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Getting Your Message Across: Best Practices for Private Companies

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Agenda

- During today's session, we will discuss the issues that many private companies now face in communicating with multiple constituencies, including:
  - Disparities in disclosure requirements for exempt offerings;
  - Information required to be furnished under Rule 701;
  - Information required to be furnished to facilitate resales of restricted securities;
  - Information provided to investors pursuant to information rights;
  - Information issues arising in connection with late stage financings and liquidity programs;
  - Insider trading and Regulation FD policies; and
  - Social media and other communications considerations.

COMPANIES STAYING PRIVATE LONGER, UNICORNS

Companies Deferring IPOs

- Various SEC representatives have commented on changes in the IPO market:
  - During the 1990s, between 30 percent and 50 percent of worldwide IPOs occurred in the United States
  - However, since 2000, the average annual number of IPOs is 135 – less than one-third the average annual number of IPOs – 457 – in the 1990s
  - The fraction of worldwide IPOs occurring on U.S. markets fell below 10 percent between 2007 and 2011
  - In the 1980s and 1990s, IPOs with proceeds of less than $30 million constituted approximately 60 percent and 30 percent, respectively, of all IPOs; IPOs with proceeds less than $30 million accounted for only 10 percent of all IPOs in the period of 2000-2015
  - By comparison, large IPOs have increased from 13 percent in the 1990s to approximately 45 percent of all IPOs since then

Larger Privately Held Companies

- There are now at least 256 private companies valued by venture capital firms at $1 billion or more. (CB Insights)
  - These companies, often referred to as "unicorns," have a median valuation after their most recent investment of $3 billion. (CB Insights)
  - Uber has been able to raise significant amounts (reportedly $5 billion) in private financings, giving it a value of close to $68 billion.
- Venture-backed companies raised more than $82.9 billion in the private markets in 2017, and $57.5 billion in the first half of 2018, according to the National Venture Capital Association (NVCA) and PitchBook.

DISCLOSURE REQUIREMENTS AND EXEMPT OFFERINGS

Disclosure Requirements and Exempt Offerings

- Rule 506 specifies disclosure requirements to the extent securities are offered to non-accredited investors
- For offerings made to non-accredited investors pursuant to Rule 506(b) an issuer is required to prepare the following:
  - *Financial statements*. For offerings up to $2,000,000, the issuer is required to provide the financial statements required by Article 8 of Regulation S-X under the Securities Act (except that only the issuer's balance sheet, which must be dated within 120 days of the start of the offering, is required to be audited); and for offerings between $5,000,000 and $5,000,000, the issuer is required to provide the audited financial statements required on a Form S-1 registration statement for smaller reporting companies (unless such financial statements cannot be obtained without unreasonable effort or expense, in which case only the issuer's balance sheet, which must be dated within 120 days of the start of the offering, is required to be audited).
  - *Non-financial statement information*. The issuer is required to provide "the same kind of information" as would be required in Part II of Form 1-A, if the issuer is eligible to use Regulation A, or Part I of a Form S-1 registration statement, if the issuer is not eligible to use Regulation A.

Disclosure Requirements and Exempt Offerings *(cont'd)*

  - *Business combinations and exchange offers*. If securities are issued in a business combination or exchange offer (i.e., issued in an M&A transaction), the issuer must provide the information required in a Form S-4 registration statement.
- Offerings made pursuant to Rule 504 (up to $5 million) are not subject to specific disclosure requirements to the extent that the offering does not involve general solicitation. By contrast, for offerings involving general solicitation and registered with a state, the state may require disclosure using the SCOR form and if more than $1 million is sought to be raised, audited financial statements.
- Non-reporting companies also may rely on Regulation A or Regulation CF for offerings to non-accredited investors.
- Each of these exemptions has specific disclosure requirements.

Disclosure Requirements and Exempt Offerings *(cont'd)*

- In a Regulation A offering, there are specified disclosure requirements as follows:
  - Offering disclosure requirements: An issuer must prepare and file with the SEC and have qualified an offering statement on Form 1-A.
  - Part I (Notification) requires certain basic information regarding the issuer, its eligibility, the offering details, the jurisdictions where the securities will be offered, and sales of unregistered securities.
  - Part II (Offering Circular)
    - Part II contains the narrative portion of the Offering Circular and requires disclosures of basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A-type discussion; disclosures about executive officers and directors and compensation; beneficial ownership information; related-party transactions; and a description of the offered securities.
    - This is similar to Part I of Form S-1 and an issuer can choose to comply with Part I of Form S-1 in connection with its Offering Circular.
      - An issuer that chooses to list its securities concurrent with the completion of a Regulation A offering will be required to use Part I of Form S-1 in connection with the Offering Circular
      - Other Tier 2 issuers also are likely to use Part I of Form S-1 as well

Disclosure Requirements and Exempt Offerings *(cont'd)*

- Financial statement requirements: differ for Tier 1 and Tier 2 offerings:
  - Tier 1 and Tier 2 issuers must file balance sheets and other required financial statements as of the two most recently completed fiscal year ends, or for such shorter time as they have been in existence, subject to certain exceptions.
  - The financial statements for an issuer in a Tier 2 offering are required to be audited by an independent auditor that need not be PCAOB-registered, except as noted below.
  - An issuer in a Tier 2 offering that seeks to have a class of securities listed on a national securities exchange concurrent with the Regulation A offering must include financial statements audited in accordance with PCAOB standards by a PCAOB-registered firm.
- Reporting following the offering: Tier 1 issuers would have no ongoing reporting obligation, other than to file an exit report on Form 1-Z within 30 days after the termination or completion of a Regulation A-exempt offering. Tier 2 issuers will be subject to ongoing reporting. Tier 2 issuers would be required to file:

Disclosure Requirements and Exempt Offerings *(cont'd)*

  - Annual reports on Form 1-K (120 calendar days after the issuer's fiscal year end);
  - Semi-annual reports on Form 1-SA (90 calendar days after the end of the first six months of the issuer's fiscal year);
  - Current reports on Form 1-U;
  - Special financial reports on Form 1-K and Form 1-SA; and
  - Exit reports on Form 1-Z.
- For an offering made pursuant to Regulation CF, there also are specific requirements as follows:
- Offering disclosure requirements: an issuer that elects to engage in a crowdfunded offering will be required to prepare initial disclosure about the issuer and the offering on Form C
- Form C requirements resemble the Form 1-A requirements for a Regulation A offering and include a discussion of:

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Disclosure Requirements and Exempt Offerings *(cont'd)*

Use of Proceeds	Indebtedness
The targeted offering size	Related party transactions
Offering price	Exempt offerings
Business	Risk factors
Directors and officers	Transfer restrictions
Beneficial ownership and capital structure	Management's discussion and analysis

- Financial Statement Requirements: In addition, a Form C must include certain financial statements prepared in accordance with U.S. GAAP. Audited financial statements must be conducted in accordance either with AICPA standards or PCAOB standards. Requirements depend on the target offering size as follows:

Disclosure Requirements and Exempt Offerings *(cont'd)*

- *$100,000 or less*: the amount of total income, taxable income and total tax or equivalent line items, as reported on the federal tax forms filed by the issuer for the most recently completed year (if any), certified by the principal executive officer of the issuer, and the financial statements of the issuer, also certified by the principal executive officer. If financial statements of the issuer are available that have either been reviewed or audited by a public accountant independent of the issuer, then these financial statements must be provided instead of the materials described in the preceding sentence.
- *More than $100,000 and less than $500,000*: financial statements of the issuer reviewed by a public accountant independent of the issuer. If financial statements of the issuer are available that have been audited by a public accountant independent of the issuer, the issuer must provide those instead of the reviewed statements.
- *More than $500,000*: financial statements of the issuer audited by a public accountant independent of the issuer; provided, however, that for issuers that are first-time issuers, offerings that have a target offering amount of more than $500,000 but not more than $1 million, financial statements of the issuer reviewed by a public accountant independent of the issuer. If audited statements are available, those must be provided instead.

Disclosure Requirements and Exempt Offerings *(cont'd)*

- An issuer that has relied on various different offering exemptions may want to consider what information it already has prepared and provided to certain of its investors
- Regardless of the lack of specific disclosure requirements for certain exempt offerings, it is important to keep in mind that private placements ***are*** subject to:
  - Section 17(a) (the antifraud provision) of the Securities Act,
  - Section 10(b) (the antifraud provision) and Section 20(a) (the "control person" provision) of the Exchange Act,
  - State securities laws ("Blue Sky" laws),
  - State common law of fraud and negligent misrepresentation, and
  - To the extent a broker-dealer is involved, FINRA suitability, advertising and supervisory rules.

RULE 701

Rule 701

- Exemption for compensatory issuances by private companies to directors, employees, consultants and advisors
- In any 12-month period, not more than greatest of:
  - $1 million
  - 15% of total assets
  - 15% of class
- Disclosure required:
  - Written plan or contract
  - Additional disclosure if > $10 million sold in any 12-month period
- No integration
- Restricted securities but may be resold 90 days after IPO by non-affiliates
- Recent legislation, referred to as the Crapo Act, required that the SEC amend Rule 701 in order to raise the threshold that triggers the enhanced disclosure requirement to $10 million (from $5 million).

Rule 701 *(cont'd)*

- The SEC approved the amendment to Rule 701 on July 18, 2018, which only addresses the threshold triggering the disclosure requirement as required by the Crapo Act.
- The required disclosures include:
  - A copy of the summary plan description required by the Employee Retirement Income Security Act of 1974 ("ERISA") or, if the plan is not subject to ERISA, a summary of the plan's material terms;
  - Risk factors associated with an investment in the securities under the plan or agreement; and
  - The financial statements required in an offering statement on Form 1-A under Regulation A.

Rule 701 Concerns

- These required disclosures must be provided before the sale, otherwise the issuer loses the exemption for the entire offering once the sales exceed the dollar threshold
  - How can issuers provide this information?
    - Some issuers have expressed concerns about the confidentiality of the required disclosures
    - The Staff has indicated that the information may be subject to confidentiality undertakings
    - The Staff issued guidance to this effect

Rule 701 Concerns *(cont'd)*

- C&DI 271.25 reads as follows:
  - ***Question:*** To protect against the unauthorized disclosure of Rule 701(e) information, may companies that are using electronic delivery to satisfy Rule 701(e) disclosure requirements implement safeguards with respect to electronic access to Rule 701(e) information?
  - ***Answer:*** We understand that some companies satisfying their Rule 701(e) delivery obligations electronically have concerns about the potential disclosure of sensitive company information. Standard electronic safeguards, such as user-specific login requirements and related measures, are permissible. The use of a particular electronic disclosure medium either alone or in combination with other safeguards, such as the use of dedicated physical disclosure rooms that house the medium used to convey the information required to be disclosed, should not be so burdensome that intended recipients cannot effectively access the required disclosures. For example, we would expect that physical disclosure rooms would be accessible during ordinary business hours upon reasonable notice. Once access to the required information has been granted, however, the medium used to communicate the required disclosure should provide the opportunity to retain the information or have ongoing access substantially equivalent to personal retention.

Rule 701 Concerns *(cont'd)*

- To the extent, Rule 701 is not available, what are the alternative exemptions that an issuer can consider?
- The SEC has become more focused on compliance with the disclosure requirements of Rule 701 as evidenced by a recent enforcement action. Issuers must have in place systems to track securities offered and the applicable exemption and compliance with the conditions for the stated exemption.
- The SEC recently issued a concept release on Rule 701. Among other things, the release solicits comments on the disclosure requirement. For example, among other questions, the SEC asks the following:
  - Should Rule 701(e) continue to require more disclosure for a period that precedes the threshold amount being exceeded?
  - If so, should the consequence for failure to deliver continue to be loss of the exemption?
  - To what extent are non-reporting companies that issue securities in an amount that would exceed the new threshold already preparing forms of financial disclosure, such as in connection with Regulation D or Regulation A?

Rule 701 Concerns *(cont'd)*

- Should the consequence for failing to provide the disclosure be loss of the exemption only for transactions in offerings that occur after the threshold is crossed and for which disclosure was not provided? Alternatively, should there instead be a grace period, such that if the threshold is crossed, the issuer has an opportunity to provide the required disclosure before losing the exemption for the entire offering?
- Should we provide a regulatory option whereby all Rule 701(e) information would be disclosed to all investors, so that all would receive equal information and there would be no risk of losing the exemption in the manner there is today? Should we provide a different regulatory alternative that would provide all investors all Rule 701(e) information other than the financial statement disclosure?
- Should we consider other alternatives to the Regulation A financial statements, such as the issuer's most recent balance sheet and income statement as of a date no more than 180 days before the sale of securities?
- Should we provide a regulatory option that would provide valuation information regarding the securities in lieu of, or in addition to, financial statements?

RESALES OF RESTRICTED SECURITIES

Resales of Restricted Securities

- The securities issued in reliance on a securities offering that is exempt from the Section 5 registration requirements under the Securities Act are "restricted securities"
- Restricted securities must be resold either pursuant to a registered offering or pursuant to a resale exemption. Generally, resales are effected pursuant to:
  - Section 4(a)(1-1/2)
  - Section 4(a)(7)
  - Rule 144
  - Rule 144A
- There are disparities in the disclosure required in order for the resale exemption to be available

The “4(a)($1^1/_2$) Exemption”

- The Section 4(a)($1^1/_2$) exemption has evolved in practice, without the benefit of any official rulemaking. It is a hybrid consisting of:
  - A Section 4(a)(1) exemption which exempts transactions by anyone other than an “issuer, underwriter or dealer,” and
  - A Section 4(a)(2) analysis to determine whether the seller is an “underwriter,” *i.e.*, whether the seller purchased the securities with a view to a distribution.
- In 1980, the SEC recognized the Section 4(a)($1^1/_2$) exemption, which although not specifically provided for in the Securities Act “[is] clearly within its intended purpose,” provided that the established criteria for sales under both Sections 4(a)(1) and 4(a)(2) are satisfied.
- The Section 4(a)($1^1/_2$) exemption can be used by institutional investors to resell restricted securities purchased in a private placement. The Section 4(a)($1^1/_2$) exemption can also be used by affiliates for the sale of control securities when Rule 144 is unavailable.
- There are no specific information requirements since it is based on, and is intended to replicate the conditions for, Section 4(a)(2).

Section 4(a)(7) Exemption

- The FAST Act codifies a specific resale exemption, Section 4(a)(7)
- The exemption provides certainty for transactions that meet the following requirements:
  - Each purchaser is an accredited investor;
  - Neither the seller nor any person acting on the seller's behalf engages in any form of general solicitation; and
  - In the case of an issuer that is not a reporting company, exempt from the reporting requirements pursuant to Rule 12g3-2(b) or a foreign government eligible to register securities on Schedule B, at the request of the seller, the seller and a prospective purchaser obtain from the issuer reasonably current information, including:
    - The issuer's exact name (as well as the name of any predecessor);
    - The address of the issuer's principal place of business;
    - The exact title and class of the offered security, its par or stated value and the current capitalization of the issuer;
    - Details for the transfer agent or other person responsible for stock transfers;

Section 4(a)(7) Exemption *(cont'd)*

- A statement of the nature of the issuer's business that will be presumed current if it is as of 12 months before the transaction date;
- The issuer's officers and directors;
- Information about any broker, dealer or other person being paid a commission or fee in connection with the sale of the securities;
- The issuer's most recent balance sheet and profit and loss statement and similar financial statement for the two preceding fiscal years during which the issuer has been in business, prepared in accordance with GAAP or, in the case of a foreign issuer, IFRS. The balance sheet will be deemed reasonably current if it is as of a date not less than 16 months before the transaction date and the profit and loss statement shall be deemed reasonably current if it is as of a date not less than 12 months preceding the date of the issuer's balance sheet. If the balance sheet is not as of a date less than six months before the transaction date, it must be accompanied by additional statements of profit and loss for the period from the dates of such balance sheet to a date less than six months before the transaction date; and
- If the seller is an affiliate, a statement regarding the nature of the affiliation accompanied by a certification from the seller that it has no reasonable grounds to believe that the issuer is in violation of the securities laws or regulations.

Rule 144 and Rule 144A

Rule 144

- In addition to satisfying the required holding period, and any other applicable requirements in connection with sales made in reliance on Rule 144, in order for a holder to be able to resell there must be "adequate current public information with respect to the issuer"
- For a non-reporting issuer, the information specified in Rule 15c2-11 must be available and must be reasonably current in relation to the proposed sale:
  - Exact name of the issuer and any predecessor;
  - Address of its principal executive offices;
  - The state of incorporation, if it is a corporation;
  - The exact title and class of the security;
  - The par or stated value of the security;
  - The number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year;
  - The name and address of the transfer agent;

Rule 144 and Rule 144A *(cont'd)*

- The nature of the issuer's business;
- The nature of products or services offered;
- The nature and extent of the issuer's facilities;
- The name of the CEO and members of the board of directors;
- The issuer's most recent balance sheet and profit and loss and retained earnings statements;
- Similar financial information for such part of the two preceding fiscal years as the issuer or its predecessor has been in existence; and
- Whether the broker or dealer or any associated person is affiliated, directly or indirectly with the issuer, and whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10% of the outstanding equity securities of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

• The "current information" requirement for a non-reporting issuer under Rule 144 is quite similar to the information required for compliance with Section 4(a)(7)

Rule 144 and Rule 144A *(cont'd)*

Rule 144A

- In order to be eligible for resales to qualified institutional buyers under Rule 144A, an issuer also must satisfy certain information requirements
- For a non-reporting issuer that also is not a foreign issuer exempt from reporting under Exchange Act Rule 12g3-2(b), the holder and a prospective purchaser designated by the holder have the right to obtain from the issuer the following information (which shall be reasonably current in relation to the date of resale under Rule 144A):
  - A very brief statement of the business of the issuer and the products and services it offers; and
  - The issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar familiar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available).

Rule 144 and Rule 144A *(cont'd)*

- The requirement that the information be *reasonably current* will be presumed to be satisfied if:
  - The balance sheet is as of a date less than 16 months before the date of resale, the statements of profit and loss and retained earnings are for the 12 months preceding the date of such balance sheet, and if such balance sheet is not as of a date less than 6 months before the date of resale, it shall be accompanied by additional statements of profit and loss and retained earnings for the period from the date of such balance sheet to a date less than 6 months before the date of resale; and
  - The statement of the nature of the issuer's business and its products and services offered is as of a date within 12 months prior to the date of resale

Transfer and Trading Restrictions

- Contractual transfer and trading restrictions
  - In addition to the customary rights of first refusal and co-sale rights that companies often negotiate with venture and private equity investors, private companies may want to impose additional transfer restrictions or conditions
  - For example, a private company may choose to impose:
    - Ownership or transfer restrictions to address regulatory concerns;
    - Ownership or transfer restrictions that are intended to prevent certain holders from acquiring a control stake (like a standstill provision);
    - Provisions that limit transfers to competitors;
    - Provisions that limit transfers to the occurrence of specific events, such as disability, retirement, death, etc.; and
    - Provisions that limit transfers of more than a specified percentage of voting stock
- Private companies also may want redemption rights in certain instances

INFORMATION RIGHTS

Information Rights

- Investor rights
  - Investors, even those that do not have a board seat or an observer right, may have contractual rights to receive certain information from the company
  - Private companies must keep a close eye on the types of management and information rights that they negotiate with investors
  - As a result of complying with its contractual obligations, a company may find itself sharing different types of information with different constituencies and this may lead to concerns regarding information asymmetries as well as timeliness of information
- A venture fund may negotiate management rights, which may include the following:
  - The right to receive quarterly financial statements;
  - The right to receive annual audited financial statements;
  - The right to receive any periodic reports required by securities laws;
  - The right to receive documents, reports, financial data, and other information as reasonably requested;

Information Rights *(cont'd)*

  - The right to visit and inspect the company's properties, including books and records;
  - The right to discuss company's affairs, finances, and accounts with the officers; and
  - The right to consult with and advise management on all matters relating to the company's operation.
- If the investor does not have board rights, it may negotiate for the right to receive material the company provides to directors
- Cross-over and other institutional investors also will insist on information rights
- The types of information may vary, and may include quarterly and annual financial statements, access to budgets, certain monthly financial information, etc.
- While it may be possible to limit the information rights to major holders, at least in the case of cross-over funds that have certain requirements to disclose valuations, the information rights may be necessary regardless of holdings

LATE-STAGE PRIVATE PLACEMENTS AND LIQUIDITY PROGRAMS

Late Stage Private Placements

- For larger private companies that may be 12 to 24 months away from an IPO or an M&A opportunity, a late stage (or "mezzanine") private placement may be an attractive capital-raising opportunity
- Generally, investors in such offerings will include private equity funds, sovereign wealth funds, specialist or sector funds, sovereign wealth funds, and cross-over funds
- Of course, the company also may seek to raise capital from strategic investors
- Although these investors more often than not will not seek board or observer rights, they will want information rights
- In connection with their potential investment, they also will generally undertake an extensive due diligence review and ask to be provided access to a data room
- Private companies should consider and review with counsel the type of information that is made available in such a data room or through the diligence process and consider whether the same or similar information has been made available to the company's board members, investors with information rights and other stakeholders

Late Stage Private Placements *(cont'd)*

- The information that is made available to late stage investors will form the basis for the valuation and will also shape the periodic valuation updates made public by cross-over funds subject to reporting requirements
- Concerns relating to the type of information that is shared may become more challenging in transactions involving secondary purchasers. Secondary purchases combine investments directly in the issuer with purchases directly from existing stockholders
  - This is also often referred to as a "cross-purchase" structure
  - Typically late stage investors will purchase common stock from management and employees in order to provide liquidity for them
  - Late stage investors can also purchase preferred stock from existing institutional investors, particularly those that need an exit given LP demands
- The issuer and its counsel will want to consider the type of information made available to cross-over investors versus the type of information available to the sellers (employees, friends, family and angel investors)
- Are there information asymmetries?

Late Stage Private Placements *(cont'd)*

- Are the sellers able to form a basis on which to evaluate the cross-over investors' valuation proposal?
- To the extent that a late stage investor has been provided with data, is that investor in possession of material nonpublic information?
  - Will that investor be able to purchase securities of the company in a private market having the benefit of superior information?
  - Will that investor be able to participate in the issuer's IPO if the IPO occurs in close proximity to the last financing round?
- Often, private companies will provide liquidity opportunities for existing holders. Sponsored liquidity programs may well play a role in recruitment and retention. For many companies, stock-based compensation may be an important element of overall compensation. With companies staying private longer, employees and consultants will want some ability to monetize their holdings

Liquidity Programs and Tender Offers

- By providing a sponsored liquidity program, the company can set defined parameters, whether relating to the overall amounts to be sold, the amounts to be sold as a percentage of holdings, the timing of sales, etc.
- Certain information will be required to be made available in connection with the resales—the company should consider the type of information that it has shared with other constituencies
- A company also may structure these transactions as tender offers, whether an issuer tender or a tender by a third-party (an investor)
  - Not subject to tender offer rules but important that it be "fair" particularly if insiders are selling
  - Information prepared by the issuer and included in OTP but often it is investor effecting the purchase and taking the securities

BEST PRACTICES FOR COMMUNICATIONS

Best Practices for Communications

- As we have discussed, even with a privately held company, there may be many required disclosures to be made in connection with securities offerings and stock-based compensation plans.
- There may also be various stakeholders with information rights and their rights may differ.
- Finally, because of the need to provide liquidity to employees, consultants, and early investors, privately held companies may be required to furnish and periodically update disclosures about the company.
- Of course, in addition to addressing these requirements, privately held companies also will want to communicate with a number of other constituencies, including strategic partners, vendors/collaborators, financial intermediaries, and customers. The type of information provided to each of these constituencies may be different, but, it will have to be consistent.
- As a result, we recommend that privately held companies adopt a number of policies and procedures.

Policies and Procedures

- *Document retention*
  - A privately held company should consider adopting a formal document retention policy.
  - The policy should address the types of materials that will be retained, the retention period, the format for recordkeeping, and the persons responsible for monitoring compliance with the policy.
  - Consider that a privately held company will want to have a record of the diligence materials (including projections, market data, regulatory communications, etc.) furnished to potential investors and the date at which or as of which such information has been provided.
  - Similarly, the company will want to have a record of all offering materials used by it, including the disclosure materials furnished for purposes of Section 701 compliance, as well as investor presentations.
  - A company also will want to ensure that it maintains copies of all confidentiality and non-disclosure agreements

Policies and Procedures *(cont'd)*

- *Communications policy*
  - A privately held company also should consider adopting a written communications policy and training its staff on communications issues.
  - A communications policy would address, among other things:
    - The persons authorized to speak on the company's behalf;
    - The review or approval policy for formal communications made by or on behalf of the company;
    - The venues that the company will use to communicate with third parties;
    - The approach to interacting with the press; and
    - The approach to interacting with financial professionals

Policies and Procedures *(cont'd)*

- *Regulation FD*
  - Regulation FD applies to public companies. Regulation FD requires that whenever a public company, or any person acting on its behalf, discloses material nonpublic information to certain enumerated persons, the company must disclose that information either simultaneously (in the case of intentional disclosures) or promptly (in the case of unintentional disclosures).
  - Regulation FD was intended to "level the playing field" and safeguard against the selective disclosure of information.
  - Given that many private companies now conduct multiple rounds of financing and have a dispersed stockholder base, and some companies have sponsored (or unsponsored) liquidity programs, it may be appropriate for private companies to consider adopting a communications policy that is informed by the same principles as Regulation FD.

Policies and Procedures *(cont'd)*

- *Industry and investor conferences and presentations*
  - Private companies also should develop a consistent approach with respect to presenting at industry, trade and investor conferences
  - Many private companies, especially those anticipated to be close to an IPO, are invited to present at industry conferences
  - The materials used should be consistent with those furnished in connection with liquidity programs, recent funding rounds, and investor updates (for those with information rights)
  - Presentations should be dated, prefaced by appropriate disclaimers, and should be fair and balanced
  - Industry and market data should be appropriately sourced
  - To the extent that projections are presented, the projections should be accompanied by an explanation of the material assumptions
  - As with any other communication, ensuring consistency with other communications and avoiding misstatements and omissions is essential

Policies and Procedures *(cont'd)*

- *Disclosure controls*
  - The company also may want to consider adopting certain disclosure controls although these are not technically required
  - The objective of implementing such controls would be to mitigate legal and reputational risks
  - A group within the company would be charged with responsibility for reviewing the information that the company regularly releases or publishes, including information that is furnished to investors with information rights, information shared with potential investors, and information that is presented at investor conferences, trade associations, and in similar venues
  - The information that is presented to various constituencies will necessarily be different, but it should all tell a consistent story and it should be free of material misstatements and omissions

Policies and Procedures *(cont'd)*

- *Insider trading and blackout policies*
  - Section 10(b) of the Exchange Act and Rule 10b-5 prohibit trading while in possession of material nonpublic information
  - Public companies have insider trading policies that restrict trading by employees, directors and other affiliated persons when in possession of material nonpublic information and limit trading to specific trading windows
  - While the securities of a private company will not be traded on a national securities exchange, there may be a sponsored or unsponsored private market in the company's securities
  - In addition, many private companies will commit to make available the information required under Rule 144
  - As a result, it may be sensible to formulate a trading policy

Policies and Procedures *(cont'd)*

- *Communications in proximity to a planned IPO*
  - As a company approaches a potential IPO, it should take care to monitor more closely its comments, both internally and to third parties
  - There are a number of safe harbors under the Securities Act for certain communications, including:
    - Communications made in the regular course of business, relating to a company's products and services, and not referencing any "offering"
    - Communications made more than 30 days prior to an offering (and not referencing an offering)
    - Test the waters communications in the case of companies that qualify as emerging growth companies
    - However, the time to revamp a website or product materials is not immediately prior to, or once the company has commenced, the offering process

Policies and Procedures *(cont'd)*

- *Social media*
  - Communications made through a social media channel are subject to the same securities liability, including anti-fraud provisions
  - For private companies with securities that trade in a private secondary market, concerns regarding insider trading and market manipulation would be relevant
  - A company will be held responsible for communications made by employees that are acting as company representatives—making a communications policy important
  - The Securities and Exchange Commission has said that a company is not responsible for statements that third parties post on a company-sponsored website unless the company has adopted or endorsed the statement
  - However, a company can be held liable for third-party information to which it hyperlinks from its website and which could be attributable to the company based on either the theory of:
    - Entanglement—involving itself with the preparation of third-party content; or
    - Adoption—explicitly or implicitly endorsing or approving third-party content

Policies and Procedures *(cont'd)*

– Just as with a public company, a privately held company that is approaching an IPO will want to consider the following:

- Identifying each social media channel it uses for corporate purposes
- Which venue it uses to communicate with particular constituencies
- Who is responsible for monitoring, posting, and other maintenance
- Identifying which sites or channels are official company sites (as opposed to sites maintained by executives or employees for their personal use)
- Ensuring that executives understand the need to differentiate between personal and company sites or channels, and avoid communicating material information about the company and its business on their personal sites
- Ensuring that information across platforms is consistent
- A private company may want to consider adopting certain disclaimers for use on its sites

FREE WRITINGS + Perspectives

The **Free Writings & Perspectives**, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up to the minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or "late stage" private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities related topics that pique our and our readers' interest.

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SEC Issues Concept Release on Compensatory Offerings

On July 18, 2018, the US Securities and Exchange Commission (SEC) issued a concept release[1] soliciting public comment on potential ways to modernize compensatory offerings and sales of securities, consistent with investor protection. Specifically, the concept release requests comment on aspects of Rule 701 under the Securities Act of 1933 (Securities Act), an exemption from registration for securities issued by non-reporting companies pursuant to compensatory arrangements, and on Form S-8, a registration statement used by SEC-reporting companies for compensatory offerings. This Legal Update highlights key questions raised by the concept release. The comment period is scheduled to remain open through September 24, 2018.

Request for Comment on Rule 701

Rule 701 provides an exemption from the registration requirements of the Securities Act for securities issued in compensatory circumstances to specified persons (for example, officers, directors, employees, consultants and advisors) by companies that are not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934. The SEC recognizes that since the time it last adopted substantive amendments to Rule 701, there has been a "significant evolution" in the types of compensatory offerings that companies make and in the composition of the work force. Accordingly, the concept release raises 41 topics for comment relating to Rule 701 under the Securities Act, including those described below.

Gig Economy. The concept release asks a series of questions geared to the development of the "gig economy," which involves more short-term, part-time or freelance arrangements. Individuals participating in the gig economy may use a company's Internet platform to perform services or sell goods to end users on an independent contractor basis in areas such as ride-sharing, food delivery, lodging and car rentals. These individuals may have similar arrangements with multiple companies in which they may engage in the same or different business activities. Recognizing that workers participating in such arrangements may not be "employees" in a traditional sense, and also may not qualify as consultants or advisors, the concept release seeks comment on whether the definition of employee under regulatory regimes other than the securities laws should apply for Rule 701 purposes. It also asks what services, if any, should an individual working in the gig economy be providing to the issuer in order to be eligible to participate in a Rule 701 offering and whether Rule 701 eligibility should require that the issuer exercise some level of control over, or vetting of, the individual providing the services.

Some of the requests for comment in the gig economy area focus on whether the eligibility test should take into account the individual's level of dependence on the issuer or the issuer's degree of dependence on such individual. Other requests for comment relate to the potential impact of increased volume of Rule 701 issuances if the rule were to be revised to accommodate issuers involved in the gig economy and whether having a separate ceiling, or additional disclosures, would be appropriate for issuers in the gig economy. The SEC is also seeking information about gig economy issuers' use of securities to compensate individuals generally and the impact on competition of potential Rule 701 offerings by gig economy issuers.

Disclosure. At the same time that the SEC issued the concept release, it amended Rule 701(e) by increasing to $10 million the aggregate sales price or amount of securities sold during any consecutive 12-month period.[2] In the event that issuances are made by an issuer in excess of that amount, the company is required to deliver additional disclosures to investors (including a summary of the plan's material terms, a description of the risks associated with an investment in the securities and specified financial statements) before the sale or, with respect to options or other derivative securities, within a reasonable period of time before the date of exercise or conversion. The concept release raises a number of questions relating to the timing of such disclosures, such as whether the additional disclosure should continue to be required for the period that precedes the threshold amount being exceeded and whether the consequence for failing to provide the disclosure should be

loss of exemption only for transactions that occur after the threshold is crossed and for which no disclosure was provided.

The concept release solicits comment on whether the type of information provided should depend on the recipient of the securities and whether such disclosure should be updated less frequently than currently required. The concept release asks which methods of disclosure delivery best satisfy the purpose of disclosure without undermining the confidentiality of financial information of private companies and whether there is a need for the rule to specify that confidentiality safeguards should not be so burdensome that they interfere with effective access by the intended recipients.

RSUs. Because restricted stock units (RSUs) may settle without the recipient taking action, the SEC noted that the investment decision, if any, likely takes place on the date of grant. Observing that the requirement to deliver disclosures at a reasonable time before the date of grant could compel disclosure of financial information at a time when potential new hires are negotiating the terms of employment before joining a company, the concept release requests comment on when disclosure should be required for RSUs and what the appropriate valuation for RSUs is for the purpose of Rule 701. The concept release also asks whether any other types of derivative compensatory securities should be specifically addressed by Rule 701.

Annual Ceiling. Rule 701(d) generally provides a 12-month sales limit on the amount of securities that may be sold under the exemption on an aggregate basis under all plans equal to the greatest of (i) 15 percent of the total assets of the issuer, measured as of the most recent balance sheet date; (ii) 15 percent of the total outstanding amount of the class of securities being offered and sold in reliance on the rule, measured as of the most recent balance sheet date; and (iii) $1 million. The concept release asks whether there is a continuing need for any annual regulatory ceiling for Rule 701 transactions and, if so, whether the ceiling should be increased.

Request for Comment on Form S-8

The concept release also seeks comment on 15 topics relating to Form S-8, a simplified form of registration statement used by reporting companies for the registration of offerings of securities pursuant to employee benefit plans to specified persons (for example, officers, directors, employees, consultants and advisors). For instance, the concept release asks whether changes to Form S-8 are appropriate to address the gig economy, including whether consistent changes should be made to both Rule 701 and Form S-8. In addition, the release solicits comment on ways to reduce various perceived burdens associated with registration on Form S-8 and whether such revisions would encourage more companies to become reporting companies. There are questions relating to the possible use of a single Form S-8 for all employee benefit plans that a company sponsors and whether there should be a "pay-as-you-go" system for filing fees, similar to what is permitted for well-known seasoned issuers. The concept release solicits comment on Form S-8 generally, including on whether the current operation of Form S-8 presents significant challenges to the use of benefit plans. It also asks what the advantages, disadvantages and impact would be of eliminating Form S-8 and instead extending the Rule 701 exemption to reporting companies.

Practical Considerations

Private companies that offer securities as part of their compensation programs in reliance on the Rule 701 exemption—or that are considering doing so—should consider submitting comments to the SEC, whether in response to specific questions raised in the concept release or to any other concerns that they may have based on the current operation of that rule.

Because Rule 701 is available for foreign private issuers as well as private domestic companies, foreign private issuers that are not SEC-reporting companies should focus on the issues raised by the concept release. The SEC has encouraged comment on the concept release from all interested parties. Accordingly, foreign private issuers are welcome to submit comments on the concept release, and it could be in their interest to do so, particularly with respect to topics impacting specifically them.

Public companies that offer, or are considering offering, securities as part of their compensation programs should determine whether there are any issues relating to Form S-8 for which they would like to submit comments and whether reliance on Rule 701 would be a viable alternative if made available to public companies.

The concept release reflects a desire by the SEC to encourage public offerings. Therefore, private companies that may be considering going public in the future may want to submit comments to the SEC regarding any changes in compensatory securities offerings and sales regulations that would impact their decisions to engage in an initial public offering.

[1]Available at https://www.sec.gov/rules/concept/2018/33-10521.pdf.

[2]See our Legal Update, "SEC Amends Rule 701(e) Threshold for Compensatory Offerings ," dated July 19, 2018, available at https://www.mayerbrown.com/sec-amends-rule-701e-threshold-for-compensatory-offerings-07-19-2018/.

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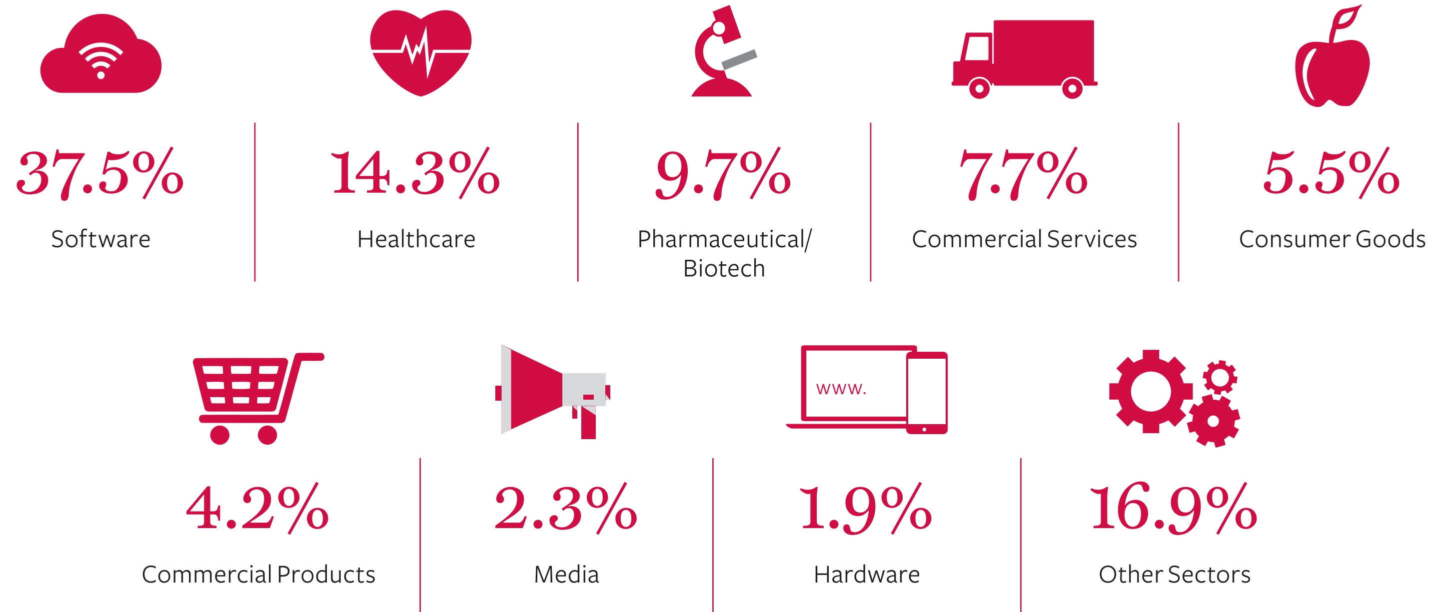
Mezzanine Private Placements

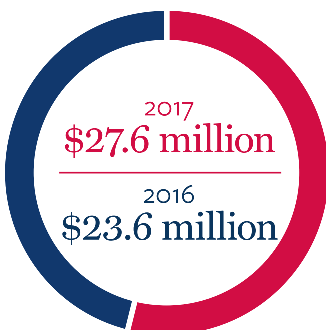
At A Glance

As privately held companies choose to remain private longer and defer their IPOs, or other liquidity opportunities, these companies are raising capital in private placements made principally to institutional investors, cross-over funds, sovereign wealth funds, and strategic investors. These private placements, often referred to as pre-IPO private placements, have almost become a guiding step to an IPO, or maybe they are the new IPOs.

2017 Volume By Industry



Average Deal Size



2017
Capital raised: $48.9 billion
Deals: 1,916

2017
Capital raised: $41.3 billion
Deals: 1,750

2017 Biotech Sector

Raised
$4.2 billion
177 late stage deals completed

2017 Technology Sector

Raised
$20.4 billion
811 late stage deals completed

Unicorns

“Unicorns” are private companies valued at $1 billion and above.
As of January 2018 in the US there were a total of :

113 Unicorns valued at over **$395 billion**

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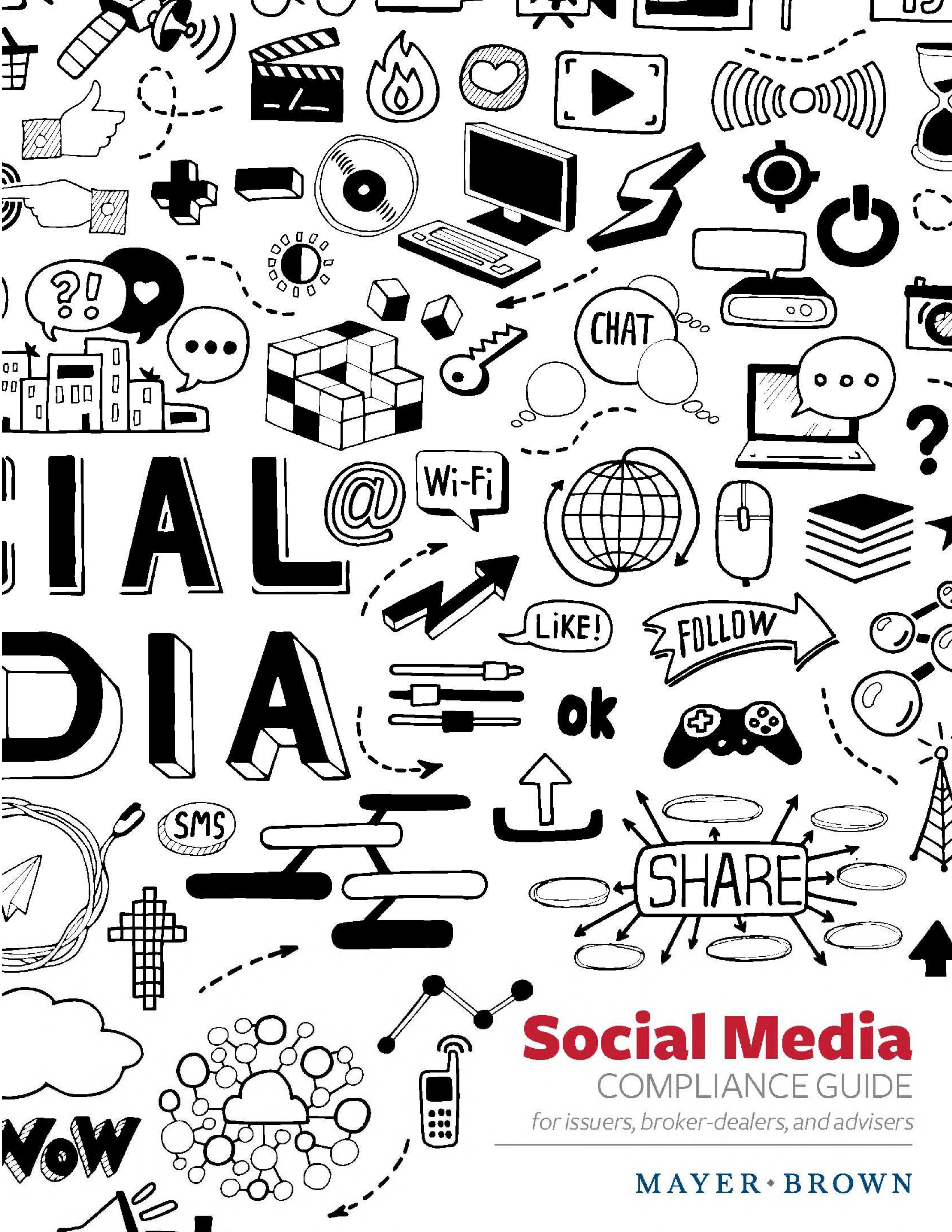

Social Media

COMPLIANCE GUIDE

for issuers, broker-dealers, and advisers

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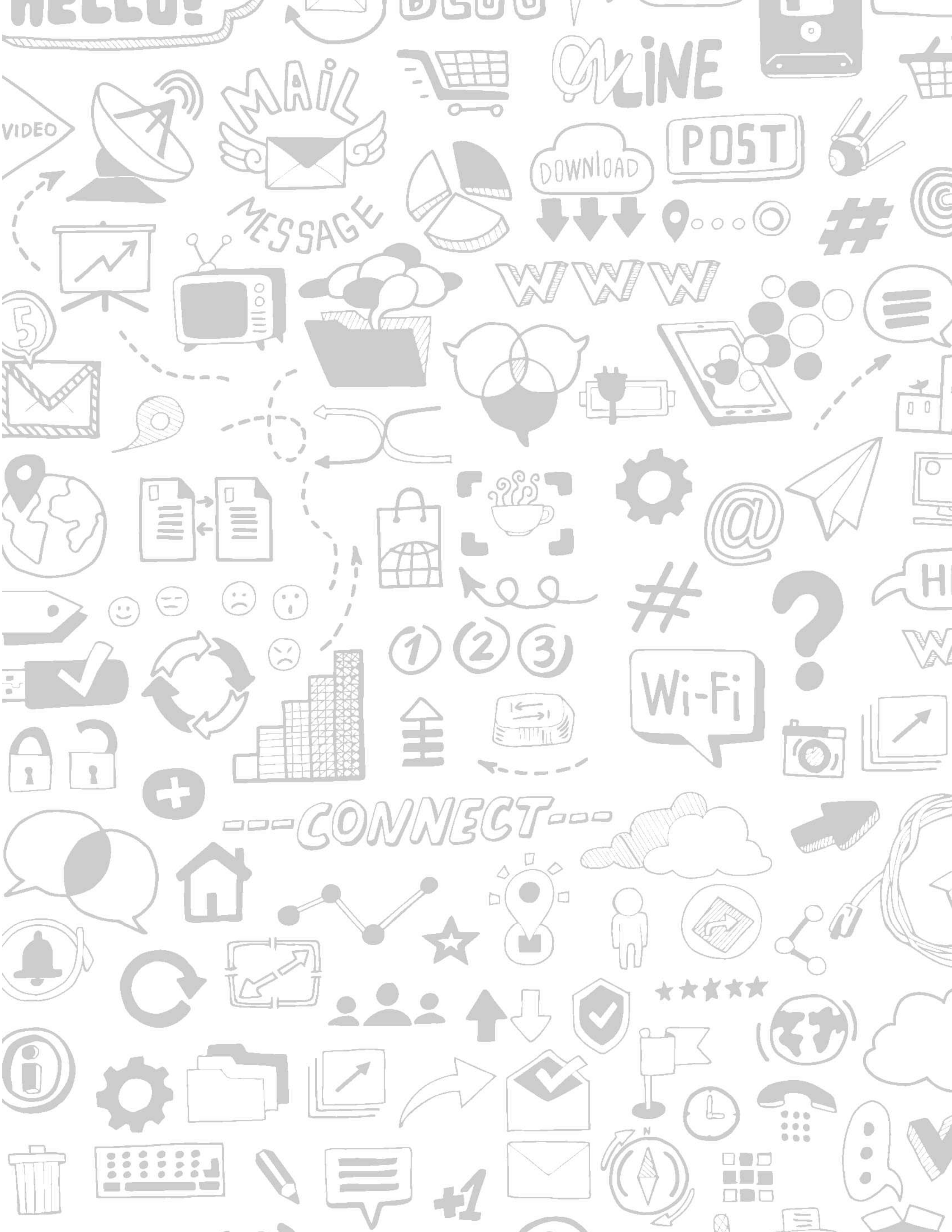

MAIL
ONLINE
VIDEO
DOWNLOAD
POST
MESSAGE
WWW
Wi-Fi
---CONNECT---

The use of social media raises many securities law and compliance challenges for issuers, broker-dealers, and investment advisers. This Compliance Guide summarizes briefly some key principles.

GUIDANCE FOR ISSUERS

REGULATION FD

In 2000, the Securities and Exchange Commission (the "SEC") adopted Regulation Fair Disclosure ("Regulation FD") in order to address concerns relating to selective disclosure and to promote full and fair disclosure. In its Regulation FD adopting release, the SEC noted that selective disclosure of information bore a close resemblance to insider trading, giving a privileged few an informational edge and the ability to use that benefit at the expense of others.[1] This unfair advantage, the SEC noted, might lead to a loss of confidence in the integrity of the capital markets. Regulation FD requires that when an issuer, or a person acting on its behalf, discloses material nonpublic information to certain enumerated persons, such as securities market professionals, where it is reasonably foreseeable that they will trade on the basis of the information, the issuer must distribute that information in a manner reasonably designed to achieve effective broad and non-exclusionary distribution to the public. An issuer must make material nonpublic information available to the public contemporaneously if such information is intentionally disclosed or promptly if such material nonpublic information is unintentionally disclosed. These principles are applicable to social media as we discuss below.

DISSEMINATION OF COMPANY INFORMATION

Website Postings

The SEC's Regulation FD adopting release and Rule 101(e) of Regulation FD state that public disclosure "may be made by filing or furnishing a Form 8-K, or by another method or combination of methods that is reasonably designed to effect broad, nonexclusionary distribution of the information to the public."[2] In 2008, the SEC issued an interpretive release (the "2008 interpretive release") on the use of company websites to disseminate information to investors in compliance with Regulation FD.[3] The SEC reiterated in its 2008 interpretive release that information is public if it is disseminated "in a manner calculated to reach the securities marketplace in general through recognized channels of distribution, and public investors [are] afforded a reasonable waiting period to react to the information."[4] In line with this standard, the SEC set forth the following three factors that a company should evaluate when considering whether its website may be used to disseminate material information for Regulation FD purposes:

[1] *Selective Disclosure and Insider Trading*, 65 Fed. Reg. 51,716 (Aug. 24, 2000), available at: https://goo.gl/HZhJp6.
[2] *Id.*
[3] *Commission Guidance on the Use of Company Web Sites*, 73 Fed. Reg. 45,862 (Aug. 7, 2008), available at: https://goo.gl/VQUc4Y.
[4] *Id.*

- whether the company website is a recognized channel of distribution;
- whether posting of information on the company website disseminates the information in a manner making it available to the investors and the markets in general; and
- whether there has been a reasonable waiting period for investors and the markets to react to the posted information.[5]

Recognized Channel of Distribution

Whether a company's website is a recognized channel of distribution depends on a number of factors. To establish a website as a recognized channel for disclosing information, a company should consider:

- promoting its website, by including its website address in its periodic reports and its press releases;
- informing investors and the market in company communications that the company routinely posts important information about the company on its website, including a reference to the URL of the company's website;
- establishing a pattern of posting important information on its website;
- making investor information readily accessible on its website by providing a separate means of accessing the Investor Relations page on the company's website from the company's main website page, ensuring that the website is designed to direct visitors to important information;
- monitoring the dissemination of information in order to determine the extent to which information reaches intended audiences and the extent to which persons access the company's website for material information about the company; and
- keeping information current and accurate on the company's website.

Companies with a small market following should consider taking extra steps to improve the accessibility of information on their websites. The SEC noted the use of "push" technology, a type of communication that originates with the publisher of the information, such as RSS feeds or releases through other distribution channels, as additional steps to ensure their websites are a recognized channel of communication.

Dissemination of Information

Whether information is disseminated in a manner that makes the information available to the securities market in general depends on the manner in which information is posted on a company website and the timely and ready accessibility of such information to investors and the markets. The SEC identified in its 2008 interpretive release the following factors that should be considered in determining whether information on a company's website is "posted and accessible" and therefore "disseminated"[6]:

- how the company informs investors and the markets that the company has a website and that such website is where investors and the markets should find company information;
- whether the company has made investors and the markets aware that it will post important information on its website;
- the company's practice of posting such information on its website;
- whether the company's website is designed for clear and easy access to investor information, and the information is presented in a format that is readily accessible to the general public; and

[5] *Id.*
[6] *Id.*

- the extent to which information posted on the website is regularly picked up by the market and readily available to and reported by the media.

In public forums, the SEC Staff (the "Staff") has indicated that an effective model for disseminating information in a Regulation FD-compliant manner, at least with respect to earnings announcements, would be to first furnish an earnings release under cover of a current report on a Form 8-K under Item 2.02 and then to post the earnings release on its website.[7]

Reasonable Waiting Period

A reasonable waiting period for investors to react to website information depends on the circumstances of the dissemination, including the following factors:

- the traffic that the site generates;
- the frequency with which investor-specific information is accessed;
- the steps the company has taken to make investors and the markets aware of the use of the company website as a key source of company information;
- the steps the company has taken to actively disseminate the information or the availability of such information on the company's website; and
- the complexity of the information presented.

In its 2008 interpretive release, the SEC noted that a reasonable waiting period would vary based on the type of company and the information. For example, a reasonable waiting period for simple information posted on a website with heavy traffic that is routinely used by investors would likely be shorter than the waiting period when complex information is posted on a website that has little traffic and is not routinely used by investors.

Social Media

In April 2013, the SEC issued a Report of Investigation under Section 21(a) (the "21(a) Report") in the course of an investigation of a potential Regulation FD violation arising from a CEO's post on Facebook.[8] The SEC emphasized that disclosure of material nonpublic information to a broader group that includes both enumerated and nonenumerated persons would not render Regulation FD inapplicable. As a result, whenever a company discloses information through a social media channel, the company must consider whether that disclosure implicates Regulation FD. The SEC noted that Regulation FD is not intended to interfere with "legitimate, ordinary course business communications" or communications with the press.[9] However, an issuer should determine, for example, whether the disclosure includes material nonpublic information and whether the information was disseminated in a manner "reasonably designed to provide broad, nonexclusionary distribution of the information to the public" if the issuer did not file a Form 8-K.

The SEC acknowledged in the 21(a) Report that the ways in which companies may use social media channels are not fundamentally different from the ways in which websites, blogs and RSS feeds are used and that the principles articulated in the 2008 interpretative release could be extended to social media channels.

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[7] Listed public companies also must consider stock exchange guidelines on the release and dissemination of information. Both the New York Stock Exchange and Nasdaq have policies that require prompt release of material nonpublic information to the public in a manner that is compliant with Regulation FD.

[8] *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings*, Release No. 34-69279 (April 2, 2013), available at: https://goo.gl/LfTZMh.

[9] Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716 (Aug. 24, 2000), available at: https://goo.gl/BzvzU2.

The SEC noted that an issuer must analyze whether social media channels are recognized channels of distribution. In the 21(a) Report, the SEC noted that personal social media sites of individuals employed by a public company would not ordinarily be assumed by investors to be channels through which a company would disclose material corporate information. The SEC also indicated that, while every situation must be evaluated based on the facts and circumstances, absent advance notice to investors, personal social media sites of public company employees would not be considered Regulation FD compliant, even if such sites have a large number of followers.

To ensure Regulation FD compliance, a company must take steps to alert investors and the markets regarding the channels of communications it intends to use to disseminate material nonpublic information and the types of information that it may disclose through these channels. The steps companies should consider include:

- evaluating which social media channels may be useful to communicate information to investors;
- identifying on its website the social media channels that the company intends to use to disseminate material nonpublic information;
- providing investors and the markets opportunities to subscribe, join or review such channels; and
- alerting investors and the markets of the use of such channels to disseminate material information about the company.

Companies should consider addressing the use of social media in their Regulation FD policies. For example, companies might limit the use of company social media channels to authorized persons. The policy also might address any prohibitions, restrictions or editorial oversight that will govern the use of social media. Company officers, directors and employees should be advised that posting information about the company and its business on company or personal social media channels could potentially implicate Regulation FD. Therefore, such persons must exercise caution when communicating about the company through social media. Companies should monitor the use of all of their social media channels.

LIABILITY AND DISCLAIMERS

Liability for Content on Website or Social Media Platforms

In an interpretive release entitled "Use of Electronic Media" (the "May 2000 Release"), the SEC stated that the federal securities laws apply in the same manner to the content of company websites as to any other statements made by or attributable to the company.[10] An issuer is responsible for the accuracy of statements that "can be reasonably expected to reach investors and the securities markets, regardless of the medium through which the statements are made, including the Internet."[11] Given the potential liability under the securities laws for a material misstatement or omission in public communications, a company should vet any statements by or on behalf of the company made on its website or any social media channels with the same care that it uses in evaluating disclosures in SEC reports. A company also should also take care to avoid liability under the "entanglement" theory for third-party information, as we discuss below.

[10] *Use of Electronic Media*, SEC Release No. 33-7856, May 4, 2000, available at: https://goo.gl/r8PpKt. The May 2000 Release also includes guidance relating to investment companies.
[11] *Id.*

Disclosures by a Person Acting on a Company's Behalf

Regulation FD applies to any communication made by "a person acting on behalf of an issuer."[12] In the Regulation FD adopting release, the SEC noted such persons include (1) any senior official of the issuer and (2) any other officer, employee, or agent of an issuer who regularly communicates with broker-dealers, investment advisers, investment companies and shareholders. The SEC noted that the definition is intended to cover senior management, investor relations professionals, and others who regularly interact with securities market professionals or security holders.[13] The obligations under Regulation FD also extend to any employee directed to make a selective disclosure by a member of senior management and such senior management member would be held responsible for the selective disclosure.

Companies should ensure that employees understand the application of Regulation FD. As discussed above, any person communicating company information on social media must consider carefully whether statements made through social media would be attributable to the company and subject to Regulation FD.

Third-Party Statements

The SEC has generally taken the view that a company is not responsible for statements that third parties post on a company-sponsored website and has no obligation to correct a misstatement made by a third party. However, a company may be liable for web content provided by a third party that is hyperlinked from the company's website under the "entanglement" theory if the company was involved in the preparation of the information or under the "adoption" theory if the company explicitly or implicitly endorses or approves the information. In addition, companies must be careful about hyperlinking in the forms of "framing" or "inlining" in which a website is imported and displayed along with the website being used. The SEC will generally assume such information was provided by the company as information that would be of interest to its website users and attribute that information to the company.

A company should therefore be careful when referencing and linking to online content that it does not control. The company should also include appropriate legends or disclaimers when referencing or linking third-party content, as discussed below. Activities such as "friending" a securities research analyst on Facebook or tweeting an analyst's handle on Twitter, as well as retweeting an analyst's tweet about the company, could potentially be considered adoption of the analyst's past and future statements about the company or its securities.

Forward-Looking Statements

Sections 27A of the Securities Act of 1933 (the "Securities Act") and 21E of the Securities Exchange Act of 1934 provide a safe harbor from liability for forward-looking statements ("FLS"), such as estimates, projections, plans and beliefs regarding future performance, if a statement is (1) identified as an FLS and accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from the FLS. Making FLS in certain social media channels that have character limitations, such as Twitter's character limit, may pose challenges. Some companies address this issue by posting multiple disclaimer tweets before tweeting the FLS. Others include links to the FLS disclaimers in their SEC filings or press releases. The SEC Staff has provided guidance in Compliance & Disclosure Interpretations on hyperlinking to certain required disclosures if the particular social media channel has a character limit. However, it remains

[12] See note 1.
[13] *Id.*

uncertain whether a court would determine that the methods that companies have been using to provide FLS disclaimers on social media channels are sufficient.

Non-GAAP Financial Measures

Regulation G requires issuers to reconcile a non-GAAP financial measure to a comparable GAAP financial measure. This reconciliation requirement also applies to any non-GAAP financial measure provided through social media channels. Companies have satisfied the Regulation G reconciliation requirement by hyperlinking. This approach raises concerns if posts are taken out of context or are partially retweeted. In addition, given the SEC's recent focus on the use of non-GAAP measures,[14] companies are advised to monitor the use of non-GAAP measures in social media communications.[15]

USE OF WEBSITES AND SOCIAL MEDIA IN CAPITAL-RAISING TRANSACTIONS

Public Offerings

Gun Jumping

A company conducting a public offering should consider the various SEC rules restricting communications in close proximity to or during an offering. Section 5(c) of the Securities Act prohibits any oral or written offers of a security before a registration statement is filed. Any statements, whether intentional or inadvertent, made prior to filing a registration statement could be deemed to be an offer of securities or an effort to "condition the market" for the offering and may be considered a gun-jumping violation. A gun-jumping violation can put an offering at risk and subject an issuer to a potential SEC enforcement action.

The SEC has indicated that statements made through electronic means, such as media interviews, website postings, emails, Facebook posts and Twitter tweets can be deemed written offers for purposes of the communications rules under the Securities Act. Companies should apply the same level of review applied to communications made through traditional channels to their social media communications. Prior to its first registered public offering, an issuer should consider adopting a social media policy that addresses which social media channels are authorized for use, identifies the persons authorized to communicate on the company's behalf, and sets forth a review process for all such communications. A company also should consider putting in place special controls relating to the content of, and the process for disseminating, information posted on social media channels.

Communications Safe Harbors

Rule 134 Notices

After a prospectus meeting the requirements of Section 10 of the Securities Act (a "Section 10 prospectus") is filed, Rule 134 permits an issuer conducting a registered public offering to communicate limited factual

[14] See Mary Jo White, Chair, U.S. Securities and Exchange Commission, *Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability* (June 27, 2016), available at: https://goo.gl/54JfMm; James V. Schnurr, Chief Accountant, U.S. Securities and Exchange Commission, *Remarks Before the 12th Annual Life Sciences Accounting and Reporting Congress* (Mar. 22, 2016), available at: https://goo.gl/E8mmzH; Wesley R. Bricker, Deputy Chief Accountant, U.S. Securities and Exchange Commission, *Remarks Before the 2016 Baruch College Financial Reporting Conference* (May 5, 2016), available at: https://goo.gl/1YKXnj; and Mark Kronforst, Chief Accountant, Division of Corporate Finance, U.S. Securities and Exchange Commission, *Remarks at the 36th Annual Ray Garret Jr. Corporate and Securities Law Institute* (Apr. 28, 2016).
[15] See Compliance & Disclosure Interpretations on Non-GAAP Financial Measures, available at: https://goo.gl/2p8dr8.

information (a "Rule 134 Notice") about an offering without such communications being deemed a prospectus or free writing prospectus. If the registration statement is not yet effective, the Rule 134 Notice must contain the name and address of the person or persons from whom a written prospectus for the offering may be obtained and the following legend:

A registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective.

If an issuer provides a 134 Notice pursuant to Rule 134(d) that includes a price range and is accompanied or preceded by a Section 10 prospectus, an issuer may solicit an indication of interest or an offer to buy the security if the 134 Notice contains the following legend:

No offer to buy the securities can be accepted and no part of the purchase price can be received until the registration statement has become effective, and any such offer may be withdrawn or revoked, without obligation or commitment of any kind, at any time prior to notice of its acceptance given after the effective date.

Securities Act Rules Compliance and Disclosure Interpretations Question 110.01[16] indicates that active hyperlinks are permissible in order to satisfy the legend requirements discussed above if:

- the electronic communication platform has technological limitations such as character or text limitations;
- the inclusion of the entire required legends, together with the other information in the communication, would cause the communication to exceed the limit on the number of characters or amount of text; and
- the communication contains an active hyperlink to the required legends and prominently conveys, through introductory language or otherwise, that important or required information is provided through the hyperlink.

However, if the electronic communication does not have such limitations, the SEC noted that hyperlinking would not be appropriate.

In addition, the Staff noted in Securities Act Rules Compliance and Disclosure Interpretations Questions 110.02 and 232.16 that an issuer does not need to ensure compliance with Rule 134 or Rule 433 (discussed below) for electronic communications that are retransmitted by a third party that is not an offering participant or acting on behalf of the issuer, as long as the issuer has no involvement in the third party's retransmission of the information other than having initially prepared the communication in compliance with Rule 134 or Rule 433.

Rule 433

With the exception of a free writing prospectus under Rule 433(f)(1), any free writing prospectus used pursuant to Rule 433 must contain the following legend:

The issuer has filed a registration statement (including a prospectus) with the SEC for the offering to which this communication relates. Before you invest, you should read the prospectus in that registration statement and

[16] *Securities Act Rules Compliance and Disclosure Interpretations* (last update Apr. 19, 2017), available at: https://goo.gl/GzUDwD.

other documents the issuer has filed with the SEC for more complete information about the issuer and this offering. You may get these documents for free by visiting EDGAR on the SEC Web site at www.sec.gov. Alternatively, the issuer, any underwriter or any dealer participating in the offering will arrange to send you the prospectus if you request it by calling toll-free 1-8[xx-xxx-xxxx].

The legend also may provide an email address at which the documents can be requested, a statement that the documents are also available on the issuer's website and the issuer's website address and the specific location at which the documents are posted.

In the SEC Staff's Securities Act Rules Compliance and Disclosure Interpretation Question 232.15, the Staff noted that it would not object to the use of hyperlinks to fulfill the Rule 433 legend requirement if the conditions listed above (in the context of Rule 134 Notices) are met.

Testing-the-Waters Communications for Emerging Growth Companies

The Jumpstart Our Business Startups Act (the "JOBS Act") amended the securities rules and created a new category of issuer, an emerging growth company ("EGC"). An EGC is defined as an issuer with total gross revenues of less than $1.07 billion (subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year. A company remains an "EGC" until the earliest of:

- the last day of the fiscal year during which the issuer has total annual gross revenues in excess of $1.07 billion (subject to inflationary indexing);
- the last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act;
- the date on which such issuer has, during the prior three-year period, issued more than $1 billion in nonconvertible debt; or
- the date on which the issuer is deemed a "large accelerated filer."

Before or after filing a registration statement, EGCs may "test the waters" ("TTW") and engage in oral or written communications with qualified institutional buyers ("QIBs") and institutional accredited investors ("IAI") (as defined in Rule 501 of the Securities Act) in order to assess interest in a proposed public offering. TTW communications would not constitute "gun jumping" and would not constitute an "offer" for purposes of Section 5 of the Securities Act. It would be difficult to make TTW communications through social media and ensure that such communications are limited to QIBs and IAIs.

Private Placements

Prior to 2013, Rule 502(c) of Regulation D prohibited the use of general solicitation or general advertising, including, but not limited to, "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising" for any private offers and sales of securities under Regulation D. The existence of a pre-existing, substantive relationship with an investor negated the concern of general solicitation.

Title II of the JOBS Act, titled "Access to Capital for Job Creators," required that the SEC adopt rules to relax the prohibition against general solicitation in certain Rule 506 offerings. In 2013, the SEC adopted rules implementing this JOBS Act mandate. As a result, an issuer may conduct an exempt offering using general solicitation under Rule 506(c) of Regulation D as long as (1) the issuer takes reasonable steps to verify the accredited investor status of the purchasers of the securities; (2) all purchasers of securities are accredited investors, either because they fall within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors at the time of the sale of the securities; and (3) the issuer satisfies the conditions of Rule 501 and Rules 502(a) and 502(d). However, the prohibition against general solicitation remains applicable to the extent an issuer relies on the Section 4(a)(2) exemption and/or the Rule 506(b) safe harbor.

Websites and social media channels may play an important role in private placements made pursuant to Regulation D. For example, an issuer conducting a Rule 506(c) offering may use an unrestricted, publicly available website to offer or sell securities.[17] An unrestricted website that does not contain any offering-related information may also be used by a placement agent, a matchmaking portal or another intermediary in order to establish a pre-existing relationship with an investor. However, a website that relies solely on self-certification of accredited investor status, in the absence of any other knowledge of the investor's financial circumstances or sophistication, is not sufficient to form a "substantive" relationship and will likely not satisfy the Rule 502(c) requirements.[18] Of course, a financial intermediary may have a pre-existing substantive relationship with potential investors and invite such qualified investors to access a password-protected website, and that approach would not involve the use of general solicitation.

With the expanding use of websites and social media channels, companies should take care when employing such communications channels to solicit investors in securities offerings. Certain types of issuers, such as private funds and their registered investment advisers and commodity pools, should take care to understand the additional specific restrictions on the content of their offering-related communications.

Rule 504

In 2016, the SEC also adopted final rules amending Rule 504 ("Rule 504") of Regulation D in order to (1) increase the aggregate amount of securities that may be offered and sold in any twelve-month period from $1 million to $5 million and (2) disqualify certain bad actors from participating in Rule 504 offerings. The final rules repealed Rule 505 of Regulation D, which had provided a safe harbor from registration for securities offered and sold in any twelve-month period from $1 million to $5 million.

A Rule 504 offering may be structured as a private placement or as a state-registered offering. If the offering is structured as a private placement, then the issuer cannot use general solicitation or general advertising and must obtain investment representations, impose transfer restrictions, use restrictive legends on the securities, etc. However, if the offering is structured as a state-registered offering, the issuer must comply with state registration requirements ("qualification") in each state where securities are sold, including preparing and delivering a required "substantive disclosure document before sale" to purchasers in all states (whether or not each state requires registration and delivery of a disclosure document), or sell only to "accredited investors" in accordance with available state law exemptions that permit general solicitation and general advertising.

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[17] Securities Act Rules Compliance and Disclosure Interpretations 256.23 (Aug. 5, 2015).
[18] *Citizen VC, Inc.*, SEC No-Action Letter (Aug. 6, 2015) and Securities Act Rules Compliance and Disclosure Interpretation 256.31 (Aug. 5, 2015).

Regulation A

In 2015, the SEC adopted amendments to Regulation A (“Regulation A”), which is an exemption from registration under the Securities Act that allows U.S. and Canadian companies not required to file Exchange Act reports to raise up to $20 million in a Tier 1 Regulation A offering and up to $50 million in a Tier 2 Regulation A offering, in each case in a 12-month period. Regulation A also allows sales by existing stockholders under certain conditions.

Under Regulation A, an issuer contemplating a Regulation A offering may conduct TTW communications prior to filing a Form 1-A offering statement with the SEC. An issuer may also use sales literature before or after the filing of the Form 1-A or after qualification of the Form 1-A. After an offering statement is filed, an issuer must provide the filed offering statement or a link to the offering statement when using solicitation materials. All solicitation materials must be filed with the SEC. Most issuers that have relied on the Regulation A offering exemption to date have used internet-based marketing efforts, including targeted social media campaigns, in order to attract interest in the offerings.

Crowdfunding

Title III of the JOBS Act, titled “Crowdfunding,” amends Section 4(a) of the Securities Act to provide a crowdfunding exemption from registration under the Securities Act. An offering under Regulation Crowdfunding (“Regulation CF”) may be a less costly alternative to other current offering exemptions for issuers seeking to raise a limited amount of capital through a broad group of investors over the Internet. Rule 100 of Regulation CF sets forth the following conditions for the exemption:

- the issuer has raised no more than an aggregate amount of $1,070,000 in the past and the contemplated offerings in reliance on Regulation CF, in a twelve-month period preceding the date of the contemplated crowdfunding transaction;
- individual investors cannot invest more than the following investment amounts in a Regulation CF offering during the twelve-month period preceding the date of the contemplated crowdfunding transaction:
  - the greater of $2,200 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than $107,000; or
  - 10% of the lesser of the investor’s annual income or net worth, not to exceed a maximum aggregate amount sold of $107,000, if both the annual income and net worth of the investor is equal to or more than $107,000;
- the transaction is conducted through an intermediary that is a broker or funding portal that complies with the requirements of the exemption;
- the issuer must be a domestic issuer and not an Exchange Act–reporting company or an investment company; and
- the issuer is not disqualified under the bad actor disqualification provisions under Rule 503 of Regulation CF.

An issuer relying on Regulation CF must provide certain information regarding the issuer and the offering to investors, intermediaries, and file such information with the SEC. In addition, the issuer would need to file with the SEC and post on its website, no less than annually, reports of the results of operations and financial

statements of the issuer as the SEC may determine appropriate. Issuers relying on Regulation CF are also prohibited from advertising the terms of the Regulation CF offering other than providing notices directing investors to the funding portal or broker, offering terms and certain factual information about the issuer. If the issuer compensates any promoter of the offering, the issuer must disclose the amounts paid to the promoter through the intermediary and funding portal. An issuer is subject to rescission in accordance with Section 12(b) and Section 13 of the Securities Act, as if liability were created under Section 12(a)(2) of the Securities Act, in the event that there are material misstatements or omissions in connection with the offering.

An intermediary that acts as a gatekeeper in crowdfunding must either (1) be a registered broker-dealer and a member of FINRA or (2) if not a registered broker-dealer, must register with the SEC as a funding portal on Form Funding Portal and is prohibited from the following:

- offering investment advice or recommendations;
- soliciting purchases, sales or offers to buy the securities offered or displayed on its platform;
- compensating employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform; or
- holding, managing, possessing or otherwise handling investor funds or securities.

An intermediary of a crowdfunding portal must ensure that it has conducted certain checks and that the platform meets certain requirements. The following are some of these requirements:

- provide required disclosure, including the risks involved with crowdfunding in general and the contemplated offering to investors;
- have a reasonable basis for believing that an issuer complies with the statutory requirements for a crowdfunding offering and Regulation CF, and that the issuer has established means to keep accurate records of securities holders;
- conduct background checks and securities enforcement regulatory history checks, of officers, directors and significant shareholders of the issuer;
- ensure that issuer information required to be disclosed is available on the platform throughout the offering period and for a minimum of 21 days before any security may be sold in the offering;
- ensure that investors meet the crowdfunding investor limitations;
- provide a communication channel on its platform for investors to communicate with the issuer about the issuer and the offering and have such discussions publicly available for viewing;
- provide disclosures to investors about the compensation the intermediary receives;
- accept an investment commitment from an investor only after that investor certification that they meet Regulation CF requirements, they opened an account and consented to electronic delivery;
- have a reasonable basis for believing an investor complies with the investment limitations in Regulation CF;
- provide investors with certain notices once they have made investment commitments and confirmations at or before completion of a transaction;
- comply with maintenance and transmission of funds requirements;
- ensure that all offering proceeds are provided to the issuers only when the amount equals or exceeds the target offering amount; and
- comply with completion, cancellation and reconfirmation of offerings requirements.

Section 3(a)(11) and Rule 147/Rule 147A Offerings

A number of states permit crowdfunding within their states, or "intrastate crowdfunding." Under Section 3(a)(11) and Rule 147 of the Securities Act, an issue offered and sold to persons residing in a single state or territory, where the issuer of such security is a person resident or corporation incorporated in and, in each case, doing business within such state or territory, would be exempt from registration under the Securities Act.[19] Rule 147 does not prohibit general advertising or general solicitation in a Section 3(a)(11) offering but such general advertising or general solicitation must be limited to persons resident in the state or territory of which the issuer is conducting the intrastate offering. In Securities Act Rules Questions and Answers of General Applicability Compliance and Disclosure Interpretations Question 141.04, the Staff notes that an issuer relying on Rule 147 may use a third-party Internet portal to promote an offering to residents of a single state in accordance with a state statute or regulation intended to enable crowdfunding within that state if the portal implements adequate measures to ensure that offers of securities are made only to persons resident in the relevant state or territory. These measures must include, among others, the following:

- satisfaction of all conditions under Rule 147;
- disclaimers and restrictive legends that make clear that the offering is limited to residents of the relevant state under applicable law; and
- limiting access to information about specific investment opportunities to persons who confirm they are residents of the relevant state.

The Staff also noted in Compliance and Disclosure Interpretations Question 141.05 that issuers may use websites and social media channels to advertise an offering under Rule 147, provided that such offers are limited to persons whose Internet Protocol ("IP") address originates from the relevant state or territory and prevents any offers to be made to persons whose IP address originates in other states or territories. Offers should include disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law.

In 2016, the SEC adopted new rules amending Rule 147 and adopting new Rule 147A. Under Rule 147A, issuers are able to conduct exempt intrastate offerings under the same conditions as Rule 147 except Rule 147A offerings can be made to out-of-state residents and the issuer is not required to be a resident or incorporated in such state. However, under both the amended Rule 147 and new Rule 147A, an issuer conducting an intrastate offering must have a principal place of business in the target state or territory and satisfy at least one of the "doing business" qualifications:

- the issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in-state or from the rendering of services in-state;

- the issuer had at least 80% of its consolidated assets located in-state;

- the issuer intends to use and uses at least 80% of the net proceeds from the offering towards the operation of a business or of real property in-state, the purchase of real property located in-state, or the rendering of services in-state; or

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[19] See Securities Act Rules Questions and Answers of General Applicability Compliance and Disclosure Interpretations Questions 141.03, 141.04 and 141.05, available at: https://goo.gl/vsbnHd.

- a majority of the issuer's employees are based in-state.

Issuers that have changed their principal place of business after making sales in an intrastate offering pursuant to the amended Rule 147 or new Rule 147A, as applicable, cannot conduct another intrastate offering pursuant to either rule in another state for a period of six months from the date of the last sale in the prior state. In addition, an issuer relying on Rule 147 or Rule 147A must obtain written representation from each purchaser as to residency.

SEC GUIDANCE FOR REGISTERED INVESTMENT ADVISERS

ADVISERS ACT AND ADVERTISEMENTS

The SEC Staff has stated its view that use of social media to communicate with clients and prospective clients may implicate Rule 206(4)-1 under the Investment Advisers Act of 1940 (the "Advisers Act"), which governs advertisements made by investment advisers. This rule (the "Advertisement Rule"), in relevant part, provides that an investment adviser will violate the Investment Advisers Act's antifraud provisions if it publishes, circulates or distributes "any advertisement" that:

- refers, directly or indirectly, to "testimonials of any kind concerning the investment adviser" or the investment advice it provides;
- refers, directly or indirectly, to past specific recommendations it provides (e.g., "cherry-picking"), unless the adviser discloses a list of all recommendations, subject to certain requirements;
- represents that a graph, chart or formula, by itself, can be used to determine which securities to buy, without prescribed disclosures;
- contains a statement to the effect that a report, analysis or other service will be furnished free of charge, unless it is actually provided entirely free of charge without condition; or
- contains any untrue statement of a material fact, or that is otherwise false or misleading.

The Staff defines "advertisement" broadly. An "advertisement" includes (1) any notice, circular, letter or other written communication addressed to more than one person, or any notice or announcement in any publication or by radio or television, that offers analysis, reports or publications concerning securities, or that is to be used in making any determination as to when to buy or sell any security; (2) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security; or (3) any other investment advisory service with regard to securities. We can reasonably conclude that the term applies to social media communications, including blogs, photo and video sharing, podcasts, social networking and virtual worlds.

OCIE COMPLIANCE

Use of Social Media

With the increased use of social media by advisers, clients and prospects, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a National Examination Risk Alert, dated January 4, 2012 ("2012 Risk Alert"), which provides guidance on the use of social media by registered investment advisers

("RIAs").[20] In the 2012 Risk Alert, the Staff noted three areas of concern in the use of social media by RIAs: compliance policies and procedures, third-party content and recordkeeping. On September 14, 2017, OCIE issued a National Examination Risk Alert ("2017 Risk Alert") discussing the most frequent Advertising Rule compliance issues identified in deficiency letters from over 1,000 adviser examinations.[21]

Compliance Policies and Procedures

In the recent Risk Alert, the Staff observed that many firms' compliance policies and procedures for communications do not specifically or appropriately address the use of social media, and such policies and procedures tend to overlap with those applicable to advertisements, investor communications or electronic communications, generally. The lack of specificity for social media use, the Staff noted, may cause confusion as to which procedures or standards are applicable to social media use, and many policies do not specifically address which types or social networking activity are allowed or prohibited. In light of this observation, the Staff provided guidance for RIAs in evaluating their controls and compliance programs, which includes the following:

- **Usage guidelines**. Implement usage guidelines that provide guidance on appropriate and inappropriate use of social media and appropriate restrictions and prohibitions on such use of social media sites based on applicable risks.
- **Content Standards**. Consider the fiduciary duty and other regulatory risks implicated by the social media content created by the RIA and its investment advisory representatives ("IARs"). Consider creating clear guidelines on social media content.
- **Monitoring**. Monitor the RIA's social media sites or its use of third-party sites, taking into account whether the third-party sites provide complete access to a supervisor or compliance personnel.
- **Frequency of Monitoring**. Consider the frequency with which an RIA monitors activity on social media sites, taking into consideration the volume and pace of communications posted on a site or the nature of or probability of misleading content.
- **Approval of content**. Consider preapproval of communications, rather than after-the-fact reviews.
- **Firm resources**. Evaluate whether the RIA has sufficient resources to adequately monitor personnel using social media.
- **Criteria for approving participation**. Establish compliance procedures that assess the risk exposure arising from the use of a social networking site, including a site's reputation, privacy policy, ability to remove third-party posts, controls on anonymous postings and advertising policies.
- **Training**. Consider implementing a training program related to social media, with a view toward promoting compliance and prevention of violations of federal securities laws and an RIA's internal policies.
- **Certification**. Consider certification of compliance with social media policies and procedures.

[20] Office of Compliance Inspections and Examinations, National Examination Risk Alert, Vol. II, Issue 1, *Investment Adviser Use of Social Media* (January 2012), available at: https://goo.gl/uuFZBQ.
[21] Office of Compliance Inspections and Examinations, National Examination Risk Alert, Vol. VI, Issue 6, *The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers* (Sept. 2017), available at: https://goo.gl/f5BDTK.

- **Functionality**. Consider the functionality of an approved social media site, including the continuing obligation to address any upgrades or modifications that affect risk exposure.
- **Personal/professional sites**. Consider adopting policies and procedures to address the RIA or solicitor conducting business on personal or third-party social media sites.
- **Information security**. Evaluate whether allowing access to social media sites poses any information security risks and consider measures for protecting at-risk information.
- **Enterprise-wide sites**. RIAs that are part of a larger financial services or corporate enterprise may consider creating usage guidelines designed to prevent the advertising practices of a firm-wide social media site from violations of the Advisers Act.

Third-Party Content

The Staff has indicated that third-party content on social media sites presents special compliance challenges. These issues arise when third parties post messages, forward links or post articles to an adviser's website or on social media sites. Adviser representatives and solicitors generally do not interact with their third parties or respond to their postings. The Staff noted its concern about direct or indirect testimonials "of any kind," and it broadly construes the type of communication that constitutes a testimonial. A posting by a third party that comments on an adviser's stock-picking prowess, the Staff warns, may amount to a prohibited "testimonial." Even hitting the "Like" button on an adviser's Facebook page could be a prohibited testimonial if the thumbs-up represents an explicit or implicit statement of a client's experience with an investment adviser or its representative.

Recordkeeping

OCIE noted that the recordkeeping rules do not differentiate between traditional paper communications, like mail, and electronic communications, such as emails, instant messages and other ways that investment advisers provide advisory services. Federal regulators focus on the content of the communication, rather than its form. OCIE urges investment advisers to ensure that their recordkeeping policies and procedures address social media channels.

TESTIMONIALS

In the 2017 Risk Alert, OCIE observed that some advisers' publication of certain client statements attesting to their services or otherwise endorsing the adviser, such as client endorsements published on firm websites or social media pages, may be prohibited testimonials under subsection (a)(1) of the Advertising Rule. Acknowledging the growing demand by consumers for information through social media, the SEC's Division of Investment Management set some ground rules on how investment advisers can use social media to publish advertisements that feature public commentary about the advisers and that appears on social media sites.[22]

[22] The Division of Investment Management Guidance Update No. 2014-4, *Guidance on the Testimonial Rule and Social Media*, available at: https://goo.gl/dn22cq.

Generally, advisers may refer to commentary published on social media sites without violating the rule prohibiting publication of client “testimonials” if the content is independently produced and the adviser has no “material connection” with the independent social media site.

Section 206 of the Advisers Act contains broad antifraud provisions that apply to advisers. Rule 206(4)-1(a)(1) under the Advisers Act defines fraud to include “any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service” provided by the adviser. This is the so-called “testimonial rule.” In a 1985 no-action letter, the SEC Staff said that the basis of the prohibition is that a “testimonial may give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser’s clients.”

While the SEC’s rules do not define the term “testimonial,” the Staff has indicated that public commentary made by a client endorsing an investment adviser, or a statement made by a third party about a client’s experience with the adviser, may be a testimonial for this purpose. As the guidance notes, whether public commentary on a social media site constitutes a testimonial depends on the facts and circumstances relating to the statement.

In the age of social media, this rule presents compliance challenges for advisers whose clients rely on social media. The Staff, through the “no-action” process, has provided limited guidance on what constitutes a testimonial. For example, the Staff has said that publication of an article by an unbiased third party regarding an adviser’s performance, unless it includes a statement of a client’s experience with the adviser, or an endorsement of the adviser, would not violate the testimonial rule. The Staff has relied on this concept as the basis for its current guidance.

Third-party commentary. The Staff attempted to draw a distinction between endorsements and legitimate third-party commentary:

- Advisers may not publish public commentary on their websites that is an explicit or implicit statement of a client’s experience with the adviser.
    - Commentaries posted directly on the adviser’s website, blog or social media site that tout the adviser’s services are prohibited testimonials.
- Advisers will not necessarily violate the testimonial rule if they publish commentary originating from an independent social media site on their own websites or social media sites, provided:
    - the independent social media site provides content that is independent of the investment adviser or its representative;
    - there is no material connection between the independent social media site and the investment adviser or its representative that would “call into question the independence” of the independent social media site or its commentary; and
    - the investment adviser or representative publishes all of the unedited comments appearing on the independent social media site regarding the adviser or representative.

- Content is not “independent” if the adviser or its representative had a hand in authoring the commentary, directly or indirectly. For example, paying a client (or offering a discount to a client) for saying nice things would implicate the testimonial rule.
- Advisers may not use testimonials from independent social media sites that directly or indirectly emphasize commentary favorable to the adviser or downplay unfavorable commentary.
- Advisers may publish commentary from an independent social media site that includes a mathematical average of the public commentary — for example, based on a ratings system that is not designed to benefit the adviser.

Investment adviser advertisements on independent social media sites.

- Investment advisers may advertise on an independent social media site, provided that it is readily apparent that the advertisement is separate from the public commentary on the site and that the receipt of advertising did not influence the selection of public commentary for publication.

Reference to independent social media site commentary in nonsocial media advertisements.

- In print, TV and radio ads, advisers may refer to the fact that third-party social media sites feature public commentary about the adviser, but they may not publish any actual testimonials without implicating the testimonial rule.

Client lists on social media sites.

- Simply identifying contacts or friends on a social media site by itself does not implicate the testimonial rule, as long as they are not grouped in a way that suggests that they endorse the investment adviser.

Fan and community pages.

- A third party’s creation and operation of unconnected community or fan pages generally would not implicate the testimonial rule. However, the Staff strongly cautions advisers and their employees that publishing content from those sites or directing user traffic to those sites if they do not meet the no-material-connection and independence conditions described above may implicate the testimonial rule.

Scope of regulatory approach. The Division of Investment Management’s approach to regulating the use of social media by advisers differs from the approach adopted by FINRA for broker-dealers. While both regulators focus on the substance of the communication, rather than the format, the differences arise primarily from the nature of the regulated entity and the starting point of regulation.

For example, the Division of Investment Management focuses almost exclusively on adequacy of compliance programs and whether a particular use of social media involves a prohibited “testimonial.” FINRA focuses on the suitability of a recommendation and whether a particular communication requires

advance compliance approval. Both approaches require caution when a regulated entity publishes or relies on third-party content.

The Division of Investment Management's guidance moves the ball forward and provides a starting point for chief compliance officers who are struggling to get their arms around advisers' use of social media. It may also provide an opportunity for advisers to revisit their procedures for monitoring advertising. While the guidance provides some relief for advisers, it also provides some compliance challenges, especially when advisers and their representatives make use of social media to advertise.

FORM ADV

The SEC recognizes the growing importance that social media plays in the regulation of investment advisers and believes that having current information on an adviser's social media presence collected in one place may be helpful to investors and to the SEC. Item 1.I of Part 1A of Form ADV requires registered investment advisers to list the address of each of their accounts on publicly available social media platforms when the adviser controls the content of the platform. Advisers are not required to provide addresses of websites or accounts on social media platforms for which they do not control the content, such as sites that provide job listings or allow the public to rate and review companies. The requirement does not extend to listing the address of an employee's account on a publicly available social media platform.[23] The SEC stated that "a primary purpose is to provide the Commission and our staff with information that may be used in our examination program and for regulatory purposes."[24] Among other things, the SEC will cross-reference this information with other information to better understand the business and relationships of investment advisers and to improve its regulatory oversight.

INVESTOR ALERT

The SEC also published an Investor Alert, Social Media and Investing – Avoiding Fraud,[25] intended to make investors aware of fraudulent investment schemes using social media. The alert provides tips for checking the backgrounds of investment advisers and brokers. An Investor Bulletin, Social Media and Investing, and Understanding Your Accounts provide tips for investors who use social media about privacy settings, security and password selection.

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[23] The Division of Investment Management also released a series of frequently asked questions about amended Item 1.I of Form ADV on June 12, 2017, available at: https://goo.gl/FPm4zr.

[24] Form ADV and Investment Advisers Act Rules, Investment Advisers Act Release No. 4509 at 38 (Aug. 25, 2016), available at: https://goo.gl/KVtCcd. Form ADV, highlighted to show changes adopted in 2016, is available at: https://goo.gl/U4XWJn.

[25] See *Updated Investor Alert: Social Media and Investing – Avoiding Fraud* (Nov. 12, 2014), available at: https://goo.gl/C3M7YL.

ROBO-ADVISERS

There has been a fast-growing trend in the investment advisory industry of automated advisers, or "robo-advisers," that provide more affordable investment advisory services through the internet and innovative technologies. Given that the robo-adviser business model relies largely if not exclusively on internet-based and social media communications, and has attracted significant interest from regulators, we have included in this guide, a brief overview of the current guidance.

In February 2017, the SEC Division of Investment Management ("IM") issued a Guidance Update ("IM Guidance") addressing robo-advisers and their compliance with the Advisers Act.[26] IM noted that robo-advisers are subject to the substantive and fiduciary obligations of the Advisers Act and because robo-advisers rely on algorithms and provide advisory services over the internet with limited, if any, direct human interaction to their clients, their unique business models may trigger certain issues when seeking to comply with the Advisers Act."

In the IM Guidance, the Staff focused on three distinct areas:

1. the substance and presentation of disclosures to clients about the robo-adviser and its services;
2. the robo-adviser's obligation to obtain client information to carry out its duty to provide suitable advice; and
3. the adoption and implementation of effective compliance programs reasonably designed to address particular concerns relating to the provision of automated advice.

IM also noted that robo-advisers should consider whether their organization and operation raise any issues under other federal securities laws, including the Investment Company Act of 1940 (the "Investment Company Act"), in particular Rule 3a-4. Rule 3a-4 is a conditional, non-exclusive safe harbor that provides a basis to defend a discretionary investment advisory program in which all accounts are essentially managed in the same way from being deemed a de facto registered investment company.

Disclosures to Clients

IM noted that the information a client receives from an investment adviser is critical to his or her ability to make informed decisions with respect to the client's relationship with the investment adviser. An investment adviser has a fiduciary duty to make full and fair disclosure of all material facts to clients and to use reasonable care in avoiding misleading clients. Such information given to clients must be sufficiently specific and be presented in a manner that allows a client to understand the investment adviser's business practices and conflicts of interests. As there is limited, if any, human interaction between robo-advisers and their clients and given their use of algorithms and the internet, robo-advisers must take care that electronic disclosures made via email, websites, mobile applications and/or other electronic media allow a client to make an informed decision about entering into or continuing an

[26] The Division of Investment Management Guidance Update No. 2017-02, Robo-Advisers (February 2017), available at: https://goo.gl/owQF24.

investment advisory relationship and that the client understands the limitations, risks and operational aspects of such advisory services.

IM noted the following matters that require close attention for robo-advisers:

Explanation of Business Model

A robo-adviser should disclose, among other information, information regarding its business practices and related risks, including the following:

- use of algorithms and the algorithmic functions used to manage individual client accounts (e.g., that the algorithm generates recommended portfolios, and that individual client accounts are invested and rebalanced by the algorithm);
- an algorithm's assumptions and limitations (e.g., if the algorithm is based on modern portfolio theory, a description of the assumptions underlying, and the limitations of, that theory);
- risks inherent in the use of an algorithm (e.g., that the algorithm might rebalance client accounts without regard to market conditions or on a more frequent basis than the client might expect; and that the algorithm may not address prolonged changes in market conditions);
- circumstances that might cause the robo-adviser to override the algorithm (e.g., that the robo-adviser might halt trading or take other temporary defensive measures in stressed market conditions);
- any involvement by a third party in the development, management or ownership of the algorithm, including an explanation of any conflicts of interest (e.g., if the third party offers the algorithm to the robo-adviser at a discount, but the algorithm directs clients into products from which the third party earns a fee);
- any fees the client will be charged directly by the robo-adviser, and of any other costs that the client may directly or indirectly bear (e.g., fees or expenses clients may pay in connection with the advisory services provided, such as custodian or mutual fund expenses, brokerage and other transaction costs);
- the degree of human involvement in the oversight and management of individual client accounts (e.g., that investment advisory personnel oversee the algorithm but may not monitor each client's account);
- how the robo-adviser uses the information gathered from a client to generate a recommended portfolio and any limitations (e.g., if a questionnaire is used, that the responses to the questionnaire may be the sole basis for the robo-adviser's advice; if the robo-adviser has access to other client information or accounts, whether, and if so, how, that information is used in generating investment advice); and
- how and when a client should update information he or she has provided to the robo-adviser.

Scope of Advisory Services

IM also noted that robo-advisers are subject to the same obligations as all RIAs to ensure that the descriptions of their investment advisory services are clear and that there are no false or misleading

statements relating to the scope of their services. IM noted the following examples of potential false or misleading statements:

- providing a comprehensive financial plan if it is not in fact doing so, such as the robo-adviser not taking into account a client's tax situation or debt obligations, or the robo-adviser providing the investment advice targeted to meet a specific goal without regard to the client's broader financial situation;
- providing comprehensive tax advice when the robo-adviser is only providing tax-loss harvesting service; or
- indication that client information other than that collected by the robo-adviser, its affiliates or third parties and the client is considered when generating investment recommendations if such information is not in fact considered.

Presentation of Disclosures

In the IM Guidance, IM observed that robo-advisers relied on online disclosure to provide important information to clients. The Staff highlighted the importance of the effectiveness of such disclosures in getting important information to clients who may be unlikely to read or understand disclosures that are dense and that are not in plain English. The Staff noted that robo-advisers should consider whether key disclosures necessary for a client to make an informed decision prior to engaging with or making an investment through the robo-adviser (1) are available and presented to potential clients prior to the sign-up process and (2) are emphasized, such as through design features such as pop-up boxes. The Staff also noted that robo-advisers should consider whether some disclosures should be accompanied by interactive text such as tooltips or other means to provide additional details to clients who are seeking more information, and whether disclosures are presented and formatted appropriately to adapt to mobile platforms.

Duty to Provide Suitable Advice

Investment advisers have a fiduciary duty to act in the best interests of their clients and to make reasonable determinations as to whether the investment advice they provide is suitable for a client based on the client's financial situation and investment objectives. IM noted two aspects of the robo-advisers processes that may require attention.

Reliance on Questionnaires for Client Information

IM noted in its IM Guidance that some robo-advisers provide investment advices primarily, if not solely, on client online questionnaires. Based on this limited interaction with the client, IM outlines certain factors robo-advisers should consider when evaluating the sufficiency of their questionnaires for suitability purposes:

- whether the questions elicit sufficient information to allow the robo-adviser to determine that its recommendations and investment advice are suitable and appropriate for a client based on the client's financial situation and investment objectives;

- whether the questions are sufficiently clear and/or designed to provide additional clarification or examples when necessary such as through the use of design features like tooltips or popup boxes; and
- whether steps have been taken to address inconsistent client responses, such as design features that alert a client to internally inconsistent responses or systems that automatically flag apparently inconsistent information for review or follow-up by the robo-adviser.

Client-Directed Investment Strategy Changes

IM observed that many robo-advisers allow clients to select portfolios other than those that have been recommended without giving the client an opportunity to consult with the investment advisory personnel to assess whether such selection is appropriate for the client's investment objectives and risk profile. As this may result in a client choosing unsuitable portfolios, IM noted that robo-advisers should consider providing commentary as to why particular portfolios are more appropriate in light of a client's investment objectives and risk profile and consider implementing design features that alert the client of potential inconsistencies between portfolio selections and the client's investment objectives and risk profile.

Compliance Programs for Automated Advice

All RIAs must implement compliance procedures and policies to ensure that they are in compliance with fiduciary and substantive obligations under the Advisers Act and must evaluate risk exposures related to the nature of the firm's operations. Given the business model of robo-advisers, IM outlined certain factors that robo-advisers should consider in their compliance procedures and policies:

- the development, testing and monitoring of the algorithmic code to ensure that the code is properly integrated into the robo-advisers' platform, performs as represented and any modifications to the code would not adversely affect client accounts;
- the appropriate oversight of any third party that develops, owns or manages the algorithmic code or software modules utilized by the robo-adviser;
- the suitability and appropriateness of client questionnaires used to determine investment recommendations and advice based on a client's financial situation and investment objectives;
- the disclosure to clients of changes to the algorithmic code that may materially affect their portfolios;
- the prevention and detection of, and response to, cybersecurity threats;
- the use of social and other forms of electronic media in connection with the marketing of advisory services; and
- the protection of client accounts and key advisory systems.

SEC GUIDANCE FOR INVESTMENT COMPANIES

The SEC guidance to issuers relating to the application of the federal securities laws in the context of social media, which includes the May 2000 Release, and which we discuss above under "Guidance for Issuers" would apply as well to registered investment companies. In this section, we focus principally on specific guidance provided by the SEC and the Staff relating to social media usage by investment companies. We do not comment on compliance by investment companies with regulatory guidance related to performance advertising matters.

In a March 2013 guidance update (the "2013 Guidance"), the Staff of the Division of Investment Management took the view that whether a registered investment company must file a particular communication under Section 24 of the Investment Company Act or Rule 497 under the Securities Act (if not required to be filed under applicable FINRA rules) depends on the content, context and presentation of the particular communication for relating to interactive content.[27] Investment companies do not necessarily have to file with the SEC interactive content posted in a real-time electronic forum (such as chat rooms or other social media) that is not required to be filed under FINRA Rule 2210. However, funds must examine the underlying substantive information transmitted to the social media user and consider other relevant facts and circumstances, such as whether the interactive communication is merely a response to a request for information, or whether the fund is sending previously filed content. The 2013 Guidance outlined nonexclusive examples and the Staff's views on filing requirements applicable to such examples.

Some examples of where no filing would be required are as follows:

- Incidental mention of specific funds unrelated to a discussion of the investment merits of the fund.
  - "Fund X Family of Funds invites you to their annual benefit for XYZ Charity."
  - "More than 100 Fund X employees volunteered for our Annual Day of Caring!"
- Incidental use of the word "performance" in connection with discussion of a fund without specific mention of elements of the fund's return.
  - "We update performance of our funds every month and publish them on our website."
  - "When reviewing a fund's performance, it is important to consider performance against a benchmark."
- Factual introductory statements including a hyperlink to a prospectus or information filed under Section 24(b) or Rule 497.
  - "The new ABC ETF Strategy Report is now available through this link: [website URL]."
  - "John Doe is the new portfolio manager for ABC fund [website URL]."

[27] Division of Investment Management Guidance No. 2013-01, *Filing Requirements for Certain Electronic Communications* (March 2013), available at: https://goo.gl/i2rE8R.

- Introductory statements unrelated to a discussion of investment merits of a fund that include a hyperlink and discussions of basic investment concepts or commentaries on economic, political or market conditions.
    - “Our data shows the average 401(k) balance is the highest it’s been in more than 10 years! This is partly due to increasing employer and employee contributions.”
    - “The election is over, what is next for our economy? See our report analyzing the elections.”
- Responses to inquiries that provide discrete factual information unrelated to a discussion of the investment merits of the fund.
    - *Inquiry*: “What was the NAV for ABC fund on Friday?”
        - *Fund’s posted response*: “$xx.xx”
    - *Inquiry*: “What are the fees and expenses for ABC Fund?”
        - *Fund’s posted response*: “Information on the fund’s fees and expenses is available at Feel free to contact us at 1-800-***-**** for more information about this fund.”

Some examples of instances in which filing would be required are as follows:

- Discussions of fund performance that mention some or all of the elements of a fund’s return or that promote a return.
    - “The fund slightly underperformed its benchmark, the S&P 500 Index, during the quarter that ended March 31, 2013.”
- Communications initiated by issuers that discuss investment merits of the fund.
    - “Looking for dividends? Think global and consider our new Global Equity Fund [website URL].”

FINRA GUIDANCE FOR BROKER-DEALERS

On August 18, 2011, FINRA issued Regulatory Notice 11-39,[28] providing guidance to broker-dealers on social networking websites and business communications. The notice updated FINRA's guidance contained in Regulatory Notice 10-06 from January 2010.[29] Regulatory Notice 10-06 provides guidance on the application of FINRA rules governing communications by FINRA member firms with the public through social media sites, and reminds member firms of certain requirements relating to those communications.[30] Most recently, in 2017, FINRA published Regulatory Notice 17-18, which reinforces guidance contained in Regulatory Notices 10-06 and 11-39, and includes additional guidance in the form of questions and answers relating to social media and recordkeeping, third-party posts and hyperlinks to third-party sites.[31]

To understand FINRA's guidance on social media, it is important to understand the difference between static and interactive electronic communications. Since 1999, FINRA has taken the position that participation by a registered representative of a member firm in an Internet chat room is comparable to a presentation made to a group of investors and, accordingly, is subject to the same rules applicable to public appearances.[32] This position was codified in 2003 when NASD Rule 2210 was amended to include the participation in an interactive electronic forum in the definition of "public appearance." As a result, the FINRA rules do not require prior approval of postings by member firms or their associated persons on interactive electronic forums, provided that the member firm supervises and reviews such postings in the same manner as required for the supervision and review of correspondence under FINRA Rule 3110(b)(4).

Static communications or postings are regulated as "advertisements" under FINRA rules and, accordingly, are required to have been reviewed by a registered principal.

Member firms and their associated persons must be careful to distinguish between static and interactive electronic communications. Under the current FINRA communication rule, any communication by a member firm on social media would likely be a retail communication, which includes any electronic communication to 25 or more retail investors within any 30-day period. Pursuant to revisions effective in February 2013, FINRA Rule 2210 no longer retains the "advertisement" and "public appearance" categories, but those terms are useful in explaining FINRA's disparate treatment of retail communications on the static and nonstatic portions of an interactive electronic forum.

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[28] *Social Media Websites and the Use of Personal Devices for Business Communications, Guidance on Blogs and Social Networking Websites and Business Communications*, Regulatory Notice 11-39 (August 2011), available at: https://goo.gl/zjwHZy.

[29] *Social Media Web Sites, Guidance on Blogs and Social Networking Web Sites*, Regulatory Notice 10-06 (January 2010), available at: https://goo.gl/efe79M.

[30] Updated FINRA communications rules became effective in February 2013. See Communications With the Public, SEC Approves New Rules Governing Communications With the Public, Regulatory Notice 12-29 (June 2012), available at: https://goo.gl/yj95b3. The updates to Rule 2210 (Communications with the Public) codified much of the existing guidance.

[31] *Social Media and Digital Communications, Guidance on Social Networking Websites and Business Communications*, Regulatory Notice 17-18 (April 2017), available at: https://goo.gl/1SseL5.

[32] See Regulatory Notice 10-06 at 1 and n.3.

INTERACTIVE ELECTRONIC FORUMS

Social networking sites may be subject to different rules, depending on the nature of the communication. Common social networking sites combine static content and real-time interactive communications. For example, certain portions of the content, such as biographical information, status updates and wall uploads, may be static, whereas "comments" and "likes" will be real-time interactive content. Static content remains posted until it is changed by the firm or individual who established the account. Generally, such content is accessible to all visitors of the site or page and is treated by FINRA as an advertisement. On the other hand, interactive content or nonstatic real-time communications have the characteristics of online interactive electronic forums and do not need to be approved by a registered principal, but are subject to the Rule 3310(b)(4) supervision requirements discussed above. Examples of nonstatic, real-time communications include interactive posts, such as "comments" or "likes" on Facebook or "replies" on Twitter, and these are treated as public appearances.

Although a blog (or a bulletin board) may seem to be an online interactive electronic forum, for FINRA, the treatment of a blog will depend on the manner and purpose for which the blog has been constructed. Blogs consisting of static postings are deemed advertisements, and their contents require prior principal approval before posting. Most blogs today are used to engage in real-time interactive communications with third parties. As a result, these blogs may be deemed online interactive electronic forums and regulated as public appearances.

FINRA penalized a registered representative for, among other things, misrepresenting her career accomplishments and her employer firm on a profile posted on a third-party website without obtaining prior principal approval from her then-current employer. FINRA cited FINRA Rules 2110 and 2210. The same representative was cited for violating FINRA Rule 2210 for "tweeting" a recommendation on a particular security without prior principal approval. According to FINRA, the content of the "tweets" was "unbalanced, overly positive and often predicted an imminent price increase." FINRA did not object to the form of the communication; it objected to the content and the lack of prior approval.

Recordkeeping

Regulatory Notices 11-39 and 17-18 address recordkeeping. In Regulatory Notice 11-39, FINRA clarified that the posting of any content on a website by a member firm or its associated persons is a communication under the FINRA rules and, accordingly, is subject to applicable FINRA recordkeeping rules. Rules 17a-3 and 17a-4 under the Exchange Act and FINRA Rule 3110 require that a broker-dealer retain electronic communications made by the firm and associated persons that relate to the firm's "business as such." According to FINRA, the determination of whether an electronic communication relates to a firm's "business as such," and hence is subject to the recordkeeping rules, depends on the facts and circumstances and the context and the contents of the communication. Neither the type of device or technology used to transmit the communication nor the ownership of the device is relevant to the determination. Notice 17-18 applied the recordkeeping requirements to digital communications, including text messaging and chat services, and reminded firms that they must ensure that they can retain any business communications before using those services for business purposes. Finally, with respect to recordkeeping rules, the requirements are the same for both static and interactive electronic

communications. Retail communications on an online interactive electronic forum are not subject to the filing requirements of Rule 2210.

Supervision and Review

Under FINRA Rule 3010, member firms must establish and maintain a system to supervise the activities of each registered representative, registered principal and associated person that is reasonably designed to achieve compliance with the applicable securities laws and regulations and with applicable FINRA rules. As part of this requirement, a registered principal must review any social media site that an associated person intends to use for business communications prior to its use and should approve a site for use for business purposes only if the registered principal has determined that the associated person can and will comply with all applicable FINRA communication rules, federal securities laws and individual firm policies.

Suitability

If a member firm or its associated persons recommends a security, including through social media channels, FINRA Rule 2111 would apply to such communications. Whether a social media communication is a "recommendation" depends on the facts and circumstances of such communication. FINRA references Notice to Member 01-23 as guidance for member firms in analyzing whether social media communications fall under the "recommendation" definition. In addition, member firms must take care in assessing suitability under Rule 2111 when using social media channels that include functions that make their content widely available or limit access to one or more individuals. FINRA also recommends as best practice that member firms implement policies and procedures that govern communications that promote specific investment products and require prior approval by a registered principal for all interactive electronic communications that recommend a specific investment product and any link to such recommendation.

Third-Party Posts, Third-Party Links and Websites

FINRA generally does not treat posts by customers or other third parties on member firms' websites as a firm's communication with the public subject to Rule 2210. However, under certain circumstances, such third-party posts may be attributed to the member firm if (1) the firm involves itself in the preparation of the content or pays for such content under the "entanglement theory" or (2) the firm explicitly or implicitly endorses or approves the content under the "adoption theory." A response to a third-party business-related communication posted on a firm's associated person's personal social media site would be permissible under FINRA rules as long as such communication does not violate the firm's internal communications policies. In addition, a firm that deletes or blocks certain third-party content to ensure compliance would not be deemed to have entangled itself or adopted such third-party content. In addition, if a firm co-brands any part of a third-party website, such as placing its logo prominently on such site, the firm would be responsible for the content of the entire site as the firm would be deemed to have adopted the site's content.

Sharing or linking to third-party websites would not be subject to Rule 2210 as long as the member firm is not deemed to have entangled itself or adopted such website under the two theories described above.

Whether the content of other sites is attributable to the member firm will depend on whether the link is "ongoing" or if the member firm has influence or control over the content of the third-party site. A link is ongoing if it is continuously available to investors who visit the member firm's site, investors have access to the linked site whether or not it contains favorable material about the member firm and the linked site could be updated or changed by the independent third party, and investors would still be able to use the link at the member firm's site. If the link is ongoing, content at a linked site will not be deemed to have been adopted by the member firm. However, if the firm has any influence or control over the content of the third-party site, the content of that site will be attributable to the firm through the entanglement theory. If a member firm shares or links to content that in turn links to other content and the member firm has influence or control over that other content, the member would be deemed to have adopted the other content. If a member firm shares or links to content that itself is primarily a vehicle for other links, or where the content available through such links forms the entire basis of the article, content accessed through such links would be attributable to the firm through the adoption theory.

Any language used by the member firm to introduce the link must conform to the content standards of Rule 2210(d). A firm may not establish links to third-party sites that the firm knows, or has reason to know, contain false or misleading content, and should not do so when there are red flags that indicate such linked sites contain false or misleading content. If shared or linked content is considered adopted by the member firm, the member firm must ensure that the adopted content, when read in context with the statements in the originating post, complies with Rule 2210's standards applicable to firm communications.

Firms should consider taking the following steps to avoid liability of third-party content:

- ensure that links to third-party sites are accessible only through a new window when linking to a site;
- ensure that a legend appears on the screen warning the reader that he or she is leaving the firm site and disclaim any responsibility for third-party content. It is unlikely that such legends will shield a member firm from sanction by FINRA, if applicable, but posting such legends may be effective for limiting liability relating to customer claims; and
- ensure that their policies relating to social media sites address links to third-party sites.

Many member firms also monitor third-party posts to mitigate the perception that it is adopting or entangling itself with such third-party communications. FINRA's Social Networking Task Force outlines the following steps as examples of best practices that member firms have adopted:

- establishing appropriate guidelines on use by customers and other third parties that are permitted to post on firm-sponsored websites;
- establishing screening processes of third-party content based on the expected usage and frequency of third-party posts; and
- disclosing firm policies regarding its responsibility for third-party posts.[33]

[33] See Regulatory Notice 10-06 at 8.

Testimonials, Endorsements and Recommendations

Similar to third-party posts on a member firm's social media site, unsolicited third-party opinions or comments posted on a business-related site supervised and retained by a member firm or its registered representative are not communications of the firm or the registered representative for purposes of Rule 2210, nor are such unsolicited opinions or comments considered to be testimonials subject to the requirements of Rule 2210(d)(6). However, if a representative of a member firm "likes" or shares favorable comments posted by third parties on the site, then the comments would be adopted by the firm or representative and would be subject to Rule 2210, including the content, supervision, recordkeeping and testimonial requirements. For example, social media sites, such as LinkedIn, allow third parties to "recommend" a person and allow users to request recommendations. If a firm representative shares such recommendation, the firm may be deemed to have "adopted" such third-party recommendations.

A member firm who wishes to display testimonials in compliance with Rule 2210(d)(6) may disclose them either in the interactive electronic communication itself, in close proximity to the testimonial or through a clearly marked hyperlink using language such as "important testimonial information." Firms registered under the Advisers Act are also subject to prohibitions against fraudulent, manipulative or deceptive acts or the use of any advertisement that refers to a testimonial concerning an investment adviser or any advice, analysis, report or other service rendered by the investment adviser.

Access from Personal Devices

FINRA allows firms to permit their associated persons to use personal communication devices for the firm's business communications.[34] However, a firm must be able to retain, retrieve and supervise business communications regardless of the ownership of the device used to transmit the communications. Firms should require, if possible, that associated persons use separate applications on a device for business communications to facilitate retrieval of the business communications and to separate personal communications. To facilitate retrieval of business communications, firms should ask associated persons to limit personal communications to private email accounts and to prohibit personal communications through firm email accounts. In addition, a firm should install an application that provides a secure portal into a firm's communications system, especially if confidential customer information is shared. If a firm has the ability to separate business and personal communications on a device and has adequate policies and procedures regarding usage, the firm will not be required to (but may voluntarily) supervise personal communications on the device. Firms should consider which devices are most compatible with their internal compliance efforts and require associated persons to limit their business communications to such devices.

[34] See Regulatory Notice 11-39 at 7.

CONCLUSION

The growing trend of social media as a preferred method of communication for a growing percentage of market participants highlights the need for thoughtful policy and procedural change to ensure compliance with changing securities laws and the regulatory framework applicable to issuers, broker-dealers and investment advisers regarding the use of social media channels.

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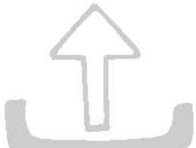

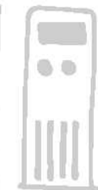

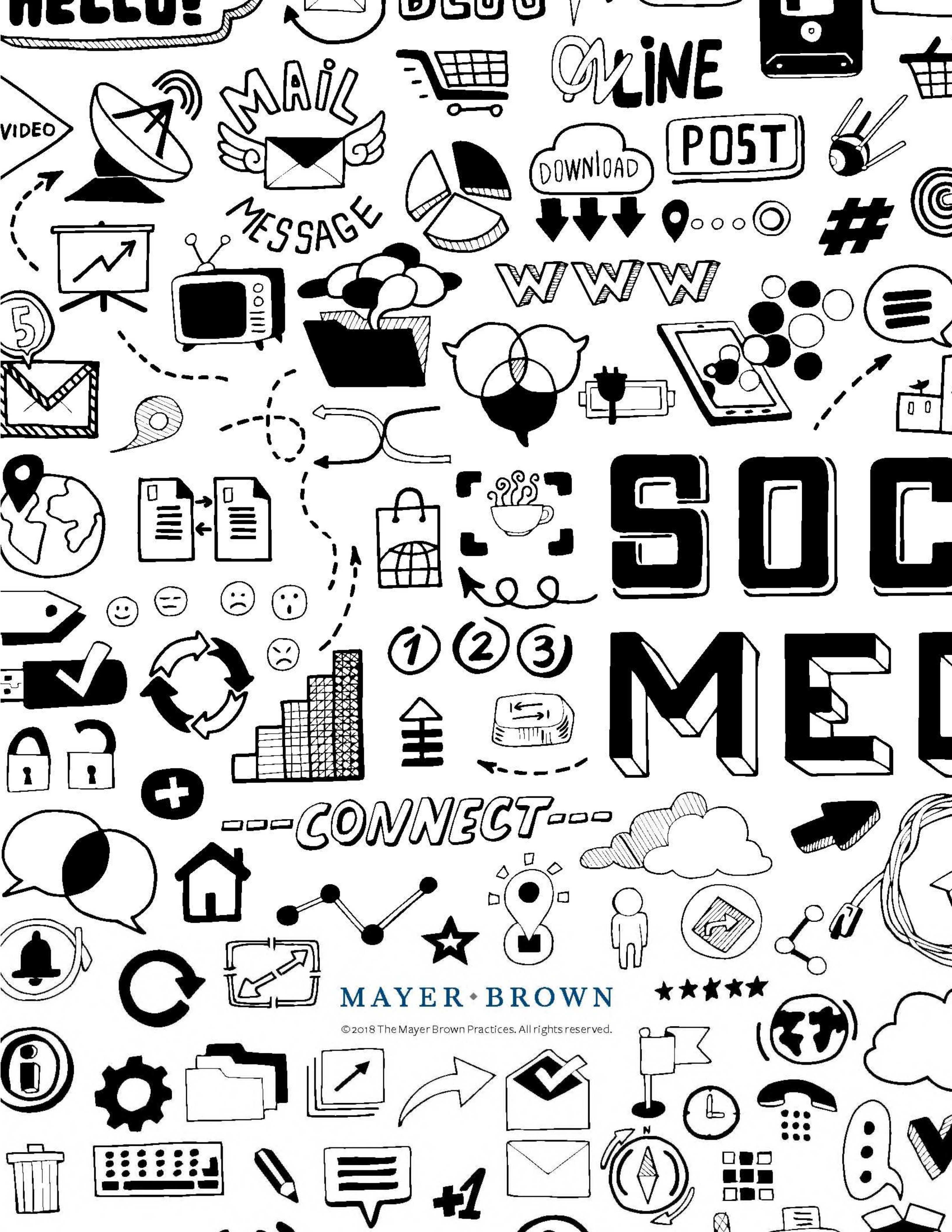

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