SUMMARY OF KEY RECENT CHANGES BY THE SECURITIES AND EXCHANGE COMMISSION TO THE PRIVATE SECURITIES OFFERING EXEMPTION FRAMEWORK

Emerging Companies and Venture Capital Committee

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I. INTRODUCTION

On June 18, 2019 the Securities and Exchange Commission (the "SEC") published the "Concept Release on Harmonization of Securities Offering Exemptions"[1] (the "Concept Release"). The SEC requested public comment on ways they could simplify and change the private offering exemption framework. The stated goals were to promote capital formation and expand investment opportunities while maintaining appropriate investor protections. SEC Chairman Jay Clayton commented, "[w]e are taking a critical look at our exemptions from registration to ensure that our multifaceted private offering framework works for investors and entrepreneurs alike, no matter where they are located in the United States."[2]

This action by the SEC, while relatively unprecedented, is in response to years of feedback. Since the Jumpstart Our Business Startups Act of 2012 (the "JOBS" Act) went into full effect, several groups have pressed the SEC to enact changes to encourage additional capital formation for small companies. Combined with the longstanding private securities exemption framework, there are now several quasi-independent regulatory structures that issuers need to navigate when fundraising. The SEC is serious about implementing potential solutions to make this process more manageable for issuers and investors.

The Concept Release requested comments over seven primary areas:[3]

1. Exempt Offering Framework
    - Whether the framework as a whole is consistent, accessible, and effective for both companies and investors or whether the Commission should consider changes to simplify, improve, or harmonize the exempt offering framework.

2. Capital Raising Exemptions within the Framework
    - Whether there should be any changes to improve, harmonize, or streamline any capital raising exemptions, specifically: the private placement exemption and Rule 506 of Regulation D ("Reg D"), Regulation A, Rule 504 of Regulation D, the intrastate offering exemptions, and Regulation Crowdfunding.

3. Potential Gaps in the Framework
    - Whether gaps in the Commission's framework make it difficult, especially for smaller companies, to rely on an exemption from registration to raise capital at key stages of their business cycle.

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[1] Concept Release on Harmonization of Securities Offerings Exemptions, 17 C.R.F. §§ 210, 227, 230, 239, 240, 249, 270, and 275 (published June 18, 2019) *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf (all websites last visited Nov. 13, 2020).

[2] SEC Seeks Public Comment on Ways to Harmonize Private Securities Offerings Exemptions, U.S. SECURITIES AND EXCHANGE COMMISSION, 2019-97 (June 18, 2019), https://www.sec.gov/news/press-release/2019-97.

[3] *Id.*

4. Investor Limitations
    - Whether the limitations on who can invest in certain exempt offerings, or the amount they can invest, provide an appropriate level of investor protection (i.e., whether the current levels of investor protection are insufficient, appropriate, or excessive) or pose an undue obstacle to capital formation or investor access to investment opportunities, including a discussion of the persons and companies that fall within the "accredited investor" definition.

5. Integration
    - Whether the Commission can and should do more to allow companies to transition from one exempt offering to another and, ultimately, to a registered public offering, if desired, without undue friction or delay.

6. Pooled Investment Funds
    - Whether the Commission should take steps to facilitate capital formation in exempt offerings through pooled investment funds, including interval funds and other closed-end funds, and whether retail investors should be allowed greater exposure to growth-stage companies through pooled investment funds in light of the potential advantages and risks of investing through such funds.

7. Secondary Trading
    - Whether the Commission should revise the rules governing exemptions for the resale of securities to facilitate capital formation and to promote investor protection by improving secondary market liquidity.

Among the topics listed above, there were 138 specific areas where the SEC requested comments. Since the Concept Release's initial publication, there were 174 comments submitted to the SEC.[4] These ranged from very brief suggestions to expansive comments from academia, professional associations, and companies. Without reading most of the comments, it can be challenging to quickly grasp the areas of particular interest to the public. The New York City Bar Association Emerging Companies and Venture Capital Committee (this "Committee") has undertaken a review of those comments to summarize and distill them into broad topic areas where the public is most interested to see changes.

This Committee undertook a review of the comments and labeled each under broad subject areas. Public comments were not evenly distributed across the initial seven topic areas in the Concept Release. Instead, the comments were primarily focused on only a handful of those topics. We reframed the taxonomy from the Concept Release to better illustrate the areas with the most comments.

[4] Comments on Concept Release: Harmonization of Securities Offering Exemptions, U.S. SECURITIES AND EXCHANGE COMMISSION, *available at* https://www.sec.gov/comments/s7-08-19/s70819.htm.

The following is a table of the reframed taxonomy:

Area	**Number of Comments**
Definition of Accredited Investor	101
Changes to the JOBS Act	51
Fund/Retail Investor Access	43
Secondary Liquidity Rules	38
Updates to Regulation D	23
Information disclosure requirements	21
Clarity on General Solicitation	12
Crypto in the securities markets	9
Misc.	25

The accredited investor definition and updating the JOBS Act received particular attention from the public, which is likely why the SEC has already moved forward with finalized rule updates. The rest of this Publication will summarize and discuss the four largest areas of public comment and what changes have already occurred. It will then conclude with this Committee's thoughts on where the SEC should next focus proposed rulemaking.

II. THE ACCREDITED INVESTOR DEFINITION

Regulation D ("Reg D") encompasses the combined exemptions from registration for small and private offerings. A central aspect of Reg D is the definition of "accredited investor" under Rule 501.[5] Accredited investors are presumed to be sophisticated enough to judge the merits of an investment for themselves. Issuers raising money from only accredited investors, or a limited number of unaccredited investors, benefit from a more streamlined compliance process for their offerings. Rule 501(a) describes the characteristics individuals and organizations need to qualify as accredited investors. Further, the accredited investor definition influences how issuers can comply with Reg D offerings, many state securities laws, financial regulations, statutes, and other SEC regulations that reference the Reg D accredited investor definition.

Since the Concept Release's publication in June 2019, the SEC has taken steps to propose and make final changes to the accredited investor definition. In December 2019, the SEC released

[5] 17 C.F.R § 230.501 (2020).

proposed rule changes to Rule 501(a).[6] In the proposal, the SEC staff referenced the Concept Release comments and a 2015 staff report as instrumental in shaping the current proposed changes.[7] The proposal received numerous public comments, which ultimately led the SEC to publish the accredited investor definition's final rules.[8]

On August 26, 2020 the SEC announced the final rules to the accredited investor definition under Rule 501 (the "August Rules").[9] The changes become effective on December 8 and are substantially similar to the proposed rules, having made only minor updates after receiving the comments to the proposed updates. In a public statement on the final rules, Chairman Clayton commented that the final rules will shift the focus away from accredited investors that are accredited solely because of their wealth to natural persons who are financially sophisticated but may belong to lower-income brackets.[10] The following sections are a summary of the changes to the accredited investor definition in the August Rules.[11]

a. Knowledgeable Employees Investing in Their Own Funds

Under the August Rules, if a natural person is deemed a "knowledgeable employee" under Rule 3c-5(a)(4) of the Investment Act,[12] that person can be an accredited investor but will be accredited only for purposes of investing in the fund for which they are employed.[13] Additionally, the knowledgeable employee must regularly participate in the fund's investment activities and have performed substantially similar activities for at least 12 months.[14] The SEC estimates approximately 32,620 private funds with employees who may qualify in this capacity under the new August Rules.[15] Several comments to the Concept Release advocated for changes similar to those in the August Rules, and comments remained primarily in favor when the SEC accepted feedback during the proposal period.

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[6] Amending the "Accredited Investor" Definition, Release Nos. 33-10734; 34-87784 (proposed Dec. 18, 2019), *available at* https://www.sec.gov/rules/proposed/2019/33-10734.pdf.

[7] Report on the Review of the Definition of "Accredited Investor", U.S. SECURITIES AND EXCHANGE COMMISSION (Dec. 18, 2015) *available at* https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.

[8] Comments on Proposed Rule: Amending the "Accredited Investor" Definition, U.S. SECURITIES AND EXCHANGE COMMISSION *available at* https://www.sec.gov/comments/s7-25-19/s72519.htm.

[9] SEC Modernizes the Accredited Investor Definition, U.S. SECURITIES AND EXCHANGE COMMISSION, 2020-191 (August 26, 2020), https://www.sec.gov/news/press-release/2020-191.

[10] Chairman Jay Clayton, *Statement on the Modernization of the Accredited Investor Definition*, U.S. SECURITIES AND EXCHANGE COMMISSION (August 26, 2020), https://www.sec.gov/news/public-statement/clayton-accredited-investor-2020-08-26.

[11] Amending the "Accredited Investor" Definition, Release Nos. 33-10824; 34-89669 (finalized Aug. 26, 2020), *available at* https://www.sec.gov/rules/final/2020/33-10824.pdf.

[12] The Investment Act of 1940 is the body of law which regulates investment funds which includes the managers of those funds.

[13] Amending the "Accredited Investor" Definition, *supra* note 11, at 164.

[14] *Id.* at 35 – 36.

[15] *Id*. at 42.

b. Adding Entities that Qualify as Accredited Investors

The August Rules provide the public with more clarification and add new entities that qualify as accredited investors under Rule 501. These three new entities are:

- Accredited Investor status to all state and SEC-registered investment advisors under 501(a)(1);
- Rural Business Investment Companies under 501(a)(1); and
- LLCs under 501(a)(3)

The SEC also added two new sections, 501(a)(12) and (13), that will include family offices with more than $5 million in assets under management and "family clients of family offices."[16] The family office must also meet the following additional requirements:

- It is not formed for the specific purpose of acquiring the securities offered; and
- Its prospective investment is directed by a person who has such knowledge and experience in financial and business matters that such family office is capable of evaluating the merits and risks of the prospective investment.[17]

Further, the SEC added a new 501(a)(9) that would act as a catch-all for entities not explicitly included in Rule 501(a). Under the August Rules, any entity not formed for the specific purpose of investing in that security with more than $5 million in investments (not assets) would qualify as an accredited investor. "Investments" for purposes of this new catch-all will be as defined in Rule 2a51-1(b) of the Investments Act.[18] This new update was primarily in response to tribal governments and state entities not qualifying as accredited entities under the old rules.

c. Spousal Equivalents

The August Rules also made updates to clarify how certain types of cohabitants can pool their resources to become accredited investors.[19] The SEC added "spousal equivalents" to include joint income for purposes of Rule 501(a)(6) and to be included for purposes of calculating net worth under Rule 501(a)(5). The August Rules defines spousal equivalents as a "cohabitant occupying a relationship generally equivalent to that of a spouse." The August Rules adds more flexibility than the previous definition. The SEC also added an important note to clarify that assets do not have to be jointly held to be included under 501(a)(5). This new definition matches the

[16] *Id.* at 61.

[17] *Id.* at 61.

[18] *Id.* at 163.

[19] *Id.* at 162.

Regulation Crowdfunding definition of spousal equivalents and will promote consistency with other rules.

d. Accreditation through Professional Certifications

The most notable update in the August Rules is the inclusion of natural persons with certain professional certifications to qualify as accredited investors. Many commenters advocated for this standard. The SEC believes these individuals can balance the risk and reward while mitigating and avoiding unsustainable loss. Through this expanded definition, the SEC will explicitly make determinations on which professional certification bodies will qualify under this new rule.

For a professional certification to qualify, it will have to meet various standards, which are:[20]

- the certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body or is issued by an accredited educational institution;

- the examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing;

- persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of a prospective investment; and

- an indication that an individual holds the certification or designation is publicly available by the relevant self-regulatory organization or other industry body.

This aspect of the August Rules gives the SEC flexibility in determining what accrediting bodies will qualify investors under this new rule and gives them the ability to disqualify certain institutions over time if they do not continue to meet these standards. It is not entirely clear at the moment which professional accrediting bodies will seek to have their members qualify under this new rule. However, the SEC initially deems a FINRA Series 7, Series 65, *or* Series 82 license will qualify investors under this new rule.[21]

This update may lead to many new individuals being able to invest in Reg D offerings. By SEC estimates, there are potentially six hundred thousand individuals that hold these FINRA licenses and could qualify as accredited investors under this new rule.[22] While it is unclear the

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[20] *Id.* 163 – 164.

[21] Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status Pursuant to Rule 501(a)(10) under the Securities Act of 1933, 17 C.F.R. §§ 230 (Aug. 26, 2020), *available at* https://www.sec.gov/rules/other/2020/33-10823.pdf.

[22] Amending the "Accredited Investor" Definition, *supra* note 11, at 32.

long-term impact these changes will have, the SEC does not believe it will initially greatly increase the quantity of Reg D transactions.

e. Increasing the Financial Thresholds Left Out

Previously under Rule 501(a)(5) and (6) individuals, whether solely or combined with their spouse, that have a net worth of over $1 million (subject to some exclusions like a primary residence) or in the previous two years earned over $200 thousand per year ($300 thousand with a spouse) qualify as accredited investors. These thresholds have not been updated for several decades. Importantly, these qualifying rules under Rule 501 are the primary ways that issuers may rely on issuing securities under Regulation D.

Updating the income thresholds to qualify an accredited investor under Rule 501(a)(5) & (6) received several comments from the public to either reduce or increase the threshold for what level of income or wealth should qualify. However, the SEC believes that the current wealth criteria and the other proposed updates were still an appropriate measurement of an investor's sophistication. The SEC argues that even though inflation over time has made more people qualify as accredited investors, the advent of better information to evaluate and determine if these offerings are not fraudulent has increased during the same time to counteract any concerns about higher risk for investors being defrauded. The SEC also specifically noted that they did not want to increase the thresholds and negatively impact the Reg D market by decreasing the pool of people who can participate in angel and similar investments.

III. UPDATING THE JOBS ACT

Approximately 51 comments advocated for changes to the laws and regulations put forth in the 2012 JOBS Act. The JOBS Act's primary purpose was to create new regulatory structures to make it easier for small businesses to raise capital. The JOBS Act created new structures for companies to raise small amounts of funds from non-accredited investors (Regulation Crowdfunding) and updates to existing frameworks like the "mini-IPO" Regulation A.

a. SEC Adopts Final Rule Changes to JOBS Act Regulations

On March 4, 2020 the SEC published proposed amendments (the "March Proposal") to alter the regulatory framework for creating and structuring early-stage fundraising.[23] After considering public feedback on the March Proposal, on November 2, 2020, the SEC adopted final rules (the "November Rules") with some minor modifications to the March Proposal.[24] The changes made in the November Rules will be effective 60 days after publication. The following

[23] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release Nos. 33-10763; 34-88321(proposed Mar. 4, 2020), *available at* https://www.sec.gov/rules/proposed/2020/33-10763.pdf.

[24] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release Nos. 33-10884; 34-90300 (finalized Nov. 2, 2020), *available at* https://www.sec.gov/rules/final/2020/33-10844.pdf.

sections summarize several changes laid out in the November Rules and how the comments to the Concept Release may have influenced the proposed changes.

b. Regulation Crowdfunding

Regulation Crowdfunding (also called "Reg CF") has not been the success that many were hoping for when the JOBS Act was enacted. The amount of funds raised under crowdfunding is still insignificant compared to Reg D. Proponents for Reg CF argued in the comments to the Concept Release that a few critical changes to the regulations would have drastic impacts on more issuers seeing Reg CF as a viable strategy for raising early investment. It appears that the SEC found many of these arguments compelling.

c. Special Purpose Vehicles

Currently, crowdfunding issuers under Reg CF cannot structure the security as one Special Purpose Vehicle ("SPV") that has a fiduciary to manage the interests of the SPV investors. Instead, each investor will have an independent entry on the issuer's capitalization table. Issuers have stated that the total potential number of investors is a concern because it impacts follow-on investment from more traditional venture capital investors and related shareholder management challenges. Additionally, many angel investors and venture capital firms are hesitant to invest alongside numerous individual shareholders. It was also suggested that later stage institutional investors could manipulate small issuers given the current regulator landscape for minority shareholder protections.

In response, the SEC added a new exclusion to the Investment Company Act, Rule 3a-9, for a "crowdfunding vehicle" to provide a limited function as a conduit to invest in business raising capital through Reg CF.[25] This new type of SPV will act as a co-issuer, and both the issuer and SPV will file a joint Form C to allow for easier potential investor information discovery.[26] Further, the SEC adopted other measures to ensure that the crowdfunding SPV allows the investors to maintain their federal and state shareholder rights and be narrowly structured to only function as a conduit for crowdfunding investors.[27]

d. Reg CF Testing the Waters

Potential crowdfunding issuers are currently unable to "test the waters" to gauge interest before opening a crowdfunding campaign. Reg CF issuers must first prepare and file a Form C to the SEC. Preparing and submitting the Form C has high costs, both in terms of time and financial resources for many small issuers. The cost to file Form C and the inability to gauge interest beforehand is cited as one of the biggest current barriers to a crowdfunding campaign.

Commenters urged the SEC to allow potential issuers the ability to test the waters to reduce the risk and cost of an unsuccessful crowdfunding campaign. Crowdfunding portal commentators

[25] *Id.* at 170 – 71.

[26] *Id.* at 174.

[27] *See id.* at 177 – 179 for a discussion of the specific concerns the SEC addressed.

also suggested that this should be limited to solicitation or advertising through the crowdfunding platform to reduce the risk of investor fraud and confusion.

In the November Rules, the SEC created a new Rule 206 under Reg CF that would function similarly to the existing Rule 255 of Regulation A.[28] This new rule will allow issuers considering issuing securities relying on Reg CF to gauge potential investor interest before any formal filings with the SEC. The issuer will be required to provide certain legends to their materials, and if the issuer initiates a Reg CF offering, it will be necessary to make any written communication or broadcast script included in those materials publicly available through its offering materials.[29]

e. Raising Investment Limits

Under Reg CF, an issuer can raise a maximum of $1,070,000 in any twelve-month period.[30] Further, all investors, whether accredited or not, can invest a maximum of $107,000 (subject to income requirements) in a crowdfunding offering. For Regulation A, a company can raise up to $50 million in any twelve-month period.

A majority of the comments in the Concept Release that addressed raising the limits spoke towards Reg CF. The consensus was to increase the per issuer limit to around $5 million. A $5 million limit, proponents argue, opens up the possibilities to raise a substantial amount of capital for small companies and precludes them from needing to raise more funds within the year. For Regulation A+ (Tier 2 offerings), the consensus was to raise the threshold to either $75 or $100 million to make it more appealing for small and medium-sized established companies to take advantage of the Regulation A framework.

Under the November Rules, the investment limits on both Reg A and Reg CF are raised to $75 million (Tier 2)[31] and $5 million[32] respectively. The SEC also changed the per investor limitations under Reg CF to allow accredited investors to have no limit on how much they can invest and non-accredited investors limits based upon the *greater* of the income or net worth standards (it is currently the lesser).[33] Additionally, investment limits under Rule 504 of Regulation D will be raised from $5 million to $10 million.[34]

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[28] *Id.* at 98.

[29] *Id.* If an issuer uses a generic test-the-waters communication under the new Rule 241 (*see infra* note 37 and accompanying text), and then launches an offering under Reg CF or Regulation A within 30 days, then any written communication or broadcast script from the Rule 241 communication must be included with the applicable public offering statement. If an issuer uses a Rule 241 communication and then launches a Rule 506(b) offering within 30 days, then any written communication or broadcast script must be provided to any non-accredited purchaser.

[30] 17 C.F.R § 227.100(a)(1) (2020).

[31] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, *supra* note 24, at 134.

[32] *Id.* at 148.

[33] *Id.*

[34] *Id.* at 140.

f. Other Notable Changes

The November Rules also included other changes to the private placement regulatory framework. Some of these changes include:

- Creating four nonexclusive safe harbors from integration—potentially allowing offerings to be separated by as little as 30 days;[35]

- Creating a "demo day" exception for certain types of communications from general solicitation or general advertising;[36]

- Creating a new Rule 241 allowing for a generic solicitation of interest before the issuer has decided on an exemption.[37]

- Harmonizing the financial disclosure requirements in 506(b) to the financial disclosures that issuers must provide in Regulation A;[38] and

- Adding a new item to the non-exhaustive list of accredited investor verification methods in 506(c) that allows an investor, subject to a five-year lookback limit, that was previously verified by the issuer to provide a written representation that no new information regarding their status as an accredited investor has changed as a sufficient verification method for subsequent offerings under 506(c).[39]

g. Updates to Section 12(g)

Section 12(g) of the Exchange Act requires issuers to register their securities if the issuer meets a certain amount of total assets *and* number of shareholders.[40] Under the JOBS Act, the SEC initially raised this threshold to more than $10 million in total assets and if the issuer has 2000 persons—or 500 total unaccredited investors.[41] These thresholds have quickly made Reg CF offerings unattractive according to feedback from several crowdfunding platforms. Platforms cite the total asset amount being a poor indicator of a company's size or sophistication and the relatively small average investment amounts, increasing the risk of having more than 2000 shareholders.

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[35] *See* note 24, 11 – 75.

[36] *See* note 24, 77 – 85.

[37] *See* note 24, 90 – 95.

[38] *See* note 24, 112 – 18.

[39] *See* note 24, 105 – 11. There have been early discussions amongst Committee members that this could potentially be the needed change to make the general solicitation benefits of 506(c) attractive enough for wider adoption in venture capital investments.

[40] Securities Exchange Act of 1934, 15 U.S.C. § 78l(g)(1) (2015).

[41] Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act: A Small Entity Compliance Guide, U.S. SECURITIES AND EXCHANGE COMMISSION (May 24, 2016), *available at* https://www.sec.gov/info/smallbus/secg/jobs-act-section-12g-small-business-compliance-guide.htm.

Commenters to the Concept Release generally advocated for a Reg CF and Regulation A exemption from these 12(g) limits to preclude private issuers from having to register their relatively low dollar investments. One commenter advocated that if there was no blanket exception to harmonize Section 12(g) as it applies to Reg CF, then Reg CF offerings should follow the 50M annual revenue exceptions from 12(g) for Tier 2 offerings under Regulation A. The SEC did not advocate for any changes in the March Proposal. However, the SEC did explicitly ask for feedback from the public on if the crowdfunding vehicle changes should be considered a single or multiple record holder for purposes of 12(g). After taking public feedback, the SEC adopted changes in the November Rules to Exchange Act Rule 12g5-1 "that a crowdfunding vehicle should constitute a single record holder in the crowdfunding issuer for purposes of Section 12(g) of the Exchange Act, but only to the extent that all investors in the crowdfunding vehicle are natural persons."[42] While this change does not address every concern raised in the comments to the Concept Release, as long as the crowdfunding issuer uses a crowdfunding vehicle for the issuance, it can now potentially avoid many of the previous Section 12(g) concerns.

IV. SECONDARY TRANSFERS FOR PRIVATE SECURITIES

The average holding period for investors in emerging and high-growth companies has been increasing. Venture capital fund limited partners often put pressure on their managing partners to provide liquidity for their investments, which adds pressure to both the startups and their investors to continue to grow the business and enhance exit opportunities.

Currently, Rule 144 and Section 4(a)(7) of the Securities Act provide a safe harbor and exemption for certain holders of restricted private securities to sell their positions[43] thereby allowing early investors opportunities for liquidity. However, the investors and issuers have found the current process under this rule and exemption challenging to navigate. This Committee found 38 comments that advocated for changes to improve safe harbors and exemptions on secondary transfers for privately held securities.

a. Determining Compliance and Preemption

Secondary transferrers relying on Rule 144 or the recently codified transaction exemption in Section 4(a)(7) often find determining if the transfer will qualify and complying with the requirements to be expensive and time-consuming. As examples, there is uncertainty if the investors attempting to sell their interests under Rule 144 would be considered "affiliates," and the information requirement in Section 4(a)(7) is extensive (see below).

[42] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, *supra* note 24, at 180.

[43] 17 C.F.R § 230.144 (2020).

Additionally, unless the shares transferred are "covered securities"[44] with federal preemption from state securities regulations, additional time and costs are incurred to ensure the transfer will comply with state securities regulations as well. Some commenters suggest that these uncertainties need to be addressed by the SEC, and the SEC should allow for these secondary transfers to have preemption. However, it is important to note that one of the biggest critiques for allowing these transactions to have preemption was state securities regulators who believe that doing so would significantly reduce investor protections.

b. Changes to the Definition of Qualified Institutional Buyer

Participants in Rule 144A secondary transfers are Qualified Institutional Buyers ("QIBs") as defined in Rule 144A(a)(1).[45] Regulatory bodies view QIBs as sophisticated and do not need the same level of investor protections as other types of buyers. Further, QIBs have certain financial thresholds that must be met to qualify as QIBs under Rule 144A and participate in these private secondary transactions.

There were several comments on proposed changes to the QIB definition. The first suggested update was to include collective investment trusts (CITs) that include participants in self-employed retirement plans for individuals that run unincorporated business (H.R. 10 Plans also known colloquially as "Keogh Plans"). Under the current rules, these CITs are unable to participate in Rule 144A sales even if the Keogh participants are sophisticated. Commenters proposed to remove this restriction and allow those CITs to be able to purchase Rule 144A securities as QIBs.

c. Final Updated Rule 144A

The August Rules also included an update to the Rule 144A definition of QIBs. The new rule would make the types of entities included in the accredited investor definition, including the catch-all in Rule 501(a)(9), to also qualify for QIB status if they have $100 million in securities.[46] This update would allow not only these previously excluded entities to invest as accredited investors but also be able to participate in certain secondary transfers. Additionally, the proposed updates would also allow for H.R. 10 plans to participate in Rule 144A transactions if they meet the new securities test. This final rule will greatly expand the institutions capable of participating in the private secondary sale market.

d. Information Disclosures

Additionally, consistent public comments on secondary transfers stated that the current Section 4(a)(7) informational disclosure requirements are often impractical. The current rules require the issuer to supply GAAP compliant financials to the potential purchaser. The time and

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[44] A security sold in a transaction exempt under Section 4(a)(7) is a covered security. *See* 15 U.S.C. § 77r(b)(4)(G). Securities resold under the Rule 144 safe harbor (i.e., exempt under Section 4(a)(1)) are not covered securities unless the issuer is a 1934 Act reporting company. *See* 15 U.S.C. § 77r(b)(4)(A).

[45] *Id.*

[46] Amending the "Accredited Investor" Definition, *supra* note 11, at 87.

high costs associated with preparing these financials are often a significant impediment for issuers. A few commenters proposed that these information requirements be relaxed or removed to better facilitate these types of exempt transactions. They argue that Section 4(a)(7) buyers, as accredited investors, are sophisticated enough and that the Section 4(a)(7) informational requirements should more closely match Rule 506(b), which does not require specific disclosure if the offering is limited to accredited investors.

e. Shorten the Holding Period Requirements

Currently, a purchaser under Rule 144 is required to hold the security for at least 12 months for a non-reporting company and six months for a reporting company before they can sell their interests. Many commenters advocated for reducing this holding period requirement. The general argument is that the holding period introduces more risk and uncertainty for these securities buyers. By lowering the holding period requirement, they argue that this would provide better prices and terms for selling investors and reduce the purchaser's risk of holding the securities.

V. ALLOWING GREATER RETAIL ACCESS TO PRIVATE MARKETS

Perhaps the most controversial of the comments to the Concept Release, many commenters (43) submitted proposals to expand the types of funds that would be permitted to invest in private markets. While the recommendations and comments under this broad topic did vary considerably, the following are broad common themes.

a. Greater Fund Access to Private Markets

Publicly traded funds are limited in their ability to invest in private markets. As was previously stated, companies are staying private longer, thereby reducing the access and exposure that these funds can get to emerging markets. Additionally, funds that invest in the private market are arguably the best way for retail investors to gain diversified exposure to startup and emerging companies.

While the comments suggested many rule changes to let these funds invest, most were intended to improve retail access to private markets. A synopsis of those changes are:

- Allowing target-date funds and internal funds to invest more than 15% of their assets in illiquid private securities;

- Allowing retail investors to invest in fund-of-funds that hold private securities rather than current rules that just allow for accredited investors to invest in these funds; and

- Allowing Business Development Companies, as defined in the 1940 Investment Act, to invest in certain private funds without limit and with more than 15% of their assets while selling their securities to accredited investors.

b. Significant Criticism

Comments within this area had the most groups and individuals urging the SEC not to consider allowing greater retail access to private markets. The prevailing concern is that these markets and mechanisms to invest in emerging private companies are more likely to expose retail investors to fraud. While some proponents argue that there is not sufficient evidence to show that private markets have higher rates of fraud, many commenters took issue with the very fact that the SEC would consider these changes. They believe the SEC's objective is not to provide greater access and liquidity to investment but to solely focus on protecting investors.

VI. COMMITTEE RESPONSE

This Committee is comprised of partners and associates in law firms from diverse practice areas, venture capital firms, startups, and in-house counsels. We benefit greatly from the wealth and diversity of our members' experiences and perspectives. The Concept Release, the public comments, the August Rules to the accredited investor definition under Rule 501(a), and the November Rules have all been exciting developments in securities law practice. This final section gives some of the Committee's opinions on the recent developments and where opportunities for further evolutions in private placement securities are warranted.

a. The Finalized Updates to the Accredited Investor Definition

The updates in the August Rules mostly make sense. Expanding and clarifying the types of entities that can participate in Regulation D transactions will expand emerging company opportunities for capital formation. Additionally, there were no compelling reasons to keep these entities (with the additional qualifications) from investing in early-stage startups. It is unlikely that these changes will drastically alter the makeup of investors in small and emerging companies. However, these changes do give more parity to previously overlooked types of entities for which there wasn't a compelling reason not to let them invest.

On the other hand, the inclusion of the professional certification standard in the August Rules creates uncertainty about how it will impact early-stage investment. Holding a Series 7, Series 65, or Series 82 licenses certainly demonstrates the investor's ability to appropriately weigh the inherent risk associated with early-stage investments. However, even if the investor will become accredited through one of these professional licenses, it is unclear how many of those individuals will choose to invest in startups. Current individual investment amounts amongst angel groups typically start at around $5000 per investment. Without any additional updates, it is unclear how many of these license holders will have the financial appetite to make the necessary number of investments to diversify their risk.

Additionally, the August Rules left open what other professional certifications will apply for and qualify its members under these new criteria. It will likely take years for the SEC to solidify their qualification criteria and accrediting bodies to qualify their members. There is much uncertainty on how this will impact early-stage investment though it is unlikely to have any immediate impacts.

b. Updating the JOBS Act

To date, the JOBS Acts has not had a significant impact on private company capital formation. As was discussed in the comments, the current regulations do not effectively address the typical capital forming process for startups.[47] The disclosure requirements and fundraising limits certainly hamper the attractiveness of Reg CF and Reg A fundraising for startups. These are aspects that continue to make fundraising relying on Rule 506(b) the most attractive for both issuers and investors.

From the Committee's perspective, the two most pragmatic updates to the JOBS Act from the November Rules are allowing SPV's to be formed for Reg CF offerings and raising the investment limits. The comments describing angel and venture capital investors being wary of large amounts of early investors are not overstated. These investors are heavily involved in company administration and want to limit the risk of complicated interactions and communications with investors.

Further, by increasing the maximum investment limits for Reg CF offerings to the new $5 million maximum allows a Reg CF offering to be a pragmatic substitute to the traditional Seed and Series A rounds for high-growth startups. This higher threshold allows companies to raise an amount of capital that better aligns with the capital needs of traditional Series A rounds relying on 506(b) for similarly situated companies. Updating Reg CF with both of these proposed changes would significantly improve assimilating crowdfunding into the greater early-stage fundraising ecosystem. This Committee is in general support of the changes published in the November Rules.

c. Broadening Secondary Transfer Regulations

The time-to-exit on investments has only been increasing over the past 20 years. Companies are staying private longer, which requires investors to wait longer before realizing returns on their investments. Rule 144 and Section 4(a)(7) exists but, as discussed in the commentary, imposes costly burdens on both issuers and investors to produce the necessary disclosures and compliance to sell their securities.

This Committee endorses the suggestion put forth by AngelList[48] in their comments on secondary transfers.[49] They advocate for the SEC to create a "Qualifying Private Sale" safe harbor to Section 4(a)(7) for a self-executing limit sale to accredited investors. It would have the following general characteristics:[50]

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[47] This committee defines a startup as a high-growth company, typically through technology, that is raising capital to rapidly grow and scale its operation. This definition is not inclusive of traditional small businesses, but we recognize the term is often used interchangeably with all early businesses.

[48] Erik Syvertsen of AngelList is a current Committee member.

[49] AngelList, Comment Letter on Concept Release on Harmonization of Securities Offering (Sept. 25, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6203757-192567.pdf.

[50] For a more detailed explanation of these characterization, please read the AngelList commentary on the Concept Release.

- Available only for sales to accredited inventors
- Available only for securities issued by private issuers
- Available only below a limited transaction size
- General Solicitation permitted
- No affirmative disclosure requirements
- Clarifying the outstanding class requirement in Section 4(a)(7)(d)(8)
- Updates to Section 12(g) to only count transfers from a single seller to a holder as a single beneficial owner
- Private securities litigation safe harbor
- Would not be integrated with primary offerings or sales under Regulation D
- Allow platforms to facilitate these transactions without registering as broker-dealers
- Be a covered security for purposes of blue-sky preemption

We believe that such an approach would best balance investors' interests in early-stage startups, the companies, and the SEC's interest in preventing investor fraud. Allowing early investors to exit their positions will increase the amount of capital available to fund new companies. Shortening the investment to exit period with the safe harbor could create a multiplier effect for the entire early-stage funding ecosystem, catalyzing company and job creation.

Further, the SEC should clarify the tender offer rules as they apply to private companies. The current rules present a massive barrier to secondary transactions in private markets and add a legal and compliance cost burden for buyers as tenders are typically sophisticated and insiders. Since the SEC has not been clear on the rules and applicability of the public tender rules to private companies, many private companies follow some form of the public company tender rules when conducting private secondaries consisting of more than ten holders. A cottage industry has formed to help companies navigate these rules' ambiguous nature as they apply to private companies. This Committee is in favor of simplifying and clarifying the tender offer rules as they apply to private companies.

VII. CONCLUSION

The COVID-19 pandemic has ushered in an era of increased volatility and uncertainty to the global economy. Many industries and high performers of the previous decade have not been faring particularly well as domestic and foreign economies react to social distancing and other new life and work paradigms. The pandemic's long-term impact on startups and venture capital firms that fund them remains to be seen.

Just as the 2008 Financial Crisis required a historic policy response that included the JOBS Act, the COVID-19 pandemic induced economic contraction requires a similarly robust response from policymakers. The pandemic response should encourage the SEC to continue the efforts begun last summer. A low rate environment, economic stimulus, and successful IPOs are likely to ensure that capital remains available to the most promising new companies and technologies. Updating existing frameworks and regulations will reduce specific investment barriers and make startup investing more equitably distributed while also maintaining necessary investor protections. The SEC's continued modernization of these rules is vital to encouraging the funding and creation of the next generation of emerging technology companies in this country.

We look forward to seeing the impacts of the August Rules on accredited investors, if the November Rules will expand access to capital for startups, and other future proposals put forth by the SEC in response to the comments on the Concept Release. Comparing this Committee's classification of comments on the Concept Release to what the SEC has already begun to change suggests the next proposed rules will in some part touch on broadening the secondary transfer requirements or on allowing greater retail investor access to the private securities markets.

This Committee believes in the positive impacts that early-stage companies have on the broader economy. By committing to make thoughtful improvements to early-stage capital raising regulation, the SEC is creating more opportunities for founders to grow and scale their products. We are confident that this private placement harmonization effort will have lasting positive impacts on American innovation.

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