STINSON

News & Insights

SEC Proposal Paves the Way for Contemporaneous 506(b)/506(c) Fund Raising Strategies

Insight
05.15.2020

The Securities and Exchange Commission (SEC) announced the proposal of certain amendments that would "simplify, harmonize and improve certain aspects of the exempt offering framework." Specifically, the SEC proposes replacing the five-factor test currently used to evaluate integration issues for offerings outside the Rule 502(a) safe harbor, with the general principle that offerings will not be integrated if, based on the particular facts and circumstances, the issuer can establish that each offering either complies with the registration requirements of the Securities Act, or that an exemption from registration is available for the particular offering.

The proposal builds on the work begun with the enactment of the Jumpstart Our Business Startups Act (JOBS Act) in 2012, pursuant to which the SEC amended Rule 506 of Regulation D, a widely used securities exemption for private companies raising money from investors. The addition of new Rule 506(c) created an offering exemption, which eliminated the ban on general solicitation and advertising, so long as:

- The investors in the offering are all accredited investors
- The issuer takes reasonable steps to verify that the investors are accredited investors (which could include reviewing documentation, such as W-2s, tax returns, bank and brokerage statements, credit reports and the like)

By contrast, under Rule 506(b), issuers can make offers and sales to accredited investors without investor verification requirements, but issuers are not permitted to use general solicitation and advertising methods. Both rules permit potentially unlimited capital raises.

SEC Proposal Paves the Way for Contemporaneous 506(b)/506(c) Fund Raising Strategies

The Rule 506(c) exemption has become a favorite of virtual issuer-investor matchmakers such as CrowdStreet, an internet-based crowdfunding marketplace serving real estate sponsors seeking passive capital from a large pool of individual investors. This model has shown promise – earlier this year, CrowdStreet reported that it had eclipsed the $1 billion mark for online investments. According to Statista, crowdfunding raises as a whole in North America topped $17 billion a year starting in 2018, and have a forecasted annual growth rate over 14% for the upcoming years with a potential to mature to a $300 billion market by 2030.

However, the establishment of Rule 506(c) adds complexity to the ongoing debate of whether two or more offerings should be "integrated." The concern from the SEC has been that simultaneous Rule 506(b) and 506(c) offerings from the same issuer, could result in generally solicited investors under the Rule 506(c) offering unlawfully subscribing to the Rule 506(b) offering.[1]

SEC integration rules seek to prevent issuers from improperly avoiding registration by duplicating a single offering into multiple versions under two or more separate exemptions. The safe harbor provisions of Rule 502(a) provide that offers and sales made more than six months before the start, or after the completion, of a Regulation D offering will not be considered an integrated part of that Regulation D offering so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under that Regulation D offering.[1]

For offerings where the Rule 502(a) safe harbor is unavailable, a five-factor test determines whether offers and sales should be integrated:

(a) Whether the sales are part of a single plan of financing

(b) Whether the sales involve issuance of the same class of securities

(c) Whether the sales have been made at or about the same time

(d) Whether the same type of consideration is being received

(e) Whether the sales are made for the same general purpose

The recent emergence of the crowdfunding market and growing popularity of Rule 506(c) offerings provides new opportunities but also creates new challenges to sponsors who once solely depended on Rule 506(b) offerings for capital raises. Consider a hypothetical example of fictional sponsor Ezekiel, seeking to finance the $50 million purchase and renovation of the soon to be Ezekiel's Amusement Park. Previously, Ezekiel's predominant capital formation tool would have been a Rule 506(b) offering. Without the ability to use any general solicitation or advertising, raising that amount of capital could prove difficult or nearly impossible, especially if the project involved the type of time sensitive investment funding deadlines typical to real estate ventures. Clearly the ability to broaden the net of potential investors via general solicitation and advertising under Rule 506(c) is a useful tool, whether via a crowdfunding platform or the sponsor's independent promotional activities.

However, the present integration regime is such that if sponsor Ezekiel attempted to raise the entire $50 million under Rule 506(c) but ultimately fell short of the target, he would be unable to conduct a subsequent Rule 506(b) offering to backfill any deficient amounts for at least six months. The proposal offers a way to conceptually separate the Rule 506(c) and Rule 506(b) offerings for integration purposes even when the capital is ultimately used for the same general purpose.

The most significant aspect of the proposal would be to shorten the safe harbor waiting period between a Rule 506(c) offering and subsequent Rule 506(b) offering from six months to 30 days if one of the following requirements is met:

> (i) The issuer has a reasonable belief that the investors in the Rule 506(b) offering were not solicited using general solicitation
>
> (ii) The issuer (or person acting on the issuer's behalf) had established a substantive relationship with the investors prior to the commencement of the Rule 506(b) offering

Hence, any offering that satisfies one of the above requirements and is made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, would not be integrated.

The traditional five-factor test may still be available for offerings made during the 30-day safe harbor window.

Additionally, the proposal cautions issuers that the SEC continues to believe that "an issuer will not be considered to have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, require only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status."

Returning to the hypothetical example, the enactment of the SEC's proposal would allow Ezekiel to finance his amusement park using subsequent Rule 506(b) and 506(c) offerings if he complied with the aforementioned conditions.

The COVID-19 crisis has pushed much of the global population into remote environments and individuals become more comfortable operating online. Issuers, investors and their counsel should expect to see even greater growth in digitally promoted investments and crowdfunding platforms utilizing Rule 506(c) offerings to generally solicit and raise capital for projects, and should be prepared to adapt if the proposal is formally adopted.

---

[1] Please note that although integration questions arise between Rule 506(c) and other exemptions, this article focuses only on the most widely used exemptions, by far: Rules 506(b) and 506(c).

RELATED CAPABILITIES

Banking & Financial Services

Corporate Finance

Private Business