Alert

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COZEN O'CONNOR

SEC Votes to Harmonize and Improve "Patchwork" Exempt Offering Framework

On November 2, 2020, the U.S. Securities and Exchange Commission (the SEC), by a 3 – 2 vote, amended certain rules under the Securities Act of 1933 (the Securities Act) in order to harmonize, simplify, and modernize the exempt offering framework, primarily for the benefit of small and medium-size companies and their potential investors. The underlying goal of the amendments is to promote capital formation and expand investment opportunities while maintaining investor protections. The SEC has been working towards harmonizing the private offering exemptions, which is the primary method that entrepreneurs and emerging businesses utilize to raise seed capital for startups and to obtain growth capital for expansion, without the need to register their securities offerings with the SEC. However, after 50 years of legislation, certain structural and procedural aspects of the exempt offering framework have become increasingly confusing and difficult to navigate. A complex patchwork of 10 principal exemptions from the registration requirements has been built over time to address developments and changes in the economy, technology and financial markets. Given such backdrop, a harmonization of the exempt offering framework, which frequently contains differing requirements or conditions for essentially the same issue, should be welcomed by both issuers and the investment community.

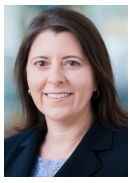
After months of soliciting public comments to proposals issued in March 2020, which were on a concept release from June 2019, along with direct outreach to investors and issuers, as well as listening to recommendations from the SEC's advisory committees and the Government-Business Forum on Small Business Capital Formation, the SEC has adopted a series of amendments aimed at making the capital raising process more "effective and efficient" by addressing "gaps and complexities" in the exempt offering framework that have created problems for issuers seeking to gain access to capital and investors looking to participate in investment opportunities.

Some of the amendments cover the following exempt offering provisions:

Allowing Issuers to Move from One Exemption to Another Pursuant to a Fact-Oriented Principle of Integration, and Making Safe-Harbors Available to Avoid Integration

One issue that has confronted issuers since the beginning of the federal securities laws is the SEC's integration doctrine, which seeks to prevent an issuer from avoiding the registration requirements by artificially dividing a single offering into multiple offerings and thereby applying exemptions for the multiple offerings that would be unavailable to the combined offering. In situations where an issuer is using multiple private offering exemptions, either concurrently or within close proximity to each other, the issuer has the risk that one or more of the exemptions may be determined by the SEC not to apply when the offerings are viewed as being "integrated" for purposes of analyzing compliance. With each exemption having different limitations and conditions, including in some cases, restrictions on general solicitation of investors, an issuer can be out of compliance if the offerings are viewed as one integrated offering. New Rule 152(a) under the Securities Act provides an integration framework composed of a general principle of integration based on the facts and circumstances of each offering. New Rule 152(b) further establishes four non-exclusive safe harbors from integration, which provide that:

1. if compliant with certain restrictions on general solicitation, 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, will not be integrated with such other offering(s);
2. offers and sales made in compliance with the SEC's Rule 701 safe harbor exemption,



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pursuant to an employee benefit plan, or in compliance with the SEC's Regulation S safe harbor exemption, will not be integrated with other offerings;
3. an offering for which a Securities Act registration statement has been filed will not be integrated if it is 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 that was made only to qualified institutional buyers and institutional accredited investors, or (c) an offering for which general solicitation is permitted that terminated or was completed more than 30 calendar days prior to the commencement of the registered offering; and
4. offers and sales made in reliance on an exemption for which general solicitation is permitted will not be integrated if made subsequent to any terminated or completed offering.

Permitting "Test-The-Waters" and "Demo Day" Communications

Issuers in exempt offerings are subject to regulatory restrictions on communications to potential investors that can be expensive to comply with and limit issuers' ability to reach such investors. These regulatory restrictions are expansive, given the SEC's broad interpretation of the terms "offer," "general solicitation," and "general advertising." To address these issues, the amendments:

1. permit certain "demo day"[1] communications to be excluded from being deemed general solicitation or general advertising under new Rule 148;
2. permit issuers to use generic solicitation of interest materials to "test-the-waters" under new Rule 241, before selecting an applicable exemption and undertaking the cost and expense of preparing and conducting a securities offering under such exemption;
3. permit Regulation Crowdfunding issuers to "test-the-waters" with potential investors under new Rule 206, which is based on Rule 255 of Regulation A, before filing an offering document with the SEC; and
4. in an amendment to Rule 204, permit Regulation Crowdfunding issuers to have oral communications with prospective investors after filing, as long as the communications comply with the requirements of Rule 204.

Harmonizing Certain Disclosure and Eligibility Requirements and Bad Actor Disqualification Provisions

The amendments also:

1. add a new item to the non-exclusive list of methods to verify accredited investor status in Rule 506(c), in the case of an investor that the issuer previously took reasonable steps to verify as an accredited investor; the issuer may verify that such investor remains an accredited investor as of the time of a subsequent sale, if the investor provides a written representation to such effect and the issuer is not aware of information to the contrary;
2. reduce the amount of financial information that must be provided by non-reporting issuers to non-accredited investors in Rule 506(b) offerings to conform with the financial information issuers must provide to investors in Regulation A offerings;
3. allow the use of certain limited-purpose vehicles that would be exempt from the Investment Company Act of 1940 to serve as a conduit for investors to invest in Regulation Crowdfunding offerings; the crowdfunding conduit would not function as an independent investment vehicle;
4. simplify certain requirements for Regulation A offerings where compliance with Regulation A is more complex or difficult than for registered offerings, such as the redaction of confidential information in material contracts; and
5. harmonize the "bad actor" disqualification provisions in Regulation D, Regulation A, and Regulation Crowdfunding so each has the same look-back requirement.

Revising Offering Limits and Individual Investment Limits for Regulation A, Regulation Crowdfunding, and Rule 504 Offerings

Regulation A, Regulation Crowdfunding, and Regulation D contain limits on the amount of securities that can be offered, and Regulation Crowdfunding also limits the amount that individual investors can invest. In an effort to broaden the use of the private offering exemptions, the SEC has amended such restrictions as follows:

1. For Tier 2 of Regulation A, the amendments:
    - raise the maximum offering amount from $50 million to $75 million in a 12-month period; and
    - raise the maximum offering amount for secondary sales from $15 million to $22.5 million.
2. For Rule 504 of Regulation D, the amendments raise the maximum offering amount of securities in a 12-month period from $5 million to $10 million.
3. For Regulation Crowdfunding, the amendments:
    - raise the offering limit from $1.07 million to $5 million in a 12-month period;
    - remove the investment limits for accredited investors, which is consistent with Tier 2 Regulation A offerings;
    - revise the investment limit calculation for non-accredited investors by using the greater of their annual income or net worth, which is also consistent with Tier 2 Regulation A Offerings; and
    - extend temporary relief until August 28, 2022, of certain financial statement review requirements for issuers offering $250,000 or less of securities.

The amendments go into effect 60 days after publication in the Federal Register, except for the extension of the temporary Regulation Crowdfunding provisions, which will be effective upon publication in the Federal Register. The SEC fact sheet press release may be accessed here. The final rules may be accessed here.

To discuss any questions you may have regarding this Alert, or how it may apply to your particular circumstances, please contact a member of Cozen O'Connor's Corporate Governance & Securities group.

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[1] A "demo day" is generally an event organized by a group or entity that invites startup companies to present their businesses to potential investors, with the goal of obtaining an investment.