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SEC Proposes Further Changes to the Exempt Offering Framework and Amendments to the Confidentiality Standard in Forms

[32340]

April 1, 2020 TO: ICI Members
Investment Company Directors SUBJECTS: Advertising
Compliance
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Distribution RE: SEC Proposes Further Changes to the Exempt Offering Framework and Amendments to the Confidentiality Standard in Forms

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

While the Proposal is broad in scope, it would prominently:

- Expand the ability of issuers to solicit interest in exempt offerings through “demo days” and testing-the-water communications;
- Establish a general principle of integration to determine if multiple securities transactions should be considered part of the same offering, along with non-exclusive safe harbors;
- Increase offering limits and individual investment limits for Regulation A, Regulation Crowdfunding, and Regulation D Rule 504 offerings; and
- Create a new category of investment vehicle to facilitate investment in crowdfunding offerings.[3]

Unrelated to exempt offerings, but notable for investment companies, the Proposal also would revise the standard and instructions for redacting confidential exhibits used in Commission filings, including several Investment Company Act forms.

We discuss these aspects of the Proposal in more detail below.

Comments on the Proposal are due to the Commission on June 1, 2020.

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

The Proposal would revise the standard for redacting confidential exhibits in several Commission forms that investment companies use, including Form N1-A.[4] Currently, registrants who file exhibits to those forms are permitted to redact portions of those exhibits that are not material but would likely cause competitive harm if publicly disclosed.

The Proposal would change that standard to accord with a recent Supreme Court holding[5] 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. Where the current instructions to these forms require registrants to provide a statement that redacted information would likely cause competitive harm or provide their competitive harm analyses to Commission staff, the proposed amended instructions would require registrants to apply and reference the new confidentiality standard in so doing.[6]

Expanding Exempt Offering Solicitation for Demo Days and Testing the Waters

The Commission proposes two new sets of rules that would expand the scope of issuers to communicate about exempt offerings: 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.[7]

- *Demo days*: Demo days are events that invite issuers to present their businesses to potential investors, with the aim of securing investment. The Commission proposes new Securities Act Rule 148 to conditionally exempt issuers participating in demo days from being deemed to have made a general solicitation.[8] If demo day communications are not deemed general solicitations, then the issuer preserves compatibility with the Securities Act Section 4(a)(2) exemption from registration for transactions not involving a public offering.

  Proposed Rule 148 would exempt demo day communications from being deemed general solicitations if an issuer makes those communications in connection with a seminar or meeting by a college, university, or other institution of higher education, a local government, a nonprofit organization, or an angel investor group,[9] incubator, or accelerator sponsoring the seminar or meeting. The rule would require the event organizer not to provide investment advice, charge an entrance fee, or receive any compensation in connection with the demo day, in addition to placing limitations on event advertising.

- *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 proposes a new "generic" testing-the-waters rule to permit an issuer to use general solicitation to gauge investor interest prior to determining which specific exemption from registration it may rely on for a subsequent offering.[11] The proposed rule also would not limit the types of investors that the issuer may solicit, similar to an existing test-the-water rule under Regulation A.[12] Testing-the-water communications must comply with the anti-fraud rules under

the federal securities laws, and issuers would be required to include disclaimers and legends in any testing-the-waters materials. The Commission states that, unlike demo day communications, depending on the method of dissemination of the information, testing-the-water communications may be deemed to be general solicitations.[13]

Consolidating the Integration Framework

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. The Commission proposes to streamline this framework in Securities Act Rule 152.

Specifically, proposed Rule 152 would establish:

- 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 Securities Act or that an exemption from registration is available for the particular offer.[14]
- Four non-exclusive safe harbors from integration if an issuer makes an offering:[15]
  - Thirty days before the commencement of any other offering;[16]
  - In compliance with Rule 701, pursuant to an employee benefit plan, or in compliance with Regulation S;[17]
  - In reliance on an exemption for which general solicitation is permitted if the offering is made after any prior terminated or completed offering;[18] or
  - For registered offerings, if 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.[19]

Proposed Rule 152 would specify that the safe harbors are not available to any issuer for any transaction or series of transactions that are part of a scheme to evade the registration requirements of the Securities Act.

Raising Offering and Investment Limits

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 proposes to raise offering and investment limits so that the regulations are better aligned.[20] Notably, these amendments, if adopted, would permit:

- Regulation Crowdfunding issuers to raise up to $5 million in an offering, compared to the current $ 1.07 million limit. In addition, the Proposal would eliminate investment limits for crowdfunding investors who are accredited investors.
- Regulation D Rule 504 issuers to raise up to $10 million in an offering, compared to the current $5 million limit.
- Regulation A Tier 2 issuers to raise up to $75 million in an offering, compared to the current $50 million limit.

There would be no change in the offering limits for Regulation A Tier 1 offerings, which are capped at $20 million.

Creating Special Purpose Crowdfunding Vehicles

Current Regulation Crowdfunding rules require that investors in crowdfunding issuers hold their securities in their own names, which crowdfunding issuers have noted creates administrative difficulties in managing their capitalization tables.[21] To alleviate these difficulties, the Commission would create a special purpose vehicle to act as a conduit for investors in crowdfunding offerings. Specifically, the Commission would do so by creating a new exclusion from the definition of "investment company" in the Investment Company Act for limited-purpose crowdfunding vehicles.[22]

A crowdfunding vehicle would serve as a conduit for investors to invest in a single underlying issuer and would not have a separate business purpose. 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 crowdfunding issuer and vehicle would each be deemed to be the maker of any statements by the crowdfunding vehicle and any material misstatements or omissions with respect to the offering.

Bridget Farrell
Assistant General Counsel

endnotes

[1] *See Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, Securities Act Release No. 10763 (March 4, 2020) (the "Proposal" or "Proposing Release"), *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. The Commission recently issued another proposal arising from the concept release. *See* Amending the "Accredited Investor" Definition, Securities Act Release No. 10734 (Dec. 18, 2019), *available at* https://www.sec.gov/rules/proposed/2019/33-10734.pdf.

[3] In addition, the Proposal would (1) update the requirements that Regulation D Rule 506(c) issuers use to verify that their purchasers are accredited investors; (2) align the financial information requirements under Regulation D Rule 502(b) with those of Regulation A (Proposal at 94); (3) amend Regulation A to make ineligible any companies that do not file all the reports required to have been filed by Exchange Act Sections 13 or 15(d) in the two-year period before the company files an offering statement (Proposal at 158); and (4) harmonize the "bad actor" disqualification lookback periods under Regulation A, Regulation D, and Regulation Crowdfunding.

[4] *See* Proposal at 103–106. The Proposal would also affect 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.

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

[6] For example, proposed amended Form N1-A, Item 28, Instruction 4 would require registrants to "include a prominent statement on the first page of the redacted exhibit that certain identified information has been excluded from the exhibit because it is both not material and *the type that the Registrant treats as private or confidential.*" (emphasis added). Further, the form instructions would state "If requested by the Commission or its staff, the Registrant must promptly provide on a supplemental basis ... its materiality and *privacy or confidentiality analyses*". (emphasis added). *See* Proposal at 333.

[7] The Commission also requests comment about adding examples of general solicitation to Rule 502(c) or 506(c) Proposal at 67

[8] *See* Proposal at 63.

[9] The Proposal would define "angel investor group" as a group of (A) accredited investors; (B) that holds regular meetings and has written proposes and procedures for making investment decisions, either individually or among the membership of the group as a whole; and (C) is neither associated or affiliated with brokers, dealers, or investment advisers. Proposal at 65 n. 133.

[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] Proposed Rule 241. *See also* Proposal at 70. The Commission also proposes Rule 206 permitting Regulation Crowdfunding issuers to "test-the-waters" prior to filing an offering document with the Commission. *See* Proposal at 77.

[12] Regulation A Rule 255.

[13] *See* Proposal at 73-74. If the communication is considered a general solicitation, the issuer would have to do further analysis to determine which, if any, exemptions from registration would be available for a subsequent offering.

[14] Applying this general principle, the Commission notes that exempt offerings that do not permit general solicitation would not be integrated with other offerings if each other offering also did not include general solicitation or the purchasers in each offering established a substantive relationship with the issuer prior to the offering. Proposal at 31. For issuers that are using general solicitation, any of those general solicitation materials that discuss the terms of another concurrent offering under another exemption must comply with the requirements of each exemption.

[15] *See* Proposal at 36-37.

[16] Proposed Rule 152(b)(1).

[17] Proposed Rule 152(b)(2).

[18] Proposed Rule 152(b)(4).

[19] Proposed Rule 152(b)(3).

[20] *See* Proposal at 114.

[21] For example, commenters have reported that a large number of investors on an issuer's capitalization table can be unwieldy in seeking required shareholder votes and potentially impede future financing. Proposal at 142.

[22] *See* Proposal at 143-144. The current Regulation Crowdfunding rules exclude investment companies from being investors in crowdfunding offerings; because crowdfunding vehicles would be excluded from the definition of investment company, it would be not be so precluded. Proposal at 144 n. 327.
