FAST Act Amendments to the U.S. Securities Laws

On December 4, 2015, President Obama signed into law the Fixing America's Surface Transportation Act (the "FAST Act"), which, among other legislation in its 1300+ pages, includes several bills designed to facilitate the offer and sale of securities. In this memorandum we focus on two of those bills. The first provides additional accommodations related to the SEC registration process for emerging growth companies ("EGCs"), a category of issuer established by the Jumpstart Our Business Startups Act (the "JOBS Act") in 2012. The second creates a non-exclusive safe harbor under Section 4 of the Securities Act of 1933, as amended (the "Securities Act") for resales of securities that meet the conditions of the safe harbor.

I. Adjustments to the EGC Accommodations of the JOBS Act

In the 2012 JOBS Act, Congress sought to facilitate capital formation by EGCs (which are generally defined as companies with revenues of $1 billion or less) by allowing them to take advantage of significant regulatory accommodations in carrying out an equity IPO and for up to five years after an IPO (the so-called "IPO on-ramp" provisions). Title LXXI of the FAST Act ("Improving Access to Capital for Emerging Growth Companies") does three things to further facilitate capital raising by EGCs.

First, it amends the Securities Act to reduce from 21 to 15 the number of days required between an EGC's first *public* filing of its IPO registration statement and the commencement of a road show. We expect EGC issuers will welcome the ability to go to market sooner after the first public filing because they will have more flexibility to take advantage of favorable market conditions.

Second, Title LXXI establishes a grace period for an EGC that loses EGC status after its initial filing or confidential submission but before completing its IPO, by allowing it to be treated as an EGC until the earlier of the consummation of its IPO and one year after it ceases to be an EGC. As written, this provision amends only Section 6(e)(1) of the Securities Act, which includes only the accommodation for EGCs to confidentially file IPO registration statements. We believe Congress could not have intended this reference to apply so narrowly (i.e., to allow EGCs that lose EGC status to use only the confidential filing accommodation and not the other accommodations for EGCs) and must have intended the grace period to apply to all EGC accommodations. We would welcome the SEC staff confirming that view.

Third, Title LXXI permits EGCs to omit historical financial information for certain periods otherwise required by Regulation S-X under the Securities Act ("S-X") as of the time of filing or confidential submission, provided the issuer reasonably believes the information will not be required to be included at the time of the contemplated offering. This would allow an EGC, for example, to omit 2013 financial statements in a December 2015 filing if it does not intend to consummate the offering until its year-end 2015 audited financial statements are available (at which point 2014 and 2015 financial statements will be included in the registration statement).

On December 11, 2015, the SEC staff issued two Compliance and Disclosure Interpretations to clarify the scope of this accommodation. One clarifies that it applies to all historical financial information required by S-X, including financial statements of other entities (e.g., financial statements of an acquired company required under S-X Rule 3-05). The other establishes that issuers cannot use the accommodation to exclude the most recent interim period required by S-X, even if that period will be replaced with a longer interim or annual period in the final registration statement (e.g., for a January 2016 filing where an EGC expects to consummate the offering after its year-end 2015 audited financial statements are available, it can omit 2013 as noted above but cannot omit the nine-month periods ended September 30, 2015 and September 30, 2014). While issuers may find it burdensome to prepare interim period unaudited financial statements that ultimately will not be necessary, we believe the ability to exclude a prior year of audited financial statements that an issuer may not have prepared could significantly speed up the IPO process and significantly reduce an issuer's costs associated with the preparation and audit of the required financial statements.

II. New Securities Act Exemption for Resales

Title LXXVI ("Reforming Access for Investments in Startup Enterprises," or the "RAISE" Act) amends the Securities Act by creating a non-exclusive safe harbor in a new Section 4(a)(7)[1] to exempt from registration certain resales of securities to accredited investors. The exemption provides investors with a third safe harbor under which to resell "restricted" securities received in private transactions – the first is Rule 144A, which requires that all purchasers be "qualified institutional buyers ("QIBs"), and the second is Rule 144, which imposes a holding period requirement for non-affiliate sellers and, in addition, volume, manner of sale and other restrictions on affiliate sellers.

Our understanding is that Congress intended Section 4(a)(7) to codify existing market use of "4(1)(1/2)," which is the traditional name for a long-standing set of principles used by market participants where a resale satisfies the requirements for a private sale developed through SEC guidance and case law. In addition to the well-settled indicia of a transaction not constituting a public offering (and thus consistent with the statutory private placement exemption for issuers in Section 4(a)(2)) – i.e., no general solicitation and transfer restrictions on resales – the 4(1)(1/2) analysis has more subjective elements, regarding the characteristics of potential investors. Following the seminal case, *SEC vs. Ralston Purina & Co.*,[2] which involved a putative private placement to employees, it is necessary to assess investors' sophistication, familiarity with the issuer and ability to "fend for themselves." The new exemption, like Regulation D for private placements by issuers, provides sellers, and issuers required to police resales following their private placements, with certainty regarding these subjective elements for private resales, which is particularly important for sales to natural persons.

Section 4(a)(7) includes several significant limitations that will not allow sellers to rely on it as broadly as they have relied on 4(1)(1/2) in the past. However, Section 4(a)(7) by its terms is a non-exclusive safe harbor, and we believe market participants will continue to rely on

[1] Conditions to the use of Section 4(a)(7) are set forth in new Sections 4(d) and 4(e).

[2] 346 U.S. 119, 126 (1953).

4(1)(1/2) in many situations, which we discuss below under "Practical Implications for Market Participants".

The requirements of Section 4(a)(7) are as follows:

- All purchasers must be accredited investors ("AIs").
  - ✓ *Note: The language of Section 4(a)(7) requires that purchasers be AIs as defined in Regulation D, where an AI is defined as someone the issuer reasonably believes comes within one of the categories of purchasers set forth in Rule 501. Section 4(a)(7) by its terms is unavailable to an issuer, so we believe Congress intended by using the AI definition to apply the reasonable belief standard to a seller that relies on Section 4(a)(7). The reasonable belief standard is consistent with the fundamental purpose of a safe harbor – whether Regulation D or Section 4(a)(7) – to provide greater certainty to the exempt sales process. We would welcome clarification from the SEC staff on this point.*
- No general solicitation or advertising may be used by the seller or anyone acting on the seller's behalf.
  - ✓ *Note: This prohibition is generally consistent with the similar prohibition for issuer offerings under Section 4(a)(2) and Regulation D, with the exception of Rule 506(c) offerings, which permit general solicitation so long as an issuer takes reasonable steps to verify that all purchasers are AIs. Notably, the prohibition is limited to actions taken by the seller or anyone acting on its behalf and does not capture concurrent actions by the issuer, which provides confirmation that an issuer's conduct should not affect a private resale by an unaffiliated seller not acting in concert with the issuer.*
- Information delivery requirement – For resales of securities of an issuer that is not an SEC reporting company or exempt from reporting pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), certain information must be delivered to a prospective purchaser. The required information includes, among other items, "reasonably current" financial information[3] prepared in accordance with GAAP or IFRS but which need not be audited or reviewed.
  - ✓ *Note: This information requirement is more burdensome than the information requirements imposed by Rule 144A and Regulation D. First and most importantly, while the information is similar to what an issuer is required to make available if requested by a purchaser under Rule 144A(d)(4), Section 4(a)(7) <u>requires</u> a seller to deliver the information to a purchaser. Section 4(a)(7) also*

[3] This financial information must include the issuer's most recent balance sheet and profit and loss statement and "similar financial statements" for the two preceding fiscal years (for which the issuer has been in operation) and it must be "reasonably current," meaning it must include a balance sheet and corresponding profit and loss statement as of a date and for a fiscal year ended less than 16 months prior to the sale and, if those items are not as of a date and for a period ending less than six months prior to the sale, be accompanied by an interim balance sheet and profit and loss statement for a date and a period ending less than six months before the transaction date.

imposes the same requirement for all issuers, while Rule 144A has a special rule for foreign private issuers.[4] *The Section 4(a)(7) information requirement is also more stringent than Regulation D, where information delivery is mandatory only for offerings that include non-AIs.* [5]

- Affiliate disclosure requirement – If the seller is a control person with respect to the issuer, the affiliate must include a brief statement regarding the nature of the affiliation and a statement certified by the seller that it has no reasonable grounds to believe the issuer is in violation of the securities laws or regulations.

  ✓ *Note: It is not clear what duty this imposes on a seller with respect to potential securities law violations by the issuer. By comparison, an affiliate can avoid control person liability under Section 20 of the Exchange Act if the person "in good faith" was unaware of issuer violations of the Exchange Act. Further, as written, the representation would extend to any violations of the securities laws or regulations (which could include minor violations). We would welcome the SEC staff confirming that the representation is limited to issuer violations that meet a certain threshold, for example those that would make an issuer a "bad actor" under Rule 506(d)(1) of Regulation D.*

- Bad actor disqualification – The new exemption may not be used if the seller or any agent being compensated for its participation in the transaction would be disqualified under the bad actor provisions of Rule 506(d)(1) of Regulation D.

  ✓ *Note: The bad actor disqualification does not apply in offerings under Rules 504 or 505 of Regulation D, which permit issuers to offer, subject to certain conditions, up to $1 million and $5 million of securities over a 12-month period, respectively. Sellers, however, will be disqualified, regardless of the size of the transaction, from using the new exemption if they fail the bad actor test. Further, we note that under Section 4(a)(7) the disqualification applies to the seller itself, not to the issuer.*

- Issuer disqualification – The exemption may not be used by an issuer.

- Subsidiary disqualification – The exemption may not be used by a subsidiary (either direct or indirect) of the issuer.

[4] Rule 144A permits a foreign private issuer to meet the "reasonably current" requirement for financial information by complying with home country or principal trading market requirements.

[5] Although the Section 4(a)(7) information requirement is more burdensome than Rule 144A and Regulation D, it is generally consistent with the information requirement in the new "Regulation Crowdfunding" (intended to facilitate capital raising for small companies). But while Regulation Crowdfunding requires the financial statements of an issuer to be either reviewed or audited depending on the size of the offering, Section 4(a)(7) does not. Comments on the original crowdfunding proposal overwhelmingly cited the cost of auditing financial statements, and not the cost of producing them, in their responses to the SEC's Regulation C original proposal.

- Business requirement – The issuer must be engaged in business. The exemption may not be used for resales of securities of an issuer that is in bankruptcy or reorganization, or in formation, or that is a blank check, blind pool or shell company.

- Underwriter prohibition – The exemption cannot be used for an unsold allotment held by a brokers or dealer as underwriter.

  - ✓ *Note: This provision prohibits the use of Section 4(a)(7) by broker-dealers to resell securities acquired with a "view to distribution," e.g., the classic "sticky deal" situation following a public offering.*[6]

- Seasoning requirement – The exemption may only be used for securities of a class that has been authorized and outstanding for at least 90 days.

  - ✓ *Note: This is consistent with the focus of Congress on facilitating resales of securities – particularly common stock – originally acquired privately by employees and venture capital investors from startup and similar non-public companies.*

In addition to the requirements set forth above, Section 4(a)(7) expressly establishes the following:

- Securities sold under the exemption are "covered securities" within the meaning of Section 18 of the Securities Act, and therefore state "Blue Sky" laws are preempted for resales made in compliance with the exemption.

  - ✓ *Note: We believe the preemption of Blue Sky laws is an important benefit of the exemption, and one of its primary uses will be where a resale would otherwise require registration under (or other compliance with) state Blue Sky laws, which can be burdensome.*

- Non-exclusive safe harbor – New Section 4(e)(2) provides that the exemption provided by Section 4(a)(7) "shall not be the exclusive means for establishing an exemption from the registration requirements of Section 5."

[6] By contrast, the SEC staff has indicated that an underwriter may resell, in compliance with Rule 144's volume and manner of sale restrictions, an unsold allotment of securities from a public offering, provided that six months have elapsed since the closing of the last sale under the relevant registration statement. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 128.02 (Jan. 26, 2009).

Practical Implications for Market Participants

Secondary Market Trading in Private Company Securities

The new exemption will be particularly useful for private resales to natural person AIs, because, as discussed above, it avoids the need to assess investors' sophistication, familiarity with the issuer and ability to "fend for themselves" as required by *Ralston Purina*. Equally important to facilitate such sales is the preemption of Blue Sky laws provided by the exemption, because those laws are more burdensome for offers and sales to natural persons, even AIs, than to institutional investors.

For sales of securities of private companies, the information delivery requirement in Section 4(a)(7) appears at first glance to be the biggest obstacle to using the new exemption, but it generally should not be too burdensome for sellers. Even small companies should be able to provide the required financial information, which need not be audited or reviewed. The information requirement does make resales contingent on the issuer cooperating with the seller by making the required information available. It is common, however, for private companies to contractually regulate permitted transferees anyway, by imposing pre-approval requirements at the time of an initial investment. In any event, we expect the market may require an issuer in a private offering to covenant to make the information required by Section 4(a)(7) available to sellers on request, similar to the covenant to make information available to a prospective investor required by Rule 144A(d)(4).

Section 4(a)(7) is available to affiliates of the issuer. The exemption will therefore provide affiliates with additional secondary market liquidity, which could be particularly valuable where there is no public market for the securities.[7]

Other Traditional Uses of 4(1)(1/2)

As discussed above, we believe the principal use of the Section 4(a)(7) exemption will be for the secondary market trading of equity securities of private companies. In other situations, we expect its use to be limited because of the conditions of the exemption and the burdens of complying with some of its requirements.

In light of the 90-day seasoning condition for the class of securities sought to be sold, Section 4(a)(7) will not be available for the kind of side-by-side transaction that is sometimes used, for example in a private placement of a newly issued class of debt or preferred stock, to expand the investor pool beyond QIBs to include institutional AIs. Nevertheless, the use of 4(1)(1/2) for those private placements has never been viewed as problematic, because those AIs are sophisticated and have adequate access to information about the issuer, and offers and sales to them therefore typically do not raise any burdensome *Ralston Purina* (or Blue Sky) concerns. We expect the market will continue to rely on 4(1)(1/2) in these contexts.

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[7] Affiliates of *public* companies will of course need to take into account that securities sold under Section 4(a)(7) remain "restricted," and therefore a sale in reliance on the new exemption will be subject to the substantial illiquidity discount that invariably accompanies the sale of restricted securities. Accordingly, the Rule 144 safe harbor will remain the best option for affiliate resales of publicly traded restricted securities unless the holding period requirement or volume constraints of Rule 144 make its use problematic in a particular case.

Section 4(a)(7) will be available, but burdensome to comply with, for other resales to institutional investors that are traditionally made in reliance on 4(1)(1/2), such as private, secondary block trades. In these cases, because Section 4(a)(7) is a non-exclusive safe harbor, we believe sellers will generally treat the choice between 4(1)(1/2) and Section 4(a)(7) as issuers have historically treated the choice between Section 4(a)(2) and Regulation D. Where private offerings by issuers are limited principally to institutional investors, they generally are made under Section 4(a)(2) and not Regulation D. Similarly, we believe private resales principally to institutional investors will generally continue to rely on 4(1)(1/2) notwithstanding the availability of Section 4(a)(7).

In these contexts, we do not expect law firms to change their practices regarding no-registration opinions just because the transactions either cannot or do not comply with Section 4(a)(7).

Implications for Broker-Dealers

As noted above, it is clear that a broker-dealer cannot use Section 4(a)(7) to resell unsold allotments of securities acquired in a public offering. We think a question remains whether a broker-dealer can effect a firmly underwritten resale, under Section 4(a)(7), of securities acquired privately from the issuer (assuming the class of securities has been outstanding for 90 days).[8] There is no express prohibition on this type of resale, but in contrast to Rule 144A, Section 4(a)(7) does not expressly permit an immediate resale by a broker-dealer following a purchase from an issuer,.[9] Moreover, Congress may well have intended the prohibition on issuer use of the exemption to also prohibit sales made in a planned, two-step process effectively on behalf of an issuer.

Broker-dealers will need to consider this question when deciding whether to rely on Section 4(a)(7) to expand the universe of potential purchasers in underwritten offerings of private company equity securities, particularly to natural person AIs. They also will need to consider the question in connection with reopenings of debt and preferred stock issues, which will often meet the requirement of Section 4(a)(7) that the class of securities have been outstanding for 90 days. Of course, broker-dealers can continue to rely on 4(1)(1/2) for these types of underwritten offerings so long as sales are made only to institutional AIs and to natural person AIs that clearly meet the requirements of *Ralston Purina* and raise no Blue Sky concerns.

[8] We believe it is clear that a broker-dealer may purchase restricted securities from a non-subsidiary affiliate and resell them in reliance on Section 4(a)(7), because the new exemption expressly permits use by such affiliates and there is no reason why such use could not be done indirectly via a broker-dealer.

[9] In Rule 144A, it is explicit that these types of firmly underwritten back-to-back sales are permitted. See Note 7 to Rule 144A and Rule 144A(e).

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