ALERT MEMORANDUM

SEC Proposal: Improving Access to Capital in Private Markets

March 30, 2020

On March 4, 2020, the SEC voted 3-1 to propose amendments to "simplify, harmonize, and improve certain aspects" of the framework for offerings exempt from Securities Act registration. The amendments cover a number of areas, including integration, general solicitation and offering communications, and Rule 506(c) verification requirements. We discuss below selected key aspects of the proposal.

I. Integration

Background

The SEC first articulated the concept of integration in 1933 and has subsequently developed various approaches for determining when multiple offerings should be treated as a single offering. These approaches include:

— The well-known five-factor test in Regulation D[1] – whether:

- the different offerings are part of a single plan of financing;
- the offerings involve issuance of the same class of security;
- the offerings are made at or about the same time;
- the same type of consideration is to be received; and
- the offerings are made for the same general purpose.

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[1] Note to Rule 502(a).

— The 2007 guidance for analyzing the integration of simultaneous registered and private offerings:[2]

  - The filing of a registration statement should not be considered general solicitation that undermines the availability of the Section 4(a)(2) exemption for a concurrent private placement if the private placement investors were not solicited by the registration statement.
  - A prospective investor could become interested in the concurrent private placement through a "pre-existing, substantive relationship" with the issuer, or direct contact by the issuer or its agents outside the public offering effort.

— The integration framework for concurrent exempt offerings developed as part of promulgating Regulation A and Crowdfunding rules in 2015 and Rule 147 and 147A in 2016 that focused on facts and circumstances, including each offering complying with the requirements of the relevant exemption.[3]

Proposal

The proposal would build on and simplify these concepts by establishing a general principle of integration that looks to facts and circumstances, supplemented by four non-exclusive safe harbors to address specific situations.

General Principle

For all offerings not covered by a safe harbor, offers and sales would not be integrated if, based on the facts and circumstances, the issuer can establish that each offering either complies with the registration requirements of the Securities Act, or that an exemption from registration is available for the particular offering.

— ***If General Solicitation is NOT Permitted:*** The issuer must have a reasonable belief, based on the facts and circumstances, that:

  - the purchasers in each exempt offering were not solicited through the use of general solicitation; or
  - the purchasers in each exempt offering must have a pre-existing, substantive relationship with the issuer, or a person acting on the issuer's behalf, that was established prior to the commencement of the offering.

— ***If General Solicitation IS Permitted:*** If an exempt offering includes information about the material terms of a concurrent offering under another exemption also permitting general solicitation, the offering materials must include the legends for, and otherwise comply with, the requirements of each exemption.

Application

The general principle would apply where an issuer is, for example, conducting an IPO alongside a Rule 506(b) offering, or a Rule 506(c) offering followed by a Rule 506(b) offering. The offerings would not be integrated if the investors in the Rule 506(b) offering were not solicited through the registration statement or general solicitation from the Rule 506(c) offering, or if the investors had a pre-existing, substantive relationship with the issuer (or person acting on the issuer's behalf) before the commencement of the Rule 506(b) offering.

— ***Pre-Existing, Substantive Relationship.*** Investors with which the issuer has a pre-existing, substantive relationship may include the issuer's existing or prior investors, investors in prior deals of the issuer's management, or friends or family of the issuer's control persons. The proposed rule

[2] SEC Release No. 33-8828 (Aug. 3, 2007), at Section II.C.1, available at https://www.sec.gov/rules/proposed/2007/33-8828.pdf.

[3] SEC Release No. 33-9741 (March 25, 2015), at Section II.B.5, available at https://www.sec.gov/rules/final/2015/33-9741.pdf; SEC Release No. 33-9974 (Oct. 30, 2015), at Section II.A.1.c, available at https://www.sec.gov/rules/final/2015/33-9974.pdf; and SEC Release No. 33-10238 (Oct. 26, 2016), at Section II.B.5, available at https://www.sec.gov/rules/final/2016/33-10238.pdf.

would allow a purchaser with which the issuer has a pre-existing, substantive relationship to become aware of the issuer's registered offering due to the marketing of that offering, and still participate in a concurrent or subsequent private offering by the issuer in reliance on an exemption prohibiting general solicitation. The proposal reiterates that:

- A "pre-existing" relationship is one that an issuer has formed with an offeree before the commencement of the offering or, alternatively, that was established through another person – e.g., a registered broker-dealer or investment adviser – before the person's participation in the offering.
- A "substantive" relationship is one in which the issuer (or a person acting on its behalf, such as a registered broker-dealer or investment adviser) has sufficient information to evaluate, and does, in fact, evaluate, an offeree's financial circumstances and sophistication, in determining his, her or its status as an accredited or sophisticated investor.
- Self-certification alone (by checking a box) without any other knowledge of a person's financial circumstances or sophistication is not sufficient to form a "substantive" relationship for these purposes.
- Persons acting for an issuer other than registered broker-dealers and investment advisers may form a pre-existing, substantive relationship with an offeree. SEC staff interpretations on whether a "pre-existing, substantive relationship" exists have generally turned on procedures established by broker-dealers in connection with their customers. This is because traditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers, which implies that a substantive relationship exists between the two. The existence of a sufficient relationship to avoid general solicitation, however, always depends on the particular facts and circumstances, and it is therefore possible that a third-party other than a broker-dealer or investment adviser could establish such a relationship.
- Issuers may develop pre-existing, substantive relationships with offerees. However, in the absence of a prior business relationship or a recognized legal duty to offerees, it is likely more difficult for an issuer to establish a pre-existing, substantive relationship, especially when contemplating or engaged in an offering over the internet (or other means of unrestricted communication). Issuers would have to consider not only whether they have sufficient information about particular offerees, but also whether they in fact use that information appropriately to evaluate the financial circumstances and sophistication of the offerees before commencing the offering.

— ***Other Approaches to Overcome General Solicitation.*** The proposal further clarifies that a pre-existing, substantive relationship is ***not*** the exclusive means of overcoming the effect of general solicitation. An issuer could sell exclusively to investors whom the issuer or its agents contact outside the issuer's public offering or other general solicitation activity. The proposal reiterates that:

- In general, the greater the number of persons without financial experience, sophistication, or any prior personal or business relationship with the issuer that are contacted by an issuer or persons acting on its behalf through impersonal, non-selective means of communication, the more likely the communications are part of a general solicitation.
- Groups of experienced, sophisticated investors, such as "angel investors," also may share information about offerings through their network, and members who have a relationship with a particular issuer may introduce that issuer to other members. Issuers that contact

one or more experienced, sophisticated members of the group through this type of referral may be able to establish a reasonable belief that other offerees in the network have the necessary financial experience and sophistication.

Safe Harbor 1 (30-Day Gap): Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, would not be integrated. However, for an exempt offering for which general solicitation is not permitted, the purchasers must either not be solicited through the use of general solicitation, or have established a substantive relationship with the issuer before the commencement of the offering for which general solicitation is not permitted.

— ***Elimination of Six-Month Rule.*** In light of changes to markets, technology and the securities laws, the six-month period in existing integration safe harbors would be eliminated in favor of this 30-day rule.

— ***Covers both Registered and Unregistered Offerings.*** The new safe harbor would apply both to offerings for which a registration statement has been filed and exempt offerings.

— ***Facts and Circumstances if Fewer than 30 Days Between Offerings.*** For offerings separated by fewer than 30 days, integration would turn on the facts and circumstances.

  • Based on this principle, it also should be possible to make sales to AIs and QIBs as part of a ***single*** exempt offering in which general solicitation is not permitted, notwithstanding inadvertent publicity (a so-called "foot fault"), based on pre-existing substantive relationships or finding those purchasers otherwise than as a result of that publicity. We do not believe this treatment of inadvertent publicity is inconsistent with the SEC's decision in KCD,[4] because it would be limited to inadvertent publicity and thus not in conflict with the underlying policy prohibiting general solicitation in exempt offerings under Section 4(a)(2) of the Securities Act or Rule 506(b).

— ***Cap on Non-AIs.*** To prevent serial Rule 506(b) offerings to up to 35 non-accredited purchasers (non-AIs) each month, the number of non-AI purchasers permitted in all Rule 506(b) offerings within a 90-day period would be capped at 35.

Safe Harbor 2: Offers and sales made in compliance with Rule 701, pursuant to an employee benefit plan, or in compliance with Regulation S would not be integrated with other offerings.

— ***Concurrent Regulation S and Rule 506(c) Offerings.*** In response to uncertainty among market participants around conducting concurrent Regulation S and Rule 506(c) offerings, the proposal would amend Regulation S to permit an issuer conducting an exempt offering using general solicitation (*e.g.*, under Rule 506(c)) to be able to rely on Regulation S for a concurrent offshore offering even though the general solicitation activity likely would be deemed "directed selling efforts" under current Rule 902(c).

  • An issuer that engages in general solicitation would not be considered to have engaged in "directed selling efforts," if the general solicitation activity is not undertaken for the purpose (as contrasted with merely having the effect) of conditioning the U.S. market for the Regulation S securities.

  • However, because general solicitation could increase the risk of the Regulation S securities flowing back into the United States, a new Rule 906 would be added to Regulation S that would require the issuer to prohibit resales of the securities to U.S. persons for a period of six months from the date of sale except to

[4] *See In the Matter of the Application of KCD Financial Inc.* SEC Release No. 80340 (March 29, 2017).

"qualified institutional buyers" (QIBs) as defined in Rule 144A or institutional accredited investors under Rule 501 (IAIs). The restriction would apply regardless of whether the offering fits within Category 1, 2 or 3 of Regulation S and would apply in addition to the applicable distribution compliance period (if any).

- We believe proposed Rule 906 is unnecessary and inconsistent with prior SEC guidance on Regulation S. It is unnecessary because Regulation S already applies a distribution compliance period to protect against flowback that is calibrated, in duration and certain other respects, based on the likelihood of flowback. Even in a Category 1 transaction, where there is no distribution compliance period, Section 4(a)(3)'s prospectus delivery obligations preclude free public resale in the United States for a 40-day period following the Regulation S offering.

  Rule 905 of Regulation S also already reflects an SEC determination that domestic equity securities are the only securities offered under Regulation S with a flowback risk that warrants treatment as "restricted securities," thus precluding their free public resale in the United States for six months or one year, as applicable.[5] Finally, as the proposal itself notes, the SEC has long recognized that Regulation S offerings will not be integrated with concurrent public offerings or private placements, and more directly applicable to the purported concern about directed selling effort restrictions in the context of a concurrent registered or exempt offering involving general solicitation, the adopting release for Regulation S expressly states that such general solicitation will ***not*** constitute directed selling efforts.[6]

Safe Harbor 3: An offering for which a Securities Act registration statement has been filed would not be integrated if made subsequent to:

— ***Completed Offerings without General Solicitation.*** A terminated or completed offering for which general solicitation is not permitted.

— ***Completed Offerings to QIBs and IAIs with General Solicitation.*** A terminated or completed offering for which general solicitation is permitted and made only to QIBs and IAIs.

— ***Completed Offering with General Solicitation Completed more than 30 Days in Advance.*** An offering for which general solicitation is permitted that was terminated or completed more than 30 calendar days prior to the commencement of the registered offering.

This safe harbor reflects the SEC's position that capital raising around the time of a public offering, particularly an IPO, can be critical to ensuring the issuer has sufficient funds to continue operating while the public offering process is ongoing.

Safe Harbor 4: Offers and sales made in reliance on an exemption for which general solicitation is permitted would not be integrated if made subsequent to any prior terminated or completed offering. This safe harbor reflects the view that offers and sales preceding exempt offerings that allow general solicitation generally are not the type of transaction that conditions the market for the subsequent offering.

[5] *See* Rule 144 under the Securities Act.

[6] In addressing directed selling efforts in the Regulation S adopting release, the SEC stated: "Offering activities in contemporaneous registered offerings or offerings exempt from registration will not preclude reliance on the safe harbors." SEC Release No. 33-10763 (March 4, 2020), at n. 107 (quoting SEC Release No. 33-6863 (April 24, 1990), at n. 47), available at https://www.sec.gov/rules/proposed/2020/33-10763.pdf.

II. General Solicitation and Offering Communications

TTW for Exempt Offerings

The proposal would expand "testing-the-waters" (TTW) to exempt offerings by proposing a new rule that would allow an issuer to solicit indications of interest in an exempt offering orally or in writing prior to determining which exemption it would rely on to conduct the offering.

— ***No Exemption Chosen Yet.*** The rule could not be used if the issuer already has decided on an applicable exemption.

- We believe this condition is both unnecessarily restrictive and too subjective to enforce as a practical matter. In both respects it seems similar to the restriction in current Rule 152 that integration of a private placement and subsequent registered offering can be avoided only if the issuer had not decided to make the public offering at the time of the private placement. The proposal would in fact eliminate this restriction.
- The SEC's concern here is that issuers not engage in TTW as a means of general solicitation. That concern is reasonable, and the balance of the TTW proposal adequately addresses it. In addition, the SEC should consider adding to the TTW proposal an alternative that permits TTW only to QIBs and IAIs, which should then not be integrated with (*i.e.*, should not taint) the ensuing private placement, whether or not it permits general solicitation, and without the burdensome requirement that the exempt offering not commence for at least 30 days after the completion of TTW.

— ***Legend.*** A legend would have to be provided indicating that: (1) the issuer is considering an exempt offering, but has not determined a specific exemption on which to rely; (2) no money or other consideration is being solicited or will be accepted; (3) no sales will be made or commitments to purchase accepted until the issuer determines the exemption and any required filing, disclosure or qualification requirements are met; and (4) any indication of interest is non-binding. These solicitations would be deemed offers for purposes of the federal securities laws' antifraud provisions.

- As discussed above, the SEC should delete the "but" clause in (1).

— ***May be General Solicitation or Directed Selling Efforts.*** Depending on the method of dissemination of the information, TTW may be considered a general solicitation or (contrary to our view discussed above) directed selling efforts.

- In these circumstances, before conducting an unregistered offering that does not allow general solicitation, the issuer would need to assess whether the two offerings should be integrated, rendering the exemption for the second offering unavailable.
- Even in this case, however, the issuer may be able to rely on the proposed safe harbor for an offering that does not permit general solicitation if the issuer waits 30 days following termination of the TTW activity before commencing the private offering. (The issuer still would need to ensure that offerees contacted in the private offering were not solicited by means of the general solicitation.)

— ***TTW Materials to Non-AIs.*** If the issuer sells securities under Rule 506(b) within 30 days of the generic solicitation to any purchaser that is not an AI, the issuer would be required to provide the purchaser with any written TTW materials a reasonable time before the sale.

— ***No Blue Sky Preemption.*** The rule also would not preempt state "blue sky" laws. This is consistent with the approach taken for Regulation A Tier 1 offerings, where concerns were raised by state regulators about TTW provisions in that context.

Demo Days and Similar Events

The proposal would add Rule 148 under the Securities Act, which would provide that certain "demo day" communications would not be deemed general solicitation. The rule would apply to communications made in connection with a seminar or meeting held by an institution of higher education, a local government, a nonprofit, or angel investor group, incubator, or accelerator sponsoring the meeting, provided that advertising for the event does not reference any specific offering and information communicated or distributed in connection with the event regarding any offering is limited to a notification that an offering is being planned, the type and amount of securities being offered and the intended use of proceeds. Additionally, for communications at such an event to be covered, the sponsor would be prohibited from:

- making investment recommendations or providing investment advice to attendees;
- engaging in any investment negotiations between the issuer and investors attending the event;
- charging attendees any fees, other than reasonable administrative fees; and
- receiving any compensation for making introductions or investment negotiations, or any other activity that would require registration as a broker or dealer under the Exchange Act or as an investment adviser under the Advisers Act.

Other Activities NOT Constituting General Solicitation

We refer to the discussion in Part I above about pre-existing substantive relationships and groups of angel investors. The proposal makes clear that both sets of circumstances can be used either to overcome the effect of permissible general solicitation in one offering on the eligibility of a concurrent offering that does not permit general solicitation or to provide the basis for concluding that there has been no general solicitation in the context of a single offering.

III. Rule 506(c) Verification Requirements

Rule 506(c) allows general solicitation so long as the issuer takes "reasonable steps to verify" (RSTV) purchasers' AI status. Although the rule's verification methods are non-exclusive, the proposal recognizes that the rule may be encouraging market participants to treat them as exclusive, and that some market participants have viewed the methods as onerous. The proposal would add a new item to the non-exclusive list: an issuer could establish that an investor that the issuer previously took RSTV as an AI would remain an AI at the time of a subsequent sale if the investor provides a written representation to that effect and the issuer is not aware of information to the contrary.

The proposal also reaffirms and updates the SEC's prior guidance on the principles-based method of verification. The SEC continues to believe the following factors are among those that should be considered:

— ***Nature of the Purchaser.*** The nature of the purchaser and the type of AI that the purchaser claims to be.

— ***Amount and Type of Information.*** The amount and type of information that the issuer has about the purchaser.

— ***Nature of the Offering.*** The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

In the SEC's view, there may be circumstances where the reasonable steps determination may not be substantially different from an issuer's development of a "reasonable belief" for Rule 506(b) purposes. For example, an issuer's receipt of a representation from an investor as to its AI status could meet the "reasonable steps" requirement if the issuer reasonably takes into consideration a prior substantive relationship with the investor or other facts that make apparent the accredited status of the investor.

We question whether this relatively small, incremental relaxation of the RSTV requirement in Rule 506(c)

will significantly expand its use. Accordingly we suggest, as SIFMA has,[7] that the SEC propose to modify Rule 508 of Regulation D to mitigate the risk that inadvertent publicity could reasonably constitute general solicitation in the context of a 506(b) offering – so called "foot faults." Rule 508 currently provides that any violation of the conditions relating to general solicitation is deemed significant to a Regulation D offering and thus disqualifying for those that do not permit it. Instead, the SEC should make clear that an inadvertent disclosure, even one made publicly, that is limited to information of the kind that could be included in a Rule 134 notice would not be deemed significant, and thus not disqualifying.

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[7] SIFMA Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019).