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SEC's New Exempt Offering Rules: Demo Days and Testing the Waters — All Glister No Gold?

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Issuers will likely hesitate to use some of the new changes — including the new "demo days" and "testing-the-waters" communications — due to limitations on those activities under other laws, including the Investment Company Act and state "blue sky" laws.

On November 2, the Securities and Exchange Commission (SEC) issued a final rule amending the exempt offering framework to harmonize registration exemptions, eliminate complexity, and facilitate access to capital — all while preserving investor protection. See our previous client alert that provides a high-level overview of the exempt offering framework concept release prior to finalization. Now that the final rule is upon us, will issuers get a boost in capital raising from the new rules to increase access to private capital? While issuers may celebrate some of these new changes, as well as earlier changes modernizing the accredited investor definition, certain portions of the new rule seem more glister than gold. Specifically, the SEC's expansion of an issuer's ability to reach potential investors through "demo days" communications and through "testing-the-waters" generic solicitations before an exempt offering includes accompanying caveats and limitations on those activities under other laws that will likely cause issuers hesitation to use the new changes.

Demo Days

Rule 148 allows that certain demo day communications will not be deemed general solicitations or general advertising if the communications are made in connection with a seminar or meeting sponsored by a college, university, or other institution of higher education, state or local government or instrumentality of a state or local government, a nonprofit or an angel investor group, incubator or accelerator.

The rule further provides that to qualify as a demo day communication, more than one issuer needs to participate, and the sponsors may not:

- Make investment recommendations or provide investment advice to attendees of the event;
- Engage in any investment negotiations between the issuer and investors attending the event;
- Charge event attendees any fees, other than reasonable administrative fees;
- Receive any compensation for making introductions between event attendees and issuers, or for investment negotiations between the parties; or

- Receive any compensation with respect to the event that would require it to register as a broker or dealer under the Securities Exchange Act of 1934 or as an investment adviser under the Investment Advisers Act of 1940.

Further, event advertising may not reference any specific offering, and to protect against broad offering-related communications to nonaccredited investors, virtual events are limited to (1) individuals who are members of, or otherwise associated with, the organization hosting the event, (2) individuals that the sponsor reasonable believes are accredited investors, or (3) individuals who have been invited to the event by the sponsor based on industry- or investment-related experience reasonably selected by the sponsor in good faith and disclosed in the public communications about the event.

During the event the issuer can only communicate the following information with respect to a planned capital raise:

- Notification that the issuer is in the process of offering or planning to offer securities;
- The type and amount of securities being offered;
- The intended use of the proceeds of the offering; and
- The unsubscribed amount in an offering.

The foregoing allows issuers to note unequivocally plans to raise capital. However, the limitations are intended to allow discussions with potential investors without jeopardizing their ability to rely on certain exemptions that, for instance, prohibit general solicitation or advertising. Under the final rules, qualifying demo day communications will not be considered general solicitations, thus, the rule opens the window to communicate with investors within the parameters of an exempt offering that does not allow general solicitation.

The question remains whether the limitations on who can sponsor demo day events will really increase access to capital under the new rule. The SEC acknowledged in its final rule that the primary purpose for limiting the allowable sponsors to those listed should exclude organizations that have a profit interest or whose primary goal is to attract investors to private issuers. The SEC left the door open for private fund managers and other persons authorized to act on behalf of issuers to organize nonprofit organizations to sponsor demo day events — a potential trend to watch for…

Testing the Waters

New Rule 241 provides an exemption from the prohibition on offers prior to filing a registration statement in Section 5(c) of the Securities Act of 1933 that allows issuers to make a generic solicitation of interest before an exempt offering. The new rule is similar to the exemption for solicitations of interest under Securities Act Rule 163B for registered offerings, allowing issuer representatives to gauge interest through discussions with qualified institutional buyers and institutional accredited investors. Like Rule 163B, Rule 241 provides an exemption from registration only — the solicitations will be deemed offers of securities for sale for purposes of the antifraud provisions of the federal securities laws. Unlike Rule 163B, solicitations under Rule 241 are not limited to certain

prospective investors, nor do the solicitations need to note on what exemption the issuer plans to rely. However, issuers should be wary of these new testing-the-waters solicitations because they may be deemed to be a general solicitation and could ruin a potential exemption from registration or even exceptions relied upon with respect to the Investment Company Act (ICA) — most private funds rely on the exceptions to the definition of "investment company" under Section 3(c)(1) and 3(c)(7) of the ICA, which are not available for public offerings, making it unclear if a testing-the-waters communication that is deemed a general solicitation would constitute a public offering under the ICA.

The general solicitation issue can pose a problem for an issuer taking advantage of this new testing-the-waters rule and then later deciding to conduct a private placement under Regulation D, Rule 506(b) or 4(a)(2), each prohibiting general solicitation. If the generic solicitation of interest allowed under Rule 241 occurred in a manner to be deemed a general solicitation, the issuer will have to analyze whether the testing-the-waters communication will be integrated into the private placement, thus ruining the exemption. As part of the final rule, new Rule 152 provides a hard 30-day stop for integration in this situation if the issuer has reasonable belief, based on the facts and circumstances, with respect to each purchaser in the exempt offering prohibiting general solicitation, that the issuer (or any person acting on the issuer's behalf) either: (1) did not solicit such purchaser through the use of general solicitation; or (2) established a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation. However, issuers are likely better off avoiding a testing-the-waters communication that is deemed a general solicitation if they are considering a private placement.

Under Rule 241, testing-the-waters materials must include language regarding the limitations of generic solicitations, specifically the following:

- The issuer is considering an offering of securities exempt from registration under the Securities Act, but has not determined a specific exemption from registration the issuer intends to rely on for the subsequent offer and sale of the securities;

- No money or other consideration is being solicited, and if sent in response, will not be accepted;

- No offer to buy the securities can be accepted and no part of the purchase price can be received until the issuer determines the exemption under which the offering is intended to be conducted, and where applicable, the filing, disclosure, or qualification requirements of such exemption are met; and

- A person's indication of interest involves no obligation or commitment of any kind.

The materials may, however, include means for a person to indicate interest in the potential offering. Depending on the type of offering that follows, testing-the-waters materials may need to be filed or attached as an exhibit to the offering materials if such offering is commenced within 30 days of the testing-the-waters communication.

Furthermore, and perhaps the biggest blow to the utility of the new rule, the SEC explicitly noted that Rule 241 does not preempt state blue sky laws, so issuers looking to test the waters will first need to determine any applicable state laws before proceeding.

Similar to the demo day rule, the new testing-the-waters rule for exempt offerings leaves us questioning its ultimate usefulness — while issuers can limit communications to avoid a general solicitation, issuers considering a private placement or otherwise avoiding general solicitations should carefully consider this risk before charging forward to test the waters before every offering. Further, without preemption, the cost of navigating blue sky laws may outweigh the benefit of preemptively soliciting interest before an offering commences. The SEC left the door open to hear concerns regarding the effect of blue sky laws on the efficacy of the new rule, which may eventually lead to preemption and ultimately a far more useful rule.

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