November 13, 2020

SEC Adopts Rules Affecting Private Offerings

The SEC adopted new rules under the title "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets." The concept release from which this rulemaking arose signaled the potential for a grand harmonization of the various private offering exemptions.[1] This rulemaking achieved important, but far more modest, objectives. The new rules tackle the nuts and bolts of various aspects of private offerings – integration, general solicitation and accredited investor verification, among others – and seek to reduce sources of regulatory friction. The result should help improve the efficiency of the private markets and provide more certainty for issuers that access them.

The key areas this rulemaking addresses and that this alert will discuss[2] are:

- Integration – The amendments eliminate the outdated "five-factor test" for evaluating whether two seemingly separate offerings affect the registration or exemptive status of each other. In its place, the Commission adopted a general integration principle along with four specific safe harbors.

- General Solicitation – Although the SEC staff had previously provided helpful guidance on "demo days" and general solicitation, the amendments provide an express regulatory exemption for demo days and similar events from general solicitations or general advertising characterization. In a separate rule, generic solicitation of interest materials about a private offering will not be considered general solicitation of the private offering.

- Rule 506(c) Verification – For offerings under Rule 506(c), which permits general solicitation, the issuer must take reasonable steps to verify that each purchaser is an accredited investor. The amendments add an additional safe harbor, verification method that, in effect, provides a five-year shelf life to a prior verification.

- Regulation D Financial Information – The amendments modify the requirements for the financial statements that must be provided in a Rule 506(b) offering to purchasers who are not accredited investors. The new requirements align with the financial statement requirements in Regulation A offerings.

- Confidential Information Standard – Although not squarely on the topic of private offerings, the amendments change the standard for when redaction of confidential information is permitted in an SEC filing. The existing standard allows the issuer to redact information that is not material and that the issuer treats as confidential, if the issuer demonstrates that the disclosure would cause competitive harm. The U.S. Supreme Court recently held that the Freedom of Information Act does not require a showing of competitive harm to protect confidential information. The SEC has chosen to align its rule with this standard and, consequently, issuers no longer must demonstrate that disclosure of the confidential information would cause competitive harm.

- Regulation A and Crowdfunding – A substantial number of the amendments address these two exemptions, on which the JOBS Act had focused. Please reach out to your regular Ropes & Gray contacts if you would like to learn more about this portion of the new rules.

[1] Concept Release on Harmonization of Securities Offering Exemptions https://www.sec.gov/rules/concept/2019/33-10649.pdf (June 2019)

[2] This alert will only refer in passing to various changes the SEC made to Regulation A and Crowdfunding. These changes are important to these offering exemptions, but Ropes & Gray clients infrequently rely on those exemptions. Please contact your regular Ropes & Gray contacts if you are interested in more detailed information about these changes.

Integration

The five-factor test for assessing whether two separate sales of securities should be considered together for purposes of determining Section 5 compliance has long been a frustrating exercise that frequently reached unsatisfactory conclusions. The amendments replace the five-factor test with a general principle. In considering whether two or more offerings should be treated as one, the issuer should look at each offering separately to determine whether it meets the requirements either for registration or for a particular exemption. This principle sounds simple, but the Commission had to address the consequences of general solicitation, which is permitted for registered offerings and some exempt offerings, but prohibited for others. For an exempt offering that prohibits general solicitation (e.g., under Rule 506(b)), the issuer must have a reasonable belief that each purchaser in the offering either (1) was not solicited through the use of general solicitation or (2) had a substantive relationship with the issuer before the exempt offering commenced. With two concurrent exempt offerings that permit general solicitation (e.g.. under Rule 506(c) and under Regulation A), offering materials used in a general solicitation for one offering that mention the material terms of the other offering must comply with the requirement for, and restrictions on, offers that apply to the other offering.

The new rules also address exemptions that limit the number of purchasers – namely, Rule 506(b). Under that rule, an issuer can sell to up to 35 non-accredited investors, provided certain conditions are met. To address the possibility that issuers might attempt to conduct separate, concurrent Rule 506(b) offerings that each involve 35 non-accredited investors, the amendments limit the number of non-accredited investor purchasers under all offerings under that rule to 35 in any 90-day period.

Safe Harbors

The amendments set forth four specific safe harbors that will permit issuers to dispense with any analysis under the general principle set out above:

- 30-Day Safe Harbor. Replacing the former six-month cooling-off period, offerings separated by more than 30 calendar days will not be integrated. For an exempt offering that does not permit general solicitation, however, the issuer must perform the analysis of whether a purchaser was solicited by means of a general solicitation or whether it had a pre-existing, substantive relationship with the purchaser.

- Rule 701/Regulation S. As under the existing rules, offers and sales that comply with Rule 701 (for employee offerings) or Regulation S (for offshore offerings) are not integrated with other offerings.

- Subsequent Registered Offerings. A registered offering will not be integrated with a prior terminated or completed offering:

    - for which general solicitation was not permitted;

    - for which general solicitation was permitted but sales were made only to qualified institutional buyers (QIBs) or institutional accredited investors; or

    - for which permitted general solicitation terminated or completed more than 30 calendar days before the registered offering commenced.

This safe harbor addresses so-called “gunjumping” concerns about communications that could be considered offers and that occur immediately before a registered offering. It builds upon – and replaces – the previous safe harbors under former Rules 152 and 155.

- Subsequent general solicitations. The fourth safe harbor provides for non-integration of any exempt offering for which general solicitation is permitted with any prior offering that was terminated or completed. In the release, the Commission specifically observed that this means an issuer conducting a Rule 506(b) offering can switch to Rule 506(c) so long as any sales made after the switch are only to accredited investors whose status the issuer has taken reasonable steps to verify.

Commencement, Termination or Completion.

Because the general integration principle and safe harbors rely on the concepts of commencement, termination and completion, the amendments provide a non-exclusive list of factors that apply to various types of offerings. Assessments of commencement, termination, or completion falling outside the safe harbors depend on the particular facts and circumstances that apply at the time.

General Solicitation and Offering Communications

The amendments create a new Rule 148 that excludes certain "demo day" communications from general solicitation or general advertising. Demo days are meetings or seminars sponsored by colleges or universities, state or local governments, non-profit organizations, angel investor groups or incubators in which companies that are seeking financing present business plans. This new exemption requires that no advertising about the event can refer to a specific offering of securities. In addition, the sponsor of the event must not make investment recommendations, charge any fees (other than reasonable administrative fees) or receive compensation for making introductions. For its part, an issuer can only inform attendees that it is offering or planning to offer securities, the type and amount of securities offered, the intended use of proceeds and any unsubscribed amount. If the event allows virtual participation, those attendees must be associated with the sponsor, accredited investors or individuals who have been invited based on their industry or investment experience.

The requirements for this exemption, although somewhat detailed, are likely not difficult for most sponsors and issuers to meet. Presumably the exemption is not the exclusive way by which an event such as a demo day could avoid characterization as general solicitation, and companies will still be able to argue, based on facts and circumstances, that communications did not constitute offers.

The amendments also create a new exemption for "testing-the-waters" communications for private offerings. Under new Rule 241, issuers are permitted to communicate orally and in writing to gauge investor interest in a contemplated private offering of securities. The source of demand for such a provision is unclear. One somewhat curious feature of the new exemption is exclusion of an issuer that has elected its intended offering exemption. Regulation A already permits testing the waters (TTW), and the Commission added a TTW provision for Crowdfunding in these amendments. Offerings under Rule 506(c) do not need the exemption, as general solicitation is permissible for those offerings. If the issuer decides to use Rule 506(b) for its offering, the Commission recognized that these earlier solicitations of interest, although exempt, could be considered general solicitations for purposes of that rule, thus throwing the issuer back to the general integration principle (or waiting at least 30 days).

A trap for the unwary in this exemption is that the Commission did not preempt the application of state law to these communications. Thus issuers will still need to make sure that they have an available exemption from state registration for these solicitations of interest.

Rule 506(c) Verification Requirements

Rule 506(c) permits general solicitation so long as all purchasers are accredited investors whose status the issuer has taken reasonable steps to verify. Although the rule as adopted included four safe harbors, many issuers, concerned about demonstrating compliance, have been reluctant to take advantage of the communication flexibility provided by Rule

506(c). The amendments add another safe harbor, allowing an issuer to rely on reasonable steps that it took within the prior five years so long as the investor provides a representation that it still qualifies. Moreover, the Commission seemed to go out of its way in the release to affirm that what is necessary to establish the principles-based "reasonable steps to verify" is less than issuers may have feared. Indeed, the Commission expressed the view that in many cases the steps may not be substantially different from what an issuer would do to establish its "reasonable belief" – the general standard under Regulation D - that an investor is accredited.

Financial Statement Requirements in Regulation D Offerings

The amendments align the financial statements that must be provided to non-accredited investors in a Regulation D offering to the financial statement requirements of Regulation A. For offerings up to $20 million, issuers would have to provide the same financial statements as in a Tier 1 Regulation A offering. For offerings of more than $20 million, the requirements for Tier 2 Regulation A offerings would apply.

Confidential Information Standard

Although a little far afield from private offerings, the amendments change the standard for when confidential information may be redacted from exhibits that are filed with the Commission. The Commission's rules had followed the standard for the Freedom of Information Act that had been interpreted by the Court of Appeals for the D.C. Circuit – namely, that the information had to be confidential and its public disclosure would cause the issuer competitive harm. Recently the Supreme Court held that the FOIA required only that the information be confidential and dropped the competitive harm portion of the test. The amendments align the Commission's rules with this new standard. Taken together, this and the recent changes that permit issuers to redact confidential information without filing a confidential treatment request serve to substantially streamline the process of obtaining confidential treatment.

Changes to Regulation A and Crowdfunding

The amendments increase the offering limits for Tier 2 Regulation A offerings from $50 million to $75 million and for Crowdfunding offerings from $1.07 million to $5 million. The maximum amount for Regulation D Rule 504 offerings was increased from $5 million to $10 million. Some of the procedural requirements for Regulation A offerings have been streamlined in ways comparable to registered offerings, and several changes were made to Crowdfunding offerings, including a provision that permits special purpose vehicles to invest in these offerings.

******

The new rules will take effect 60 days after publication in the Federal Register, which has not yet occurred. They likely will be in effect sometime in January 2021. Although early voluntary compliance is not expressly permitted, principles underlying some of the changes (e.g., with integration) will likely be instructive in analyzing current problems. Similarly, one would hope that the SEC staff would recognize the impending changes to the confidential treatment requirement when requesting that issuers justify their eligibility to exclude certain information.

If you have any questions about any of the topics covered in this Alert, please contact your usual legal advisor at Ropes & Gray.