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Private Market Update: SEC Adopts Changes to Exempt Offering Framework

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Investment Company Directors SUBJECTS: Advertising
Closed-End Funds
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Trading and Markets RE: Private Market Update: SEC Adopts Changes to Exempt Offering Framework

The Securities and Exchange Commission recently adopted amendments to harmonize exemptions from registration available to issuers under Securities Act Regulation A, Regulation Crowdfunding, and Regulation D Rule 504.[1] The rulemaking builds on ideas discussed in a concept release that the Commission issued in June 2019.[2]

While the rulemaking is broad in scope, it notably:

- Expands the ability of issuers to solicit interest in exempt offerings through “demo days” and testing-the-water communications;
- Establishes a new integration framework to determine if multiple securities transactions should be considered part of the same offering;
- Increases offering limits and individual investment limits for Regulation A, Regulation Crowdfunding, and Regulation D Rule 504 offerings;
- Creates a new category of investment vehicle to facilitate investment in crowdfunding offerings; and
- Revises the standard for redacting confidential exhibits used in Commission filings, including several Investment Company Act forms.[3]

The rulemaking was adopted in a divided 3-2 vote from the Commission. Chairman Jay Clayton approved of the amendments eliminating costs for private issuers and providing access for investors to some private market opportunities, including in areas where individual investors can be more likely to sit side by side with professional investors.[4] Approving Commissioners Elad Roisman[5] and Hester Peirce[6] lauded the rulemaking’s aim to facilitate capital formation for small and medium sized businesses. Commissioners

Allison Herren Lee[7] and Caroline Crenshaw,[8] however, expressed concerns about expanding private market access to investors without adequate investor protections and questioned whether private issuers currently need greater capacity for capital raising.

We discuss the rulemaking in more detail below.

Amending General Solicitation Provisions

The Commission adopted rules to expand the scope of issuers to communicate about exempt offerings by allowing issuers to participate in "demo days" without making a general solicitation and allowing issuers to "test the waters" through a general solicitation of interest before determining which specific exemption from registration it may rely on for an offer of the securities.

- *Demo days:* Demo days are events that invite issuers to present their businesses to potential investors, with the aim of securing investment. New Securities Act Rule 148 conditionally exempts issuers participating in demo days from being deemed to have made a general solicitation.[9] The rule requires that more than one issuer participate in the demo day for the exemption to apply. The rule also prohibits the event sponsor from providing investment advice, charging an entrance fee, or receiving any compensation in connection with the demo day, in addition to placing limitations on event advertising. Finally, online participation in the event is limited to individuals who are members of, or associated with the sponsor organization, individuals that the sponsor reasonably believes are accredited investors or individuals who have been invited to the event by the sponsor based on industry or investment experience.
- *Testing-the-water*: Testing-the-water communications are generally oral or written communications to gauge investors' interest in a contemplated securities offering.[10] The Commission adopted Rule 241, a "generic" testing-the-waters rule, to conditionally permit an issuer to use generic solicitation of interest materials prior to filing a registration statement in Section 5(c) of the Securities Act..[11] If the issuer moves forward with an exempt offering following the generic solicitation of interest, it will be required to comply with an applicable exemption for the subsequent offering.

The Commission also adopted amendments to Rule 506(c), which permits general solicitation for offerings where issuers have verified that purchasers are accredited investors. The amendments will allow issuers to rely on a prior verification made within the past five years to currently verify that an investor is an accredited investor so long as the investor provides a written representation that it continues to be an accredited investor and the issuer is not aware of information to the contrary.[12]

Consolidating the Integration Framework

The Commission adopted amendments under the Securities Act to streamline disparate integration regulations into a single, comprehensive rule. Generally, integration regulations seek to prevent an issuer from improperly avoiding Securities Act registration by dividing a single offering into separate exempt offerings when those exemptions would not be available for the single offering. The current integration framework consists of a mixture of rules and Commission guidance for determining whether multiple exempt offerings should be considered part of a single offering.

As adopted, new Securities Act Rule 152 streamlines those disparate rules and provides a general principle of integration and four safe harbors as follows:

- A general principle to not treat a series of offerings as a single integrated offering if, based on facts and circumstances, the issuer can establish that each offering either complies with the registration of requirements of the Securities Act or that an exemption from registration is available for the particular offering.[13]

- Four non-exclusive safe harbors from integration if an issuer makes an offering:
  - Thirty days before the commencement[14] of any other offering;[15]
  - In compliance with Rule 701, pursuant to an employee benefit plan, or in compliance with Regulation S;[16]
  - In reliance on an exemption for which general solicitation is permitted if the offering is made after any prior terminated or completed offering;[17] or
  - For registered offerings, if as the issuer makes the offering after it makes a terminated or completed offering for which general solicitation was not permitted, for which the issuer only solicited qualified institutional buyers and institutional accredited investors, or which was terminated or completed more than 30 days before the registered offering.[18]

The introductory text of Rule 152 specifies that issuers are not permitted to avoid integration for any series of transactions that, although in technical compliance with the rule, are part of a plan or scheme to evade the registration requirements of the Securities Act.

Raising Offering and Investment Limits for Exempt Offerings

Under the current framework, the amount that an issuer can raise in an exempt offering and the amount that an individual investor can invest in that offering differ from one set of regulations to the next (*e.g.*, Regulation D or Regulation A). While not setting identical limits across the framework, the Commission's amendments to the Securities Act raise offering and investment limits. Notably, these amendments increase maximum offering amounts:

- For Regulation Crowdfunding issuers, from $1.07 million to $5 million.[19]

- For Regulation D Rule 504 issuers, from $5 million to $10 million.

- For Regulation A Tier 2 issuers, from $50 million to $75 million. In addition, the amendments would increase the maximum offering amount for secondary sales under Tier 2 from $15 million to $22.5 million.

Creating Special Purpose Crowdfunding Vehicles

The Commission adopted rules that permit the use of certain special purpose vehicles that function as a conduit for investors to facilitate investing in Regulation Crowdfunding issuers.[20] Doing so is expected to alleviate crowdfunding issuers' reported administrative difficulties in managing individual investors.

Crowdfunding vehicles must be organized and operated for the sole purpose of directly acquiring, holding, and disposing of securities issued by a single crowdfunding issuer and raising capital in one or more offerings made in compliance with Regulation Crowdfunding. Crowdfunding issuers would raise capital as co-issuers with a crowdfunding vehicle, which would purchase securities from the crowdfunding issuer and sell its own securities to investors. The Commission declined to require that the vehicle be managed by a registered investment adviser and clarified that neither the crowdfunding vehicle nor its operating staff would not implicate broker-dealer registration requirements.[21]

Amending the Standard for Redacting Confidential Exhibits on Several Investment Company Forms

The Commission revised the standard for redacting confidential exhibits in several Commission forms for investment companies, including Form N1-A.[22] Previously, registrants who file material contracts as exhibits to those forms were permitted to redact portions of those exhibits that they deem not to be material, but would likely cause competitive harm if publicly disclosed.

The amendments change the standard to accord with a recent Supreme Court holding[23] by removing the competitive harm requirement and replacing it with a requirement that the redacted information is the type of information that the registrant both customarily and actually treats as private and confidential.

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endnotes

[1] *See Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, Securities Act Release No. 10884 (Nov. 2, 2020); *see also* Securities Act Release No. 10763 (March 4, 2020), *available at* https://www.sec.gov/rules/proposed/2020/33-10763.pdf.

[2] *See Concept Release on Harmonization of Securities Offering Exemptions*, Securities Act Release No. 10649 (June 18, 2019), *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf. *See also* the Institute's comment letter in response to the Concept Release, *available at* https://www.sec.gov/comments/s7-08-19/s70819-6190597-192465.pdf..

[3] In addition, the rulemaking aligns the financial information requirements under Regulation D Rule 502(b) with those of Regulation A, aligned Regulation A filing procedures with those for Securities Act draft registration statements, and harmonized the "bad actor" disqualification provisions in Regulation A, Regulation Crowdfunding, and Regulation D by using the same disqualification lookback period.

[4] *See* Chairman Jay Clayton, *Statement on Harmonizing, Simplifying and Improving the Exempt Offering Framework: Benefits to Small and Medium-Sized Businesses and Their Investors* (Nov. 2, 2020), *available at* https://www.sec.gov/news/public-statement/clayton-harmonization-2020-11-2.

[5] *See* Commissioner Elad L. Roisman, *Statement at Open Meeting on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets* (Nov. 2, 2020), *available at* https://www.sec.gov/news/public-statement/roisman-harmonization-2020-11-02.

[6] *See* Commissioner Hester M. Peirce, *Statement at Open Meeting on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets* (Nov. 2, 2020), *available at*

https://www.sec.gov/news/public-statement/peirce-harmonization-2020-11-02.

[7] *See* Commissioner Allison Herren Lee, *Statement on Amendments to the Exempt Offering Framework* (Nov. 2, 2020), *available at* https://www.sec.gov/news/public-statement/lee-harmonization-2020-11-02.

[8] *See* Commissioner Caroline A. Crenshaw, *Statement on Harmonization of Securities Offering Exemptions* (Nov. 2, 2020), *available at* https://www.sec.gov/news/public-statement/crenshaw-harmonization-2020-11-02.

[9] As adopted, demo days must be in connection with a seminar or meeting sponsored by a college, university, or other institution of higher education, a state or local government or instrumentality of a State or local government, a nonprofit organization, or an angel investor group, incubator, or accelerator.

[10] *See*, *e.g.*, Securities Act Rule 163B (permitting an issuer to engage in oral or written communications with potential investors that are, or are reasonably believed to be, qualified institutional buyers or institutional accredited investors either prior to or following the filing of a registration statement, to determine whether such investors might have an interest in a contemplated registered securities offering).

[11] The Commission also adopted Rule 206 permitting Regulation Crowdfunding issuers to "test-the-waters" prior to filing an offering document with the Commission. *See* Rule 206.

[12] Securities Act Rule 506(c).

[13] Securities Act Rule 152(a). Rule 152(a) applies the general principle to two specific fact patterns, if the four safe harbors set forth in new Rule 152(b) do not apply. Rule 152(a)(1) specifies that the issuer must have a reasonable belief that purchasers were not solicited through general solicitation or that the issuer had a prior substantive relationship with the purchaser if the offering exemption being relied upon prohibits general solicitation. Second, in the context of two or more concurrent offerings each relying on a Securities Act exemption permitting general solicitation, new Rule 152(a)(2) clarifies that an issuer's general solicitation offering materials for one offering that includes information about the material terms of a concurrent offering under another exemption may constitute an "offer" of the securities in such other offering, and therefore the offer must comply with all the requirements for, and restrictions on, offers under the exemption being relied on for such other offering, including any necessary legends or communications restrictions.

[14] Securities Act Rule 152(c) defines when an offer has been commenced.

[15] Securities Act Rule 152(b)(1). If an exempt offering for which general solicitation is not permitted follows an offering that allows general solicitation, the provisions of Rule 152(a)(1) still apply.

[16] Securities Act Rule 152(b)(2).

[17] Securities Act Rule 152(b)(4). New Rule 152(d) defines when an offer is terminated or completed.

[18] Securities Act Rule 152(b)(3).

[19] Regulation Crowdfunding limits the amount individual investors are allowed to invest

across all offerings based on the individual's annual income or net worth. The amendments allow individual investors to rely on the greater of their income or net worth to calculate their investment limit. In addition, the amendments eliminate investment limits for crowdfunding investors who are accredited investors.

[20] Specifically, the rulemaking amends the Investment Company Act to exclude from the definition of "investment company" a newly-devised limited-purpose crowdfunding vehicle that meets specified conditions. Investment Company Act Rule 3a-9. Regulation Crowdfunding excludes investment companies as permitted investors in crowdfunding offerings.

[21] Release at p.175. Also note that the Commission has separately proposed an order under the Exchange Act to exempt from broker-dealer registration finder who assist issuers with raising capital in private markets from accredited investors. *See Notice of Proposed Exemptive Order Granting Conditional Exemption from the Broker Registration Requirements of Section 15(a) of the Securities Exchange Act of 1934 for Certain Activities of Finders*, Exchange Act Release No. 90112 (Oct. 6, 2020), *available at* https://www.sec.gov/rules/exorders/2020/34-90112.pdf.

[22] The amendments would also change the confidentiality standard for the following forms: Form S-6 ; Form N-14; Form 20-F; Form 8-K; Form N-2; Form N-3; Form N-4; Form N-5; Form N-6; and Form N-8B-2.

[23] *Food Marketing Institute v. Argus Leader Media*, 139 S.Ct. 2356 (Jun. 2019).
