PRIVATE OFFERINGS UPDATE – 2021

Hodgson Russ Canada-U.S. Cross-Border Alert
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This article summarizes various changes or proposed changes that were announced in 2020 to aspects of private markets securities regulation that we have written about previously on our publications page.

SEC Modernizes Accredited Investor Definition

On August 26, 2020, the Securities and Exchange Commission (the "SEC") adopted amendments to the "accredited investor" definition, one of the principal tests for determining who is eligible to participate in private capital markets offerings. Historically, individual investors who do not meet specific income or net worth tests, regardless of their financial sophistication, have been denied the opportunity to invest in the multifaceted and vast U.S. private markets.

We have previously discussed these definitions and their applicability to private offerings **here**.

Accredited investors are presumed to be financially sophisticated and able to fend for themselves in purchasing unregistered securities, more particularly under Rule 506 (b) of Regulation D under the Securities Act of 1933, as amended. This rule is a central capital raising pathway for private companies and private equity or hedge funds—investment opportunities that are not typically available for retail investors.

However, the accreditation requirement has also prevented millions of Americans from participating in the potential growth of private companies. Although technically non-accredited investors may participate in Rule 506(b) offerings under Reg. D, aggregate investments in exempt offerings in which non-accredited investors participated represented less than one percent of investment in all exempt offerings due to additional onerous compliance and disclosure requirements when retail investors participate.

Prior to 2020, the "accredited investor" definition had not changed significantly since 1982. For instance, the following income and wealth tests for individuals has remained constant over the years, without an index to inflation:

- annual income of at least $200,000 per year ($300,000 joint with their spouse) or
- net worth of at least $1 million (outside primary residence)

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In 1982 (on adoption), it was estimated that approximately 1.8% of U.S. households were accredited. It is now presently estimated that 13% of U.S. households are accredited.

The SEC has now adopted the following amendments to the accredited investor definition in Securities Act Rule 501(a):

- add a new category to the definition that permits natural persons to qualify as accredited investors based on certain professional certifications, designations or credentials or other credentials issued by an accredited educational institution, which the SEC may designate from time to time by order. At present, the SEC designated by order holders in good standing of the Series 7, Series 65, and Series 82 licenses as qualifying natural persons. This approach provides the SEC with flexibility to reevaluate or add certifications, designations, or credentials in the future;
- include as accredited investors, with respect to investments in a private fund, natural persons who are "knowledgeable employees" of the fund;
- clarify that limited liability companies with $5 million in assets may be accredited investors and add SEC- and state-registered investment advisers, exempt reporting advisers, and rural business investment companies (RBICs) to the list of entities that may qualify;
- add a new category for any entity that owns "investments," as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million and was not formed for the specific purpose of investing in the securities offered;
- add "family offices" with at least $5 million in assets under management and their "family clients," as each term is defined under the Investment Advisers Act; and
- add the term "spousal equivalent" to the accredited investor definition, so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors.

In 2018, the estimated amount of capital raised in Rule 506 offerings was $1.7 trillion, larger than the $1.4 trillion raised in registered offerings. More and more businesses are staying private longer, while growing quickly and generating high returns for investors. Under the new amendments, newly eligible accredited investors will be able to participate in the high-growth stage of these issuers and gain broader access to investment opportunities.

SEC Announces Proposed Finders Exemption

In a previous post linked **here**, we discussed various pitfalls and risks associated with paying transaction-based compensation to an unlicensed broker in connection with a private offering of securities.

On October 7, 2020, the SEC voted to propose a new limited, conditional exemption from broker registration requirements for "finders" who assist issuers with raising capital in private markets from accredited investors. If adopted, the proposed exemption would permit natural persons to engage in certain limited activities involving accredited investors without registering with the Commission as brokers. The proposed exemption seeks to assist small businesses to raise capital and to provide regulatory clarity to investors, issuers, and the finders who assist them.

The proposal would create two classes of finders, Tier I Finders and Tier II Finders, that would be subject to conditions tailored to the scope of their respective activities. The proposed exemption would establish clear guidelines for both registered broker activity and limited activity by finders that would be exempt from registration. Tier I and Tier II Finders

would both be permitted to accept transaction-based compensation under the terms of the proposed exemption.

Tier I Finders

A Tier I Finder would be limited to providing contact information of potential investors in connection with only a single capital raising transaction by a single issuer in a 12 month period. A Tier I Finder could not have any contact with a potential investor about the issuer.

Tier II Finders

A Tier II Finder could solicit investors on behalf of an issuer, but the solicitation-related activities would be limited to: (i) identifying, screening, and contacting potential investors; (ii) distributing issuer offering materials to investors; (iii) discussing issuer information included in any offering materials, provided that the Tier II Finder does not provide advice as to the valuation or advisability of the investment; and (iv) arranging or participating in meetings with the issuer and investor.

Conditions for Both Tier I and Tier II Finders

Both Tier I and Tier II Finders would be subject to certain conditions. The proposed exemption for Tier I and Tier II Finders would be available only where:

- the issuer is not required to file reports under Section 13 or Section 15(d) of the Exchange Act;
- the issuer is seeking to conduct the securities offering in reliance on an applicable exemption from registration under the Securities Act;
- the Finder does not engage in general solicitation;
- the potential investor is an "accredited investor" as defined in Rule 501 of Regulation D or the Finder has a reasonable belief that the potential investor is an "accredited investor";
- the Finder provides services pursuant to a written agreement with the issuer that includes a description of the services provided and associated compensation;
- the Finder is not an associated person of a broker-dealer; and
- the Finder is not subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act, at the time of his or her participation.

A finder could not rely on this proposed exemption to engage in broker activity beyond the scope of the proposed exemption. Among other things, a finder could not rely on this proposed exemption to facilitate a registered offering, a resale of securities, or the sale of securities to investors that are not accredited investors or that the finder does not have a reasonable belief are accredited investors.

Further, a finder could not (i) be involved in structuring the transaction or negotiating the terms of the offering; (ii) handle customer funds or securities or bind the issuer or investor; (iii) participate in the preparation of any sales materials; (iv) perform any independent analysis of the sale; (v) engage in any "due diligence" activities; (vi) assist or provide financing for such purchases; or (vii) provide advice as to the valuation or financial advisability of the investment.

Additional Conditions for Tier II Finders

Because Tier II Finders could participate in a wider range of activity and have the potential to engage in more offerings with issuers and investors, the Commission has proposed additional, heightened requirements. A Tier II Finder wishing to rely on the proposed exemption would need to satisfy certain disclosure requirements and other conditions. These disclosure requirements, which include a requirement that the Tier II Finder provide appropriate disclosures of the Tier II Finder's role and compensation, must be made prior to or at the time of the solicitation. Further, the Tier II Finder must obtain from the investor, prior to or at the time of any investment in the issuer's securities, a dated written acknowledgment of receipt of the required disclosures.

Issuers should take note that while the SEC states that the proposed finders exemption is intended to help small businesses raise capital, the proposal does not materially limit the issuers or size of offerings that may use finders operating under the exemption. The only proposed limitation on the exemption was to issuers not required to file reports under Section 13 or Section 15(d) of the Exchange Act. This leaves open the possibility that larger private companies or private investment vehicles may use the exemption, regardless of the amount of capital the issuer intends to raise.

Finders should take note that the proposed exemption would not affect a finder's obligation to continue to comply with all other applicable laws, including the antifraud provisions of the Securities Act and the Exchange Act, such as the obligations under Section 10(b) and Rule 10b-5 under the Exchange Act, and state law. It should be noted that some state securities regulators have already spoken out against the proposed exemptions. Additionally, the proposed exemption does not insulate a finder from the registration requirements of the U.S. Investment Advisers Act if such finder is deemed to be acting as an investment adviser.

Importantly, though, it is not clear whether the SEC will adopt the proposed order in its current form. One of the weaknesses of the SEC addressing the finders issue through an exemptive order (which is an unusual approach), rather than by adopting a rule that is subject to notice and comment requirements, is that the commission can more easily change or rescind an exemptive order than it can a rule.

New York amends its Rule 506 Offering Procedures

We have previously discussed state blue sky law considerations in connection with private offerings in the blog post available **here**.

In particular, we noted the unusual approach taken by New York State in connection with Rule 506(b) offerings under Regulation D – an approach that is at odds with most other states. Securities offerings in New York are regulated under New York General Business Law, Chapter 20, Article 23-A, known as the "Martin Act." In contrast to federal securities laws and those of other states, the Martin Act generally regulates dealers of securities rather than the offer and sale of the securities themselves. Under the Martin Act, "dealer" is generally defined to include the issuer of a security.

Under the previous regime, the New York Department of Law required an issuer conducting a Rule 506 offering of securities in New York to register as a dealer prior to making the first offer or sale in New York by filing a Form 99 with the Investor Protection Bureau. This dealer registration was valid for four years. The Form 99 filing was required to be accompanied by a State Notice and Further State Notice filed with the Miscellaneous Records Bureau and a Form U-2, Consent to Service of

Process, filed with the Division of Corporations. However, a number of securities practitioners had taken the view that New York's filing requirements for Rule 506 offerings were inconsistent with, and pre-empted by, the National Securities Markets Improvement Act of 1996 (NSMIA). Consistent with this position, many issuers in Rule 506 offerings relied on federal pre-emption in lieu of registering as a dealer in New York. This view was supported by a position paper prepared by the Committee on Securities Regulation of the New York State Bar Association in August 2002.

On Dec. 1, 2020, the New York Department of Law modernized its dealer rules to more closely align with federal requirements for a Regulation D Rule 506 offering. Under the amended rules, an issuer conducting a Rule 506 offering in New York must file a copy of the federal Form D with New York's Investor Protection Bureau in lieu of the pre-offer Form 99 filing previously required.

The Form D filing in New York should be submitted online through the Electronic Filing Depository (EFD) system developed by the North American Association of Securities Administrators (NASAA), which a number of states have adopted for their Form D filings. These changes generally bring New York in line with other states with respect to notice filings for Rule 506 offerings.

The Form D filing in New York provides a four-year dealer registration period that begins on the date of such filing. The state filing fee associated with the new Form D filing will be either $300 or $1,200, depending on the size of the offering, which is consistent with New York's historical filing fees. Of important note, issuers of real estate securities currently are still required to file the Form 99, as prescribed by New York's Real Estate Financing Bureau.

If you have questions about any of the topics addressed in this alert, please contact Timothy Ho (416.595.2673).

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