Corporate Alert

Akin Gump
STRAUSS HAUER & FELD LLP

SEC Proposes Changes to Rules Governing Integration of Exempt Offerings and General Solicitation

June 4, 2020

Contact Information

If you have any questions concerning this alert, please contact:

Patrick J. Hurley
Partner
phurley@akingump.com
Houston
+1 713.220.8132

Jacob G. Johnson
Associate
jgjohnson@akingump.com
Houston
+1 713.250.2145

On March 4, 2020, the Securities and Exchange Commission (SEC) published a release entitled "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets" (the "Release"). Citing a desire to "facilitate capital formation and increase opportunities for investors by expanding access to capital for entrepreneurs across the United States," the SEC included in the release a number of proposed amendments that would seek to address gaps and complexities in the current rules regarding offerings that are exempt from registration under the Securities Act of 1933. By adopting these rules, the SEC hopes to remove barriers to investment opportunities for investors and access to capital for issuers by simplifying the exempt offering framework while preserving or enhancing investor protections. In this alert, we will focus on two portions of the release: the proposed amendments related to the integration of offerings and the proposed amendments related to general solicitations and offering communications.

As we will discuss below, the proposed amendments are designed to provide significantly enhanced flexibility to issuers who desire to engage in exempted securities offerings without eliminating current investor protections. The SEC believes that the proposed amendments will be especially helpful to smaller companies and emerging growth companies because the practical effect of the current regulations may disadvantage these entities more severely than larger, more established companies. Although the proposed amendments seem to be helpful on their own merits, we believe that the Release is especially timely given the ongoing effect of the COVID-19 pandemic on the United States and global economies. As everyone is aware, COVID-19 has placed tremendous strains on certain American businesses, and these strains are generally felt most severely by smaller companies and emerging growth companies. Now, more than ever, many of those companies may need to access capital quickly and efficiently. The amendments in the release are designed to do exactly that, and may make it significantly easier for companies to access capital at a time when they need it most.

Integration

The first section of the Release discussed below pertains to potential amendments to the rules governing whether multiple securities transactions should be "integrated"; that is, considered to be part of the same offering. Currently, there is a patchwork of different rules and guidance that the SEC believes creates regulatory uncertainty and leads to certain issuers transitioning inefficiently between different types of exempt and registered offerings as they grow. To rectify this uncertainty, the SEC proposes certain amendments to the integration rules to allow issuers to more efficiently access capital while attempting to preserve the investor protections that the current framework provides.

Background

Currently, the concept of integration is governed by various SEC rules, interpretive releases and no-action letters. The current determination of whether a securities offering should be integrated with another offering is driven by an analysis of the facts and circumstances of the offerings, with the following five factors to be considered for analyzing whether two or more exempt offerings should be integrated with each other: (1) whether the different offerings are part of a single plan of financing; (2) whether the offerings involve issuance of the same class of security; (3) whether the offerings are made at or about the same time; (4) whether the same type of consideration is to be received; and (5) whether the offerings are made for the same general purpose. Problematically, as pointed out by others, this analysis provides no specific weights to be assigned to any of these factors and there is no guidance as to how many of these factors need to be present in order for the offerings to be integrated, creating a significant degree of uncertainty around an integration analysis that relies on this test.

This five factor test, set forth in SEC Release No. 33-4552, "Nonpublic Offering Exemption" (November 6, 1962), was used when the SEC established the framework to determine whether offerings that fall outside of the Rule 502(a) six month safe harbor in Regulation D should be integrated, and this analysis is often used when considering integration of offerings relying on exemptions that do not have their own integration guidelines. In addition, Rule 152 and related no-action letters (see, e.g., Verticom, Inc. (December 12, 1986)) and the Black Box Incorporated (June 2, 1990) no-action letter provides a separate framework for conducting a public registered offering after or concurrently with a private offering, and Rule 155 provides another set of guidelines for conducting a private offering after an abandoned public offering and vice versa. In more recent years, the SEC has sought to provide additional clarity with respect to integration, such as providing a new framework for analyzing integration of simultaneous registered and private offerings in SEC Release No. 33-8828, "Revisions of Limited Offering Exemptions in Regulation D" (August 3, 2007) (the "2007 Release"), and providing more clarity regarding the integration of concurrent offerings with the Regulation A and Regulation Crowdfunding rulemakings in 2015 and Rule 147 and Rule 147A rulemakings in 2016 consistent with the approach taken in the 2007 Release. With the Release, the SEC seeks to build upon these developments and provide comprehensive integration rules applicable to **all** securities offerings, including registered and exempt offerings, and eliminate the five factor test articulated by the SEC in 1962. The SEC believes that doing so will reduce uncertainty and perceived risk among issuers when considering possible capital raising alternatives, and provide increased certainty to issuers on how offerings interrelate and flexibility to choose between types of offering, which may in turn encourage companies to more frequently utilize the capital markets, including via registered offerings.

Proposal

Facts and Circumstances Analysis

The SEC's new integration proposal would provide for a general principle of integration in Rule 152(a) consisting of a fact-based analysis and specific guidelines for exempt offerings prohibiting or permitting general solicitation in Rule 152(a)(1) and Rule 152(a)(2), respectively, along with safe harbors in Rule 152(b) that issuers could utilize to render such analysis unnecessary and ensure that their offerings would not be integrated.

The general principle of integration in Rule 152(a) would provide that for offerings not covered by a safe harbor, any offerings or sales would not be integrated if the issuer could establish that the offering either complies with the registration requirements of the Securities Act, or that an exemption from registration is available for the particular offering, based on the particular facts and circumstances. The SEC further proposes to include two provisions in Rule 152(a)(1) and Rule 152(a)(2) applying the general principle in specific circumstances in order to provide greater clarity to the analysis.

The first of these would relate to exempt offerings for which general solicitation is not permitted and codify SEC guidance initially provided in the 2007 Release for the appropriate framework for analyzing concurrent registered and private offerings. To avoid integration of such offerings, the issuer would be required to have a reasonable belief, based on the facts and circumstances, that (1) the purchasers in each exempt offering were not solicited through the use of general solicitation, or (2) the purchasers in each exempt offering established a substantive relationship with the issuer (or person acting on the issuer's behalf) prior to the commencement of such offering. In the Release, the SEC reiterated that a "substantive" relationship is one in which the issuer, prior to the commencement of the offering, or another person (such as a broker-dealer), prior to such person's participation in the offering, evaluates an offeree's financial circumstances and sophistication, and has sufficient information to determine his or her status as an accredited or sophisticated investor. Proposed Rule 152(a)(1) would allow a purchaser with whom the issuer (or person acting on its behalf) has such a pre-existing relationship to still participate in a concurrent or subsequent private offering even if the prospective investor was aware of the issuer's marketing of the public offering. The Release also acknowledges that a pre-existing substantive relationship is not the exclusive means of demonstrating the absence of a general solicitation.

The second application of the general principle discussed in the Release and set forth in new Rule 152(a) would provide that if an exempt offering that permits general solicitation includes information about the material terms of a concurrent offering under another exemption also permitting general solicitation, the offering materials would be required to include the necessary legends for, and otherwise comply with, the requirements of each exemption. In other words, an issuer engaging in two concurrent offerings under different exemptions that each allow general solicitation would need to ensure that **each** offering complies with the requirements of not only the exemption that is being utilized with respect to such offering, but also with the requirements of the exemption under which the other concurrent offering is being conducted.

Safe Harbors

In addition to the facts and circumstances analysis detailed above, the SEC proposes a number of safe harbors in new Rule 152(b) which, if utilized by issuers, would ensure that their offerings are safe from integration without the need for a facts and circumstances analysis under Rule 152(a). Those safe harbors include:

30 Day Safe Harbor

Under proposed Rule 152(b)(1), any offering made more than 30 days before the commencement of, or after the termination of, any other offering would not be integrated. However, if the exemption used for the offering does not allow general solicitation, either (i) the purchasers were not solicited via general solicitation or (ii) the purchasers established a substantive relationship with the issuer prior to the commencement of the offering for which general solicitation is not permitted.

The proposed Rule 152(b)(1) also eliminates a number of conditions to relying on this safe harbor that are found in the current Rule 155. Notably, this 30 day time period is also significantly shorter than the current six-month period provided by the current integration safe harbor in Rule 502(a) of Regulation D and in the recent rulemakings, and even the 90-day period for the Rule 502(a) safe harbor proposed in the 2007 Release. The SEC asserts that the six-month period, which was adopted in Regulation D in 1982, is ill suited for today’s informational and technological environment, and that a 30-day period between offerings allows for enough intervening market developments between the offerings to render an integration analysis unnecessary on its face. The SEC noted that for these reasons, that the core principle behind integration (which is to prevent issuers from improperly avoiding registration via the false division of what is essentially a single offering into multiple offerings) remains preserved with a 30-day waiting period, since any offerings conducted 30 days apart would be separated by enough intervening market developments to avoid integration on their face. To reduce the possibility of an issuer conducting multiple Rule 506(b) Regulation D offerings every 30 days, each with up to 35 non-accredited investors, and effectively conducting a public distribution to a large number nonaccredited investors, the Release proposes to amend Rule 506(b) to limit the number of non-accredited investors purchasing in all such offerings within 90 calendar days of each other to 35.

This shorter time period will undoubtedly be welcomed by issuers, and the SEC emphasizes in the Release that this safe harbor will likely be especially helpful to smaller issuers who probably find the current six-month period to be overly burdensome on their ability to raise capital.

Other Safe Harbors

In addition to the 30 day safe harbor detailed above, the SEC also proposes to include safe harbors for (i) offers and sales made in compliance with Rule 701, pursuant to an employee benefit plan or in compliance with Regulation S under Rule 152(b)(2), (ii) registered offerings if made subsequent to (A) a terminated or completed offering for which general solicitation is not permitted, (B) a terminated or completed offering for which general solicitation is permitted and made only to qualified institutional buyers and institutional accredited investors, or (C) an offering for which general solicitation is permitted that terminated or completed more than 30 days prior to the commencement of such registered offering under Rule 152(b)(3), and (iii) offers and sales made in reliance on an exemption for which general solicitation is permitted if made subsequent to any prior terminated or completed offering under Rule 152(b)(4). The proposed amendments would permit an issuer conducting an offering with general solicitation to undertake a Regulation S offering so long as the general solicitation activity is not undertaken for the purpose of conditioning the U.S. market for any of the Regulation S securities through an amendment to the definition of "directed selling efforts" in Rule 902(c) of Regulation S. To reduce the risk of flowback of such securities to the United States, under proposed Rule 906 of Regulation S, the Regulation S issuer must prohibit resales of the Regulation S securities to U.S. persons for a period of six months from the sale date, except to qualified institutional buyers and institutional accredited investors. The Release contains extensive rationale and background with respect to these proposed safe harbors, which are generally based upon the desire to make capital raising easier for issuers without reducing investor protections.

The safe harbors in new Rule 152 would replace current Rules 152 and 155 concerning the integration of public and nonpublic offerings. The rule would provide that these safe harbors are not available for any transactions that are part of a plan or scheme to evade registration requirements, even if in technical compliance with the rule. This Rule 152 would replace the current integration provisions or guidance applicable to Regulation D, Regulation A, Regulation Crowdfunding, and Rules 147 and 147A.

General Solicitation and Offering Communications

Currently, Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering" from registration. However, the meanings of "offer" or "general solicitation" are currently construed broadly and not well defined.

Against this background, the SEC notes that it has received numerous questions about "demo days" or similar events. Currently, an issuer's presentation at a "demo day" is considered to be an offer of securities unless the organizer of the event limits participation to people with whom the issuer or organizer has a pre-existing substantive relationship, or people that have been contacted through an informal, personal network of experienced and financially sophisticated individuals.

Recognizing the impracticality of the foregoing, the SEC proposed new Rule 148, which would provide that "demo days" would not be deemed a general solicitation or general advertising under certain circumstances. The proposed rule would provide that an issuer would not be deemed to have engaged in a "general solicitation" if communications are made 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, incubator or accelerator sponsoring the seminar or meeting. Additionally, the sponsor of the event would not be allowed to give investment advice or recommendations to attendees, and would not be permitted to participate in investment negotiations between issuers and attendees, charge any fees other than reasonable administrative fees or receive any compensation (i) for introducing attendees and issuers to each other, (ii) for investment negotiations or (iii) that would require it to register as a broker or dealer under the Securities Exchange Act of 1934, or as an investment adviser under the Investment Advisers Act of 1940. Further, advertising for the event would not be allowed to reference any specific offering, and issuers would only be allowed to (i) notify attendees that the issuer is in the process of offering or planning to offer securities, (ii) specify the type and amount of securities being offered, and (iii) detail the intended use of proceeds from the offering. As with the other proposals in the Release, the SEC believes that these changes will provide issuers, particularly small and emerging issuers that have less access to capital at startup, with the opportunity to network more efficiently and bridge funding gaps by enabling them to reach a broader audience.

Solicitations of Interest

Currently, issuers may gauge market interest ("testing the water") in a registered offering through discussions with qualified institutional buyers and institutional accredited investors. Additionally, Regulation A permits issuers to test the waters with the general public, provided that all materials include certain required legends and that, after an offering statement is filed, are preceded or accompanied by a preliminary offering circular or contain a notice directing investors to the most current preliminary offering circular.

In the Release, the SEC proposes an additional exemption (represented by new Rule 241) that would permit issuers to solicit indications of interest in an exempt offering prior to determining which exemption they would rely on to conduct the exempt offering. The SEC notes that this rule would further the public interest by allowing issuers enhanced flexibility to gauge market interest in an exempt offering and tailor the size and terms of the offering, thereby reducing the costs of such exempt offering.

Rule 241 would contain several limitations. First, an issuer testing the waters under this exemption would not be allowed to identify which registration exemption it intends to rely on—in other words, if the issuer already knows which exemption it will use, it must comply with the requirements of that exemption. Further, issuers utilizing Rule 241 would be required to include a legend notifying potential investors that (i) it is considering an exempt offering but has not decided on a specific exemption to use for the offering, (ii) no consideration is being solicited and will not be accepted if sent, (iii) no sales will be made or commitments to purchase accepted until the issuer determines the exemption on which it will rely and has complied with all requirements under such exemption, and (iv) any indications of interest are nonbinding.

Second, depending on the method of dissemination, such offers may be considered general solicitations. If such an offer does indeed constitute a general solicitation, and the issuer decides to conduct an offering under an exemption that forbids general solicitation, the issuer would need to analyze whether the generally solicited offer and subsequent private offering might be integrated, thereby making such an exemption unavailable. Note, however, that in this instance an issuer could rely on the 30 day safe harbor in proposed Rule 152 detailed above.

Third, Rule 241 would only apply to generic solicitations of interest, not to subsequent offers or sales. Once the issuer engages in an exempt offering, it would be required to rely on the exemption used for the offering, and would no longer be able to utilize Rule 241.

The Release also details several additional requirements generally relating to the disclosure of information used in connection with an issuer's exercise of Rule 241 to potential investors in subsequent Regulation A, Regulation D and Regulation Crowdfunding offerings.

Finally, the Release contains several proposals relating to Regulation Crowdfunding, generally dealing with permissible communications before and after a Form C is filed with the SEC. For additional detail on these matters, please consult the Release.

Going Forward

The proposals contained in the Release are subject to a 60-day comment period that concluded on June 1, 2020. If the proposals detailed above are indeed adopted by the SEC, issuers (especially smaller and newer ones) will likely welcome the increased flexibility and access to capital that these proposals are intended to provide.

akingump.com

