a fiduciary (personal representatives, guardians, conservators) and through virtual representation. This article also confirms the court's authority to appoint representatives to represent and approve settlements for minors, and the incapacitated, unborn, or individuals whose identity or location is not reasonably ascertainable. Many practitioners have issues involving trusts with unborn or minor contingent beneficiaries. In these cases, practitioners must go to court, get a guardian ad litem appointed for the minors and unborns, who then examines the situation and makes a report to the court – even though the interests of the minor/unborns are the same as their parents who are trust beneficiaries. With virtual representation, if the parents are in a position to represent those interests, the costly and time-consuming guardian ad litem process will be avoided.

Article 4 provides statutory framework for creating, modifying and terminating trusts. The requirements do not generally depart from traditional doctrine. The trust code does utilize a three-part classification of trusts: charitable, non-charitable, and honorary. The most common trust is the non-charitable trust. Non-charitable trusts require a valid purpose and ascertainable beneficiary or beneficiaries. Charitable trusts have the opposite purpose, which is to benefit the public as a whole. The honorary trust was unenforceable at common law but is recognized under the trust code. An honorary trust lacks an ascertainable beneficiary. The most common example is a trust to care for an animal.

In addition to the terms on creation and validity, Article 4 provides terms on modification and termination of a trust. The modification

provisions are intended to help preserve the intent of the settlor, but provide flexibility if a provision of the trust no longer serves a material purpose. It also provides for termination of trusts, if properly approved, when the size of the trust is insufficient to justify continued administration.

Article 5 of the uniform act addresses creditors' rights and was not adopted in this bill; Mississippi will instead rely on the current creditors' rights laws.

Article 6 addresses revocable trusts. Generally, revocable trusts are treated as the equivalent of a will under the trust code. Trusts are presumed revocable unless the terms provide otherwise. The article also provides the procedure to amend or revoke the trust.

Article 7 covers the office of the trustee. All of the default rules found in Article 7 may be modified by the trust terms. The rules address acceptance of the office, the role of co-trustees, changes in trusteeship, resignation, removal, appointing successor trustees, and compensation.

Article 8 governs the duties and powers of trustees.

Article 9 is omitted since the Mississippi Uniform Prudent Investor Act is already enacted in Mississippi and codified in Sections 91-9-601 through 91-9-627.

Article 10 provides for the liability of trustees and rights of those dealing with trustees.

Article 11 is the miscellaneous provisions section of the act and provides for the effective date and that this bill will apply to all trusts created before andafter the effective date.

Article 12 addresses trust advisors and trust protectors. It provides a non-exhaustive list of powers that may be given to trust advisors and protectors. Under Article 12, fiduciary responsibilities are placed on trust advisors and protectors, to the extent the trust advisor or trust protector is granted power in the trust instrument. A trust advisor or trust protector is considered an excluded fiduciary with respect to each power granted or reserved exclusively to another individual. These excluded fiduciaries, are under no duty to review actions by other individuals or recommend, report, communicate with beneficiaries, or take any other action unless the terms of the trust provide otherwise. An excluded fiduciary is not liable for the actions of other individuals. Only the individuals who hold the power may be liable for the failure to exercise a power or the results of exercising that power. Likewise, administrative activities or recordkeeping required by an individual's role with a trust will not give rise to any duty concerning the exercise or non-exercise of apower exclusively held by another. A claim against a trust advisor or trust protector must be brought within one year of the date the trust beneficiary or representative of the trust beneficiary received a report indicating the existence of a potential claim. If no such report was provided, the claim must be made within three years of the termination of the beneficiary's interest, the termination of the trust, orthe removal, resignation, or death of the trust advisor or trust protector.

To avoid conflicting and overlapping provisions, SB2727 repeals Articles 1, 3, 5, and 7 of Title 91, Chapter 9.

Senator Sean Tindell sponsored SB2727. Representative Trey Lamar sponsored the counterpart bill in the House.

2. Mississippi Qualified Disposition in Trust Act (HB 846)

A qualified disposition trust, also referred to as a self-settled spendthrift trust or a domestic

asset protection trust, is an irrevocable trust in which the trust creator (settlor) is allowed to be a beneficiary of a trust while also receiving limited asset protection

Under the previous state law, only assets placed in trust for the benefit of a separate beneficiary received creditor protection.

To take advantage of a qualified disposition trust, the trust creator must first sign an affidavit stating the trust creator is solvent, has title and authority to transfer the assets being put into trust, is not taking any action to defraud creditors, is not aware of any undisclosed pending or threatened court action, is not involved in any undisclosed administrative proceeding, does not plan to file bankruptcy, and is not transferring assets into the trust that were derived from any unlawful activity. The transferor is required to secure a general liability policy of at least $1,000,000 dollars.

The trust can be attacked through the Uniform Fraudulent Transfer Act, Section 15-3-101,et seq. An action must be commenced within two years of the qualified disposition or within six months after the creditor knows or should have known the property had been transferred into trust. If the person becomes a creditor after the trust is created, the action must be brought within two years after the qualified disposition was made. The creditor must prove by clear and convincing evidence the transfer of property was made with intent to defraud the specific creditor.

A creditor's right to trust assets can prevail in cases involving court orders for payment of alimony, child support, or equitable distribution of marital property, compensation for death, personal injury or property damage occurring before the date of a qualified disposition, and judgments payable to the state or a political subdivision, including court-ordered restitution. In the event the settlor did not maintain the $1,000,000 dollar liability policy, a creditor may attach trust assets for satisfaction of a debt, but thecollection cannot exceed $1,500,000 dollars.

Representative Trey Lamar sponsored HB846. Senator Sean Tindell sponsored the counterpart bill in the Senate.

The New Regulator In Town: The Financial Stability Oversight Council

By: Cory Ferraez & Theo Polan

CORY FERRAEZ is a third year law student from Columbus, MS. Before law school, he graduated from The University of Alabama, concentrating in Entrepreneurship, Management, and Economics. Cory previously worked at the U.S. Commodity Futures Trading Commission and the Securities Division of the Mississippi Secretary of State's Office. He plans to practice financial services law.

THEO POLAN is a first year MBA student at the Yale School of Management. Prior to returning to graduate school, he served for four years at the U.S. Department of the Treasury. While working in the Office of the Fiscal Assistant Secretary, he managed a series of programs that provided $23 billion in financing for state and local housing finance agencies, and while working as a policy analyst in the Office of the Financial Stability Council, he carried out parts of the analysis that led to the first ever designation of systemically important financial market utilities and subsequently of nonbank financial companies. He graduated from Stanford University with a B.S. in Management Science & Engineering.

There's a new sheriff in town: the Financial Stability Oversight Council or FSOC. Section 111 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) created this new regulatory body led by the Treasury Department.[1] FSOC is charged with monitoring the safety and stability of the U.S. financial system. The Council is charged with designating nonbank financial companies that "could pose a threat to the financial stability of the United States" as well as financial market utilities and payment, clearing, or settlement activities that "are, or are likely to become, systemically important."[2] Entities designated by the Council would be subject to increased scrutiny by the Board of Governors of the Federal Reserve System (the Fed) or the appropriate supervisor. The Council also has more general authority to make recommendations to the Fed and other regulators regarding enhanced prudential standards for designated entities as well as other regulatory actions the Council deems appropriate to safeguard financial stability. The breadth of FSOC's mandate under Dodd-Frank largely permits the Council to determine the scope of its own jurisdiction, which, by design, creates overlaps with the jurisdictions of traditional regulators, but may simultaneously create the potential for legal action by industries weary of FSOC's new authority. This article introduces FSOC and its relevant regulatory actions including:

- Designation of Nonbank Financial Companies or "SIFIs";[3]

1 12 U.S.C. § 5321 (Dodd-Frank Act § 111)

2 12 U.S.C. §§ 5329, 5463 (Dodd-Frank Act §§ 113, 804)

3 FSOC does not use the term "SIFI," or "systemically important" to describe its nonbank financial company designations, though the term "systemically important" is used with respect to financial market utility designations. However, for the ease of reading this article, "SIFI" will be used colloquially in referring to nonbank financial institution designations even

- The Asset Management Industry; and
- Money Market Mutual Funds (MMF)

FSOC Composition

FSOC comprises 15 members; 10 are voting and 5 are non-voting. FSOC's chairman is the Secretary of the Treasury. Eight other voting members are heads of major regulatory agencies including:

- The Board of Governors of the Federal Reserve System;
- Securities and Exchange Commission;
- Office of the Comptroller of the Currency;
- Federal Deposit Insurance Corporation;
- Commodity Futures Trading Commission;
- Consumer Financial Protection Agency; and
- Federal Housing Finance Agency

The last voting member is an "independent member having insurance expertise." Additionally, the 5 non-voting members are:

- The Director of the Federal Insurance Office;
- The Director of the Office of Financial Research;[4]
- A state insurance commissioner selected by the state insurance commissioners;
- A state securities commissioner selected by the state securities commissioners; and
- A state banking supervisor selected by the state banking supervisors

A. SIFI Designations

To effectuate its purpose of monitoring and safeguarding the U.S. financial system and systemically risky industries and institutions, FSOC uses its "SIFI" designations to bring Nonbank Financial Companies and Financial Market Utilities (FMUs) under heightened supervision. The Fed (or potentially the SEC or CFTC, in the case of FMUs) would subsequently impose enhanced prudential or supervisory standards for which FSOC may provide recommendations.[5] A three-stage designation process for nonbank financial institutions is explained below.

Stage 1. FSOC must determine whether entities are "nonbank financial companies." A company is a nonbank financial company if it is "predominantly engaged in financial activities," which is defined as follows: a company must have either 85% of its gross revenue or 85% of its assets in financial assets. Financial activities are also defined as "activities that are financial in nature."[6]

If this standard is met, FSOC will then subject a company to a two-part quantitative threshold test: (1) the company must have at least $50 billion in assets and (2) at least one of the following:

- At least $30 billion in notional amount of

though "systemically important" is applicable to FMU designations, rather than nonbank financial company designations.

4 FSOC has indicated that it will rely whenever possible on the information and research by or available to OFR to fulfill its statutory obligations. OFR is housed within the Treasury and was also created in Title I of Dodd-Frank or 12 U.S.C. § 5342.

5 FMUs are defined as multilateral systems that provide the essential infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions among financial institutions or between financial institutions and the system. Depending on the nature of the FMU, designation will result in increased supervision by either the Fed, the SEC, or the CFTC. Eight entities have been designated as FMUs. FMUs will not be further discussed in this article. More information can be found at: http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Appendix%20A%20Designation%20of%20Systemically%20Important%20Market%20Utilities.pdf

6 12 U.S.C. § 5311(a)(4),(6); "financial in nature" is defined in section 4(k) of the Bank Holding Company Act of 1956; The Board of Governors' Regulation describes and defines these activities and if a company is "predominantly engaged" in these activities for purposes of Dodd-Frank;12 C.F.R. part 242.

credit default swaps for which the company is the reference entity;
- $3.5 billion in net derivative liabilities;
- Assets to equity leverage above 15 to 1;
- At least $20 billion of outstanding debt; or
- Short-term debt (less than 12 months) in excess of 10% of its total assets

Dodd-Frank affords FSOC broad discretion to determine which companies should be considered for designation, and accordingly FSOC reserved the right in its rulemaking on the designations process to subject any nonbank financial company to further review even if the company does not met the Stage 1 thresholds above. FSOC explains in its final rule and interpretive guidance that: "the Council does not believe that a determination decision can be reduced to a formula. Each determination will be made based on a company-specific evaluation . . ."[7]

Stage 2. After the nonbank financial companies have been identified in Stage 1, FSOC prioritizes its company list based on both quantitative and qualitative measures. This includes consultations with each firms' primary financial regulatory agencies. Further, each company analysis will involve a risk profile and also involve a review of specific set of characteristics based on the six-category analytic framework described below to determine if a company should move to Stage 3:[8]

- **Size.** Amount of financial services a company offers
- **Interconnectedness.** Linkages between financial companies that transmit harmful shocks to other financial companies or parts of the financial system
- **Substitutability.** Extent to which other companies provide similar services at similar price and quantity
- **Leverage.** Exposure or risk in relation to equity capital
- **Liquidity risk and maturity mismatch.** Sufficient funding to satisfy short-term obligations and the difference between maturities of a company's assets and liabilities
- **Existing regulatory Scrutiny.** Extent and consistency to which companies are already subject to regulation[9]

Analysis during Stage 2 is carried out exclusively with data that are publicly available or provided by the company's existing regulator(s).

Stage 3. If FSOC advances a nonbank financial company past Stage 2, a Notice of Consideration is sent to the company. FSOC will examine each company and see if a company falls within one of the two determinations below:

1. First Determination Standard. If the company could pose a threat to the U.S. financial system because of the institution's material financial distress.

2. Second Determination Standard. The nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to U.S. financial stability.

Again, within both determinations above, Dodd-Frank enumerated 10 statutory considerations that FSOC has used to establish a 6-category framework described in Stage 2. Though the analytical frameworks used in Stage 2 and Stage 3 are similar, the Stage 3 analysis is more detailed

7 Financial Stability Oversight Council Final Rule, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies at 20, http://www.treasury.gov/initiatives/fsoc/documents/nonbank%20designations%20-%20final%20rule%20and%20guidance.pdf

8 Dodd-Frank,12 U.S.C. 113(a)(2), (b)(2); Dodd-Frank's 9th consideration, or subsection (K), includes a catch-all provision: "any other risk-related factors that the Council deems appropriate."

9 Final Rule at 16.

and rigorous and relies on specific data requested from the company under consideration (and collected by the Office of Financial Research) rather than exclusively on public or regulatorily available data.

FSOC may subject a nonbank financial company to Board of Governors supervision and prudential standards if either the First or Second Determination Standard is met. Additionally, Stage 3 evaluations may involve qualitative factors including considerations that could mitigate or aggravate the potential of the nonbank financial company to pose a threat to U.S. financial stability such as the nonbank financial company's resolvability, the opacity of its operations, or its complexity.[10]

Three SIFI designations have been made to date: American International Group (AIG), General Electric Capital Corporation (GECC), and Prudential Financial, Inc. all three of which were evaluated under the First Determination Standard. As noted earlier, FSOC makes a first or second determination based on each company specific profile. Further, FSOC must review these and all SIFI designations annually. A nonbank entity may request a hearing to protest its designation before it is finalized and may also subsequently sue in federal court to block a SIFI designation. No company has challenged its SIFI designation to date. However, once potential legal options are exhausted in court, there are no other statutory remedies available to rid companies of a SIFI designation.

The SIFI designation process described above is important because it allows FSOC to begin examining industries where the Council and OFR's research indicate there are systemic market implications or gaps in existing regulatory oversight. To provide an example of industries where FSOC has used its limited authority, the next two industries discussed, which are already regulated by the SEC, might also be impacted: Asset Management Firms and Money Market Mutual Funds.

10 Final Rule at 33.

B. Asset Management Industry

FSOC's final rule on designations that outlines the process described above does not explicitly speak to whether Asset Management Firms (AMFs) should be considered for designation. Instead, FSOC opted to undertake further research in conjunction with OFR on the potential of AMFs to threaten financial stability and to consider whether they should be subject to enhanced prudential standards and supervision under Section 113 of Dodd-Frank. The results of that study were published in September 2013.[11]

According to OFR, AMFs, which oversee roughly $53 trillion in financial assets, and transact with many market participants to achieve risk allocation, price discovery, and investment of capital. AMFs also engage in liquidity transformations through collective investment vehicles and provide liquidity to clients and to financial markets. Thus, AMFs have functions that are both similar and dissimilar to banks and other nonbank financial institutions. This bank and nonbank link as well as their interconnectedness and role in providing liquidity brings heightened attention from FSOC to protect against certain potential market vulnerabilities. In light of these vulnerabilities as well as data gaps related to the industry, FSOC is considering what next steps it will take regarding asset management.[12]

However, some representing the asset

11 Office of Financial Research, September 2013, Report on Asset Management and Financial Stability, http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

12 FSOC, 2014 Annual Report at 109, http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf.

management industry contend that asset managers are unlikely to pose a threat to U.S. financial stability, and others note that the legal distinction between investment advisers and the funds they manage make the prudential standards contemplated by Section 165 of Dodd-Frank an inappropriate mechanism for addressing any threat posed by such firms.[13]

Either way, recent criticism from SEC Commissioner Luis Aguilar indicates a disagreement between FSOC and traditional regulators like the SEC on regulation of the mutual fund industry as well as traditional asset managers. Included in the criticism is whether OFR's report would provide an adequate basis for potentially designating asset managers as systemically important.

Future implications of FSOC's movement into other traditional regulatory regimes might incite legal action by parties against FSOC. For example, if FSOC were to designate one or more large asset managers, those companies or the industry as a whole might challenge FSOC's authority in court. The Courts would be left to interpret the depth of FSOC's authority, or, similarly, lobbying or litigation could invite Congressional action to clarify FSOC's statutory mandates or alter its statutory authority.

C. Money Market Mutual Funds

Money Market Mutual Funds (MMFs) are a type of mutual fund registered under the Investment Company Act of 1940. Investors in MMFs fall into two categories: (i) Individual, or "retail" investors; and (ii) institutional investors, such as corporations, bank trust departments, pension funds, securities lending operations, and state and local governments. MMFs had over $2.5 trillion dollars in assets under management (AUM) as of May 8, 2014 representing a sizable portion of U.S. assets, mainly comprising short-term securities or debt instruments such as Treasury notes or commercial paper.[14]

MMFs provide investors with a low-risk, low-return investment where interest is earned while holding a Net Asset Value (NAV) of $1 per share. Unlike stocks, a fund's shares are always worth $1. What actually changes is the interest rate earned, or yield, on the short-term, highly liquid securities or debt held by the fund. MMFs represent a significant source of short-term finding for businesses, financial institutions, and governments.

FSOC has concerns about MMFs' liquidity citing "structural vulnerabilities" with susceptibilities to "runs."[15] FSOC's concerns and related regulatory efforts come after the recent financial crisis saw the second "breaking of the buck" by Reserve Primary Fund, a $62 billon prime MMF. However, since 1980, over 3,000 banks have failed while only two MMFs have failed, leading many in the MMF industry to argue that regulatory changes could damage the industry and curtail capital in the MMF market without meaningfully reducing systemic risk.[16]

After the SEC failed to garner enough votes to pass regulatory measures on MMFs, FSOC proposed its own recommendations for the SEC in an attempt to bring MMFs back to the regulatory table and address the structural vulnerabilities that the SEC rules missed. Even though the current MMF proposal by the SEC is still pending, three

13 See OFR, Report on Asset Management supra note 12 at 6.

14 Investment Company Institute, Money Market Fund Asset Report, May 8, 2014, available at http://www.ici.org/research/stats/mmf/mm_05_08_14.

15 The Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform at 69455, November 19, 2012, http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform.pdf.

16 Professor Mercer E. Bullard Testimony before Congress, March 11 2009, available at http://www.banking.senate.gov/public/_files/BullardTestimony31009.pdf.

alternatives recommended by the FSOC include:[17]

- **A Floating Net Asset Value.**

This will require MMFs to have a floating net asset value per share by removing the special exemption that currently allows MMFs to utilize amortized cost accounting and/or penny rounding to maintain a stable NAV. The value of MMFs' shares would not be fixed at $1.00 and would reflect the actual market value of the underlying portfolio holdings, consistent with the requirements that apply to all other mutual funds.

- **A Stable NAV with a buffer and a minimum balance at risk.**

This will require MMFs to have an NAV buffer with a tailored or set-aside amount of assets of up to 1 percent to absorb day-to-day fluctuations in the value of the funds' portfolio securities. FSOC states that this will allow the funds to maintain a stable NAV. The NAV buffer would most likely be set in place with a 5-year transition period.

The NAV buffer would be paired with a Minimum Balance at Risk (MBR) requirement that 3 percent of a shareholder's highest account value in excess of $100,000 during the previous 30 days is made available for redemption on a delayed basis of 30 days.

In the event that an MMF suffers losses that exceed its NAV buffer, the losses would be borne first by the MBRs of shareholders who have recently redeemed. FSOC believes this will create a disincentive to redeem and provide protection for shareholders who remain in the fund. These requirements would not apply to Treasury MMFs, and the MBR requirement would not apply to investors with account balances below $100,000.

17 See FSOC, Proposed Recommendations, supra note 15 at 69456-7.

- **Stable NAV with a buffer and "other recommendations."**

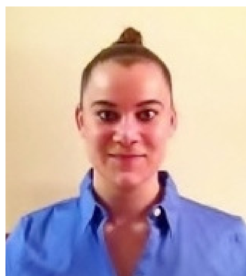
This will require MMFs to have a risk-based NAV buffer of 3 percent in cash to provide explicit loss-absorption capacity. Other measures to enhance the effectiveness of the buffer and potentially increase the resiliency of MMFs include: (1) more stringent investment diversification requirements, (2) increased minimum liquidity levels, and (3) more robust disclosure requirements.

FSOC's Future Implications

FSOC's full regulatory impact will continue to unfold based on the gaps it perceives in traditional regulators' mandates or through the evolution of the positions it takes on both domestic and foreign SIFI designations. FSOC's willingness to provide regulatory recommendations for MMFs and potentially for asset management firms indicate an attempt to increase its presence in any area of the financial industry where it perceives structural vulnerabilities would pose a material threat to the stability of the U.S. financial system. It is uncertain whether FSOC's actions will invite more extensive scrutiny in Congress or legal challenges in the court system.

S.E.C. v. Pentagon Capital Mgmt. PLC: Recent Late Trading Case and Its Implications For Securities Lawyers

By: Lauren Yonish & Stephen Lewis



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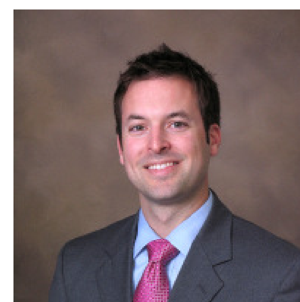

INTRODUCTION: Millions of dollars, fraud, disgorgement, deceit—this isn't the plotline for the newest John Grisham novel. It's a recent decision from the Second Circuit, *S.E.C. v. Pentagon Capital Management PLC*, wherein the Court of Appeals affirmed a district court's finding that Pentagon Capital Management and its CEO were liable for securities fraud in connection with a late trading scheme in the mutual fund market.[1] The decision serves both as a strong reprimand against late trading schemes and a reminder for both securities lawyers and investment managers of the expansive intent for securities law to curb deceptive and fraudulent trading practices. This is only one of several dozen cases that have been brought in connection with similar practices that are still being litigated ten years after being exposed.

Late trading involves placing orders after the time a mutual fund's net asset value (NAV) is calculated, based on subsequently released information. A mutual fund is generally priced by using the closing prices of the portfolio securities on the exchange where the securities are principally traded. Under the "forward pricing" rule, any trading after the market closes should be based on the mutual fund's next calculated NAV. Late trading is an issue because it allows an investor to use information acquired after the markets close to take advantage of any disparity between the actual fair value and that day's closing price, essentially allowing the investor to buy at the now stale price.

BACKGROUND

In this Securities and Exchange Commission (SEC) enforcement action, the primary defendants, Pentagon Capital Management

1 S.E.C. v. Pentagon Capital Mgmt. PLC, 725 F.3d 279 (2d Cir. 2013).

(Pentagon) and its CEO, Lewis Chester (Chester), architected a collaborative late trading scheme in the mutual fund market that was executed by their brokers. Pentagon and Chester sought out brokers who were willing to engage in late trading practices and who had access to a trade clearing system that would accommodate late trading. Under Chester's direction, a Pentagon employee would email to the brokers, at or near the close of the markets, target figures for potential trades that Pentagon was interested in executing. The brokers would create potential trade sheets and time-stamp them as if they had been placed before the 4:00 PM trade deadline, although the actual decision would not be made until after the trading window had closed. Once the markets closed for the day, a Pentagon employee would email additional instructions to the brokers as to whether the late trades should actually be executed. The brokers would timestamp the trades as being before 4:00 PM and send the orders to the clearing broker who would rely on this timestamp. Between February 15, 2001 and September 3, 2003, Pentagon realized profits of approximately $38,416,500 from this mutual fund late trading scheme.

To overcome a mutual fund's self-regulating policies, Pentagon opened 67 separate accounts with their brokerage firm, each of which could be traded without a mutual fund knowing they were related. If a mutual fund blocked an account for late trading or excessive short term trading activities, the other accounts could remain active. In fact, Pentagon was aware that some of its accounts had been expelled by certain funds, but it continued to trade in those funds using its other accounts.

In an effort to conceal the late trading and excessive short term trading practices, Chester sent to their brokers an email instructing them to use the phrase "dynamic asset allocation" to describe the trading scheme, and never to use the words "market timing" (a term associated with late trading) on any correspondence. Additionally, Chester misrepresented their trading practices in a letter to a client stating that Pentagon had not engaged in late trading or any other illegal activity, and that its trading arrangements were all in compliance with the relevant rules and regulations for such investments.

COURT'S ANALYSIS

The Pentagon case resulted in two notable conclusions: (1) an investment advisor may be liable for securities fraud violations under Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10(b)(5) without actually communicating late trade directions to the clearing broker if the advisor retained ultimate control over both the content of the communication and the decision to late trade, and (2) the Securities Act does not allow a court to impose joint and several liability for civil penalties relating to securities violations. In addition, the Court of Appeals confirmed the Supreme Court's recent decision in *Gabelli v. S.E.C.*, __ U.S. __, 133, S.Ct. 1216 (2013), that the "discovery rule" does not apply to toll the five-year statute of limitations for fraud cases in SEC enforcement actions.

Section 17(a) of the Securities Act makes it unlawful for someone, in the offer or sale of securities, to defraud purchasers, or to obtain money or property by any untrue statement or omission of a material fact. This ensures a level of safety against fraud or deceit to the purchaser.[2] Section 10(b) of the Exchange Act makes it unlawful to engage in any manipulative or deceptive behavior in the purchase or sale of a registered security, which is not in compliance with securities rules and regulations. Rule 10b-5 makes it unlawful to engage in any act which operates as a fraud or deceit upon any person.[3] To show a violation of Section 10(b) and Rule 10b-5, a defendant must have "(1)

2 Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2012).

3 Rule 10b-5, 17 C.F.R. § 240.10b–5 (2013).

made a material misrepresentation or a material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with the purchase or sale of securities."[4] These same factors also apply to a violation of Section 17(a), except that 17(a) applies only to a sale of securities and no finding of scienter is required under Section 17(a)(2) or (a)(3).

Pentagon and Chester sought to avoid liability for securities fraud by arguing that there was no fraud or deceit in their actions and, further, that as an investment advisor they did not communicate (and were not responsible for communicating) any late trade directions to the clearing broker. They premised this argument based on the fact that they did not directly communicate with the funds, but simply submitted their instructions to their brokers, who then sent the trades to the clearing broker.

The court rejected the first argument, explaining that deceitful intent is inherent in late trading, and late trading violates all three subsections of Rule 10b-5 and Section 17(a), because it violates Rule 22c-1 (the forward-pricing rule covered under the Investment Company Act, 17 C.F.R. § 270.22c–1(b)(1)). The defendants' deceitful behavior was also evident in (i) their actions to seek out brokers who would engage in late trading, (ii) their knowledge that trade sheets were time stamped before 4 p.m., even though they had no intention of trading before that time, and (iii) issuing to an investor a false and deceitful letter of assurance that they did not engage in late trading.

The court rejected the defendants' second argument, that they shouldn't be held liable since they didn't directly communicate the orders to the funds, because Pentagon's role as an investment advisor does not shield them from liability under the securities laws—especially where, as in this case, the facts make clear that Pentagon and Chester were the "architects" of the late trading scheme and retained ultimate control over both the content of the communication and the decision to execute the late trades.[5]

Notwithstanding the Second Circuit's affirmation of the liability finding, the Court of Appeals did vacate and remand the lower court's civil penalty award for two reasons – it should not have been imposed with joint and several liability, and should not have included profits that were earned by the defendants through fraudulent activities outside the applicable statute of limitations. With respect to the order of joint and several liability, the Second Circuit explained that the Securities Act only authorizes a civil penalty to be assessed based on the gross amount of pecuniary gain to such defendant—the relevant provision does not allow for the penalty to be imposed jointly and severally.[6] With respect to the amount of the award, the Second Circuit instructed the lower court to ensure that any profit earned through late trading earlier than five years before the action was instituted was not included in the penalty. Since the civil penalty was imposed in connection with the defendants' fraudulent and deceptive acts, the Supreme Court's holding in *Gabelli*—that the discovery rule, which allows the statute of limitations to toll until the cause of action is discovered, does not apply to fraud cases in SEC enforcement actions—was binding on the award.[7] Accordingly, the five-year statute of limitations for the defendant's fraudulent and deceptive securities violations commenced when the fraud occurred, not when it was discovered. Any profits Pentagon may have earned through its late trading scheme more than five years before the SEC brought suit cannot be included as part of the civil penalty award.

4 S.E.C. v. Pentagon Capital Mgmt. PLC, 725 F.3d 279, 285 (2d Cir. 2013) (quoting SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir.1999)).

5 Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302, 180 L. Ed. 2d 166 (2011).

6 15 U.S.C. § 77t(d); 15 U.S.C. § 78u(d)(3).

7 Gabelli v. S.E.C., 133 S. Ct. 1216, 1222, 185 L. Ed. 2d 297 (2013).

Unlike the civil penalty, the Second Circuit did affirm the district court's disgorgement award of $38,416,500, saying it reflected the reasonable approximation of profits made by the late trading of Defendants, and also affirmed the district court's imposition of joint and several liability, citing the collaboration of the late trading by Defendants.

FOR SECURITIES LAWYERS

Securities laws are complex and broadly drafted and, in some cases, it can be difficult to predict how the SEC and courts will interpret the various statutes, rules and regulations. Decisions such as the *Pentagon* case and the *Gabelli* case provide additional insight and knowledge of how the securities laws will be construed in an enforcement action, which in turn will aid lawyers in better advising their clients. This is especially important in view of the responsibilities the SEC imposes on securities lawyers as "gatekeepers" who, among other things, owe the public a duty to report known securities violations.[8] For a securities lawyer, the most significant take away from the Pentagon case is the broad scope of application interpreted by the Second Circuit in relation to deceptive and fraudulent acts under the securities laws. This decision is a clear statement from the court that deceptive or fraudulent activities in connection with the purchase or sale of securities can extend beyond the traditional broker role to any participant in the chain who is shown to be in control of designing and executing a fraudulent or deceptive scheme.

8 Lisa H. Nicholson, A Hobson's Choice for Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper, 16 GEO. J. LEGAL ETHICS 91 (2002).

The JOBS Act Implementation: An Essential Guide

By: George Boone & Kenneth Farmer

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Adoption of the JOBS Act

The final Securities and Exchange Commission ("SEC") regulatory amendments required by the Jumpstart Our Business Startups ("JOBS") Act of 2012 (the "JOBS Act") are in the final stages of review. The JOBS Act provides greater access to capital for small businesses and startups. The final SEC regulations required to implement the JOBS Act, not yet listed as "final rules," concern Crowdfunding[1] and Regulation A.[2] There are significant organizational structure, capital and tax implications for businesses and equity holders in the practical application of each of the five means of raising capital affected by the JOBS Act.

This article is a brief overview of all major changes implemented by the JOBS Act. The article discusses the most significant aspects of the JOBS Act and the status of SEC rulemaking under the Act.

1 Title III of the JOBS Act. See SEC File No. S7-09-13.
2 Title IV of the JOBS Act. See SEC File No. S7-11-13.

The significant changes are:
1) General Solicitation under Regulation D and in Rule 144A transactions;

2) New dollar limitations in "Regulation A+" securities offerings;

3) Increases in shareholder triggers for registration under the Exchange Act;

4) CROWDFUND offerings;

5) "Emerging Growth Companies" exemptions and beneficial IPO elections.

Private Offerings

Prior to the required revisions under Section 201(a)(1) of the JOBS Act, companies seeking to raise capital could not engage in general solicitation or advertising in the sale of securities and qualify for a safe-harbor exemption from registration.

Pursuant to "old" Rule 506 of Regulation D ("Rule 506") engaging in general solicitation in the sale of unregistered securities would be subject to registration under the Securities Act of 1933, as amended (the "Securities Act"). Under "old" Rule 506, companies were permitted to raise unlimited capital from both an unlimited number of "accredited investors" and up to 35 non-accredited investors.[3] Since general solicitation and advertising were prohibited under the "old" rule, companies had to have a pre-existing relationship with potential investors in Regulation D offerings.

Title II of the JOBS Act required an amendment to Rule 506 and the adoption of Section 230.506(c)[4] of Title 17, Code of Federal Regulations ("C.F.R.") setting forth "new" provisions that allow issuers that qualify for the exemption granted in Section 4(a)(2)[5] of the Securities Act. Under the amended provisions, issuers of certain private securities offerings may now solicit purchasers through direct contact or publicly available media so long as they conform to certain requirements. Specifically, this means that offerings under the provisions of Rule 506(C) are no longer subject to the requirements of Rule 502(c)[6] allowing general solicitation or general advertising in these offerings. Issuances exempt under the revised rule remain classified as non-public offerings, but the revised rule requires that all purchasers be reasonably verified as "accredited investors"[7] when general solicitation or advertisement is used. Issuers may also use offering platforms to facilitate offerings utilizing general advertisement without registration[8] as a "broker" or "dealer."

To qualify for 506(c) exemption, issuers must:

- satisfy the terms and conditions of Rules 501[9], 502(a), 502(b), 502(c) and 502(d)[10];

- ensure that sales are made exclusively to accredited investors;

- take "reasonable steps to verify" securities purchasers qualify as accredited investors[11]; and

- file Form D with the Commission and elect Rule 506(c).

Thus, offerings restrictions are now subject only to anti-fraud rules, though the verification requirements for accredited investors have been marginally heightened under the new provisions. The Commision has also clearly stated that the "old" rule is preserved under §230.506(b), which still permits issuers to abstain from general solicitation and advertising and raise capital from up to 35 non-accredited investors in a Regulation D offering. Though the SEC Release has been finalized, the Commission has enacted a proposal to make

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3 Sales to non-accredited purchasers, subject to verification under the "sophistication criterion" of Rule 506(b)(2)(ii), are disallowed under the "new" Rule 506 exemption.

4 See SEC File No. S7-07-12 § II(A).

5 This allows issuers to circumvent the registration requirements of Section 5 of the Securities Act.

6 17 C.F.R. § 230.502(c) imposes limitations on the manner of offering within the general requirements of Regulation D securities offerings or sales by specifically prohibiting any form of general solicitation.

7 Accredited investors are: a) a natural person with $200,000 earned income ($300k if married) for prior two years and equivalent income expectancy in current year; b) a natural person with net worth exceeding $1M individually or with spouse (excluding value of primary residence); or, c) any entity qualifying under Rule 501(a).

8 To operate without registration, platforms must not: 1) receive any compensation; 2) possess customer funds or securities; or, 3) be subject to statutory disqualification.

9 17 C.F.R. § 230.501(a) defines accredited investor. See footnote 6.

10 Sales to non-accredited investors, allowed under 17 C.F.R. § 230.506(b), have not been altered and must comply with all requirements of Rule 502, including information requirements listed in 17 C.F.R. § 230.502(b) and prohibit general solicitation under 17 C.F.R. § 230.502(c). The stricken sections are added for emphasis to demonstrate the change in requirements under the new paragraph 17 C.F.R. § 230.506(c).

11 17 C.F.R. § 230.506(c)(2)(ii) and the accompanying instructions provide methods deemed acceptable for verification and when the issuer will be deemed to have satisfied the requirement.

additional revisions to Regulation D to address investor advocate concerns.

The JOBS Act revisions also removed the restrictions imposed on offering the private resale of unregistered securities by certain institutional equity holders relying on the exemption of Rule 144A. General solicitation was prohibited prior to the rule change, which limited the means of advertising the offering, thereby limiting the pool of investors to which companies QIBs could "offer" their securities.[12] Under the revised rule, institutional investors may now engage in general solicitation or general advertising in offerings under this nonexclusive, "safe harbor" provision without being subject to the registration requirements of Section 5 of the Securities Exchange Act of 1934 (the "Exchange Act").

Thus, private resale of securities under Rule 144A now allows the solicitation of any potential investor so long as the purchasers of such offerings are limited to qualified institutional buyers (QIBs)[13]. The resale of non-public securities under Rule 144A permits liquidity among reasonably verified[14] QIBs and allows immediate trading among those entities.

Regulation A+

Regulation A offerings are available to companies organized and having their principal place of business in the U.S. or Canada that are not subject to reporting requirements under the Exchange Act.[15] Securities issued under these offerings are unrestricted[16] and sales by issuers are not limited to affiliated or non-affiliated investors. Thus, issuers may reach non-accredited investors through these issuances. All offerings under Regulation A must be fixed-price offerings and all investors are limited to contributions allowable under Rule 501.These issuances are not restricted securities and may be sold to any classification of investor. However, the restrictions are limited to equity securities, debt securities, and debt securities convertible into or exchangeable for equity interests, including any guarantees of such securities. Issuers are also required to submit a registration statement and annual audited financial statements.[17]

Title IV of the JOBS Act amends the provision of Section 3(b) of the Securities Act to allow offerings under Regulation A to exceed the previous $5M limit. The current proposed SEC rule"Regulation A+" offering limits include a new tier of security offerings allowing $5M of "Tier 1" offerings and $50M of "Tier 2" offerings.[18] The total offering amount is limited to $50M in any 12-month period. The proposed SEC Rule also offers limited preemption of "blue sky" laws for "Tier 2" issuers to enhance Regulation A offerings.[19] Tier 2 offerings completely preempt state law, but Tier 1 Solicitation

12 17 C.F.R. § 230.144A(d)(1) imposed the pre-revision requirement that disallowed offers of these private placement transactions to solicit any non-QIB investor.

13 17 C.F.R. §230.144A(a)(1) defines QIBs as entities specified in subsection (a)(1)(i) owning and investing, for its own account or accounts of another QIB, greater than $100M in non- affiliated securities on a discretionary basis, in the aggregate and net of certain holdings. Specified financial institutions must also have a net worth of $25M to qualify as a QIB. Registered broker-dealers must own and invest $10M in non-affiliated securities on a discretionary basis.

14 17 C.F.R. § 230.144A(d)(1)(i) through (iv) and the accompanying instructions provide nonexclusive methods deemed acceptable for verification and when the issuer will be deemed to have satisfied the requirement.

15 Nothing precludes reorganized companies previously, but not presently, subject to these requirements from qualifying as issuers.

16 "Unrestricted" means these securities are not subject to Rule 144, allowing a market maker to file a 15c2-11 application to establish secondary trading.

17 Offering Statements filed using modified Form 1-A may be filed on a confidential basis with the SEC and withdrawn prior to issuance.

18 The regulation is not final, but the comment period is closed.

19 GAO report GAO-12-839 indicates that "blue sky" compliance was one of the cost-effectiveness factors that stakeholders and attorneys interviewed indicated likely to deter issuers despite the increased offering limits. The study relied upon interviews with issuers, investors, and attorneys, but failed to provide significant data to support its conclusion. Furthermore, there was speculation that these factors may not be substantially effective.

of Interest or "Testing the Waters" offerings are subject to federal and state review and qualification.

Regulation A+, as proposed by the SEC, requires limitation on investor contributions in Tier 2 offerings of 10% of the greater of annual income or net worth.[20] However, there is no indication that this limitation was derived from the legislative authority provided by the JOBS Act and may be subject to challenge. The regulatory release also requires sales to the accounts of security holders are limited to 30% of total offering for both tiers.

Regulation A+ also requires "enhanced disclosures" for filings under both tiers. However, these requirements are less extensive and, therefore, less costly to issuers than previous requirements. Under the proposed regulation, Tier 1 issuers are only required to submit annual GAAP filings.[21] Tier 2 offerings require audited financial statements prepared by in accordance with PCAOB standards by an auditor complying with SEC Independence Rules.[22] The proposed regulation also creates several major conformance issues under current accounting standards.[23]

There is a puroported reduction in the total fixed cost of Regulation A+ offerings allocable to eliminating compliance costs associated with blue sky laws for most offerings.[24] Fixed costs are further reduced through relaxed reporting requirements. Also, there is an increase in cost effectiveness on capital raise in issuances exceeding the previous $5M limit. However, issuers will not benefit from the ability to raise larger sums of capital based on the eligibility of a broad equity holder base due to the proposed limitation on investor contributions.

Registration Exemption [25]

The trigger for registration under Section 12(g)[26] of the Exchange Act was previously 500 total investors of record for companies with greater than $10M in total assets. The JOBS Act increased this limitation to 2,000 accredited investors and 500 non-accredited investors.[27] These thresholds are

20 The proposed regulation permits issuer reliance on investor representations concerning their individual compliance unless misrepresentations were known by the issuer to be false prior to completion of the sale.

21 However, if a company making an offering in accordance with this tier will be required to produce audited financials with their offering circular only if they were previously audited for any other purpose. Even if audited statements were required, they may choose between conforming to AICPA or PCAOB standards.

22 The specific provisions of the proposed regulation may create an investor expectation of audit performed by PCAOB preparer, subject to PCAOB inspection and oversight. However, auditors under Reg A+ standards are not required to be PCAOB registered preparer or subject to PCAOB inspection. The result is that this conformance may be costly to Tier 2 issuers previously subject to AICPA standards and misleading to investors. Another expectation gap may exist for Tier 2 unaudited interim financial statements (Form 1-SA), which are not reviewed by an independent accountant (as required for Form 10-Q) and lacks disclosure. Commenters have recommended that both tiers conform to AICPA standards. See Deloitte & Touche, LLP comment https://www.sec.gov/comments/s7-11-13/s71113-74.pdf.

23 Issues that may increase costs: 1) Companies electing Reg A+ are not "issuers" as defined by PCAOB, meaning current AICPA standards require AICPA and PCAOB compliance; 2) production of new audited reports conforming with SEC Independence Standards, when reports exist conforming to AICPA standards; 3) possible restatement of historical financial statements for non-public companies & those IFRS reporters now classified as public business entities (PBEs) per FASB. One commenter recommends making requirements prospective from an effective date (effectively extending conformance consideration given EGCs to these filers). See KPMG, LLP comment https://www.sec.gov/comments/s7-11-13/s71113-64.pdf.

24 Although no data in the GAO study indicates that state review was significantly burdensome compared to the federal registration and review requirements.

25 Only non-bank and non-bank holding company provisions are referenced in this article. Note: the additional amendment of 15(d) of the Exchange Act raises bank registration trigger to 2,000 total shareholders of record and raises de-registration threshold from 300 shareholders to 1,200.

26 § 12(g) of the Exchange Act is a registration trigger provision that applies to companies with securities sold or traded through any means of instrumentality.

27 These limitations are mutually exclusive. Exceeding the maximum of either classification of investor and asset limit

applicable only to companies that have greater than $10M in total assets. However, these investor limits exclude those who are compensated under employee benefit plans or exempt securities. The limit also excludes investors purchasing securities under the new CROWDFUND exemption. There is a de-registration threshold requirement for companies with 300 investors of record or less.

CROWDFUND-ing

Title III of the JOBS Act, titled Capital Raising Online While Deterring Fraud and Unethical Non–Disclosure ("CROWDFUND") Act of 2012 lifts the legal obstacles and permits issuers to raise capital through qualifying crowdfunding transactions. Under Section §4(6) of the Securities Act, an issuer may now raise up to $1 million over a 12-month period from investors that do not meet the SEC's standards of an accredited investor. It should be noted, that offerings which meet the requirements of the crowdfunding exemption are exempt from state blue sky laws, which are intended to reduce the regulatory burden in these transactions. Prior to this legislation, "funding portals" (a.k.a. websites) were not allowed to transfer security interests in startups.[28] The CROWDFUND Act allows issuers to solicit investors through intermediaries and these investors are excluded from the number of investors counted toward the Exchange Act registration trigger under Section 12(g).[29]

Companies will be subject to certain reporting requirements based on their capital requirements. All issuers must disclose basic information about the company. They must also include certain financial disclosures. An issuer seeking $100,000 or less in a 12-month period must also provide the prior year income tax filings and the financial statements of the issuer that have been verified by the principal executive officer.[30] Issuers seeking more than $100,000, but less than $500,000 in capital must have their financial statements verified by a CPA. Any issuer seeking more than $500,000 in capital must have all statements audited. All issuers must disclose the deadline for funding and the target amount with regular updates of collections.

Issuers must include the capital structure of the company, including the terms and class of security being provided. The issuer must also include a listed price to the public for the security or a method of calculating price. Issuers must also report annually by filing with the Commission.

Potential purchasers are subject to limitations in their investment contribution.[31] The gross amount an issuer can sell to an investor in any 12-month period is limited to the greater of $2,000 or 5% of the investor's annual income or net worth, or 10%, not to exceed $100,000 of the annual income or net worth of an investor.[32] The threshold for investors to be allowed to contribute the 10% or $100,000 limitation is having greater than $100,000 of either annual income or net worth.[33] The calculation of income and net worth are

on the last day of the fiscal year triggers registration requirement within 120 days.

28 Kickstarter and its progeny merely transferred a product or "pre-order" interest to potential customers in a form of unrealized revenue transfer, not an equity interest to potential investors. These were never "funding portals" as first introduced in the JOBS Act.

29 A person acting as an intermediary in transactions involving the offer or sale of securities for the account of others must be registered as either brokers or funding portals. However, funding portals are subject to certain limitations as to the nature of ancillary services provided, conduct and compensation basis not otherwise applicable to brokers.

30 The statements must be verified as true and complete in all material aspects.

31 It is clear that these limitations constrain investment contributions by the individual, but remains unclear as to investor holdings of other instruments comprised of these security interests.

32 See 15 U.S.C.A. §77d(6).

33 The Commision's position is that the proper interpretation allows investors with annual income or net worth in excess of $100,000 to advance to the higher limitation. Only those with both annual income and net worth less than

subject to the Commission's rules for determining investor status in accordance with Securities Act Rule 501(a).[34]

There are provisions for the registration of intermediaries to facilitate secondary market transactions as "exchanges."[35] This would allow liquidity of these securities among individual investors. However, "funding portals" are precluded from facilitating these transactions.[36] Broker-dealers and independent exchange organizations may facilitate these transactions. [37]

Capital limitations and reporting requirements have been driven by fraud concerns, thus, these offerings may not be ideal for all private issuers. In fact, it appears the benefits of this medium may be more readily available to larger issuers wishing to expand their investor base without triggering the reporting exemption limits under the amended Rule 12(g) rather than the small companies for which the benefit was intended.

$100,000 would be subject to the lower interpretation. This distinction was made in response to several comments.

34 This would require the exclusion of the value of a primary residence in net worth calculation and, if income were expected to be lower in the current year, net income to be the lower of the two prior years' income or spouses joint income equal 1.5 their combined individual requirments (i.e. if expected income < $100K, then individual income ≥ $200K total over two prior years or married couple's joint income ≥ $300k over two prior years).

35 These intermediaries would be required to register as an exchange or as an alternative trading system if it engaged in the facilitation of secondary market activity of crowdfund securities and met the criterion of Exchange Act Rule 3b-16.

36 The Commission notes that funding portals are limited to acting as an intermediary is limited to primary issuance offer or sale transactions under Section 4(a)(6) of the JOBS Act, precluding them from effecting secondary market transactions. This preclusion does not apply to brokers.

37 The Commission notes that exchange registration is only necessary for engagement in secondary transactions, not merely transactions conducted in reliance of Section 4(a)(6) of the JOBS Act.

Emerging Growth Companies (EGCs)

Title I of the JOBS Act creates a new classification of issuer that may elect to receive beneficial treatment in the filing of an IPO and during the initial years of operation subsequent to the IPO.[38] The provisions of this title became effective upon passage on April 5, 2012. These so-called "IPO On-Ramp" provisions are applicable to companies qualifying as EGCs. EGCs are companies with less that $1B in total gross revenue during the prior fiscal year that have not been disqualified by:

- receiving greater than $1B in annual total gross revenue;

- being a public company for 5 years or greater;

- being classified as a "large accredited filer";[39]

- issuing greater than $1B in non-convertible debt in the prior three-year period.

The "on-ramp" benefits are available to qualifying EGCs until disqualified. EGCs are disqualified at the earliest occurrence of any of the disqualification conditions.

Benefits qualifying EGCs may elect include:

- new confidential filing procedures for preliminary drafts of offering documents;

- engaging in "testing the waters" communication with institutional investors;[40]

- 2 years of audited financial statements accompanying statement and reports;[41]

38 Public companies taken private may be eligible to participate in EGC offerings.

39 A "large accredited filer" is an issuer with $750M or greater in public float.

40 These communications or "road shows" are to gauge interest among QIBs and institutional accredited investors.

41 EGCs may present 2 years of audited financial state-

• scaled financial disclosure in 2 years following IPO[42]

• relaxation of reporting requirements and disclosures under the Sarbanes-Oxley Act (SOX) and the Dodd-Frank Act.[43]

Companies now classified as EGCs comprise the majority of IPOs and legislators have enacted these provisions to encourage economic growth by facilitating their public offerings. Data indicates that most EGCs have taken advantage of at least one benefit allowed by the JOBS Act. However, due to beneficial tax structure, regulatory restrictions, and the cost incurred per dollar of capital generated in public offerings, the increase of private offering options may eventually have an inverse effect on IPOs.

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ments in their registration statement and periodic reports, instead of the 3 years required by other filers.

42 This includes the 2 years of audited financial statements as well as required selected financial data. EGCs may submit as few as 2 of the 5 years of selected financial data. Submission requirements accelerate following IPO.

43 EGCs are not required to comply with: 1) auditor attestation of internal controls under SOX § 404(b); 2) certain executive compensation disclosures under Dodd-Frank; 3) PCAOB mandated auditor rotation and supplemental reports; and, 4) any new GAAP pronouncements not applicable to private companies.

ANNOUNCEMENTS

Vol. 1, No. 3| April 2014

First Annual Ole Miss Business Law Conference
Left to Right: Cory Ferraez, Mercer Bullard, Lt. Governor Tate Reeves, John McCullouch, Nader Jarun

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