SEC Tweaks Integration Provisions

Julius J. Brecht

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Recently, the Securities and Exchange Commission (SEC) issued a release (Release) announcing adoption of final rules on a different approach to be followed in determining integration of securities offerings under federal law (Changes).

The Release is entitled "Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets" (found at SEC Release Nos. 33-10884, 34-90300, IC-34082; RIN 3235-AM27; dated November 2, 2020).

With limited exception, the Changes are effective as of March 15, 2021 (Change Date).

The Changes affect a broad range of offerings, both private and public, subject to the federal Securities Act of 1933, as amended (Securities Act). They also pertain to the Securities Exchange Act of 1934 (Exchange Act) and the Investment Company Act of 1940 (ICA).

What's Integration?—

You say, what's "integration" as used by the SEC? To answer this question, we need to review a few basics of security offerings under federal law.

The Securities Act was enacted primarily to require that investors receive financial and other significant information regarding securities offered for public sale. The Exchange Act was enacted to govern security transactions in the secondary market after issue. The ICA was enacted to establish a stable financial market framework following the market crash in 1929. The Securities Act defines a security by setting forth a long list of items exemplifying the term, including stocks, bonds and numerous other identified instruments and transactions.

The Securities Act requires that an offer and sale of a security must be registered unless an exemption from registration is available. It contains numerous security registration exemptions. The Securities Act also allows the SEC to adopt additional exemptions. The SEC has, from time to time, exercised that authority.

So, the SEC uses the term "integration" in a narrow sense to address and prevent a securities issuer from improperly avoiding registration of an offering. Such avoidance might include an issuer's arbitrarily dividing a single offering into multiple offerings in an attempt to satisfy a security registration exemption based on an investor numerical limitation.

For example, prior to effectiveness of the Changes, the registration exemption under federal Regulation D, Rule 506(b) (a private offering exemption adopted under the Securities Act) allowed no more than 35 investors. This limitation did not include "accredited investors" as defined in federal Regulation D, Rule 501 (adopted under the Securities Act).

A careful read of the full Release is needed to get its impact on numerous areas of federal securities law. In addition, the Changes may affect how the State of Alaska administers the Alaska Securities Act (AS 45.56, Alaska Act) pertaining to private and public offerings.

The Alaska Act replaced the previous state statutory securities law, first enacted when Alaska became a state. However, as of the Change Date, the state had not adopted new regulations under the Alaska Act.

Changes—

Intended Purposes. The Release states the Changes are meant to facilitate capital formation, as well as to increase investor opportunities. It proposes to attain these goals by expanding access to capital for small and medium-sized businesses and entrepreneurs in the United States.

The Changes generally include the following:

- *Modernizing and simplifying integration*-- For exempt and registered offerings under the Securities Act.
- *Establishing rules governing*-- Offering communications between issuers and investors.
- *Increasing, for certain exemptions*-- Offering and investment limits.
- *Harmonizing provisions*-- For other limited matters addressed at different places in the federal rules.

As an example of the above third bullet, the offering dollar limit under federal Regulation D, Rule 504 (adopted under the Securities Act) changes from $5 million to $10 million.

A Little History. Prior to the Changes, the approach taken by the SEC on the integration concept was that integration of two or more offerings ought to be based on an analysis of specific facts and circumstances of them (Previous Approach).

The Previous Approach was based upon application of five factors. Those factors were whether the offerings (i) were a part of a single plan of financing, (ii) involved issuance of the same class of security, (iii) were made at or about the same time, (iv) consisted of the same type of consideration, and (v) were made for the same general purpose.

The Previous Approach had been the basis for determining whether two offerings fell outside safe harbor provisions set forth in federal Regulation D, Rule 502(a) (adopted under the Securities Act) and had to be treated as one offering. For example, it applied to offerings in reliance upon Regulation D, Rule 506.

New Rule 152 and Safe Harbors. The Changes establish a new approach to integration through a new Rule 152(a). This rule provides guidance in the form of a *general principle of integration* (GPI).

The Changes also set forth, in new Rule 152(b), *four safe harbors* applying to all security offerings under the Securities Act (Safe Harbors). No integration analysis under Rule 152(a) is required should an offering or offerings satisfy one or more of the Safe Harbors.

New Rule 152(a) provides as follows:

- *Should Safe Harbors in Rule 152(b) not apply—*
    - Determination of whether two or more offerings are to be treated as one for purposes of registration or qualifying for exemption-- Offers and sales are not integrated if, based on particular facts and circumstances, the issuer can establish that each offering either complies with registration requirements or that exemption from them is available for the offering.
- *Application of GPI-- Where an exempt offering prohibits general solicitation (General Solicitation)—*
    - Issuer must have reasonable belief, based on facts and circumstances and regarding each purchaser in an exempt offering prohibiting General Solicitation, that the issuer (or any person acting on the issuer's behalf) either-- Did not solicit that purchaser through General Solicitation, or did establish a substantive relationship with that purchaser prior to commencement of that exempt offering.
- *Application of GPI-- For concurrent exempt offerings that each allow General Solicitation—*
    - In addition to satisfying particular exemption requirements, General Solicitation offering materials for one offering containing material terms of a concurrent offering under another exemption may constitute a security offering, and the offer must comply with all requirements for, and restrictions on, offers under the exemption being relied upon for such other offering (including legend requirements and communication restrictions).

Federal Regulation D, Rule 502(c) (adopted under the Securities Act) defines General Solicitation or "general advertising" as including but not limited to an advertisement, article, notice or other communication published in a newspaper, magazine or similar media or broadcast over television or radio. The definition also includes any seminar or meeting whose attendees were invited through such solicitation or general advertising (with limited exception).

The Safe Harbors are set forth in new Rule 152(b) as follows:

- *Safe Harbor 1*-- Any offering made more than 30 calendar days before commencement of, or 30 calendar days after termination or completion of, any other offering would not be integrated with that offering, with limited further conditions.
- *Safe Harbor 2*-- Certain offers and sales executed outside the United States (and otherwise satisfying federal Regulation S (adopted under the Securities Act)).
- *Safe Harbor 3*-- Certain offers and sales involving "qualified institutional buyers" and "institutional accredited investors."
- *Safe Harbor 4*-- Offers and sales made in reliance on an exemption for which general solicitation is permitted are not integrated if made subsequent to any terminated or completed offering.

A lot of information is packed into the previous two Rule 152-related bullet outlines. For example, under Safe Harbor 1, the integration avoidance period for offerings under Regulation D, Rule 506(b) changes from six months to thirty days.

Nevertheless, under the Changes and as described in the Release, Regulation D, Rule 506(b) is further limited. It provides that, within any 90-calendar day period, the number of purchasers is limited

to no more than (or the issuer reasonably believes that there are no more than) 35 sophisticated but non-accredited investors in offerings of the issuer's securities in reliance upon that Rule 506(b).

Summary--

The SEC's effort on the Changes is detailed and broad in scope (the Release is almost 400 pages in length). Integration touches on numerous securities registration exemptions under federal law. With the Changes, integration also enters into the interplay between possible concurrent issuer private and registered securities offerings.

While this article covers some of the Changes in limited fashion, a prudent practitioner, in advising an issuer of, or purchaser in, a security offering under the Securities Act (or in some way subject to the Exchange Act or ICA), ought to become familiar with all of the Changes.

Good luck on your read of the Release!

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