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THE SEC'S EVOLVING INTEGRATION DOCTRINE

NEW GUIDANCE ON COMBINING OFFERING METHODS

THE SEC'S EVOLVING INTEGRATION DOCTRINE: NEW GUIDANCE ON COMBINING OFFERING METHODS

In 2015, in a trilogy of releases on early-stage capital-raising,[1] the U.S. Securities and Exchange Commission (SEC) took bold steps to clarify its integration guidance. The result changes the textbook[2] on how various securities-based offering methods can be combined. A long-required five-factor test that often blunted the concurrent use of different offering methods has now been replaced in many contexts with a unitary framework. This focuses on whether advertising and solicitation in one offering is improperly conditioning the market for another. In addition, updated integration safe harbors permit (or propose to permit) the serial use of different offering methods without risk that two such offerings might be deemed to be a single offering (integrated). This new guidance gives companies more flexibility than they had before to conduct concurrent and serial offerings using different methods within the U.S. menu of early-stage capital-raising options.[3] See Exhibit A for an Integration Risk Matrix concisely summarizing the author's findings.

The five factor test

The question of whether two or more offerings should be integrated is nearly as old as federal securities law itself.[4] The intent of the doctrine is to prevent an issuer from improperly avoiding registration under the Securities Act of 1933, as amended (the Securities Act), by artificially dividing a single offering that has no registration exemption into multiple offerings that technically fit within two or more separate exemptions.[5]

The traditional test for this determination is whether (1) different offerings are part of a single plan of financing; (2) the offerings involve issuance of the same class of security; (3) the offerings are made at or about the same time; (4) the same type of consideration is to be received in each offering; and (5) the offerings are made for the same general purpose (collectively, the Five-Factor Test).[6]

1 SEC Release No. 33-9974, Final Rule: Crowdfunding (Oct. 30, 2015) [the "Crowdfunding Adopting Release"]; SEC Release No. 33-9973, Proposed Rule: Exemptions to Facilitate Intrastate and Regional Securities Offerings (Oct. 30, 2015) [the "Rule 147 Proposing Release]; and SEC Release No. 33-9741, Final Rule: Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A) (March 25, 2015) [the "Reg A Adopting Release"].

2 For a description of the traditional integration guidance, *see* J. C. Coffee, Jr. and H. Sale, Securities Regulation, Cases and Materials, Twelfth Ed., Foundation Press, 444-449 (2012).

3 For a description of the U.S. menu of early-stage capital-raising options, see J.W. Parsont and J. Zonis, The U.S. Menu of Early-Stage Capital-Raising Options, Lessons for the European Commission, CLS Blue Sky Blog (June 22, 2015), available at http://clsbluesky.law.columbia.edu/2015/06/22/the-u-s-menu-of-early-stage-capital-raising-options-lessons-for-the-european-commission/.

4 *See* R. Campbell, The Overwhelming Case for Elimination of the Integration Doctrine Under the Securities Act of 1933, 89 Ky. L.J. 311-312 & n.70. (2001-02) (explaining that the first integration safe harbor, Rule 152, was adopted in 1935).

5 *See* the Crowdfunding Adopting Release, *supra* note 1 at p. 15, footnote 18.

6 *See* Final Rule: Nonpublic Offering Exemption, Release No. 33-4552 (Nov. 6, 1962).

The consequence of finding that two offerings should be integrated is that the integrated offering must satisfy, in full, the conditions of a single exemption.[7] Failing to do so can lead to rescission[8] and a five-year capital-raising injunction under the "bad actor" rules.[9]

Imagine, for example, that a company is planning concurrent offerings under Rule 506(c) and Regulation Crowdfunding.[10] As Rule 506(c) permits, the company plans to use general solicitation and advertising through Facebook and Twitter to generate interest in a $2 million offering of common stock that will be available to only accredited investors without imposing any other investment limits. Simultaneously, as Regulation Crowdfunding permits, the company plans to use the same social media channels to generate interest in a $1 million offering of the same common stock that will available to all investors (even non-accredited investors), subject to the investment limits imposed by Regulation Crowdfunding. In both cases, the advertisements and solicitations are planned to be limited to only the information permitted under Regulation Crowdfunding. In isolation, each offering would appear to comply with the requirements of the applicable exemption for that particular offering.

But if the Five-Factor Test is applied, the two would be integrated because, in reality, they represent (i) a single capital-raise, (ii) selling the same securities, (iii) at the same time, (iv) for cash, and (v) for the same general purpose. As a result, the presence of non-accredited investors would render Rule 506(c) unavailable and the failure to apply investment limits to the Rule 506(c) investors would render Regulation Crowdfunding unavailable.[11] In turn, companies may be deterred from combining Rule 506(c) and Regulation Crowdfunding due to the prospect of rescission or sitting in a penalty box for five years. This would be the wrong result if the capital formation benefits of combining them are found to outweigh the risks posed to investors.

Recognizing the limitations of the Five-Factor Test, the SEC adopted various safe harbor rules and other guidance throughout the years to displace its application where it believed it was appropriate.[12] In some contexts, such as Regulation S and Rule 144A offerings, the SEC displaced the test entirely, resulting in a strong-form non-integration position that facilitated the use of this combination, even in concurrent offerings. In other contexts, such as Regulation A and Rule 506 offerings, the SEC displaced the test for Rule 506 offerings that

7 *See* Coffee and H. Sale, *supra* note 2 at 444 (2012) ("for an exemption to be available, each transaction must satisfy all of the conditions of a single exemption"). Notably, the SEC has adopted certain rules to permit insignificant deviations from compliance in some contexts. *See, e.g.*, Rule 508 under Regulation D of the Securities Act.

8 *See* Section 12(a)(1) of the Securities Act.

9 *See, e.g.*, Rule 506(d)(v)(B) under Regulation D ("No exemption under this section shall be available for a sale of securities if the issuer . . . Is subject to an order of the Commission entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a violation or future violation of . . . Section 5 of the Securities Act").

10 Notably, Regulation Crowdfunding will not become effective and available for use until May 16, 2016. *See* the Crowdfunding Adopting Release, *supra* note 1.

11 Notably, the $1 million cap in Regulation Crowdfunding would not be breached by the $2 million capital-raise under Rule 506(c) because Regulation Crowdfunding only counts other offerings under Regulation Crowdfunding in the prior twelve months against the offering cap limitations.

12 *See e.g.*, Rule 502(a) under Regulation D, Rule 147(g), Rule 251(c) under Regulation A, Rule 144A(e), Rule 701(f), Rules 152 and 155 (concerning serial completed and abandoned private and public offerings), Division of Corporation Finance no-action letters to Black Box Incorporated (June 26, 1990) and Squadron, Ellenoff, Pleasant & Lehrer (Feb. 28, 1992) (concerning concurrent private and public offerings), and Securities Act Release No. 33-6863, Final Rule: Offshore Offers and Sales (Apr. 24, 1990) [the "Regulation S Release"].

precede Regulation A offerings, but did not when the Regulation A offering followed the Rule 506 offering within six months or was concurrent with it.

In other contexts, such as a combination of Rule 506 with any other available exemption under Regulation D (an "Intra-Regulation D Combination"), the SEC preserved the Five-Factor Test, except where (i) six months had passed between the completion of the first offering and the start of the second and (ii) there were no intervening offers or sales of similar securities (a "Clean Six-Month Period").[13]

New guidance in 2015[14] does not change the status quo for Intra-Regulation D Combinations, but it nonetheless implements the boldest downsizing of the Five-Factor Test to date. Building off of earlier guidance pioneered in the concurrent private and public offering context, the SEC has indicated that it will allow concurrent and serial combinations of Rule 506 offerings with each of Regulation A, proposed Rule 147, and Regulation Crowdfunding, so long as solicitation and advertising in one offering does not improperly condition the market for the other. This unitary framework (the Solicitation Guidance), which is described below, displaces the Five-Factor Test where it is applied. In addition, updated safe harbors provide airtight assurance of non-integration in certain other contexts. As a result, companies will face less integration risk, which may unlock significant value in combining different offering methods.

Summary and evaluation of the latest guidance

The origin of the SEC's Solicitation Guidance dates back to a 2007 proposing release and a subsequent compliance and disclosure interpretation (C&DI) affirming its position[15]. At the time, the SEC was seeking to better facilitate concurrent private placements under Rule 506(b), which do not allow general solicitation and advertising, and registered public offerings. The prior guidance was governed by no-action letters that generally limited the Rule 506(b) component to elite institutions and key officers and directors. Failing to follow this guidance would mean that the Five-Factor Test would apply instead.

But the 2007 Release, together with C&DI 139.25, overruled this prior guidance by disavowing the application of the Five-Factor Test in the "specific situation of concurrent private and public offerings." It clarified that "there can be a side-by-side private offering under . . . Rule 506[(b)] . . . with a registered public offering without having to limit the private offering to qualified institutional buyers and two or three additional large institutional accredited investors."

In its place, the SEC articulated the Solicitation Guidance, which it described as its "framework for analyzing potential integration issues" in concurrent private and public offerings, as follows:

> Specifically, the Commission's guidance focuses on how the investors in the private

13 *See* SEC Release No. 33-9415, Final Rule: Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings at 13, footnote 47 (July 10, 2013) [hereinafter, the "506(c) Adopting Release"]

14 *See supra* note 1.

15 *See* SEC Release No. 33-8828, Proposed Rule: Revisions of Limited Offering Exemptions in Regulation D at 51-56 (Aug. 03, 2007) [the "2007 Release"]. *See also* C&DI Question 139.25 (Nov. 26, 2008) ["C&DI 139.25"], available at http://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

> offering are solicited – whether by the registration statement or through some other means that would not otherwise foreclose the availability of [Rule 506(b)]. If the investors in the private offering become interested in the private offering by means of the registration statement, then the registration statement will have served as a general solicitation for the securities being offered privately and [Rule 506(b)] would not be available. On the other hand, if the investors in the private offering become interested in the private offering through some means other than the registration statement – for example, there is a substantive, pre-existing relationship between the investors and the company – then the registration statement would not have served as a general solicitation for the private offering and [Rule 506(b)] would be available, assuming the offering is otherwise consistent with the exemption. Hence, there would be no integration of the private offering with the public offering.[16]

Accordingly, under the Solicitation Guidance, Rule 506(b) offerings and registered public offerings can co-exist side-by-side, so long as the open advertising and solicitation allowed in the registered public offering context does not improperly condition the market for the Rule 506(b) offering, where solicitations of interest are required to be limited to only friends, family, and other relations that have been deemed "substantive" and "pre-existing."

Nonetheless, C&DI 139.25 did not address whether two offering methods, which both allow general solicitation and advertising subject to different rules can co-exist, except to say that the guidance in the C&DI would "not negate" the Five-Factor Test in other contexts. It said the Five-Factor Test "should be used to test whether two or more otherwise exempt offerings should be treated as a single offering to determine whether an exemption is available."[17]

Yet, in 2015, in a trilogy of releases, this was largely reversed. In the context of concurrent and serial combinations of Rule 506 (b) offerings with each of Regulation A, proposed Rule 147, and Regulation Crowdfunding, the SEC extended the Solicitation Guidance.[18] At the same time, it further extended it to the co-existence of certain offering methods that each allow general solicitation and advertising subject to different rules, so long as the more restrictive advertising and solicitation rules are applied in all general solicitations and advertisements under both concurrent offering methods.[19] This will allow Rule 506(b) and Rule 506(c) offerings to co-exist concurrently and serially

16 *See* C&DI 139.25 *supra* note 15.

17 *Id.*

18 *See, e.g.,* the Reg A Adopting Release *supra* note 1 at 54, footnote 180 ("For a concurrent offering under Rule 506(b), an issuer will have to conclude that purchasers in the Rule 506(b) offering were not solicited by means of a Regulation A general solicitation"). *Accord* Rule 147 Proposing Release *supra* note 1 at 40, footnote 106 and Crowdfunding Adopting Release *supra* note 1 at 19, footnote 28.

19 *See, e.g.,* the Reg A Adopting Release *supra* note 1 at 53-54 and footnote 180 ("an issuer conducting a concurrent exempt offering for which general solicitation is permitted, for example, under Rule 506(c), could not include in any such general solicitation an advertisement of the terms of a Regulation A offering, unless that advertisement also included the necessary legends for, and otherwise complied with, Regulation A"). *Accord* Rule 147 Proposing Release *supra* note 1 at 40 ("an issuer conducting a concurrent Rule 506(c) offering could not include in its Rule 506(c) general solicitation materials an advertisement of a concurrent Rule 147 offering, unless that advertisement also included the necessary disclosure for, and otherwise complied with, Rule 147(f)"); *Accord* the Crowdfunding Adopting Release *supra* note 1 at 19 ("an issuer conducting a concurrent exempt offering for which general solicitation is permitted, for example, under Securities Act Rule 506(c), could not include in any such general solicitation an advertisement of the terms of an offering made in reliance on Section 4(a)(6), unless that advertisement otherwise complied with Section 4(a)(6) and the final rules").

with offerings under Regulation A, proposed Rule 147, and Regulation Crowdfunding.

In addition, under updated integration safe harbors, there is also more (or proposed to be more) certainty that certain combinations can occur serially without regard to the Solicitation Guidance or the Five-Factor Test. For example, no analysis is needed for a proposal to conduct a Rule 506 or Regulation Crowdfunding offering immediately followed by (as opposed to concurrently with) a Regulation A or proposed Rule 147 offering and Regulation A and proposed Rule 147 offerings can be serially combined no matter which comes first.[20] A Regulation A or proposed Rule 147 offering can also precede a Regulation Crowdfunding offering without further analysis, but the Solicitation Guidance would apply to a subsequent Rule 506 offering unless a six-month period (but not a Clean Six Month Period) first passes.[21]

The Five-Factor Test, however, continues to apply in certain contexts where it has yet to be overruled. For example, concurrent Rule 506(b) and Rule 506(c) offerings, which represent an Intra-Regulation D Combination, are still subject to the Five-Factor Test. But given the similarity between these two exemptions, integration may not prevent a company from being able to satisfy all the conditions of a single exemption. So, if there is accidental general solicitation and advertising in a Rule 506(b) offering prior to the consummation of sales (a Foot Fault), a company should be able to cure this problem by selling securities only to verified accredited investors thereafter. This would allow the offering to comply fully with Rule 506(c).[22]

Conclusion

The SEC's Solicitation Guidance has boldly downsized the application of the Five-Factor Test, which now only remains relevant in only a handful of situations. This new guidance on combining offering methods, which is summarized in the Integration Risk Matrix in Exhibit A to this article, may prove to be a boon to private companies seeking to raise multiple rounds of capital concurrently or in close succession. The SEC should consider updating note 2 to Rule 502(a) under Regulation D to reflect its new position and should consider whether the Solicitation Guidance should be extended to cover Intra-Regulation D Combinations as well as others.

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20 *See* Rule 251(c) and proposed Rule 147(g) under the Securities Act.

21 *See* id.

22 While the SEC has proposed amendments to penalize Foot Faults by requiring the filing of a Form D prior to the commencement of general solicitation, such rules have not been, and may not be, finalized. See SEC Release No. 33-9416, Proposed Rule: Amendments to Regulation D, Form D and Rule 156 (July 10, 2013).

EXHIBIT A

Integration Risk Matrix For Concurrent and Serial Offerings[1]					
	Is there risk that Offering No. 2 will be integrated with Offering No. 1?				
Offering No. 1	**Rules 506(b) and 506(c)**	**Proposed Rule 147** *(not law)*	**Regulation Crowdfunding** *(not yet effective)*	**Regulation A**	**SEC Registered Offerings**
Rules 506(b) and 506(c)	■ Yes, for concurrent and serial offerings in the first six months, subject only to the Five-Factor Test. ■ No, if a Clean Six-Month Period intervenes.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for 506-147 serial offerings.	■ Yes, for concurrent and 506-Reg Crowdfunding serial offerings, subject only to the Solicitation Guidance.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for 506-Reg A serial offerings.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for 506-Registered serial offerings.
Proposed Rule 147 *(not law)*	■ Yes, for concurrent and 147-506 serial offerings within less than six months, subject only to the Solicitation Guidance. ■ No, if a six-month period intervenes.	■ No, but note offering cap look-back in prior 12-months in 147-only deals.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for 147-Reg Crowdfunding serial offerings.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for 147-Reg A serial offerings.	■ Yes, for concurrent and 147-Registered serial offerings in the first 30 days, subject only to the Five-Factor Test. ■ No, if a 30-day period intervenes.
Regulation Crowdfunding *(not yet effective)*	■ Yes, for concurrent and Reg Crowdfunding-506 serial offerings, subject only to the Solicitation Guidance.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for Reg Crowdfunding-147 serial offerings.	■ No, but note offering cap look-back in prior 12-months and the one intermediary rule in Reg Crowdfunding-only deals.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for Reg Crowdfunding-Reg A serial offerings.	■ Yes, for concurrent and Reg Crowdfunding-Registered serial offerings, subject only to the Five-Factor Test.
Regulation A	■ Yes for concurrent and Reg A-506 serial offerings within less than six months, subject only to the Solicitation Guidance. ■ No, if a six-month period intervenes.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for Reg A-147 serial offerings.	■ Yes, for concurrent offerings, subject only to the Solicitation Guidance. ■ No, for Reg A-Reg Crowdfunding serial offerings.	■ No, but note offering cap look-back in prior 12-months in Regulation A-only deals.	■ Yes, for concurrent offerings and abandoned Reg A-Registered serial offerings in the first 30 days, subject only to the Five-Factor Test. ■ No, for completed Reg A-Registered serial offerings or for abandoned Reg A-Registered serial offerings if a 30-day period intervenes.
SEC Registered Offerings	■ Yes, for concurrent and Registered-506 serial offerings, subject only to the Solicitation Guidance.	■ Yes, for concurrent offerings, subject only to the Five-Factor Test. ■ No, for Registered-147 serial offerings.	■ Yes, for concurrent and Registered-Reg Crowdfunding serial offerings, subject only to the Five-Factor Test.	■ Yes, for concurrent offerings, subject only to the Five-Factor Test. ■ No, for Registered-Reg A serial offerings.	■ No.

1 This risk matrix summarizes the author's findings based on SEC guidance as of the date hereof. It is not legal advice and should not be relied upon in isolation. Those seeking to assess integration risk under particular facts and circumstances should consult separately with their legal advisor. Excludes, among others, Rule 144A, Regulation S, Rule 504, and Rule 701. Terms with initial letters capitalized are defined in J. W. Parsont, The SEC's Evolving Integration Doctrine: New Guidance on Combining Offering Methods, SEC Reg. S Law Rep. (BNA) (January 4, 2016).

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