MAYER | BROWN

Understanding the Securities Laws 2019

July 2019

Securities Act of 1933 – registration framework

- Section 5 – Must register all transactions absent an exemption from the registration requirements
- Section 4 – Contains transactional exemptions
- Section 4(a)(2) – The statutory private placement exemption
  - "Transactions by an issuer not involving any public offering"
- Section 4(a)($1^1/_2$) exemption evolved in practice
  - Not embedded in the Securities Act

What we will cover

- Section 4(a)(2)
- Regulation D; the JOBS Act changes
- Intrastate offerings
- Integration
- Regulation A
- Rule 701
- Crowdfunding
- Section 4(a)(7)

Section 4(a)(2)

Section 4(a)(2)

- Issuer exemption
  - Most utilized exemption
  - Application of the private placement exemption, however, has been the subject of significant debate due in large part to the brevity of its wording
  - Not a "public offering" has been defined by case law and SEC interpretation and one may look to safe harbors as well
- Transactional exemption
- Restricted securities — securities sold in a private placement may not be resold absent registration or an exemption from registration (Rule 144, Rule 144A, Section 4(a)($1^1/_2$) and now Section 4(a)(7))

Section 4(a)(2) and Ralston-Purina

SEC v. Ralston Purina Co., 346 U.S. 119 (1953)

- Supreme Court confirmed SEC position that offers and sales to a large number of employees by Ralston Purina under its stock plan were not exempt under Section 4(a)(2) and provided the following "guidance":
  - Section 4(a)(2) exemption focuses on "offerees" and not actual purchasers of the securities
  - Section 4(a)(2) exemption does not depend upon a numerical test; Court rejected SEC argument that extensive number of offerees was sufficient by itself to establish loss of exemption
  - Availability of Section 4(a)(2) exemption *"should turn on whether the particular class of persons...need the protection of the 1933 Act"* and whether the offerees "*are shown to be able to fend for themselves*"
  - Court stated that where offerees do not have "access to the kind of information" that a registration statement would disclose, issuer required to provide same kind of information that otherwise generally would be available in a registration statement

Section 4(a)(2) remains available

- The JOBS Act does not amend Section 4(a)(2); it only requires the SEC to amend Rule 506
- SEC Rel. No. 33-4552 (Nov. 6, 1962)
  - Relationship between offerees and issuer
  - Nature, scope, size and manner of offering
- ABA Federal Regulation of Securities Committee, Section 4(2) and Statutory Law, 31 Bus. Law. 485 (1975)
  - Offeree qualification
  - Availability of information
  - Manner of offering
  - Absence of redistribution

Safe Harbors

Regulation D–Rules 501-508

- Rules and regulations that set forth conditions the satisfaction of which will ensure that there has not been a public offering
- Regulation D includes
  - Exemption for certain offerings by issuers under $5 million (Rule 504)
  - A private placement safe harbor (Rule 506)
- Non-exclusive safe harbor
- Section 4(a)(2) still available (to the extent general advertising and general solicitation are not used)

Resale limitations

- Rule 502(d)
  - "The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters"
- Reasonable care
  - Reasonable inquiry of purchasers
  - Written disclosure to purchasers that resale of the securities is restricted
  - Legends on the securities

Disclosure requirement

- None mandated for accredited investors
  - Anti-fraud rules do apply
- Mandated for non-accredited investors (Rule 502(b))
  - Generally, registration statement-like disclosure is required
  - Financial statement requirement varies based on size of transaction

Blue Sky considerations

- Securities that are sold pursuant to Rule 506 are considered "covered securities" for purposes of Section 18(b)(4)(D) of the Securities Act
  - This means that securities sold in reliance on Rule 506 are exempt from state securities review
- An issuer that relies on Section 4(a)(2) may need to consider state securities requirements

Rule 506 safe harbor requirements

- Rule 506 is the most widely used exemption rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D
- Traditional requirements of a Rule 506 private placement include:
  - No dollar limit on size of transaction
  - Unlimited number of accredited investors and no more than 35 unaccredited investors
  - No general solicitation or advertising *(**prohibition against general solicitation has been eliminated for Rule 506(c) offerings**)*
  - Resale limitations
  - Disclosure required for non-accredited investors
  - Form D filing within 15 days of first sale of securities
  - Good faith effort to comply (Rule 508)

No general solicitation or advertising

- Historically, Rule 502(c) contained a prohibition on general solicitation by the issuer or its agent
  - No general solicitation or advertising
  - No seminar with attendees invited by general solicitation or advertising
- Importance of preexisting substantive relationship with offerees
  - SEC Staff guidance on the meaning of a "preexisting" and "substantive relationship" has been provided through numerous no-action letters, including a recent no-action letter *(CitizenVC),* as well as through Compliance & Disclosure Interpretations
  - The issuer or the issuer's agent (may include a broker-dealer or a registered investment adviser) must have developed an understanding of the offeree's sophistication and financial circumstances

Rule 506 purchasers

- Accredited Investors (Rule 501)
  - Institutional investors, such as banks, S&Ls, broker-dealers, insurance companies, investment companies
  - Corporations or trusts with assets in excess of $5 million
    - Not formed for purpose of making the investment (look-through rule)
  - Directors and officers of the issuer
  - Individuals with
    - Income > $200,000 or joint income > $300,000
    - Net worth or joint net worth > $1 million*
  - Entity in which all equity owners are accredited investors
- Non-accredited investors
  - Sophistication required
  - Alone or with Purchaser Representative

*Dodd-Frank Act of 2010 amended definition to eliminate ability of individuals to include the equity value of primary residences in calculation of net worth

"Accredited investor" reviews

- Dodd-Frank Act provides that, upon enactment and for four years following enactment, the net worth threshold for accredited investor status will be $1 million, excluding the equity value (if any) of the investor's primary residence
- One year after enactment, the SEC is authorized to review the definition of the term "accredited investor" (as it is applied to natural persons) and to adopt rules that adjust the definition, except for modifying the net worth threshold
- Four years after enactment, and every four years thereafter, the SEC must review the "accredited investor" definition as applied to natural persons, including adjusting the threshold (although it may not be lowered below $1 million)
- In December 2015, the SEC Staff issued its report on the review of the "accredited investor" definition
- Most recently, the SEC has requested public comment on the "accredited investor" definition

The JOBS Act: Rule 506 changes

- The JOBS Act contains various provisions that affect exempt offerings
- Title II of the JOBS Act directs the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D, provided that the securities are sold only to accredited investors, and under Rule 144A offerings, provided that the securities are sold only to persons who the seller (and any person acting on behalf of the seller) reasonably believes are qualified institutional buyers ("QIBs")

Relaxation of the ban on general solicitation

- In September 2013, the final rules became effective; final rules implement a bifurcated approach to Rule 506 offerings
  - An issuer may still choose to conduct a private offering in reliance on Rule 506(b) without using general solicitation
- The SEC adopted a new paragraph (c) in Rule 506, which permits the use of general solicitation, subject to the following conditions:
  - The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
  - All purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and
  - The conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied.

Relaxation of the ban on general solicitation

(cont'd)

- In addition to the changes to Rule 506, the SEC also amended Rule 144A to eliminate references to "offer" and "offeree," and thus require only that the securities are sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believe is a QIB
- Resales of securities pursuant to Rule 144A could be conducted using general solicitation, so long as the purchasers are limited in this manner
- The SEC reiterates that general solicitation in connection with a Rule 144A offering will not be viewed as a "directed selling effort" in connection with a concurrent Regulation S offering
- The rule amends Form D to add a check box to indicate whether the issuer is relying on Rule 506(c)

Reasonable steps to verify investor sales

- The final rule retains the principles-based guidance, highlighting that the inquiry to be undertaken may differ depending on the facts and circumstances. The SEC provides a list of factors to consider:
  - *The nature of the purchaser*. The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities
  - *The nature and amount of information about the purchaser*. Simply put, the SEC states that "the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa"
  - *The nature of the offering*. The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status, *i.e.,* issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or email

Reasonable steps to verify investor sales *(cont'd)*

- The final rule does not provide for a safe harbor; however, it does set out a supplemental non-exclusive list of methods that may be used to satisfy the verification requirement, including:
  - A review of IRS forms for the two most recent years and a written representation regarding the individual's expectation of attaining the necessary income level for the current year
  - A review of bank statements, brokerage statements, tax assessments, etc. to assess assets, and a consumer report or credit report from at least one consumer reporting agency to assess liabilities
  - A written confirmation from a registered broker-dealer, RIA, CPA, etc.
  - For existing investors (pre-506(c) effective date), a certification
- The SEC confirmed the view that Congress did not intend to eliminate the existing "reasonable belief" standard Rule 501(a) of the Securities Act or Rule 506 offerings

Reasonable steps to verify investor sales *(cont'd)*

- The SEC confirmed that if a person were to supply false information to an issuer claiming status as an accredited investor, the issuer would not lose the ability to rely on the proposed Rule 506(c) exemption for that offering, provided the issuer "took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor"

"Accredited investor crowdfunding"

- Many "matchmaking portals" rely on Rule 506(b) to conduct internet- based offerings solely to accredited investors
- These offerings are structured such that the matchmaking portal makes an offer only to accredited investors with which the portal has established or has a pre-existing substantive relationship
- Issuer specific or offering specific information is not generally available and is made available only to "members" or on a password-protected basis to those investors known to the portal
- An accredited investor crowdfunded offering generally relies on the guidance provided in pre-JOBS Act no-action letters *(IPONet, Lamp Technologies,* etc.) and affirmed recently in C&DIs on general solicitation, as well as in a recent no-action letter, *Citizen VC*

Staff guidance on general solicitation

- The SEC staff has issued various C&DIs that reaffirm or restate existing principles and guidance related to the types of communications that constitute a general solicitation
  - General business communications made in the ordinary course are not a general solicitation
  - Communications that are directed and bilateral do not constitute a general solicitation
  - Communicating with individuals or groups with whom the issuer or its agent has a pre-existing substantive relationship is not a general solicitation

Bad Actor Rules

“Bad actor” disqualification

- Unlike Regulation E and Regulation A, Rule 506 of Regulation D historically did not contain “bad actor” disqualification provisions
- In May 2011, the SEC proposed amendments to rules promulgated under Regulation D to implement Dodd-Frank Act Section 926’s provision regarding the “bad actors” for Regulation D
- The final bad actor rule was adopted in conjunction with the adoption of the final rule relating to Rule 506 offerings; the rule became effective September 2013

Covered persons

- The amendment adds a new Section 506(d) to Regulation D
- This new section encompasses disqualification provisions that are substantially similar in their effect to the bad actor disqualification provisions that are codified in Rule 262 of Regulation A
- The provisions are applicable only in the context of Rule 506 offerings

Covered persons *(cont'd)*

- The disqualification provisions apply to the following "covered persons":
  - The issuer and any predecessor of the issuer or affiliated issuer;
  - Any director, executive officer, other officer participating in the offering process, general partner or managing member of the issuer;
  - Any beneficial owner of 20 percent or more of any class of the issuer's voting equity securities, calculated on the basis of voting power;
  - Any investment manager to an issuer that is a fund and any director, executive officer, officer participating in the offering, general partner or managing member of the manager, as well as any director, executive officer or officer participating in the offering of any such general partner or managing member;
  - Any promoter connected with the issuer in any capacity at the time of the sale;
  - Any person that has been or will be paid, directly or indirectly, remuneration for solicitation of purchasers in a securities offering; or
  - Any director, executive officer, other officer participating in the offering, general partner or managing member of any compensated solicitor.

Disqualifying events

- The rule includes the following categories of disqualifying events:
  - Criminal convictions;
  - Court injunctions and restraining orders;
  - Final orders of certain state regulators (such as securities, banking, and insurance) and federal regulators;
    - The CFTC was added to the list of regulatory agencies;
    - A definition of "final order" was added to Rule 501
  - Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
  - Certain Commission cease-and-desist orders;
  - Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization ("SRO");
  - Commission stop orders and orders suspending a Regulation A exemption; and
  - U.S. Postal Service false representation orders.

Reasonable care exception

- The final rule contains a reasonable care exception that applies if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person
- Issuer would need to conduct a factual inquiry; the SEC notes that the type of inquiry will depend on the facts and circumstances

Satisfying reasonable case burden

- Issuers must implement new procedures in connection with any Rule 506 offering
  - This may be especially burdensome for private funds that regularly conduct private offerings in reliance on Rule 506
- Issuers may consider:
  - Adding additional questions to D&O questionnaires
  - Requiring placement agents to complete a questionnaire or provide a representation
  - Requiring other participants (that may be covered persons) to complete questionnaires or provide representations
  - For funds or other issuers engaged in continuous or delayed offerings, refreshing or updating their diligence

Waivers

- The rule permits the Commission to grant waivers upon a showing of good cause
- The rule does not articulate standards for granting waivers
- The adopting release lists various circumstances that might be relevant to a waiver, such as a change of control, a change of supervisory personnel, absence of notice and an opportunity for hearing, and a relief from a permanent bar for a person who does not intend to apply to reassociate with a regulated entity

Rule 147 and Rule 504

Amendments

- In October 2016, the SEC adopted final rules on intrastate and regional offerings as follows:
  - The SEC amended Rule 147. Rule 147 continues as a safe harbor under Section 3(a)(11)
  - Section 3(a)(11) remains available on its own
  - The SEC established a new exemption, Rule 147A, which addresses out-of-state residents and companies incorporated or organized out-of-state
  - The SEC also amended Rule 504 and repealed Rule 505

Rule 504

- An exemption pursuant to Section 3(b) of the Securities Act; Section 3(b) authorizes the SEC to exempt from the registration requirements of the Securities Act offerings of securities not exceeding $5 million
- **Amount of offering:** The offering threshold was $1 million of securities sold under Rule 504 within a 12-month period, less selling price of other securities sold under another section 3(b) exemption within the prior 12 months; *the SEC amendments raise the threshold to $5 million*
- **By?** Issuer cannot be a reporting company, an investment company or a SPAC
- **Who can invest?** Depends on form of offering
- **Is there an investor cap?** No

Rule 504 *(cont'd)*

- **Manner of offering:** a private placement or an offering registered under applicable state laws
  - If it is structured as a private placement, then the issuer cannot use general solicitation or general advertising and must obtain investment representations, impose transfer restrictions, use restrictive legends on the securities, etc.
  - If it is structured as a state-registered offering, the issuer must comply with state registration requirements ("qualification") in each state where securities are sold, including preparing and delivering a required "substantive disclosure document before sale" to purchasers in all states (whether or not each state requires registration and delivery of a disclosure document), **or** sell only to "accredited investors" in accordance with available state law exemptions that permit general solicitation and general advertising
- **Is an intermediary required?** No, although it would be challenging for an issuer to complete a Rule 504 offering as a private placement on its own

Rule 504 *(cont'd)*

- **Offering disclosure requirements:** As discussed above, these depend on the manner of offering
- **Reporting following the offering:** None
- **Form D:** Issuer must file a Form D
- **New Bad Actor Disqualification Provision:** The SEC amendments include a provision that disqualifies certain bad actors from participation in Rule 504
- The amendments to Rule 504 are intended to "facilitate state efforts to increase the efficiencies associated with the registration of securities offerings in multiple jurisdictions through regional coordinated review programs"
- The final rules repeal Rule 505 of Regulation D, which had provided a safe harbor from registration for securities offered and sold in any twelve-month period from $1 million to $5 million sold solely to accredited investors or no more than 35 non-accredited investors

Rule 147

- Section 3(a) of the Securities Act provides an exemption from the registration requirements for "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.
- Section 3(a)(11) provides an exemption provided that:
  - The issuer be incorporated (and resident) and doing business in the state; and
  - The securities are offered and sold to persons resident in the state
- **Amount of offering:** no limitations on the dollar amount being raised
- **Who can invest:** no limitations on the number or the sophistication of offerees or purchasers
- **Advertising:** no publicity or general solicitation restrictions, except offers and sales may be made only to residents of one state
- **Disclosure requirements:** no specific disclosure requirements apart from the resale restrictions

Rule 147 *(cont'd)*

- Rule 147 is a safe harbor under Section 3(a)(11); if the conditions of the safe harbor have not been satisfied, the 3(a)(11) exemption may still be available.
- Prior to its recent amendment, the conditions of the Rule 147 safe harbor were as follows:
  - To be "doing business" in the state, the issuer must derive 80% of its consolidated gross revenues from the state, and have 80% of its consolidated assets located in the state, and use 80% of the net offering proceeds in the state, and have its principal office in the state;
  - The entire offering must be made under the exemption, i.e., no additional offers and sales of securities that would be integrated may be made under any other exemption from registration—integration is determined under the five-factor test subject to the rule of thumb that offers and sales made more than 6 months before or after an intrastate offering will not be integrated; and
  - Resales of the securities within nine months of an intrastate offering may only be made to residents of the same state—and the securities must be legended, and transfer restrictions imposed, to reflect this resale restriction.

Proposed amendments to Rule 147

- The SEC proposed to amend Rule 147 because quite a number of the conditions of Rule 147 were viewed as preventing its use in connection with intrastate crowdfunding (relying on a website), such as the prohibition on general solicitation, the requirement that the issuer be incorporated in the state in which the offering was made, etc.

Amendments to Rule 147 and new 147A

- Rule 147A is substantially identical to Rule 147 except that it allows offers to be accessible to out-of-state residents and for companies to be incorporated or organized out-of-state
- Both new Rule 147A and amended Rule 147 include the following provisions:
  - Requirement that the issuer has its "principal place of business" in-state and satisfies at least one "doing business" requirement that would demonstrate the in-state nature of the issuer's business;
  - A new "reasonable belief" standard for issuers to rely on in determining the residence of the purchaser at the time of the sale of securities;
  - Requirement that issuers obtain a written representation from each purchaser as to residency;
  - Limit on resales to persons residing within the state or territory of the offering for a period of six months from the date of the sale by the issuer to the purchaser;
  - An integration safe harbor; and
  - Legend requirements to offerees and purchasers about the limits on resales.

Principal place of business

- Amended Rule 147 and new Rule 147A define an issuer's "principal place of business" (as opposed to its "principal office" as defined in old Rule 147) as the location from which the officers, partners or managers of the issuer primarily direct, control and coordinate the activities of the issuer
- Under amended Rule 147, issuers that are incorporated or organized under state or territorial law will be deemed a "resident" of a particular state or territory in which they are both incorporated or organized and have their "principal place of business"
- New Rule 147A(c)(1) however, relies solely on the principal place of business requirement to determine the state or territory in which the issuer shall be deemed a "resident," not only for corporate issuers, but for all issuers
- Under amended Rule 147 and new Rule 147A, issuers that have changed their principal place of business after making sales in an intrastate offering pursuant to amended Rule 147 or new Rule 147A, as applicable, will not be able to conduct another intrastate offering pursuant to either rule in another state for a period of six months from the date of the last sale in the prior state

Doing business requirement

- Under amended Rule 147 and new Rule 147A, an issuer is required to meet at least one of the following requirements in order to be considered "doing business" in-state:
  - The issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in or from the rendering of services within such state or territory;
  - The issuer had at the end of its most recent semi-annual fiscal period prior to the first offer of securities pursuant to the exemption, at least 80% of its consolidated assets located within such state or territory;
  - The issuer intends to use and uses at least 8o% of the net proceeds to the issuer from sales made pursuant to the exemption in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within, such state or territory; or
  - A majority of the issuer's employees are based in such state or territory (this requirement was not included in old Rule 147).

Reasonable belief standard

- Amended Rule 147(d) and new Rule 147A(d) include a reasonable belief standard for the issuer's determination as to the residence of the purchaser at the time of the sale of the securities
- This requirement can be satisfied by
  - The existence of the fact that the purchaser is a resident of the applicable state or territory, or
  - Establishing that the issuer had a reasonable belief that the purchaser of the securities in the offering was a resident of such state or territory
- Under amended Rule 147 and new Rule 147A, the residence of a purchaser that is a legal entity (i.e., a corporation, partnership, trust or other form of business organization) is defined as the location where, at the time of the sale, the entity has its principal place of business Amended Rule 147 and new Rule 147A also define a purchaser's "principal place of business," consistent with the final definition for issuer eligibility purposes

Limitations on resales

- The final rules amend the limitation on resales in old Rule 147(e) to provide that for a period of six months from the date of the sale by the issuer of a security sold pursuant to the rule, any resale of such security by a purchaser will be made only to persons resident within such state or territory, as determined pursuant to amended Rule 147(d) or new Rule 147A(d), as applicable
- Compliance with the amended limitation on resales is not required for an issuer relying on amended Rule 147 or new Rule 147A

Integration

- The final rules also align the integration safe harbor in Rule 147 with the integration safe harbor in Rule 251(c) of Regulation A.
- Under the final rules, offers and sales made pursuant to amended Rule 147 or new Rule 147A will not be integrated with:
  - Prior offers or sales of securities; or
  - Subsequent offers or sales of securities that are:
    - Registered under the Securities Act, except as provided in amended Rule 147(h) or new Rule 147A(h);
    - Exempt from registration under Regulation A;
    - Exempt from registration under Rule 701 or under the Securities Act;
    - Made pursuant to an employee benefit plan;
    - Exempt from registration under Regulation S under the Securities Act;
    - Exempt from registration under Section 4(a)(6) of the Securities Act; or
    - Made more than six months after the completion of an offering conducted pursuant to amended Rule 147 or new Rule 147A.

Integration

Integration

- Prevents circumvention of registration requirements by separating single non-exempt offering into several exempt offerings
- Six-month safe harbor — Rule 502(a)
- Under SEC's integration doctrine, the following factors ("five factors") are considered in determining whether one sale of securities by an issuer will be integrated with (*i.e.*, treated as part of the same offering as) a prior or subsequent offer or sale of securities by the issuer:
  - Part of a single financing plan;
  - Issuances of the same class of securities;
  - Sales occur at or about the same time;
  - Same type of consideration is received; and
  - Proceeds will be used for same general purpose.

Integration – safe harbors

- Safe harbor for offshore offerings
  - Regulation S ("Reg S") provides that offshore sales under Reg S generally are not integrated with offerings in the United States
- Rule 152
  - Provides that the phrase "transactions by an issuer not involving any public offering" contained in Section 4(a)(2) of the Securities Act will be deemed to apply to transactions not involving any public offering at the time of the transactions although the issuer subsequently decides to make a public offering and/or files a registration statement
- Rule 155(b) — Private → Registered
- Rule 155(c) — Registered → Private

Integration–no-action letters

- **Black Box and Squadron, Ellenoff SEC No-Action Letters**
  - **Facts:** Restructuring involving the following transactions to occur simultaneously:
    - Existing security holders to receive new securities in a private placement in exchange for existing securities;
    - New capital to be raised in a private placement of convertible debentures; and
    - New capital to be raised in an initial public offering.
  - **Outcome:** The private placement with existing security holders and the private placement of the convertible debentures need not be integrated with the later public offering because:
    - The existing security holders and investors would have entered into their respective agreements prior to the filing of the registration statement; and
    - The private placements would be completed prior to the filing, given that the obligations to acquire the securities would be subject only to the satisfaction of specified conditions outside of the control of the security holders and investors.

Integration–no-action letters *(cont'd)*

- **Policy**
  - If the private placement of the convertible debentures was made only to qualified institutional buyers ("QIBs") and three or four accredited investors, the private placement need not be integrated with the public offering even if it would not be completed at the time the registration statement was filed.
  - If the private placement of the convertible debentures was terminated prior to completion and later there is a registered offering of the debentures based on Rule 152, the abandoned private placement would not be integrated with the public offering.
  - The filing of a registration statement is deemed to be the commencement of the public offering.
- **Subsequent Clarifications**
  - The SEC later clarified that the number of offerees and purchasers is a factor in evaluating the applicability of the policy, and the policy is limited to situations involving QIBs and no more than two or three large institutional accredited investors.

Integration–SEC interpretive guidance

- *See principally* C&DI 139.25, which addresses a side-by-side private offering (under Section 4(a)(2) or Rule 506) with a registered public offering without having to limit the private offering to QIBs and a small number of large institutional accredited investors
- The focus is on how the investors in the private offering are solicited
  - Investors were not identified or contacted in connection with the public offering
  - Investors did not contact the issuer as a result of the general solicitation by means of the registration statement

Integration and Rule 506(c)

- The Staff issued guidance in the form of a C&DI in November 2016, which is Question 256.34.
- **Question:** An issuer has been conducting a private offering in which it has made offers and sales in reliance on Rule 506(b). Less than six months after the most recent sale in that offering, the issuer decides to generally solicit investors in reliance on Rule 506(c). Are the factors listed in the Note to Rule 502(a) the sole means by which the issuer determines whether all of the offers and sales constitute a single offering?
- **Answer:** No. Under Securities Act Rule 152, a securities transaction that at the time involves a private offering will not lose that status even if the issuer subsequently decides to make a public offering. Therefore, we believe under these circumstances that offers and sales of securities made in reliance on Rule 506(b) prior to the general solicitation would not be integrated with subsequent offers and sales of securities pursuant to Rule 506(c). So long as all of the applicable requirements of Rule 506(b) were met for offers and sales that occurred prior to the general solicitation, they would be exempt from registration and the issuer would be able to make offers and sales pursuant to Rule 506(c). Of course, the issuer would have to then satisfy all of the applicable requirements of Rule 506(c) for the subsequent offers and sales, including that it take reasonable steps to verify the accredited investor status of all subsequent purchasers.

Integration and Rule 506(c) *(cont'd)*

- Prior to issuance of this C&DI, Rule 152 had been relied upon principally in the context of PIPE transactions, wherein the issuer enters into a definitive purchase agreement and subsequently files a sale registration statement.
- Although the SEC has addressed integration safe harbors in the context of adopting the amendments to Regulation A and adopting Regulation CF, additional integration questions remain. It would be helpful for the SEC to revisit the area.

Regulation A

Regulation A

- The SEC adopted final rules which:
  - Amend and modernize existing Regulation A.
  - Create two tiers of offerings:
    - Tier 1 for offerings of up to $20m ($6m for selling stockholders); or
    - Tier 2 for offerings of up to $50m ($15m for selling stockholders).
  - Set issuer eligibility, disclosure and reporting requirements.
  - Impose additional disclosure and ongoing reporting requirements, as well as an investment limit, for Tier 2 offerings, and, given these investor protection measures, makes Tier 2 offerings exempt from certain blue sky requirements.
  - Became effective June 19, 2015

Regulation A *(cont'd)*

- **Amount of offering:** Tier 1 up to $20 million in 12-month period, Tier 2 up to $50 million in 12-month period
- **By?** Eligible issuers are organized in and with their principal place of business in the United States or Canada, other than funds, blank check companies and issuers subject to various disqualifications
- **Who can invest?** Accredited and non-accredited investors
- **What is the investor cap?** A non-accredited natural person is subject to an investment limit and must limit purchases to no more than 10% of the greater of the investor's annual income and net worth, determined as provided in Rule 501 of Regulation D (for non-accredited, non-natural persons, the 10% limit is based on annual revenues and net assets). The investment limit does not apply to accredited investors and will not apply if the securities are to be listed on a national securities exchange at the consummation of the offering
- **Is an intermediary required?** No
- **Manner of offering:** The offering may involve "testing the waters"

Regulation A *(cont'd)*

- **Offering disclosure requirements:** An issuer must prepare and file with the SEC and have qualified an offering statement on Form 1-A.
- Part I (Notification) requires certain basic information regarding the issuer, its eligibility, the offering details, the jurisdictions where the securities will be offered, and sales of unregistered securities.
- Part II (Offering Circular)
  - Part II contains the narrative portion of the Offering Circular and requires disclosures of basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A-type discussion; disclosures about executive officers and directors and compensation; beneficial ownership information; related-party transactions; and a description of the offered securities.
  - This is similar to Part I of Form S-1 and an issuer can choose to comply with Part I of Form S-1 in connection with its Offering Circular.
    - An issuer that chooses to list its securities concurrent with the completion of a Regulation A offering will be required to use Part I of Form S-1 in connection with the Offering Circular
    - Other Tier 2 issuers also are likely to use Part I of Form S-1 as well

Regulation A *(cont'd)*

- **Financial statement requirements:** differ for Tier 1 and Tier 2 offerings:
  - Tier 1 and Tier 2 issuers must file balance sheets and other required financial statements as of the two most recently completed fiscal year ends, or for such shorter time as they have been in existence, subject to certain exceptions.
  - The financial statements for an issuer in a Tier 2 offering are required to be audited by an independent auditor that need not be PCAOB-registered, except as noted below.
  - An issuer in a Tier 2 offering that seeks to have a class of securities listed on a national securities exchange concurrent with the Regulation A offering must include financial statements audited in accordance with PCAOB standards by a PCAOB-registered firm.
- **Advertising:** An issuer may solicit any investors (not subject to the requirements applicable to EGCs, for example). Materials may be used both before and after the offering statement is filed
- **Intermediary restrictions and requirements:** An issuer can conduct a Regulation A offering with or without a financial intermediary

Regulation A *(cont'd)*

- **Reporting following the offering:** Tier 1 issuers would have no ongoing reporting obligation, other than to file an exit report on Form 1-Z within 30 days after the termination or completion of a Regulation A-exempt offering. Tier 2 issuers will be subject to ongoing reporting. Tier 2 issuers would be required to file:
  - Annual reports on Form 1-K (120 calendar days after the issuer's fiscal year end);
  - Semi-annual reports on Form 1-SA (90 calendar days after the end of the first six months of the issuer's fiscal year);
  - Current reports on Form 1-U;
  - Special financial reports on Form 1-K and Form 1-SA; and
  - Exit reports on Form 1-Z.
- **Bad actor disqualification:** The issuer will be required to obtain information from all covered persons

Regulation A *(cont'd)*

- **State blue sky:** Securities sold pursuant to Tier 1 will be subject to state blue sky requirements; securities sold pursuant to Tier 2 will be "covered securities"
- **Transfer restrictions:** Securities sold pursuant to Regulation A are not "restricted securities"

Rule 701

Rule 701

- Exemption for compensatory issuances by private companies to directors, employees, consultants and advisors
- In any 12-month period, not more than greatest of:
  - $1 million
  - 15% of total assets
  - 15% of class
- Disclosure required:
  - Written plan or contract
  - Additional disclosure if > $10 million sold in any 12-month period
- No integration
- Restricted securities but may be resold 90 days after IPO by non-affiliates

Rule 701 *(cont'd)*

- Exchange Act 12(g) threshold
  - The JOBS Act modified the 12(g) threshold and also required that the SEC provide guidance regarding the meaning of "held of record"
  - In May 2016, the SEC issued final rules.
  - For purposes of determining whether an issuer is required to register a class of equity securities pursuant to Section 12(g)(1) of the Exchange Act, the issuer may now exclude (from the definition of "held of record") securities that are:
    - Held by persons who received the securities pursuant to an employee compensation plan in transactions exempt from, or not subject to, the registration requirements of section 5 (now Rule 12g5-1(a)(8)(i)(A)); or
    - Held by persons who received the securities in a transaction exempt from, or not subject to, the registration requirements of section 5 from the issuer, a predecessor of the issuer or an acquired company in substitution or exchange for excludable securities under Rule 12g5-1(a)(8)(i)(A) as long as the persons were eligible to receive securities pursuant to Rule 701(c) under the Securities Act at the time the excludable securities were originally issued to them (now 12g5-1(a)(8)(i)(B)).

Rule 701 *(cont'd)*

- The Staff has issued two sets of C&DIs relating to Rule 701
- In June 2016, the Staff issued a series of C&DIs that addressed the application of Rule 701 in the context of a merger transaction.
- Specifically, the C&DIs provided that:
  - An acquirer in a merger that assumed the target's derivative securities does not need an exemption for the assumption if, at the time of the grant by the target, the plan under which the securities were issued permitted the assumption without the consent of holders of the derivative securities
  - Securities underlying the derivative securities are considered to have been sold on the grant date of the derivative securities. Therefore, provided the target company complied with Rule 701 at the time the derivative securities assumed were originally granted, the exercise or conversion of the derivatives securities would be exempt
  - Post-merger, in order to determine the amount of securities that the acquirer may sell pursuant to Rule 701, the acquirer must include the aggregate sales price and amount of securities for which the target company claimed the exemption during the same 12-month period

Rule 701 *(cont'd)*

- Post-merger, to calculate the amount that can be issued pursuant to Rule 701 (based on total assets or percentage of the class), an acquirer may use either a pro forma balance sheet as of its most recent balance sheet date that reflects the merger as if it occurred on that date, or a balance sheet date after the merger that will reflect the total assets and outstanding securities of the combined entity
- When aggregate sales in any 12-month period exceed $5 million, an issuer may elect to provide financial statements that follow the requirements of either Tier 1 or Tier 2 Regulation A offerings, without regard to whether the amount of sales that occurred pursuant to Rule 701 during the time period contemplated in Rule 701 would have required the issuer to follow the Tier 2 financial statement requirements in a Regulation A offering of the same amount
- For assumed derivative securities where the target company was required to provide disclosures under Rule 701 post-merger, the acquirer would assume the disclosure obligation and would satisfy it by providing information required under Rule 701
- Post-merger, in determining whether the amount of securities the acquirer sold during any consecutive 12-month period exceeds $5 million, the acquirer must include any securities that the target company sold during the same period

Rule 701 *(cont'd)*

- In October 2016, the Staff issued additional guidance in the form of C&DIs.
  - The Staff clarified that, when a private company not subject to Exchange Act reporting requirements issued options in reliance on Rule 701 and is acquired by a company that both is subject to the Exchange Act reporting requirements and assumes the outstanding options, the acquiring company need not register the offer and sale of the shares issuable upon the exercise of the options. The acquirer may rely on Rule 701 for the exercise of the assumed options, and the acquirer's public filings would satisfy the disclosure obligations.
  - Where an issuer relies on Rule 701 to issue an RSU to an employee, which settles upon satisfaction of certain conditions, and the employee does not pay additional consideration on settlement, the issuer would have to satisfy the enhanced disclosure requirement under Rule 701 if it has sold securities in excess of the $5 million threshold (counting the RSUs) before the sale date, which is the RSU grant date. Rule 701(e)(6) relating to the exercise or conversion of derivative securities does not apply to RSUs.

Resales of Restricted Securities

Resales of restricted securities

- Restricted securities: Securities acquired in unregistered, private sales from the issuer or from an affiliate of the issuer
- Control securities: Securities held by an affiliate of the issuer
  - An *"affiliate"* of the issuer is a person controlling, controlled by or under common control with the issuer
  - *"Control"* means the power to direct the management and policies of the company in question, whether through the ownership of voting securities, by contract or otherwise
  - Generally includes officers, directors and greater than 10% shareholders, but requires facts-and-circumstances analysis
- Sections 4(a)(1) and 4(a)(3) are not available for resales of restricted or control securities
- For resales of privately placed securities and securities held by an affiliate of the issuer, a holder needs to find other available exemptions for its resales or have its resales covered by a registration statement

Resale alternatives

- For restricted or control shares:
  - Block trade (agency basis or principal basis)
  - Section 4(a)($1^1/_2$) (agency basis)
  - Selling stockholder PIPE transaction (which is a Section 4(a)($1^1/_2$), with resale registration rights) (agency basis)
  - Rule 144 sales
    - Traditional Rule 144 (agency)
    - Market maker (principal)
    - Riskless principal
  - Section 4(a)(7) (agency, possibly principal)

The "4(a)(1 1/2) exemption"

- The Section 4(a)(1 1/2) exemption has evolved in practice, without the benefit of any official rulemaking.
- It is a hybrid consisting of:
  - A Section 4(a)(1) exemption which exempts transactions by anyone other than an "issuer, underwriter or dealer," and
  - A Section 4(a)(2) analysis to determine whether the seller is an "underwriter," *i.e.*, whether the seller purchased the securities with a view to a distribution.
- In 1980, the SEC recognized the Section 4(a)(1 1/2) exemption, which although not specifically provided for in the Securities Act "[is] clearly within its intended purpose," provided that the established criteria for sales under both Sections 4(a)(1) and 4(a)(2) are satisfied.

When is the "4(a)(1 1/2) exemption" used?

- The Section 4(a)(1 1/2) exemption can be used by institutional investors to resell restricted securities purchased in a private placement.
- The Section 4(a)(1 1/2) exemption can also be used by affiliates for the sale of control securities when Rule 144 is unavailable.
- It is still used for resales to accredited investors.

New exemption for resales

- The FAST Act codifies a specific resale exemption, Section 4(a)(7)
- With so many issuers choosing to defer their IPOs and finance their growth through private placements, we now have many more very large, well-financed privately held companies
  - Employees, consultants, angel investors and friends and family investors in these companies require liquidity opportunities
  - More private secondary market transactions are getting done; however, lack of certainty with respect to the Section 4(a)($1^1/_2$) exemption, as well as blue sky concerns, led to calls to codify a resale exemption
  - The provisions that were incorporated into the FAST Act originally were introduced in the House as the RAISE Act
- This does not replace Section 4(a)($1^1/_2$)

New exemption for resales *(cont'd)*

- The exemption provides certainty for transactions that meet the following requirements:
  - Each purchaser is an accredited investor;
  - Neither the seller nor any person acting on the seller's behalf engages in any form of general solicitation; and
  - In the case of an issuer that is not a reporting company, exempt from the reporting requirements pursuant to Rule 12g3-2(b) or a foreign government eligible to register securities on Schedule B, at the request of the seller, the seller and a prospective purchaser obtain from the issuer reasonably current information, including:
    - The issuer's exact name (as well as the name of any predecessor);
    - The address of the issuer's principal place of business;
    - The exact title and class of the offered security, its par or stated value and the current capitalization of the issuer;
    - Details for the transfer agent or other person responsible for stock transfers;

New exemption for resales *(cont'd)*

- A statement of the nature of the issuer's business that will be presumed current if it is as of 12 months before the transaction date;
- The issuer's officers and directors;
- Information about any broker, dealer or other person being paid a commission or fee in connection with the sale of the securities;
- The issuer's most recent balance sheet and profit and loss statement and similar financial statement for the two preceding fiscal years during which the issuer has been in business, prepared in accordance with GAAP or, in the case of a foreign issuer, IFRS. The balance sheet will be deemed reasonably current if it is as of a date not less than 16 months before the transaction date and the profit and loss statement shall be deemed reasonably current if it is as of a date not less than 12 months preceding the date of the issuer's balance sheet. If the balance sheet is not as of a date less than six months before the transaction date, it must be accompanied by additional statements of profit and loss for the period from the dates of such balance sheet to a date less than six months before the transaction date; and
- If the seller is an affiliate, a statement regarding the nature of the affiliation accompanied by a certification from the seller that it has no reasonable grounds to believe that the issuer is in violation of the securities laws or regulations.

New exemption for resales *(cont'd)*

- The new Section 4(a)(7) exemption is not available:
  - If the seller is a direct or indirect subsidiary of the issuer;
  - If the seller or any person that will be compensated in connection with the transaction, such as a broker-dealer, is subject to the bad actor disqualification provisions included in Rule 506 or described under Section 3(a)(39) of the Exchange Act;
  - If the issuer is a blank check, blind pool, shell company, special purpose acquisition company, or in bankruptcy or receivership;
  - If the transaction relates to an broker-dealer's or underwriter's unsold allotment; or
  - If the security that is the subject of the transaction is part of a class of securities that has not been authorized and outstanding for at least 90 days prior to the transaction date.
- The securities sold in a Section 4(a)(7) resale transaction will be considered "restricted securities" and "covered securities" for blue sky purposes.
- A transaction effected pursuant to this exemption will not be deemed to be a "distribution" under the Securities Act.

Why choose to rely on Section 4(a)(7)?

- Section 4(a)(7) provides much more flexibility than
  - Rule 144A — Resales may only be made to QIBs and Rule 144A is only available in respect of certain securities
  - Rule 144 — Resales may only be made in compliance with the holding period, volume and manner-of-sale requirements
  - Section 4(a)($1^1/_2$) — As discussed, a private reseller can sell securities in excess of the Rule 144 volume limits
- However, it is important to keep in mind that
  - 4(a)(7) requires securities to have been outstanding for 90 days, which is not as useful as Rule 144A which is immediately available
  - Securities sold in reliance on Section 4(a)(7) will be "restricted securities" as opposed to having securities sold under Rule 144 which become fungible with publicly traded stock
  - Section 4(a)(7) has an information requirement, which may not be appealing to privately held companies. Section 4(a)($1^1/_2$) does not
  - Will holders use Rule 144 and Section 4(a)(7) to dispose of their securities?