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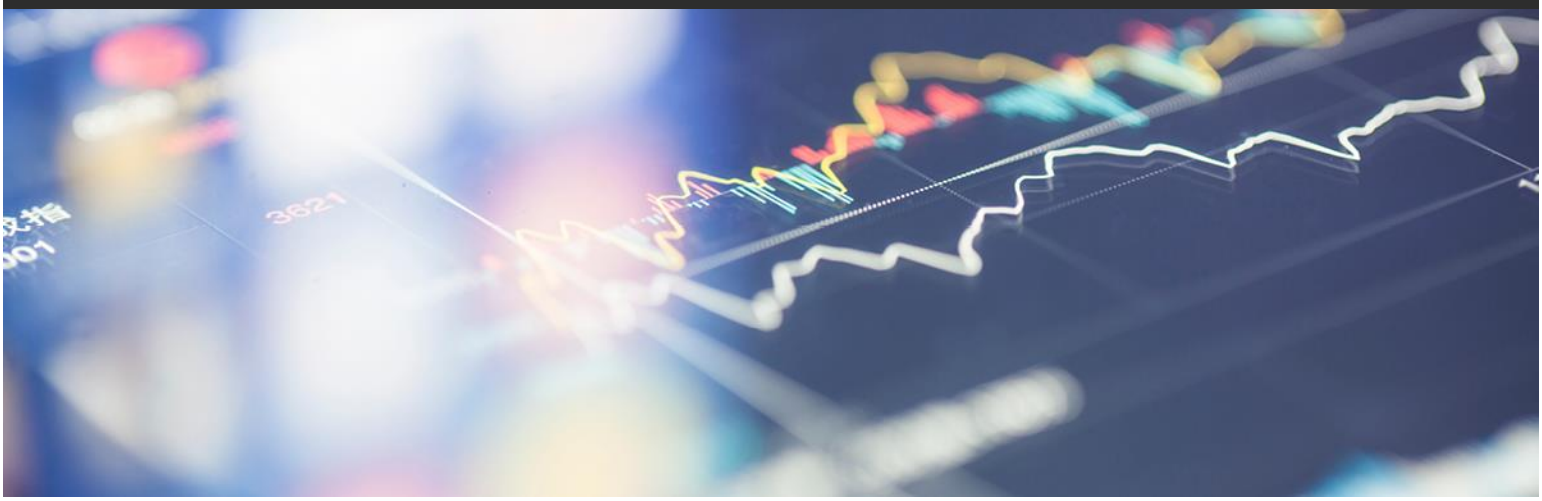

June 2019

SEC Issues Concept Release to Overhaul Current Framework for Exempt Offerings

Summary

On June 18, 2019, the U.S. Securities and Exchange Commission (SEC) issued a concept release (Release) soliciting public comment on possible ways to simplify, harmonize, and improve the overall framework for exempt offerings under the Securities Act of 1933 (Securities Act) and related SEC rules and regulations. Specifically, the SEC seeks input from issuers, investors, and other market participants on potential updates to the exempt offering framework aimed at promoting capital formation and expanding investment opportunities within the exempt market while maintaining appropriate investor protections. Comments are due on or before September 24, 2019.

As discussed below, the Release and the comment process, will be of particular interest to hedge funds, private equity funds, securitization vehicles, issuers who raise funds in the private market, and virtually any other person or entity who invests in or issues into the private market under the current regulatory scheme. Please contact one of the attorneys listed at the end of this GT Alert, or your regular GT securities counsel, to discuss whether you wish to submit a comment letter.

In the Release, the SEC explains that market participants have conveyed concerns over the complexity of the exempt offering framework, which in part stems from the fact that the current capital-raising exemptions were not adopted as part of one cohesive regulatory scheme, but rather evolved over time

through various SEC rules and legislative developments. In light of the significant changes implemented over the years with respect to the exempt offering framework, as well as the increased activity within the exempt market today, the SEC is undertaking a comprehensive review of the available exemptions from registration requirements under current federal securities laws, and requests comment on broad themes and specific comment on issues relating to the following:

- Overall framework of exempt offerings, including whether overlapping exemptions create confusion for issuers in determining the most efficient path towards raising capital, and identifying potential gaps in the framework that make it difficult for smaller issuers to rely on one of the exemptions at a key stage of capital formation;
- Specific conditions of the capital-raising exemptions under Section 4(a)(2) of the Securities Act and Rule 506 of Regulation D, Regulation A, Rule 504 of Regulation D, Rules 147 and 147A under Section 3(a)(11) of the Securities Act, and Section 4(a)(6) of the Securities Act and Regulation Crowdfunding;
- "Accredited investor" definition, including whether investor eligibility limitations should be revised to focus on the sophistication of the investor, the investment amount, or other criteria instead of just the income or wealth of the individual investor;
- Integration analyses applied in the context of exempt offerings, including whether further guidance should be provided to issuers on their ability to transition from one offering to another;
- Exempt offerings by pooled investment funds, including whether retail investors should be permitted greater exposure to growth-stage issuers through pooled investment funds; and
- Secondary trading of securities initially issued in exempt offerings, including whether revisions are needed for the current resale exemptions in light of limited secondary market liquidity concerns.

General Themes

The Release begins with an overview of the current exempt offering framework, including an introduction to the relevant statutes and SEC rules and regulations that provide exemptions from registration; the types of restrictions or conditions imposed by current exemptions; and the rationale behind the level of investor protection measures for the exemptions. The Release then highlights specific factors that have significantly influenced the state of the exempt offering framework and exempt offering market over recent years, including expansive regulatory developments, particularly in light of the Jumpstart Our Business Startups Act of 2012 (JOBS Act), as well as changes in information and communications technologies, such as the rise of social media and online trading platforms for unregistered securities. Overall, capital raised in the exempt markets has increased both by category of exemption and as compared to the amount of capital raised in the public registered markets. The Release notes that in 2018, an estimated $2.9 trillion was raised through exempt offering channels, compared to $1.4 trillion of new capital raised through registered offerings.

The SEC requests feedback on "whether, in light of the increased activity in the exempt market, the current exempt offering framework is working effectively to provide access to capital for a variety of issuers, particularly smaller issuers, and access to investment opportunities for a variety of investors while maintaining investor protections." The Release seeks comment on broad themes relating to the overall exempt offering framework, including such issues as:

- The overall efficacy of the exempt offering framework, including its ability to meet the capital-raising needs of various types of issuers at various stages in their life cycles, and whether it appropriately addresses capital formation and investor protection concerns;

- The complexity of the exempt offering framework and the exemptions themselves, including whether issuers are able to understand their options and effectively choose the best exemption available for their situations;
- Whether exemptions should focus on the size of the capital raise or the type of investor;
- Whether exemptions should be revised across the board to focus investor protections on the time of sale of a security rather than the time of offer;
- Metrics for evaluating whether the existing exemptions adequately promote efficiency, competition, capital formation, and investor protection, and the most or least effective conditions or requirements aimed at protecting investors in exempt offerings;
- The impact of technology on an issuer's ability to communicate with investors and whether rule changes should be considered regarding communications in the exempt market;
- Whether rule changes should be made to ease issuers' transitions from one exempt offering to another as their businesses grow;
- Whether rule changes that simplify and harmonize the exempt offering process would have an effect on the registered public markets, such as encouraging companies to remain private longer, and whether changes should be made to encourage more issuers to enter the registered public markets;
- Which conditions or requirements are most or least effective at protecting investors in exempt offerings, and suggested changes to increase effectiveness of investor protections and to eliminate ineffective or unnecessary protections;
- Whether and what kind of changes should be made to make exempt offerings more accessible to retail investors, such as changes to the accredited investor exemptions;
- Criteria for determining the overall offering limits or investment amount limits for individual investors, including whether inflation adjustments or other types of limits should be implemented;
- Whether the SEC should harmonize the disclosure requirements across all or certain types of exemptions;
- Whether exemptions should be conditioned on the involvement of a registered intermediary, such as the registered funding portal or broker-dealer in crowdfunding offerings, particularly if the offering is open to retail investors;
- Whether the availability of any exemptions should be conditioned on particular characteristics of the issuer or lead investor(s), such as requiring the lead investor(s) to hold a minimum amount of the same or a junior security as a condition of allowing participation by non-accredited investors;
- The possibility of implementing a more unified approach to exempt offerings that focuses on the types of investors permitted to invest in the offering and the size of the offering, and tailoring disclosure and investor protection requirements on that basis, and whether specific disclosure requirements or individual investment limits should not apply where participation is limited to accredited investors;
- Rule changes to allow non-accredited investors to participate in exempt offerings of all types, subject to limits and conditions, and the best means of addressing investor protection concerns in such situations;
- Consolidating one or more of the current exemptions into a single regulation, and the benefits of such an approach;

- The SEC's effectiveness at communicating information about the exempt offering framework, as well as the specific exemption requirements, to issuers seeking to raise capital and investors seeking investment opportunities in the market, including whether additional technologies should be used to convey such information.

The Accredited Investor Definition

The Release notes that the "accredited investor" definition is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary."[1] Under the Regulation D accredited investor definition,[2] natural persons must satisfy specific income or net worth test to qualify as an accredited investor. In addition, certain individuals affiliated with the issuer and certain entities qualify as accredited investors. The implications of qualifying as an accredited investor are significant, as accredited investors have access to investment opportunities that are generally not available to non-accredited investors under the SEC rules, such as offerings by hedge funds, venture capital funds, and private equity funds. The Release notes that the accredited investor definition has various implications outside of the Regulation D context as well because it is used in other federal securities law contexts and certain state laws. Under the current definition, the Release notes that approximately 16.0 million households qualify as accredited investors, although there is a geographic skew towards the Northeast and the West.[3]

The Release also discusses staff recommendations on how the accredited investor definition could be revised as published in a 2015 report and as recommended by the SEC's Small Business Forums. Of the recommended changes, commenters overwhelmingly supported creating additional methods of accreditation that were not solely based on financial criteria.

Regarding the accredited investor definition, the SEC has requested comment on a number of issues, including:

- Whether the definition of accredited investor should be changed; whether market developments since prior Staff recommendations have identified additional classes of potential accredited investors; and whether any changes should be consistent with the Staff's prior recommendations, including:
  - Leaving the current income and net worth thresholds in place, subject to investment limits, adding new inflation-adjusted income and net worth thresholds that are not subject to investment limits, permitting individuals with a minimum amount of investments to qualify as accredited investors, and permitting individuals with certain professional credentials, experience participating in exempt offerings, or that pass a qualifying exam to qualify as accredited investors; and
  - Permitting all entities (and not just certain entities) with investments in excess of $5 million to qualify as accredited investors.
- Whether other changes should be included to harmonize the exempt offering rules, such as expanding the types of entities that may qualify as accredited investors;
- Whether additional approaches used in foreign jurisdictions to identify sophisticated or accredited investors should be used, such as certification or verification by financial professionals;

[1] *See, e.g.*, Regulation D Revisions; Exemptions for Certain Employee Benefit Plans, Release No. 33-6683 (Jan. 16, 1987) [52 FR 3015] (the "Regulation D Revisions Proposing Release").
[2] Rule 501(a) of Regulation D.
[3] See Release, pp. 36-37.

- Whether the accredited investor definition should be revised to permit investors (natural person or entity) advised by a registered financial professional, and if so, whether additional investor protections or qualifications of such financial professionals should be required;
- If an investor advised by a financial professional will be considered an accredited investor, should there be limits on the types or amounts of investments such an investor can make? For example, should these investors be permitted to invest in pooled investment funds, and should these investments be limited in amount and permitted only out of retirement or other federally regulated accounts? If so, what portions of the 1940 Act should apply to such funds?
- Challenges presented in the application and enforcement of revised criteria for the accredited investor definition.

Private Placement Exemption and Rule 506 of Regulation D

The Release explains that Section 4(a)(2) of the Securities Act exempts from registration requirements "transactions by an issuer not involving any public offering" and discusses the basic criteria established for determining the availability of Section 4(a)(2), pursuant to *SEC v. Ralston Purina Co.*[4] Next the Release discusses the various exemptions currently available under the non-exclusive safe harbor of Rule 506, which was adopted under Section 4(a)(2).

The Release analyzes Rule 506 in the exempt market, noting that Rule 506(b) offerings continue to dominate the exempt offering market and exceed the amounts raised in the registered market. Regarding exempt transactions under §4(a)(2) and Rule 506 of Regulation D, the SEC solicits public comment on:

- Potential changes to Rule 506(b) and/or 506(c), including whether the requirements for Rule 506(b) and Rule 506(c) offerings should be combined into one exemption;
- The importance of allowing non-accredited investors to participate in Rule 506(b) offerings, including whether the current information requirements in Rule 506(b) are appropriate or should be aligned with those requirements found in another type of exempt offering (such as Regulation Crowdfunding, Tier 1 of Regulation A, Tier 2 of Regulation A, or Rule 701);
- Amending Regulation D to clarify or define "general solicitation" or "general advertising," or expanding the list of examples set forth in Rule 502(c);
- Whether the information requirements in Rules 506(b) and 506(c) should be changed, and how a reduction in information affects limits for non-accredited investors, and whether there should be limits on accredited investors;
- Whether issuers are hesitant to rely on Rule 506(c), as suggested by data on the amounts raised under Rule 506(c) offerings in comparison to other exemptions, and if the requirement to take reasonable steps to verify accredited investor status has a significant impact on the willingness of issuers to use Rule 506(c);
- Consideration of rule changes to allow non-accredited investors to purchase securities in an offering that involves general solicitation, and if so, what types of investor protection apply.

[4] 346 U.S. 119 (1953).

Regulation A

The Release provides information on the background of Regulation A, which was originally adopted by the SEC under the authority of Section 3(b) of the Securities Act as an exemption for "small issues." Today, there are two distinct tiers of Regulation A offerings, with specific requirements for each of Tier 1 and Tier 2.

Based on Staff analysis, the SEC notes that, although Regulation A offerings tend to raise higher average amounts than Regulation D offerings, significantly more capital is raised by Regulation D offerings because they are much more common. The Release also notes that the typical Regulation A issuer is a relatively small and early stage company, with the median issuer reporting no revenues and an incorporation date of three years earlier.

Regarding Regulation A, the SEC seeks comment on a number of issues, including:

- Whether Regulation A requirements appropriately address capital formation and investor protection considerations, including whether the process is unduly burdensome or if the costs associated with conducting a Regulation A offering dissuade many issuers from relying on the exemption;
- Increasing the offering limits in Tier 1 and/or Tier 2, and whether additional investor protections should be provided if the limits are increased;
- Expanding the scope of potential issuers eligible to rely on Regulation A for exempt offerings and expanding the types of eligible securities issuable under Regulation A;
- Eliminating or changing the individual investment limits for non-accredited investors in Tier 2 offerings;
- Technological considerations for Regulation A offerings, such as the use of a QR code or using the issuer's website address to facilitate access to the most recent offering circular;
- The appropriateness for issuers and investors of the ongoing reporting requirements of Rule 257 and whether the financial statement requirements in Form 1-A are appropriate for each tier;
- Amending Regulation A to permit at-the-market offerings and/or incorporation by reference of the issuer's financial statements in the Form 1-A;
- Whether additional guidance should be provided on what constitutes testing the waters materials and permissible media activities;
- Whether issuers find state advance-notice and filing-fee requirements burdensome, and if so, what changes could help alleviate such burdens; and
- Whether any intermediary in the business of facilitating Regulation A offerings should be required to register as a broker-dealer and comply with requirements similar to those for intermediaries under Regulation Crowdfunding.

Limited Offerings – Rule 504 of Regulation D

The Release describes the current scope of the exemption provided by Rule 504 of Regulation D for the offer and sale of up to $5 million of securities in a 12-month period as a result of the SEC's rule changes in 2016.

The Release seeks comments on a number of issues relating to Rule 504, including:

- Whether to increase the $5 million offering limit to $10 million or another amount, and whether additional investor protections should be imposed in connection with an increase in the annual limit;
- Whether to extend the eligibility of Rule 504 exemption to additional categories of issuers, such as Exchange Act reporting companies or investment companies;
- If Rule 504 exemption is duplicative of Regulation A Tier 1 exemption and, if Staff review of Regulation A Tier 1 offerings is eliminated, whether review of Rule 504 offerings should also be eliminated; and
- Whether any regulatory or legislative changes are necessary or beneficial to encourage regional offerings across two or more jurisdictions.

Intrastate Offerings

Section 3(a)(11) is generally known as the "intrastate offering exemption" and operates in connection with state securities laws regarding resale restrictions and offering registration. Rule 147 is a safe harbor under Section 3(a)(11), while Rule 147A is a newer exemption without safe harbor status.

The Release seeks comments on several matters, including:

- The extent to which the intrastate exemptions are being used; whether they appropriately address capital formation and investor protection considerations; data on the use of the intrastate exemptions on a repeat basis or concurrently with alternative federal offering exemptions; fraud or non-compliance associated with intrastate offerings; role of intrastate broker-dealers and other intermediaries; as well as the application of state bad actor disqualification, in offerings conducted pursuant to the exemptions;
- Whether to eliminate Rule 147 and retain Rule 147A;
- Whether issuer requirements related to principal place of business and doing business appropriately capture the intrastate issuers and whether individual purchaser requirements related to principal residence appropriately capture the intrastate investors; and
- Regulatory or legislative changes necessary to allow regional offerings not limited to one jurisdiction.

Regulation Crowdfunding

Securities Act Section 4(a)(6), added by Title III of the JOBS Act, provides an exemption from registration for certain crowdfunding transactions. Section 4A, also added by Title III, requires issuers and intermediaries of such transactions to provide certain specified information to investors and the SEC. Furthermore, Title III mandated the SEC to establish bad actor provisions. Accordingly, the SEC adopted Regulation Crowdfunding, which became effective on May 16, 2016.

The Release seeks comment on a number of issues related to Regulation Crowdfunding, including:

- Whether the requirements of Regulation Crowdfunding appropriately address capital formation and investor protection considerations, including whether the costs are burdensome and how to alleviate the burden, such as simplifying disclosure requirements or allowing reviewed rather than audited financial statements;
- Whether the offering limit of $1.07 million should be increased and to what level, and whether the increase of the offering limit would make Regulation Crowdfunding overlap with Rule 504 of Regulation D or with Regulation A;

- Whether to modify the eligibility requirements for issuers or securities offered under Regulation Crowdfunding to include Canadian issuers or all foreign issuers, whether the eligible types of securities should be modified, and whether to include issuers subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act;
- Whether to permit issuers to offer securities through SPVs under Regulation Crowdfunding, what additional requirements would be appropriate for investor protection, and whether there are other ways to modify the regulations to allow investors to invest in pooled crowdfunding vehicles that are advised by a registered investment adviser;
- Whether issuers should be required to provide reviewed or audited financial statements and at what offering sizes;
- Whether to eliminate, increase, or otherwise amend the individual investment limits, and whether certain investors should be subject to higher limits or exempt from the limits altogether;
- Whether to allow issuers to test the waters or engage general solicitation and advising prior to filing a Form C; and
- Whether to allow for more communication about the offering outside of the funding portal's platform channels, what would the investor protection concerns be if allowed, and whether there are limitations that should be imposed on such communications.

Potential Gaps in the Current Exempt Offering Framework

There remain concerns about accessing capital with respect to issuers that may be too small, or may be seeking too small an amount of capital, to realistically or cost-effectively conduct an exempt offering under the existing exemptions. Some market participants have called for a "micro-offering" or "micro-loan" exemption to assist small businesses that have insufficient capital access. The Release seeks comments on the following issues:

- Whether to add a micro-offering or micro-loan exemption, and what it should provide from an investor protection, issuer eligibility, security type, offering method and resale restrictions perspective; and
- Whether there are other perceived gaps in the current exempt offering framework that should be addressed.

Integration

The integration doctrine provides an analytical framework for determining whether multiple securities transactions should be considered part of the same offering, in order to prevent an issuer from improperly avoiding Securities Act registration by dividing a single offering into separate offerings. The current integration framework is a hodgepodge of Staff guidance, safe harbors, and rules related to specific types of offerings.

In light of this framework, the Release invites comments on the following issues:

- Whether one integration doctrine that would apply to all exempt offering should be articulated, and if so, whether to aggregate the total number of non-accredited investors for purposes of multiple Rule 506(b) offerings that occur less than six months apart, and whether any investor protection concerns arise as a result of one integration doctrine;

- Where safe harbors do not apply, whether the five-factor test should be replaced with the new analysis articulated in connection with Regulation A and Rules 147 and 147A, and whether there are other integration analyses that should be considered;
- Whether integration safe harbor for offers and sales of securities prior to the commencement of an offering that permits general solicitation and advertising should be provided;
- Whether Rule 502(a), Rule 152 and Rule 155 should be revised; and
- Whether other integration safe harbors should be considered, and how the resulting changes would affect capital formation and investor protection.

Pooled Investment Funds

Pooled investment funds include investment companies registered under the Investment Company Act, business development companies (BDC), or private funds. These may provide advantages of reduced risk through a diversified portfolio. Retail investors who are not accredited investors can only obtain exposure to exempt offerings of a pooled investment fund through registered investment companies and BDCs, which are subject to disclosure requirements and substantive regulatory provisions. While retail investors may also invest through a publicly offered Small Business Investment Company, such a SBIC does not currently exist.

For retail investors, status as an accredited investor, qualified purchaser, or qualified client, can govern or limit their ability to participate directly in private fund offerings. SEC notes concerns on the possibility of offering closed-end funds that make significant investments in private funds to retail investors. According to the SEC, no private fund currently is available to non-accredited investors.

In relation to pooled investment funds, the Release seeks comments on the following issues:

- The extent to which issuers view pooled investment funds as an important source of capital for exempt offerings and the usefulness of different types of pooled investment funds;
- The importance of angel funds as a source of capital for small issuers, particularly those that seek to raise capital in micro-offerings;
- The influence of recent market trends on retail investor access to growth-stage issuers that do not seek to raise capital in the public markets, and whether current pooled investment rules make such access difficult;
- Whether there are regulatory provisions or practices that discourage participation by registered investment companies and BDCs in exempt offerings;
- Restrictions on the ability of closed-end-funds to invest in private funds and to offer their shares to retail investors;
- Changes to rules regarding interval funds, such as length, flexibility and mechanism in determining periodic intervals;
- Whether and what changes should be made to the rules regarding tender offer funds;
- Whether there should be measures to enable a target-date retirement fund to seek a limited amount of exposure to exempt offerings in its portfolio and to allow investment advisory services to include a limited amount of exposure to securities from exempt offerings as part of a diversified retirement portfolio that they recommend to retail investors;

- Whether some other types of pooled investment funds should qualify as accredited investors without satisfying any quantitative criteria;
- Whether to define an "accredited investor" under Regulation D to specifically include a "qualified purchaser" and whether to include periodic reassessment of that standard; and
- Effect of the issue of secondary market liquidity on investors' decision-making with respect to whether to invest in pooled investment vehicles, and changes to encourage the establishment or improvement of secondary trading opportunities for closed-end funds or BDCs.

Secondary Trading of Certain Securities

The Release explains that the expansion of the exempt offering framework through the implementation of the JOBS Act and other recent Commission initiatives aim to provide additional avenues for small- and medium-sized businesses to raise capital. Acknowledging the importance of secondary market liquidity in achieving such capital formation, the Release considers factors affecting secondary market liquidity and seeks ways to revise current resale exemptions under the Securities Act provided by Section 4(a)(1) and Rule 144, Rule 144A, Section 4(a)(3), Section 4(a)(4) and Section 4(a)(7).

Relationship with State Law

Section 18: Federal Preemption for Secondary Offerings. The Release reminds us that an investor seeking to resell securities acquired in an exempt offering must also consider state securities registration in addition to federal registration requirements. State securities law registration and qualification requirements are preempted by federal securities laws for certain secondary offers or sales. However, in other instances, a selling security holder would be required to either register the transaction with the state securities regulator or rely on an exemption to such requirements.

State Exemptions for Secondary Sales. While state exemptions vary significantly, there are some that are generally applicable to secondary transactions. For example, most states offer a narrow exemption from registration for isolated sales by a seller other than the issuer. Most states also provide an exemption for offers and sales to certain financial or other institutional investors and broker-dealers.

39 of the 54 U.S. jurisdictions also provide manual exemption, which generally exempts secondary offers and sales by non-issuers if certain financial and other information about the issuer is published in a designated securities manual. As Standard & Poor's discontinued publication of its manuals in 2016, OTC Markets, Inc. began seeking recognition of its website as a source of such requisite information. In July 2018, the North American Securities Administrators Association, Inc. (NASAA) proposed two model rules to facilitate the public availability of certain information and sought comments on each of them.

The Release also notes various state exemptions for transactions through a broker-dealer that are not within the scope of Section 4(a)(4).

The Release invites comments on a number of specific issues relating to resales, including:

- Whether concerns about secondary market liquidity have a significant effect on issuers' decision-making with respect to primary capital-raising options or on individual investors' decision-making, and whether issuers take into account whether the securities issued in the transaction will be restricted securities and/or subject to other resale restrictions;
- The effect of an exemption from Section 12(g) registration for certain exempt offerings on issuers' access to capital or secondary market liquidity;

- Whether to revise the Rule 144 non-exclusive safe harbor, whether to reduce the holding period for securities of issuers meeting the current public information requirement, or to reduce the holding period for securities of issuers not subject to the current information requirement;
- Whether to impose issuer disclosure requirement in connection with resales if the SEC is to expand the population of who may qualify as accredited investors;
- Whether additional resale exemptions or safe harbors would be appropriate; and
- Whether to extend federal preemption to additional offers and sales of securities, by expanding the definition of qualified purchaser and preempting state securities registration to secondary sales of securities.

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