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June 25, 2019

Legal Update

SEC Issues Concept Release on Harmonization of Securities Offering Exemptions

On June 18, 2019, the US Securities and Exchange Commission (SEC) issued a concept release[1] soliciting "comment on possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections." Under the Securities Act of 1933, as amended (Securities Act), every offer and sale of securities must be registered with the SEC unless an exemption from registration is available. In the concept release, the SEC specifically notes that the overall framework for exempt offerings has, particularly recently, changed significantly due to the introduction, expansion or revision of various registration exemptions.

The concept release does not contain specific rule proposals. Rather, the SEC is seeking public comment on whether there are:

- Ways to make the exemption framework more consistent, accessible and effective in application;
- Ways to simplify the complexity that now exists in the exempt offering framework;
- Gaps in the exempt offering framework that make it difficult for some companies to rely on an exemption from registration at key stages of their business cycle; and
- Ways to allow issuers to transition from exempt offering types to registered public offerings without undue friction or delay.

Many of the requests for comment focus on smaller issuers and whether the exempt offering framework works for them. The SEC identified 138 separate areas on which it is specifically asking for comment and many of those areas contain multiple sub-requests for information. Rather than comprehensively describing the matters under consideration, this Legal Update highlights some of the more interesting questions raised in the concept release. The comment period is expected to remain open through late September 2019.

Exempt offering framework generally

The concept release provides a helpful overview of the exempt offering framework generally and provides details on the background of many of the exemptions from Securities Act registration. The SEC also addresses the requirements for various exemptions, including how the requirements differ among those exemptions, as well as how those exemptions are being utilized.

The SEC asks a series of questions about the overall exempt offering framework. Areas where the SEC is seeking input on this topic include:

- Whether the existing framework provides appropriate options for different types of issuers to raise capital at key stages of their business cycles;
- Whether the existing framework or the exemptions themselves are too complex either because of the number of exemptions or because of the way they are structured;
- Whether offers should be deregulated;
- How technology impacts decisions to rely on a specific exemption; and
- Whether more investors should be able to participate in exempt offerings.

Accredited investor definition

A person who qualifies as an accredited investor[2] is eligible to participate in many exempt offerings that otherwise are generally not available to non-accredited investors.[3] The Dodd-Frank Wall Street Reform and Consumer Protection Act directed the SEC to, among other things, review the accredited investor definition as it relates to natural persons every four years to determine whether the definition should be revised for the protection of investors, in the public interest and in light of the economy.

Currently, natural persons are accredited investors if their income exceeds $200,000 in each of the two most recent years (or $300,000 in joint income with the person's spouse) and they reasonably expect to reach the same income level in the current year, or their net worth exceeds $1,000,000 (individually or jointly with a spouse) excluding the value of their primary residence. In addition, directors, executive officers and general partners of the issuer are accredited investors. The SEC last reviewed the definition in 2015. Areas where the SEC is seeking input on this topic include whether:

- The current definition should be retained;
- The financial thresholds should be adjusted;
- The definition of spouse should be expanded to include spousal equivalents; and
- Other measures of sophistication should be included that would allow a person to qualify as an accredited investor.

In addition, the SEC is seeking comment on whether revisions should be made to other aspects of the definition of accredited investor, including whether:

- Other entities should be eligible to qualify as accredited investors in addition to those enumerated in the existing rule; and
- The current $5,000,000 asset test should be replaced by an investments test.

Rule 506 of Regulation D

Section 4(a)(2) of the Securities Act exempts from the registration requirements "transactions by an issuer not involving any public offering." Whether any specific transaction involved a public offering was left to the interpretation of the courts and the SEC. In order to provide objective standards that issuers could rely on, the SEC adopted Rule 506 under Regulation D of the Securities Act, now Rule 506(b), as a non-exclusive "safe harbor" under Section 4(a)(2). Subsequently the SEC adopted Rule 506(c) as another non-exclusive "safe harbor" under Section 4(a)(2) that eliminates the prohibition on general solicitation, provided that all purchasers of the securities offered are accredited investors and the issuer takes reasonable steps to verify their accredited investor status. Areas where the SEC is seeking input on this topic include whether:

- Rules 506(b) and 506(c) should be combined into one exemption and, if so, what features of the existing rules should be retained;
- It is important to allow non-accredited investors to be able to participate in a Rule 506(b) offering;
- The information requirements of Regulation D should be aligned with those of other exempt offerings;

- The SEC should define general advertising and general solicitation;
- Investment limits should be added for non-accredited investors; and
- Non-accredited investors should be allowed to participate in an offering that involves a general solicitation.

Regulation A

Regulation A was initially adopted by the SEC pursuant to its exemptive authority for offerings up to $5,000,000. In 2015, the SEC amended Regulation A and created two tiers of exempt offerings of up to $50,000,000 and in 2018 expanded eligibility to use Regulation A to include issuers that are subject to the ongoing reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Jumpstart Our Business Startups Act (JOBS Act) directed the SEC to, among other things, review the Tier 2 $50,000,000 offering limit every two years. Areas where the SEC is seeking input on this topic include whether:

- There is anything about the Regulation A process that is unduly burdensome;
- The costs associated with conducting a Regulation A offering dissuade issuers from relying on the exemption;
- The Tier 2 offering limit should be increased;
- The eligible categories of issuers and/or the types of eligible securities should be expanded;
- To eliminate or change the individual investment limits for non-accredited investors in Tier 2 offerings; and
- To permit the use of quick response (QR) codes (machine-readable images that contain data and can direct the user to a website or application) in lieu of hyperlinks to an offering circular.

Rule 504 of Regulation D

Rule 504 under Regulation D provides an exemption from Securities Act registration for offerings of up to $5,000,000 in any 12-month period. Certain categories of issuers are not eligible to rely on Rule 504, including issuers that already file public reports under the Exchange Act. Areas where the SEC is seeking input on this topic include whether:

- The Rule 504 exemption is useful to help issuers meet their capital-raising needs and address investor protection concerns;
- The $5,000,000 offering limit should be increased;
- The categories of eligible issuers should be expanded; and
- The exemption is duplicative of the Regulation A Tier 1 exemption.

Intrastate offerings

Section 3(a)(11) of the Securities Act exempts from the registration requirements any offering of securities "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." In order to provide objective standards that an issuer could rely on, the SEC adopted Rule 147 as a "safe harbor" under Section 3(a)(11), focusing on the local financing of issuers by investors within the issuer's state or territory. In order to modernize the safe harbor, in 2016 the SEC adopted Rule 147A under its general exemptive authority contained in Section 28 of the Securities Act. For this reason, Rule 147A is able to focus on sales rather than offers and on where the issuer does business as opposed to where it is organized. Areas where the SEC is seeking input on this topic include:

- The extent to which the intrastate exemptions are being used;

- Whether Rules 147 and/or 504 should be eliminated; and
- Whether the current wording of the rules captures the intrastate intention of the exemptions.

Regulation Crowdfunding

Regulation Crowdfunding was adopted by the SEC to implement the provisions of Title III of the JOBS Act. Eligible issuers are currently entitled to raise up to $1,070,000 in any 12-month period in reliance on the exemption. Areas where the SEC is seeking input on this topic include whether:

- The requirements of Regulation Crowdfunding appropriately address capital formation and investor protection concerns;
- The costs associated with conducting a Regulation Crowdfunding offering dissuade issuers from relying on the exemption or intermediaries from facilitating offerings;
- Changes should be made to Regulation Crowdfunding, such as increasing the offering limit;
- The issuer eligibility requirements should be expanded; and
- The exemption under Section 12(g) of the Exchange Act for securities issued in a Regulation Crowdfunding offering should be modified to conform to the exemption for Regulation A Tier 2 securities.

Potential micro-offering exemption

In the concept release, the SEC noted that some commentators have expressed concerns that smaller issuers continue to face difficulties in accessing capital. The release notes that concerns have been raised with respect to issuers that are too small or seeking to raise too small an amount of capital to effectively conduct an offering under existing exemptions. Areas where the SEC is seeking input on this topic include:

- Whether a micro-offering exemption should be created;
- What conditions are necessary to rely on a micro-offering exemption if one is created;
- Whether securities issued in a micro-offering should be considered "restricted" securities; and
- Whether securities issued in a micro-offering should be "covered securities" for blue sky purposes.

Integration

A concern of frequent issuers of privately-placed securities is whether multiple securities transactions should be integrated and considered part of the same offering. If multiple securities transactions are considered part of the same offering, the issue becomes whether an exemption from registration is still available for the integrated offerings as a whole. There is not a bright line test for determining whether offerings should be integrated. The determination requires an analysis of specific facts and circumstances. For example, in Rule 502(a) under Regulation D, the SEC identified five factors to consider in determining whether offerings should be integrated.[4] In addition, the SEC has created a number of "safe harbors" from integration, including with respect to Regulation A offerings, Regulation Crowdfunding offerings and intrastate offerings pursuant to Rule 147 or 147A, where the SEC explicitly identified the types of offerings that would not be integrated with the offerings in question, as well as in the circumstances set forth in Rules 152 (a transaction not involving a public offering will not be integrated with a subsequent public offering) and 155 (when an abandoned offering will not be integrated with a subsequent offering). Areas where the SEC is seeking input on this topic include whether:

- One integration doctrine should apply to all exempt offerings;

- The six-month period in the five-factor test of Rule 502(a) should be shortened; and
- The SEC should adopt additional integration safe harbors.

Pooled investment funds

An important source of funding for some investors includes pooled investment funds, such as registered investment companies, business development companies and private funds. Certain pooled funds, such as registered investment companies and business development companies, are deemed accredited investors without regard to the amount of assets or other qualifications of the fund. On the other hand, private funds, which raise funds in one or more exempt offerings, are accredited investors only if they meet the eligibility criteria. As a result, it may be difficult for non-accredited retail investors to invest in a private fund to gain access to most exempt offerings. Areas where the SEC is seeking input on this topic include:

- The extent to which issuers view pooled investment funds as an important source of capital for exempt offerings;
- How recent market trends have affected retail investor access to issuers that do not seek to raise capital in the public markets;
- Whether there are regulatory provisions or practices that discourage participation by registered investment companies in exempt offerings; and
- Whether all types of pooled funds should be able to qualify as accredited investors without regard to satisfying any quantitative requirements.

Secondary trading

In most exempt offerings, the securities issued are considered "restricted" and therefore not freely tradeable upon purchase. In addition, there may not be an exemption from applicable state laws for resales of securities acquired in exempt offerings. In the concept release, the SEC highlights the fact that potential investors are reluctant to invest in exempt offerings unless they know there will be an exit opportunity. As a result, there is a concern that many persons are unwilling to invest in, or at least have significant exposure to, securities sold in exempt offerings. Areas where the SEC is seeking input on this topic include:

- Whether concerns about secondary market liquidity have a significant effect on issuers' decision-making with regard to primary capital-raising options;
- Whether secondary market liquidity affects the decision-making of individual investors;
- Whether issuers of exempt securities are concerned that secondary trading could lead to a high number of record holders, resulting in a requirement to register under Section 12(g) of the Exchange Act;
- Whether Rule 144 should be revised to reduce the holding period requirement;
- Whether the SEC should expand the number of offerings that qualify for federal preemption of blue sky laws; and
- What other steps could be taken to enhance secondary trading liquidity of securities issued in exempt transactions.

Practical considerations

Although changes to the exempt offering framework may not be imminent, the concept release provides an opportunity for issuers and investors to provide input on issues they have faced in this area either on a regular basis or under particular circumstances. This is the time for interested parties to become part of the conversation.

Interested persons should consider submitting comments to the SEC either in response to one or more of the specific questions raised in the concept release or to raise any other concerns

that they may have with regard to the exempt offering framework.

In addition to requesting public comments, the concept release contains extensive discussion on the background of many of the exempt offering provisions. Therefore, the release itself provides a resource that can be consulted on issues as they arise in the future.

For more information about the topics raised in this Legal Update, please contact the author, Michael L. Hermsen, any of the following lawyers or any other member of our Corporate & Securities practice.

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Endnotes

[1] Available at https://www.sec.gov/rules/concept/2019/33-10649.pdf

[2] Various definitions of the term accredited investor are contained in Section 2(a)(15) of the Securities Act, as well as in Rule 215 and in Rule 501(a) of Regulation D, each promulgated under the Securities Act.

[3] The term has other uses including in determining whether a company is required to register under Section 12(g) of the Exchange Act, who an emerging growth company can communicate with when it is "testing-the-waters" and which FINRA member firms must file private offering documents with FINRA.

[4] The five factors identified in Rule 502(a) are whether: (i) the sales are part of a single plan of financing, (ii) the sales involve issuance of the same class of securities, (iii) the sales have been made at or about the same time, (iv) the same type of consideration is being received, and (v) the sales are being made for the same general purpose.