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Securities

A recent study by the Securities and Exchange Commission's Division of Risk, Strategy, and Financial Innovation noted that there has been a shift from public to private capital raising, with more capital having been raised over the last three years through private offerings, write Anna T. Pinedo, a partner in the Capital Markets group at Morrison & Foerster, and James Tanenbaum, who chairs the firm's Capital Markets practice. The recently enacted Jumpstart Our Business Startups (JOBS) Act will contribute to an even greater reliance on private offerings and to more blurring of the lines between private and public, they say, and is likely to prove to be the most significant development in private offerings since the promulgation of Regulation D.

Is Nothing Private Anymore?

BY ANNA T. PINEDO AND JAMES R. TANENBAUM

In a world dominated by Twitter tweets, Facebook status updates and a proliferation of reality television shows, a commentator may naturally wonder whether the traditional bounds between private and public have fallen away. As we are securities lawyers, we tend to be more focused on the blurring of lines between private placements and public offerings, than on whether the Kardashians are sharing too much information.

It was not that long ago that a company's financing life cycle was rather predictable. An emerging company

Anna T. Pinedo, a partner at Morrison & Foerster, concentrates her practice on securities and derivatives. She represents issuers, investment banks/financial intermediaries, and investors in financing transactions, and is, with James R. Tanenbaum, the co-author of "Exempt and Hybrid Securities Offerings," a treatise on securities matters. James R. Tanenbaum chairs Morrison & Foerster's Global Capital Markets practice. He concentrates his practice on corporate finance and the structuring of complex capital markets transactions.

financed its growth by raising capital from friends and family, willing angel investors, and, if it were lucky, venture or private equity investors. These offerings were structured as private offerings, exempt from the registration requirements of Section 5 of the Securities Act. After a number of successful financing rounds, the company might be ready to take the next step and pursue an initial public offering, or IPO. Once public, the company might subsequently turn to the capital markets again through a follow-on offering, if it needed to raise additional funds.

Over time, regulatory reforms brought greater certainty to private placements and exempt offerings, through the adoption of Regulation D and the promulgation of the Rule 144A resale safe harbor. The holding period for securities not sold in public offerings, or restricted securities, has been shortened several times. In addition, market structure changes contributed to greater liquidity for restricted securities, and also resulted in significant changes to the IPO market. Over the last two decades, more and more companies (both private and public reporting companies) have come to rely on exempt offerings, and securities offering methodologies have morphed as new forms of hybrid offerings have become more popular. A recent study by the SEC's Division of Risk, Strategy, and Financial Innovation noted that there has been a shift from public to private capital raising, with more capital having been

raised over the last three years through private offerings. It is easy to trace the rise of Regulation D offerings, and the development of private investment in public equity (PIPE) transactions, as well as that of public offerings that bear many of the characteristics typically associated with private offerings, such as registered direct offerings and wall-crossed or confidentially marketed public offerings. The recently enacted Jumpstart Our Business Startups (JOBS) Act likely will contribute to an even greater reliance on private offerings and to more blurring of the lines between private and public.

JOBS Act Eases General Solicitation Prohibition

Regulation D was intended to facilitate capital formation by providing issuers with a safe harbor from the Securities Act registration requirements. Because Regulation D provides a non-exclusive safe harbor from registration, an issuer that fails to satisfy the objective conditions of Regulation D may still be in a position to rely on the broader Section 4(2) private placement exemption. Over time, issuers have come to rely on Rule 506 of Regulation D, which permits issuers to sell their securities in a private placement to an unlimited number of accredited investors, provided that issuers comply with the general requirements of Regulation D. Rule 502(c) of Regulation D prohibits the issuer or any person acting on the issuer's behalf from offering or selling securities by any form of general solicitation or general advertising.

Even prior to the JOBS Act, the SEC had been considering whether this prohibition against general solicitation made sense given the prevalence of internet communications and the use of social media. Many market participants had suggested that the SEC consider "deregulating" offers, and focus instead on the actual purchasers in exempt offerings. The JOBS Act requires that the SEC undertake rulemaking to revise the prohibition against general solicitation. Within 90 days of enactment of the JOBS Act, the SEC must revise Rule 506 to make the prohibition against general solicitation or general advertising contained in Rule 502 inapplicable in the context of Rule 506 offerings, provided that the issuer takes reasonable steps to verify that all purchasers in the offering are accredited investors. Also within the same time period, the SEC must revise Rule 144A(d)(1) to permit the use of general solicitation or general advertising in connection with Rule 144A offerings.

While it is clear that during this interim period, prior to SEC rulemaking, market participants should continue to refrain from the use of general solicitation and general advertising, there are a number of questions left unanswered by the JOBS Act. For example, the Act remains silent on the Section 4(2) private offering exemption. Generally, a statutory private placement involves an offering to a limited number of financially sophisticated offerees who: are given access to information relevant to their potential investment, have some relationship to each other and to the issuer, and are offered securities in a manner not involving any general advertising or general solicitation. As we noted above, an issuer often structures its private offering as a Regulation D/Section 4(2) offering, such that if the issuer fails to satisfy a condition of Regulation D, it may still rely on the broader Section 4(2) exemption. Will the Section 4(2) exemption be available if general solicitation has been used? Over the years, courts have consid-

ered closely whether investors contacted in connection with an offering had a pre-existing relationship with the issuer. Of course, relaxing the ban on general solicitation would seem to diminish the significance, at least in the context of Rule 506 offerings, of a pre-existing relationship. SEC staff has indicated that the SEC will not address Section 4(2).

There are a few other ambiguities which may be addressed by the staff in connection with its rulemaking in the area. The JOBS Act does not address the prohibition against "directed selling efforts" contained in Regulation S. For cross-border offerings structured as Rule 144A/Regulation S offerings, in the absence of further guidance, a general solicitation may be regarded as a directed selling effort.

Testing the Waters; Integration Issues

The JOBS Act has put into place a more liberalized and contemporary regime for communications by or about emerging growth companies (EGCs). The JOBS Act expands the range of permissible communications to permit an EGC, or a person authorized to act on its behalf, whether before or after the filing of a registration statement, to "test the waters" and gauge market interest in a potential offering by engaging in oral or written communications with potential investors that are qualified institutional buyers (QIBs) or institutional accredited investors. Undoubtedly, these test-the-waters communications may provide important feedback for an EGC and its advisers; however, this ability to test the waters also will contribute inevitably to additional blurring of the distinctions between private and public.

First, of course, this is a departure from the traditional offering communications framework. Securities practitioners have long been worried about communications conducted by an issuer or on its behalf prior to the filing of a registration statement. Those communications might have constituted "gun-jumping" or conditioning of the market. Now, the JOBS Act sanctions limit communications by the issuer prior to the filing of a registration statement. These communications presumably may be initiated to persons with whom the issuer has no pre-existing relationship. Again, this seems to diminish the significance of a pre-existing relationship even in the context of a "limited" offering.

The ability to use general solicitation in the context of Rule 506 offerings, and the ability to test the waters, will test existing notions regarding the "integration" of securities offerings.

Practitioners also fretted about offerings that occurred in close proximity to one another. Worry might have given way to serious anxiety in the case of proposed private offerings conducted while an issuer was contemplating or already had embarked on a public offering. The ability to use general solicitation in the context of Rule 506 offerings, and the ability to test the waters, will test existing notions regarding the "integration" of securities offerings.

Often, an issuer that intended to conduct an IPO found that the IPO window had closed and the process had extended itself, and the issuer needed to complete a private placement. One could also foresee a different dynamic now. A private equity investor approached during the test-the-waters process might be interested in making a private investment prior to the IPO. The SEC has the view that under appropriate circumstances an issuer may conduct a private offering at the same time as a registered public offering, without having to limit the private offering to QIBs and a few additional large institutional accredited investors, or to the issuer's key officers or directors. Provided that the investors in the private offering were contacted about, and became interested in, the exempt offering through some means other than the filing of the registration statement for the public offering, and there has been no general solicitation, then the prior filing of a registration statement alone would not impact the potential availability of a private placement exemption. The SEC's analysis typically focuses on whether the investors in the private placement had a pre-existing relationship with the issuer and were contacted directly by the issuer or by an agent on its behalf outside the public offering effort. This analysis will need to be revised in a post-JOBS Act world.

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The SEC also has affirmed that, consistent with Rule 152 under the Securities Act, it will not integrate a completed private placement with a public offering that is conducted subsequently pursuant to a registration statement, even if the issuer is contemplating the public offering while conducting the private placement. However, one could see that there might be some confusion during a test-the-waters process. During this process, an issuer is in fact approaching institutions about a potential investment. Investors will be asked about their interest in participating in a public offering, but depending on market interest, a public offering may or may not proceed. The SEC also has long taken the view that if an issuer starts an offering as a public offering, it must proceed with the offering as a public offering, and that an offering that began as a private offering should conclude as a private offering. So, does this mean that an investor approached in the test-the-waters phase cannot participate in a private placement? Some time ago, the SEC had adopted Rule 155 to provide greater certainty to issuers in relation to offerings that took place in close proximity to one another. Rule 155(c) provides guidance for an issuer that abandons a public offering and elects to commence a private placement. Would this guidance be applicable? Or is it more appropriate to conclude that the test-the-waters process does not signal the commencement of any offering (public or private)?

In connection with its adoption of Rule 155(c), the staff noted: "We believe that ordinarily an issuer would not be inclined to incur the costs of preparing and filing a registration statement with the intention to withdraw it later and commence a private offering. Nevertheless, we wish to assure that issuers do not use this integration safe harbor merely as a mechanism to avoid the private offering prohibition on general solicitation and advertising. At the time the private offering is made, in order to establish the availability of a private offering exemption, the issuer or any person acting on its behalf must be able to demonstrate that the private offering does not involve a general solicitation or advertising. Use of the registered offering to generate publicity for the purpose of soliciting purchasers for the private offering would be considered a plan or scheme to evade the registration requirements of the Securities Act." Of course, post-JOBS Act, there will be no prohibition on general solicitation, and the purpose of permitting test-the-waters communications is precisely to permit an issuer to withdraw from the IPO process if there is insufficient interest. All of this suggests that the JOBS Act may require revisiting some integration safe harbors.

Regulation A+

The JOBS Act also amends Section 3(b) of the Securities Act, which provides an exemption from registration for certain smaller public offerings by nonreporting issuers. The SEC is required to undertake rulemaking to implement the changes to Section 3(b)(2), which may include revising existing Regulation A. Pursuant to the Section 3(b)(2), an issuer will be able to offer and sell up to \$50 million in securities within a 12-month period in reliance on the exemption. The issuer may offer equity securities, debt securities, and debt securities convertible or exchangeable for equity interests, including any guarantees of such securities. The securities sold pursuant to the exemption will be offered and sold publicly (without restrictions on the use of general solicitation or general advertising) and will not be "restricted securities." The issuer may "test the waters" or solicit interest in the offering prior to filing any offering statement with the SEC, subject to any additional conditions or requirements that may be imposed by the SEC. The securities will be considered "covered securities" for National Securities Markets Improvement Act (NSMIA) purposes (and not subject to state securities review) if the securities are offered and sold on a national securities exchange, or the securities are offered or sold to a "qualified purchaser."

Private companies may find Regulation A+ offerings a compelling capital raising alternative. A Regulation A+ offering may be more useful than a Rule 506 offering. Regulation A does not impose any limitations on offerees. In contrast to Rules 505 and 506 of Regulation D, and Section 4(2) of the Securities Act, Regulation A does not limit the number of offerees or investors that can participate in the offering, nor does it impose any requirement that offerees be accredited investors. Securities offered and sold pursuant to Regulation A are offered publicly and are not "restricted securities." The securities are freely tradable in the secondary market (assuming that there is a secondary market) after the offering. No holding period applies to the securities purchased in this type of offering. This may be important to certain institutional investors that are subject to limitations on investments in "restricted securities." A

company also may consider conducting a Regulation D offering, or a Regulation S offering, after it has completed a Regulation A-type offering. A company may choose to remain a nonreporting company even after it completes the Regulation A-type offering. Alternatively, a company may choose to list its securities and become a reporting company contemporaneous with undertaking a Regulation A-type offering. In essence, a Regulation A+ offering may be a company's "IPO" but the company will still have available to it the opportunity to submit confidentially its registration statement for its first registration statement for the public offering of its equity securities.

Conclusion

Although most of the headlines concerning the JOBS Act have drawn attention to its potential significance in facilitating capital raising in public offerings for small and not-so-small companies, there is a back story that is very encouraging. The provisions of the JOBS Act relating to private offerings will, when the remaining ambiguities have been resolved, prove to be the most significant development in private offerings since the promulgation of Regulation D.

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