Supplement for Chapter 4

Insert on p. 224, before IV. Accuracy of Disclosure

F. Climate Disclosure

In early 2022, the SEC issued proposed rules to impose mandatory climate-related disclosure requirements in both registration statements used in public offerings and periodic filings. Sec. Rel. No. 33-11042 (Climate Release). The proposed rules would require disclosure of:

(1) the registrant's governance of climate-related risks and relevant risk management processes;

(2) how any climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term;

(3) how any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook; and

(4) the impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a registrant's consolidated financial statements, as well as on the financial estimates and assumptions used in the financial statements.

SEC, Press Release 2022-46 (March 21, 2022).

The proposed rules would also require disclosure of greenhouse gas emissions. These disclosures are divided into three "Scope" categories based on the Green House Gas Protocol (GHG Protocol). The GHG Protocol establishes "global standardized frameworks to measure and manage greenhouse gas … emission from private and public sector operations, value chains and mitigation actions." The three Scope categories are as follows:

> *Scope 1*: the company's direct greenhouse gas emissions. According to the SEC, this might include emissions from "company-owned or controlled machinery or vehicles, or methane emissions from petroleum operations."
>
> *Scope 2*: indirect emissions from the company's purchase and consumption of electricity or other forms of energy. The SEC stated that: "Because these emissions derive from the activities of another party (the power provider), they are considered indirect emissions."
>
> *Scope 3*: indirect emissions not accounted for in Scope 2 if *material*. According to the SEC: "These might include emissions associated with the production and transportation of goods a registrant purchases from third parties, employee commuting or business travel, and the processing or use of the registrant's products by third parties."

Climate Release at 39-40.

The proposed rules would require accelerated filers and large accelerated filers to include an attestation report from an attestation service provider with minimum qualifications as specified by the SEC on the Scopes 1 and 2 emissions disclosures. Among other requirements, the attestation service provider must be independent and an "expert in GHG emissions by virtue of having significant experience in measuring, analyzing, reporting, or attesting to GHG emissions." Climate Release at 239-240.

In justifying the proposed rules, the SEC claimed "broad authority to promulgate disclosure requirements that are 'necessary or appropriate in the public interest or for the protection of investors.'" Climate Release at. 7. While referring to the "public interest," the SEC focused specifically on investors stating that "existing disclosures of climate-related risks do not adequately protect investors … we believe that additional disclosure requirements may be necessary or appropriate to elicit climate-related disclosures and to improve the consistency, comparability, and reliability of climate-related disclosures." Climate Release at 8. The SEC also pointed to the increase demand, particularly among institutional investors, for climate-related information from companies. Climate Release at 24.

Of course, climate change and regulatory responses to climate change can affect a company's future business prospects. Knowing about such risks would help investors estimate future cash flows. The question though is whether the benefits to investors outweigh the costs making such disclosures, including the cost of calculating the different scopes of emissions. The SEC noted that: "Unlike Scopes 1 and 2 emissions, Scope 3 emissions typically result from the activities of third parties in a registrant's value chain and thus collecting the appropriate data and calculating these emissions would potentially be more difficult than for Scopes 1 and 2 emissions." Climate Release at 160. The SEC has said it expects additional costs related to the proposal of $420,000 a year on average for a small public company and $530,000 a year for a large public company. Climate Release at 373. For a large company with profits in the billions of dollars, such costs seem small. However, for a small company with profits of, say, $1 million, the costs would amount to 42% of the profits.

The SEC noted: "many investors—including shareholders, investment advisers, and investment management companies—currently seek information about climate-related risks from companies to inform their investment decision-making." Climate Release at 7. But the critical question is what motivates these investors. Consider three possible scenarios:

> *Scenario 1:* The financial benefit of disclosing climate risks at a particular company is $100. The financial cost to the company (and indirectly its investors) is $90. There are no external effects from the disclosure or other costs. In this case, the benefit outweighs the cost, justifying disclosure.
>
> *Scenario 2*: The financial benefit of disclosing climate risks at a particular company is $70. The financial cost to the company (and indirectly its investors) is $90. Now the benefit does *not* outweigh the cost to the company (and indirectly its investors). For an investor that invests in a single company, climate-related disclosure is not cost justified from a purely financial perspective. What if part of the benefit from climate-related disclosures accrues to investors of *other* companies? An investor that invests in a portfolio of companies internalizes these external benefits when one company discloses on climate risk to other company investors. Suppose these external financial benefits when the particular company disclosures total to $30. To this portfolio investor, the financial benefit of climate-related disclosures (now $100) outweighs the cost ($90) even if they do not for a single firm investor.
>
> *Scenario 3*: Same as Scenario 2 but now the external financial benefit from disclosure by a particular company is only $10. Even for the portfolio investor, the financial benefit ($80) now outweighs the cost ($90). Nonetheless, non-investors benefit from climate related disclosures by a company. For example, more climate disclosures may lead companies to emit fewer greenhouse gases. This in turn may slow climate change which could benefit employees in the fishing industry who are not investors (suppose this financial benefit in aggregate is $20). Slowing climate change could also benefit non-humans, such as whales (how should we value this?). Suppose that the aggregate financial benefit to all humans ($100) exceeds the cost ($90) of climate related disclosures for the company. Are disclosures justified in this scenario?

Consider as well situations in which the benefit to a company of disclosing climate risks does not outweigh the cost from a financial perspective—whether for a single firm investor or a portfolio investor. A specific subset of investors, however, care about more than just financial returns. These investors have a "preference" for climate-related disclosures and the incentive effect such disclosures may have on reducing greenhouse gas emissions that makes climate-related disclosures worthwhile to these investors even if not directly financially justified. Should the non-financial preferences of a subset of investors matter sufficiently to justify mandatory disclosure even if the financial benefit does not?

When climate-related disclosures are cost-justified even for investors narrowly focused on financial returns in a single company (Scenario 1 above), it is easy to make the case for mandatory disclosures. In this case, we can justify climate-related disclosures as advancing the welfare of all investors. However, in the release accompanying the proposed rules, the SEC did not conduct a cost-benefit analysis that precisely calibrated how the benefits from the rules compared with the costs. Nor did the SEC try to distinguish between the three scenarios above (or whether the non-financial preferences of a subset of investors should be determinative).

What if we are in Scenario 2 or 3 or the corollary to Scenario 3 where a subset of investors is willing to sacrifice financial returns to further climate-related goals? If the costs from the proposed rules in fact do outweigh the benefits to an investor that invests in a single company, or indeed even for a portfolio investor—can we still justify the proposed rules as an action that is necessary for humanity and indeed, all life on the planet? Can the SEC in fact regulate to further the general "public interest," or alternatively the non-financial preferences of a subset of investors, if investors as a whole do not benefit in their capacity as investors?

Indicative of the shift of the SEC away from narrowly focusing on investor financial returns is the SEC's discussion of materiality with respect to Scope 3 disclosures. Although the SEC cites *TSC Industries, Inc. v. Northway*'s classic statement of materiality, the SEC goes on to mention a possible numerical threshold test for the materiality of Scope 3 emissions that does not turn on revenues or profits but instead focuses on total amounts of emissions. The SEC stated: "When assessing the materiality of Scope 3 emissions, registrants should consider whether Scope 3 emissions make up a relatively significant portion of their *overall GHG emissions*. While we are not proposing a quantitative threshold for determining materiality, we note that some companies rely on, or support reliance on, a *quantitative threshold such as 40 percent* when assessing the materiality of Scope 3 emissions." Climate Release at 165 (emphasis supplied). An unstated assumption of the SEC statement is that total emissions is naturally of importance to investors and thus emissions that constitute a high enough percentage to total emissions would be material. But why? Shouldn't the question instead be whether Scope 3 emissions affect a large enough percentage of revenues or profits to be material for investors?

More fundamentally, the SEC's mandate is to protect investors and the capital markets. What happens to this mandate if the SEC can justify rules based on the purported interest of a subset of investors in things beyond financial returns? Investors are people; they presumably care about housing, crime, education, inflation, and so on. Does the SEC have authority to require a company to disclose how much the company's operations and upstream and downstream supply chain contribute to crime in the localities in which the company or businesses in its supply chain operate if a subset of investors care about crime and not just financial returns? Perhaps such disclosure may lead companies to invest in reducing crime in these localities—a worthwhile goal. Does this public interest give the SEC's authority to impose such disclosure even if financial returns may suffer from the increased cost of disclosure?

The climate-related disclosure proposal for public companies is not the only initiative by the SEC to shift the focus of disclosure away from traditional financial returns and toward broader social issues. In 2022, the SEC proposed enhanced mandatory disclosures on environmental, social, and governance (or ESG) issues for certain investment advisors and investment companies. Inv. Adv. Act. Rel. 6034.

Shortly after the SEC proposed these rules, the Supreme Court handed down a significant case relating to regulatory authority, *West Virginia v. EPA*, 597 U.S. ___ (2022). In *West Virginia*, the Supreme Court addressed whether § 111(d) of the Clean Air Act gave the EPA authority to adopt a so-called Clean Power Plan rule. The Clean Air Act authorizes the EPA to regulate emissions of certain pollutants from power plants by setting a "standard of performance" based on the "best system of emission reduction" as determined by the EPA. States then implement the standard of performance, issuing rules on emissions from "sources within their border." Traditionally, this framework resulted in the EPA setting performance standards that reduce the emission of pollutants at power plants. In contrast, the Clean Power Plan rule required existing coal-fired plants to "reduce their own production of electricity, *or* subsidize increased generation by natural gas, wind, or solar sources." (emphasis supplied). The focus of the Clean Power Plan rule was therefore not on using technology or other means to reduce emissions at specific coal plants, the more traditional form of EPA regulation, but instead to "generation shift" the production of electricity from coal to lower emission sources.

At issue before the Court was whether § 111(d) of the Clean Air Act gave the EPA authority to require the generation shift of electricity production. The Court held that under the "major questions" doctrine, Congress did not intend to grant the EPA that authority. The Court wrote: "[O]ur precedent teaches that there are 'extraordinary cases' that call for a different approach—cases in which the 'history and the breadth of the authority that [the agency] has asserted,' and the 'economic and political significance' of that assertion, provide a 'reason to hesitate before concluding that Congress' meant to confer such authority." The Court further noted that: "Such cases have arisen from all corners of the administrative state." Applying the major questions doctrine, the Court held that Congress did not intend in the Clean Air Act to confer on the EPA the power to restructure the American energy market through generation shift of electricity production. Indeed, the Court noted that Congress had repeatedly declined to enact a cap-and-trade program that shifted production from high emission to cleaner sources of production.

The Supreme Court's holding in *West Virginia v. EPA* raises the question of whether the SEC's proposed rules run afoul of the major questions doctrine. To the extent the focus on climate, the environment, and social issues goes beyond an investor's interest in financial returns but instead advances the preferences of a subset of investors on non-financial issues or, alternatively, the general public interest, one can wonder whether the SEC is regulating on behalf of all investors and the capital markets. Indeed, to the extent climate disclosures and ESG disclosures aim to benefit, in part, non-investors, the SEC can be viewed as moving away from its mandate from Congress to protect investors and the capital markets.

Underscoring the question, Congress can and has required disclosures from companies not related to investor financial returns, calling into question whether the SEC can do so without Congressional authorization. In Section 1502 of the Dodd Frank Act of 2010, Congress directed the SEC to issue rules to require certain companies to disclosure their use of conflict minerals if the conflict minerals are "necessary to the functionality or production of a product" manufactured by the companies. Trade in conflict minerals, such as gold, can lead to human rights abuses and insecurity in certain countries, such as the Democratic Republic of the Congo. Congress intended to limit such abuses in requiring conflict mineral disclosures from companies.

Supplement for Chapter 5

Insert before QUESTIONS on p. 340.

3. *Clarifying price impact*. In a follow-on to *Halliburton II*, *Goldman Sachs Group, Inc. v. Arkansas Teacher Ret. Sys*., 594 U.S. -- (2021), the Supreme Court clarified two aspects of the price impact defense it adopted in *Halliburton II*. First, the Court reconciled the availability of a price impact defense with its holding in *Amgen, Inc. v. Connecticut Ret. Plans and Trust Funds*, 568 U.S. 455 (2013). *Amgen* rejected the argument that plaintiffs should have to show materiality at the class certification stage, instead reserving the question of materiality for trial. The *Goldman* Court held that *Amgen* did not preclude defendants from rebutting the fraud-on-the-market presumption by showing that the alleged misstatements were too generic to have affected the company's stock price, even though evidence of a lack of price impact might overlap with the question of materiality. Second, the Court held that defendants bear the burden of proving a lack of price impact to defeat class certification. The Court minimized the importance of who bears the burden: "The defendant's burden of persuasion will have bite only when the court finds the evidence in equipoise—a situation that should rarely arise."

Supplement for Chapter 7

Insert before The Underwriters on p. 493.

2. Alternate Ways of Going Public

Although most private companies gain public company status through a registered public offering, typically with a listing on an exchange, there are shortcuts to public company status. Many of these alternatives involve some form of business combination between a private company and a public company, typically a merger. For simplicity, we focus primarily on mergers although other transaction forms can achieve the same end.

In comparing these alternatives, consider the various goals of a company and its shareholders from going public. Does the alternative meet these goals? First, a company may go public to obtain capital to obtain financing for expansion, research, marketing and other business purposes. Second, a company may go public to promote its overall profile. Public company status makes it easier to find investors in the future and to attract both customers and employees. Third, a company may hope to create a liquid secondary market for its shares, allowing insiders and early-stage investors to sell their shares more readily. More liquid shares are an asset that the company can use as consideration in acquiring other companies and other transactions. A liquid secondary market also allows the market to engage in price discovery, resulting in an aggregate, and arguably more accurate, assessment of a company's valuation. One cost of going public is that it will dilute the ownership interest of the pre-IPO investors, most notably the company's founders. The founders may want to retain control over the company even after going public, although they will have to give up some portion of their cash flow rights in the company.

Traditional Merger. A private company and its shareholders may gain some of the benefits of going public if the company merges with an operating public company. In a merger with a public company, the public company will typically give the private company's shareholders either shares of the public company or cash as consideration. The private company will either become absorbed into the public company or become a separate subsidiary. (A triangular merger structure facilitates the latter.) In addition, key employees of the private company may become employees or consultants of the public company for a period after the merger. For example, in 2006, Google acquired YouTube. YouTube shareholders received $1.65 billion worth of Google shares. One of the founders of YouTube, Chad Hurley, remained as the CEO of YouTube for several years after the Google acquisition.

As with a public offering, a private company acquired by a public company may gain access to financing. Post-acquisition, YouTube had access to the considerable resources of Google. An acquisition by a public company may or may not raise the public's awareness of the private company, but this goal may be of secondary importance now that it has been subsumed into the existing public company, which may have a profile of its own. An acquisition by a public company will not create a liquid secondary market for the shares of the private company. Indeed, the private company shares will typically be cancelled as part of the merger. Nonetheless, the acquisition may give the shareholders of the private company liquidity, either through the public company shares or cash obtained in the acquisition.

Along one important dimension, an acquisition by an existing public company is not a good substitute for going public. The parties controlling the private company pre-acquisition typically lose control in the acquisition. The shareholders of the private company will either exit their investment (if they receive cash as consideration) or become shareholders in a larger entity, the operating public company. Either exit path reflects a considerable change in the nature of their investment. Post-acquisition, the former shareholders of YouTube found themselves as shareholders of a much larger corporate entity at derived revenue not only from people watching videos of dogs taking selfies but also from Google's search engine.

Reverse Merger. In our first alternative, an existing public company merges with a private company, leaving the public company as the survivor, with the shareholders of the private company usually receiving shares of the public company in the merger. For our second alternative, consider a twist on that path. Suppose that the existing public company is a shell company. It is a legal entity with possibly a listing for its shares, but does not have an operating business, and typically, few assets. Post-merger the shell public company will now have the operating assets of the private company and the shareholders of the private company will typically have all or almost all of the shares of the shell public company. The private company shareholders collectively, as a result, will control the public company after the merger. The board and management of the private company will typically continue to run the business through the public company after the merger. Post-merger the public company can change its name and ticker symbol to match the private company. This method of going public is called a "reverse" merger.

Unlike a public offering, the reverse merger will typically not raise capital to fund the business. Although going public through a reverse merger may raise the private company's profile, the company will receive less publicity than it would have in the public offering process soliciting investors through roadshows. Moreover, the secondary market for a public shell company typically is not very liquid—most shell companies trade on the over-the-counter market (OTCBB) because they do not meet the listing standards for the exchanges. Therefore, investors in the private company may still face difficulties in monetizing their investments through post-merger resales of the public company shares. A well-known private company that goes public through a reverse merger, however, may attract its own base of investors, promoting a liquid resale market. Finally, because there are no operating assets for the public shell company, the post-merger operating assets will come entirely from the private company. Accordingly, the nature of the shareholders' investment will remain largely unchanged.

A typical initial public offering can take six months or longer to complete. By contrast, a private company can become public through a reverse merger in one to two months. Disclosures in a reverse merger are also much simpler, sometimes involving only a Form 8-K filing by the public company. Because there is no need for a firm commitment offering, there are no corresponding underwriter fees or commissions. If the public shell company will issue new shares to the private company shareholders in the merger, the issuance of the shares may require registration on Form S-4 of the Securities Act.

Reverse mergers grew in popularity in the mid-2000s but rapidly declined after 2011. Many foreign private companies, including hundreds of Chinese corporations, went public into the U.S. capital markets through mergers with non-operating U.S. public companies. These transactions lacked the screening that come with a traditional public offering: 1) from an investment bank, which has its own money on the line in a firm commitment offering, and 2) from investors. Consequently, private companies that went public through reverse mergers posed heightened risk to investors. In 2011 the SEC suspended trading in a number of reverse merger public companies due to questions relating to the accuracy and completeness of the companies' public disclosures.

Special Purpose Acquisition Company (SPAC). More recently, a method of going public that combines aspects of the mid-2000s reverse mergers with the capital raising aspects of a traditional public offering has gained popularity. In this method of going public, sponsors raise capital through the initial public offering of a shell company commonly known as special purpose acquisition company or SPAC (also referred to as a blank check company). A SPAC is a company with no operations. It offers securities for cash. The offering proceeds are placed into a trust or escrow account to be used for a future acquisition of an operating company. Sponsors will typically pay a nominal amount and take a 20% equity interest in the SPAC and then sell the remaining 80% of shares to the public in the IPO. SPAC IPOs typically price the common stock at $10 per share. In many SPAC IPOs, the SPAC will offer units consisting of common stock and warrants giving the holder the right to purchase additional common stock at a specified price for a period (for example, five years) after an acquisition. In a typical SPAC IPO, underwriters are compensated with 5.5% of the IPO proceeds. The remaining IPO proceeds are kept in trust until used by the SPAC to fund an acquisition. If no acquisition is identified, the money is returned to the IPO investors. The sponsors of a SPAC attract investors in the IPO based on their promise that they will use this capital to find and acquire value-increasing private companies.

Once the sponsors identify a private company target, the SPAC will either merge with the private company or acquire it an alternative form of business combination. From the private company's perspective, entering into a transaction with a SPAC allows the private company to go public by combining with a public SPAC without going through the public offering process. The result is a quicker path to becoming a public company, typically six months or less. Unlike the reverse mergers of the mid-2000s, a merger with a SPAC also potentially provides the private company with funds raised from the SPAC public offering. The shareholders of the private company either get cash as consideration or shares in the SPAC or a subsidiary of the SPAC. A target private company that negotiates for more equity and less cash as consideration from the SPAC may retain some control for the target company's shareholders post-acquisition.

In a traditional public offering, a private company makes disclosures and then investors decide whether to buy the shares of the company. Investors in a SPAC offering, however, do not directly assess the business of a private company because a target has not been identified at the time of the initial investment. Investors who invest in a SPAC offering are trusting the SPAC sponsors to find a promising private company, negotiate good terms, and acquire it. Accordingly, the expertise and incentives of the SPAC sponsors are critical to the investment returns of SPAC investors.

A typical SPAC structure give the sponsors a set period, for example two years, to find one or more acquisition targets. As part of their compensation, SPAC sponsors typically receive a percentage of the deal (often 5%) as compensation. If no acquisition target is identified, the typical SPAC agreement requires the SPAC to liquidate and return the net offering proceeds from the SPAC IPO to the public shareholders. Because liquidation results in no deal compensation for the SPAC sponsors, the SPAC sponsors have an incentive to conclude an acquisition, whether or not it is in the best interests of the SPAC investors. That incentive becomes more salient as the SPAC nears the end of its specified acquisition term. The SEC warns: "[I]nvestors should be aware that although most of the SPAC's capital has been provided by IPO investors, the sponsors and potentially other initial investors will benefit more than investors from the SPAC's completion of an initial business combination and may have an incentive to complete a transaction on terms that may be less favorable to you." SEC, What You Need to Know about SPACs—Updated Investor Bulletin (May 25, 2021).

Once an acquisition target is identified, the SPACs will sometimes give its shareholders as a group the right to vote on the acquisition, particularly if the SPAC is merged with the target company. Individual shareholders also typically have the right to opt out of the acquisition by redeeming their shares at the time of the acquisition. Shareholders who redeem will receive a pro rata amount of the funds held in the SPAC trust account.

SPACs will often give the sponsors the right to seek additional funding to help offset any redemptions and to provide financing for an acquisition. Often SPACs will obtain this financing through a private placement, referred to as a private investment in public equity (or PIPE) offering. According to the SEC: "[T]he SPAC may require additional financings to fund the initial business combination, and those financings often involve the sponsors. As a result, the interests of the sponsors may further diverge from your interests. For example, additional funding from the sponsors may dilute your interest in the combined company or may be provided in the form of a loan or security that has different rights from your investments." SEC, What You Need to Know about SPACs—Updated Investor Bulletin (May 25, 2021).

SPACs have grown increasingly popular. In 2014, SPAC offerings raised almost $2 billion. In 2020, SPACs raised over $80 billion. In 2020, hedge fund manager Bill Ackman raised $4 billion through his "Super"-SPAC Pershing Square Tontine Holdings. Despite their increasing popularity, questions persist about whether investors in SPAC IPOs are getting a good deal. The 5.5% commission given to underwriters, combined with the 20% of IPO shares given to the sponsors, puts considerable pressure on the SPAC sponsors to identify an attractive acquisition target if the SPAC investors are to profit. SPACs offer the benefit to private companies of a quicker method of going public at a lower cost, but the benefit to investors is less clear.

Direct Listing with a Securities Exchange. Companies may go public through a direct listing of securities with the NYSE or NASDAQ, providing a liquid secondary market on an exchange. In a traditional IPO, existing shareholders typically are required not to resell during a 90 to 180 day "lock-up" period. In a direct listing of existing shares, existing shareholders may sell immediately.

Unlike a traditional IPO, a direct listing does not raise any capital, and, as a result, does not require any underwriter discount or commission. Without a capital raise, a company can only directly list its existing outstanding shares. For most private companies, those existing shares would be held by a small number of investors, principally company employees, although some may be held by the founders and venture capitalists. That small shareholder base created an obstacle for companies in meeting the initial listing requirements of the NYSE or NASDAQ. NYSE initial listing, for example, requires that a company have at least 1.1 million publicly held shares, 400 round lot holders (i.e., holders of 100 shares), and a price per share of $4.00 or more. See NYSE Quantitative Initial Listing Standards (Section 1).

In 2018, Spotify used a direct listing of its existing common stock on the NYSE to go public. The direct listing allowed Spotify's employees and early-stage investors to sell their shares. Some those shares were sold by Spotify in private placements, however, meaning they were restricted shares unable to qualify for a Rule 144 resale exemption. To allow those shares to be sold in the public market, Spotify filed a registration statement with the SEC. We will discuss restricted shares and private placements in Chapter 9. Instead of a series of roadshow events, Spotify held a single "Investor Day" with presentations from Spotify's top officers.

Companies directly listing on the NYSE or NASDAQ will typically receive publicity at the time of the direct listing, raising awareness of the company among investors and the general public. Listing on the NYSE or NASDAQ also provides liquidity to a company's existing shareholders and increases the value to the company of using its shares as consideration in transactions such as an acquisition. Because the company is not issuing typically selling any new shares, the direct listing of existing shares does not change the ownership structure of the firm, although resale transactions may alter who owns the shares of the company. Large shareholders, such as the founders of a company, will continue to own a large fraction of the shares if they do not sell them.

In 2020 and 2021, the SEC approved NYSE and NASDAQ rule changes to allow companies to raise capital through a primary offering in a direct listing of equity. The NYSE refers to a direct listing that also raises capital for the company as a "primary direct floor listing." NASDAQ refers to such a direct listing as a "Direct Listing with a Capital Raise." Both the NYSE and NASDAQ impose additional requirements for a direct listing that raises capital through a primary offering on top of the initial listing requirements. The NYSE, for example, requires that a company selling through a primary direct floor listing must either: 1) sell at least $100 million in shares in the opening auction on the first day of trading; or 2) have an aggregate market valuation of newly issued and pre-existing publicly held shares of at least $250 million at the time of listing.

Although primary offerings through direct listings allow companies to raise capital while avoiding underwriters' fees, the companies also skip underwriter due diligence. This may raise concerns for less well-known companies for which investors are at a relatively large informational disadvantage. The lack of a “certification” intermediary such as a Wall Street investment bank playing the role of an underwriter in a firm commitment offering may expose investors to greater risks that in traditional initial public offerings.

Supplement for Chapter 8

Replace Krim v. pcOrder on p. 571

Slack v. Pirani

143 S.Ct. 1433 (2023)

■ GORSUCH, J.

This case concerns the meaning of one provision of the federal securities laws. For many years, lower federal courts have held that liability under § 11 of the Securities Act of 1933 attaches only when a buyer can trace the shares he has purchased to a false or misleading registration statement. Recently, the Ninth Circuit parted ways with these decisions, holding that a plaintiff may sometimes recover under § 11 even when the shares he owns are not traceable to a defective registration statement. The question we face is which of these approaches best conforms to the statute's terms.

I

Together, the Securities Act of 1933 and the Securities Exchange Act of 1934 form the backbone of American securities law. The first is " 'narrower' " and focused " 'primarily' " on the regulation of new offerings. Generally speaking, the 1933 Act requires a company to register the securities it intends to offer to the public with the Securities and Exchange Commission (SEC). As part of that process, a company must prepare a registration statement that includes detailed information about the firm's business and financial health so prospective buyers may fairly assess whether to invest. The law imposes strict liability on issuing companies when their registration statements contain material misstatements or misleading omissions.

The 1934 Act sweeps more broadly. Among other things, it requires publicly traded companies to provide ongoing disclosures and regulates trading on secondary markets. This law's main liability provision sweeps more broadly too. It allows suits in connection with the purchase or sale of "any security," whether registered or not. But to prevail under this provision, a plaintiff must prove that any material misleading statement or omission was made "with scienter, *i.e.*, with intent to deceive, manipulate, or defraud."

This case arises from a public offering governed by the 1933 Act. Typically, when a company goes public it issues new shares pursuant to a registration statement. That registration statement is filed with the SEC and made available to the public. Investment banks underwrite the offering, usually by buying these new registered shares at a negotiated price and then selling them to investors at a higher price. In this way, underwriters often carry the risk of loss should they fail to sell the shares at a profit.

Of course, a company's early investors and employees may own preexisting shares. Often, too, these shares are not subject to registration requirements. To prevent the stock price from falling once public trading begins, underwriters may require insiders to consent to a "lockup agreement"—a commitment to hold their unregistered shares for a period of time before selling them on the new public market.

Initial public offerings (IPOs) are an effective way of raising capital, but they also have drawbacks. Among other things, they can involve significant transaction costs. Nor is raising capital the only reason firms might wish to go public; some may simply wish to afford their shareholders (whether investors, employees, or others) the convenience of being able to sell their existing shares on a public exchange. Several years ago, a number of companies approached the New York Stock Exchange (NYSE) about the possibility of selling shares publicly on that exchange without an IPO. Ultimately, the NYSE proposed rules to facilitate and regulate these "direct listings," which the SEC approved with modifications.

Slack is a technology company that offers a platform for instant messaging. It conducted a direct listing on the NYSE in 2019. As part of that process, Slack filed a registration statement for a specified number of registered shares it intended to offer in its direct listing. But because Slack employed a direct listing rather than an IPO, there was no underwriter and no lockup agreement. Accordingly, holders of preexisting unregistered shares were free to sell them to the public right away. All told, Slack's direct listing offered for purchase 118 million registered shares and 165 million unregistered shares.

Fiyyaz Pirani bought 30,000 Slack shares on the day Slack went public. He bought 220,000 additional shares over the next few months. When the stock price later dropped, Mr. Pirani filed a class-action lawsuit against Slack. In that suit, he alleged that Slack had violated §§ 11 and 12 of the 1933 Act by filing a materially misleading registration statement.

Slack moved to dismiss the complaint for failure to state a claim. Sections 11 and 12, Slack argued, authorize suit only for those who hold shares issued pursuant to a false or misleading registration statement. And this feature of the law, the company said, was dispositive in this case because Mr. Pirani had not alleged that he purchased shares traceable to the allegedly misleading registration statement. For all anyone could tell, he may have purchased unregistered shares unconnected to the registration statement and its representations about the firm's business and financial health. Of course, Slack would go on to acknowledge that the 1934 Act allows investors to recover for fraud in the sale of unregistered shares upon proof of scienter. But, the company emphasized, Mr. Pirani had not sought to sue under that law.

Ultimately, the district court denied the motion to dismiss but certified its ruling for interlocutory appeal. The Ninth Circuit accepted the appeal and a divided panel affirmed. In dissent, Judge Miller argued that §§ 11 and 12 of the 1933 Act require a plaintiff to plead and prove that he purchased securities registered under a materially misleading registration statement, something Mr. Pirani had not done. Judge Miller pointed out that a long line of lower court cases have interpreted § 11 as applying only to shares purchased pursuant to a registration statement. Because the Ninth Circuit's decision created a split of authority in the courts of appeals about § 11's scope, we granted certiorari.

II

We begin with the relevant language of § 11(a) of the 1933 Act. It provides:

> "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue [certain enumerated parties]."

The statute authorizes an individual to sue for a material misstatement or omission in a registration statement when he has acquired "such security." The question we face is what this means. Does the term "such security" refer to a security issued pursuant to the allegedly misleading registration statement? Or can the term also sometimes encompass a security that was not issued pursuant to the allegedly misleading registration statement? Slack advances the first interpretation; Mr. Pirani defends the second.

Immediately, we face a bit of a challenge. The word "such" usually refers to something that has already been "described" or that is "implied or intelligible from the context or circumstances." But there is no clear referent in § 11(a) telling us what "such security" means. As a result, we must ascertain the statute's critical referent "from the context or circumstances."

As it turns out, context provides several clues. For one thing, the statute imposes liability for false statements or misleading omissions in "*the* registration statement." Not just a registration statement or any registration statement. The statute uses the definite article to reference the particular registration statement alleged to be misleading, and in this way seems to suggest the plaintiff must "acquir[e] such security" under that document's terms.

For another thing, the statute repeatedly uses the word "such" to narrow the law's focus. The statute directs us to "such part" of the registration statement that contains a misstatement or misleading omission. It speaks of "such acquisition" when a person has acquired securities pursuant to the registration statement. And it points to "such untruth or omission" found in the registration statement. Each time, the law trains our view on particular things or statements. All of which suggests that, when it comes to "such security," the law speaks to a security registered under the particular registration statement alleged to contain a falsehood or misleading omission.

Other provisions in the 1933 Act follow suit. Under § 5, for example, "[u]nless a registration statement is in effect as to a security," it is unlawful "to sell such security." Here, the term "such security" clearly refers to shares subject to registration. Meanwhile, § 6 provides that a "registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered." It's an instruction that would seem hard to square with Mr. Pirani's broader reading of § 11(a)—after all, adopting that reading would give the registration statement effect (in the sense of creating liability) for securities that are not "specified" in the registration statement "as proposed to be offered."

Beyond these clues lies still another. Section 11(e) caps damages against an underwriter in a § 11 suit to the "total price at which the securities underwritten by him and distributed to the public were offered to the public." This provision thus ties the maximum available recovery to the value of the registered shares alone. It's another feature that makes little sense on Mr. Pirani's account, for if § 11(a) liability extended beyond registered shares presumably available damages would too.

Collectively, these contextual clues persuade us that Slack's reading of the law is the better one. Nor is anything we say here particularly novel. For while direct listings are new, the question how far § 11(a) liability extends is not. More than half a century ago, Judge Friendly addressed the question in an opinion for the Second Circuit in *Barnes* [v. *Osofsky*] and concluded that "the narrower reading" we adopt today is the more "natural" one. 373 F.2d at 271, 273 [(2d Cir.1967)]. Since *Barnes*, every court of appeals to consider the issue has reached the same conclusion: To bring a claim under § 11, the securities held by the plaintiff must be traceable to the particular registration statement alleged to be false or misleading. Until this decision, even the Ninth Circuit seemed to take the same view.

Resisting this conclusion, Mr. Pirani argues that we should read the phrase "such security" to include not only securities traceable to a defective registration statement. We should also read the phrase to include other securities that bear some sort of minimal relationship to a defective registration statement. And, he argues, a reading like that would allow his case to proceed because, but for the existence of Slack's registration statement for the registered shares, its unregistered shares would not have been eligible for sale to the public. Beyond assuring us that the rule he proposes would save his case, however, Mr. Pirani does not offer much more. He does not explain what the limits of his rule would be, how we might derive them from § 11, or how any of this can be squared with the various contextual clues we have encountered suggesting that liability runs with registered shares alone.

Perhaps the closest Mr. Pirani comes to answering these questions comes when he directs us to § 5. If Congress wanted liability under § 11(a) to attach only to securities issued pursuant to a particular registration statement, he observes, it could have simply borrowed similar language from § 5. That provision, he stresses, speaks of "any security with respect to which a registration statement has been filed." But even taken on its own terms, this argument does not prove much.

If Mr. Pirani's example shows that Congress could have written § 11(a) to explain more clearly that liability attaches only to securities issued pursuant to a particular registration statement, it also shows that Congress could have written § 11(a) to explain more clearly that liability attaches to "any security" or "any security" bearing some specified relationship to a registration statement. That Congress could have been clearer, no one disputes. But none of this proves it adopted anything like the rule Mr. Pirani proposes.

Finally, Mr. Pirani argues from policy and purpose. Adopting a broader reading of "such security" would, he says, expand liability for falsehoods and misleading omissions and thus better accomplish the purpose of the 1933 Act. We cannot endorse this line of reasoning. This Court does not "presume ... that any result consistent with [one party's] account of the statute's overarching goal must be the law." Nor, for that matter, is Mr. Pirani's account of the law's purpose altogether obvious. As we have seen, the 1933 Act is "limited in scope." Its main liability provision imposes strict liability on issuers for material falsehoods or misleading omissions in the registration statement. Meanwhile, the 1934 Act requires ongoing disclosures for publicly traded companies and its main liability provision allows suits involving any sale of a security but only on proof of scienter. Given this design, it seems equally possible that Congress sought a balanced liability regime that allows a narrow class of claims to proceed on lesser proof but requires a higher standard of proof to sustain a broader set of claims.

III

Naturally, Congress remains free to revise the securities laws at any time, whether to address the rise of direct listings or any other development. Our only function lies in discerning and applying the law as we find it. And because we think the better reading of the particular provision before us requires a plaintiff to plead and prove that he purchased shares traceable to the allegedly defective registration statement, we vacate the Ninth Circuit's judgment holding otherwise. Whether Mr. Pirani's pleadings can satisfy § 11(a) as properly construed, we leave for that court to decide in the first instance on remand.[3]

* * *

NOTES

1. *Statistical tracing*. Courts applying the tracing rule have barred claims even when plaintiffs have provided strong statistical evidence that at least some of the shares were registered in a public offering. In *Krim v. pcOrder.com*, 402 F.3d. 489 (2005), the Fifth Circuit found that the plaintiff could not trace his shares to the registration statement even though there registered shares constituted 99.85% of the stock trading at the time of his purchase.

QUESTIONS

1. Section 11 does not require plaintiffs to demonstrate any reliance on the registration statement. Does § 11's strict tracing requirement substitute for a reliance requirement?

2. The Court cites one of the earliest cases to impose a tracing requirement on § 11 plaintiffs, *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967), justified the requirement by pointing to § 11(g)'s limit on damages:

[3] As we noted at the outset, the parties do not just spar over the best interpretation of § 11 and its application to this case. They do the same when it comes to § 12. But we have no need to reach the merits of that particular dispute. The Ninth Circuit said that its decision to permit Mr. Pirani's § 12 claim to proceed "follow[ed] from" its analysis of his § 11 claim. And because we find that court's § 11 analysis flawed, we think the best course is to vacate its judgment with respect to Mr. Pirani's § 12 claim as well for reconsideration in the light of our holding today about the meaning of § 11. In doing so, we express no views about the proper interpretation of § 12 or its application to this case. Nor do we endorse the Ninth Circuit's apparent belief that § 11 and § 12 necessarily travel together, but instead caution that the two provisions contain distinct language that warrants careful consideration.

[T]he over-all limitation of § 11(g) that "In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public," and the provision of § 11(e) whereby, with qualifications not here material, an underwriter's liability shall not exceed "the total price at which the securities underwritten by him and distributed to the public were offered to the public," point in the direction of limiting § 11 to purchasers of the registered shares, since otherwise their recovery would be greatly diluted when the new issue was small in relation to the trading in previously outstanding shares. . . .

Do you agree with the *Barnes* court's reading of § 11(g)? Does the tracing requirement prevent dilution of recovery at the expense of another policy goal of § 11?

3. The Court left open the question of how a plaintiff is to demonstrate tracing. Pirani purchased a total of 250,000 Slack shares through the NYSE after the direct listing. What is the probability that one share, if purchased in the secondary market, came from the initial public offering? Should Pirani be able to demonstrate tracing if the probability is greater than a specific threshold (such as 99%)?

4. Do you agree with the "balanced" liability regime to which the Court refers in rejecting Pirani's "policy and purpose" argument that expanding liability for falsehoods and misleading omissions better accomplishes the purpose of the Securities Act?

Supplement for Chapter 9

Replace the last full paragraph on p. 675

The starting point to understanding Regulation D is Rules 504 and 506. These rules set forth the requirements for the two exemptions under Regulation D. Although we started our discussion with § 4(a)(2), only Rule 506 is a § 4(a)(2) exemption. Offerings under Rules 504 fall under § 3(b)(1) of the Securities Act, which allows the SEC to exempt from § 5 offerings up to $5 million. In 2020, the SEC used its general exemptive authority under § 28 of the Securities Act to increase the Rule 504 aggregate offering price ceiling to $10 million. Two other provisions establish the framework for Regulation D. Rule 501 provides definitions used throughout Regulation D. Rule 502 sets forth the various requirements incorporated in the two offering exemptions found in Rules 504 and 506.

Replace Section A. Aggregate Offering Price on p. 676

A. Aggregate Offering Price

The most conspicuous difference between the Regulation D exemptions is the offering amount allowed, i.e., "aggregate offering price." Under Rule 504, issuers may sell up to $10 million of securities; under Rule 506, issuers may sell an unlimited amount.

Constraining the aggregate offering price limits the potential scope of a Rule 504 offering. Smaller offerings are less likely to involve widespread public selling efforts. Individual retail investors are therefore also unlikely to invest in such smaller offerings.

The aggregate offering price limit raises two questions. Why might an issuer prefer a Rule 504 offering over a Rule 506 offering, which does not limit the offering amount? The answer, of course, is that the requirements for a Rule 506 private placement are more restrictive.

Second, what prevents an issuer from simply doing repeated Rule 504 offerings to evade the offering price limitation? For example, a corporation could sell $10 million on May 1, $10 million on June 1, $10 million on June 15, etc. This strategy is thwarted by aggregation rules that determine the aggregate offering price for Rule 504. Under Rule 504, issuers must reduce the offering price ceiling—$10 million—by the amount of securities sold in the twelve months preceding the offering pursuant to either (1) another offering under Rule 504, or (2) an offering made in violation of § 5. Thus, a corporation that sold $10 million of securities on May 1 under Rule 504 would have its aggregate offering price ceiling for a subsequent Rule 504 offering limited to $0 until May 1 of the next year.

Hypothetical Two

Trendy decides to do a Regulation D offering to raise capital for its contemplated expansion of the marketing and distribution of Trendy's Lean Green drink.

1. *Scenario One:* Suppose that Trendy raises $2 million per month over a five-month period from January 2019 to May 2019. Sales are made to 25 unsophisticated purchasers. Do either of the Regulation D offering types exempt Trendy from § 5?

2. *Scenario Two:* After raising $10 million from January 2019 to May 2019, on February 1, 2020, Trendy decides to engage in a new round of financing. Trendy seeks to raise an additional $10 million quickly in an exempt offering to twenty unsophisticated purchasers. Can Trendy sell securities under either of the Regulation D exemptions?

3. *Scenario Three:* Suppose that earlier in June 2018, Trendy sold $10 million of common stock attempting to use § 4(a)(2). Trendy made the mistake of selling to 25 investors without providing either information or access. How does this 2018 offering affect Trendy's January to May, 2019 sale of securities in Scenario One?

Replace B. Purchasers on p. 677:

B. PURCHASERS

The SEC's central concern with unregistered offerings is the broad-based sales of securities to the general public. Many public investors lack investment sophistication, which could lead them to purchase overpriced securities. In addition, public investors may feed off of each other's excessive optimism, driving the price of overvalued securities still higher. Regulation D addresses this concern by restricting purchasers.

First, Regulation D limits the number of purchasers. Rule 506 limits offerings to a maximum of 35 purchasers. The 35 purchaser limit applies for purchasers aggregated across all Rule 506 offerings in any 90 calendar day period. Rule 506(b)(2)(i). Rule 504, however, does not limit the number of purchasers, instead the $10 million aggregate offering price indirectly constrains the number of purchasers.

The 35-purchaser ceiling under Rule 506 has an enormous loophole. Rule 501(e) excludes certain investors from the count of purchasers. For example, under Rule 501(e)(1)(i) any "relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser" is not counted as a separate purchaser. More importantly, Rule 501(e)(1)(iv) excludes "accredited investors" from the purchaser tally. Because of the accredited investor exclusion, Rule 506 allow sales to an unlimited number of accredited investors plus not more than 35 persons who are not accredited investors. In practice, most offerings are sold exclusively to accredited investors.

Who counts as an accredited investor? Many of the categories involve large entities and institutions, including banks, broker-dealers, and insurance companies. Trusts, partnerships, limited liability companies, and corporations also qualify if they have a minimum of $5 million in total assets, among other requirements. In addition, Rule 501(a) defines three additional categories of accredited investors:

- Rule 501(a)(4): Any director, executive officer, or general partner of the issuer of the securities.
- Rule 501(a)(5): Any natural person whose individual net worth, or joint net worth with that person's spouse or spousal equivalent, at the time of his purchase exceeds $1,000,000.
- Rule 501(a)(6): Any natural person whose individual income exceeded $200,000 in each of the two most recent years or whose joint income with his/her spouse or spousal equivalent exceeded $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

The concept of accredited investors is central to Regulation D. Because accredited investors are excluded from the calculation of the number of purchasers, issuers may sell to an unlimited number of accredited investors under Rule 506. Rule 506 has no limit on the aggregate offering price. As a legal matter, then, an issuer can sell an unlimited amount of securities under Rule 506 (i.e., into the billions of dollars) to an unlimited number of accredited investors.

Outside of Regulation D, Securities Act § 4(a)(5) exempts offers and sales to accredited investors from § 5. Offerings under § 4(a)(5) are limited to the $5 million limit established under § 3(b)(1). Issuers or anyone acting on behalf of the issuer may not engage in "advertising or public solicitation." Section 4(a)(5) also requires that issuers file a notice of the transaction with the

SEC, which is done on Form D. Presumably because of the $5 million limit, issuers rarely rely on § 4(a)(5) exclusively as an exemption from § 5.

Issuers typically rely on placement agents to provide access to pre-screened pools of accredited investors. Placement agents maintain databases of potential accredited investors, typically determining accredited status using information found in suitability questionnaires filled out by the investors. But what if an investor lies or makes a mistake on the questionnaire? Rule 501(a) provides that the issuer need only "reasonably" believe that an investor falls in one of the specified categories of accredited investors.

Even accredited investors have a limited appetite for privately placed securities. The chief constraint on that appetite is that securities sold through Regulation D are "restricted": Resales are limited unless the securities are registered under § 5 or the selling investor finds an exemption from § 5. Rule 144, covered in Chapter 10, provides such an exemption, allowing resales of restricted securities after a specified holding period of six months (for reporting issuers) or one year (for non-reporting issuers). If the accredited investors decide to rebalance their portfolios, or need to raise cash for some other reason, the investors will be unable to sell the restricted securities immediately.

Regulation D did not originally provide for inflation adjustment for the income and net worth tests for individuals to become accredited investors. Since the income and net worth numerical thresholds were implemented in April 1982, inflation has substantially eroded those limits. One million dollars in 1982 is the equivalent of $2.68 million in 2018, so the $1 million net worth eligibility requirement is effectively less than half of what it was when Regulation D was introduced. Failing to adjust for inflation has allowed an ever-expanding group of individuals to qualify as accredited investors. The net worth test, moreover, when originally implemented in 1982 did not take into account the mix of assets that go into a person's net worth. Should a person whose net worth consists entirely of marketable securities be treated differently from a person whose net worth consists almost entirely of the person's house?

In 2010, Congress stepped in to compel the SEC to revise its accredited investor definition. The Dodd-Frank Act requires the SEC to adopt rules adjusting the $1 million net worth test for a natural person to become an accredited investor to exclude the "value of the primary residence of such national person." Dodd-Frank Act § 413(a). Beyond the $1 million net worth test, the Dodd-Frank Act instructs that SEC to undertake a review of the definition of an accredited investor as applied to natural persons to determine whether the definition should be adjusted "for the protection of investors, in the public interest, and in light of the economy." Dodd-Frank Act § 413(b). The Act requires the SEC to undertake a subsequent review of the accredited investor definition "in its entirety" at least once every four years thereafter.

In early 2012, the SEC adopted a rule adjusting the net worth test for a natural person accredited investor under Rule 501(a)(5). The SEC also provided parallel adjustments to the definition of accredited investor under Rule 215 that defines the terms accredited investor under § 2(a)(15) of the Securities Act for purposes of the § 4(a)(5) exemption. Under the new rule, both equity and liability in the investor's primary residence are excluded, unless the liability exceeds the fair market value of the home.

In August 2020, the SEC updated its definition of an accredited investor under Regulation D. The SEC did not change the existing dollar thresholds in the Rule 501(a), including the total asset requirement of more than $5 million for the various entities delineated in Rules 501(a)(3). Individuals with income above $200,000, or $300,000 together with a spouse, or with a net worth of over $1 million, excluding one's primary residence, also remain accredited investors. The SEC created a new category called "spousal equivalent" defined as "a cohabitant occupying a relationship generally equivalent to that of a spouse" and allowed the joint income test under Rule 501(a)(4) to include joint income with a spouse or spousal equivalent and the net worth test under Rule 501(a)(5) to include joint net worth together with a spouse or spousal equivalent.

Although the SEC acknowledged the effect of inflation in effectively reducing the dollar threshold requirements in real terms since they were initially established in 1982, the SEC contended that "availability of information and advances in technologies" that lead to information being "more readily available now to a wide range of market participants" than in 1982. SEC Rel. No. 33-10824 at 73 (August 26, 2020). In addition, while the $1 million net worth requirement is the same as initially set in 1982, the SEC noted that the exclusion of one's primary residence in calculating the $1 million amount effectively has raised the net worth requirement.

Instead of changing dollar thresholds, the SEC's update primarily focused on expanding the accredited investor for both individuals and entities. For individuals, the expansion focused on those individuals who do not meet the existing categories of individual accredited investors. The SEC's update dealt with the question of when less wealthy individuals possess the "ability to assess an investment opportunity—which includes the ability to analyze the risks and rewards, the capacity to allocate investments in such a way as to mitigate or avoid risks of unsustainable loss, or the ability to gain access to information about an issuer or about an investment opportunity—or the ability to bear the risk of a loss." SEC Rel. No. 33-10824 at 6.

In answering this question, the SEC focused on formal professional certification as a proxy for sophistication. The SEC designated three FINRA-administered exams as the initial certifications that qualify an individual as an accredited investor under Rule 501(a)(10): the General Securities Representative license (Series 7), the Licensed Investment Adviser Representative (Series 65), and the Private Securities Offerings Representative license (Series 82). In justifying the use of these professional certifications to define accredited investors for individuals that do not meet the income or net worth thresholds, the SEC noted that "these certifications and designations are required in order to represent or advise others in connection with securities market transactions." SEC Rel. No. 33-10824 at 30. The SEC did not require any actual practice experience noting that "we believe that passing the requisite examinations and maintaining an active certification, designation, or license is sufficient to demonstrate the individual's financial sophistication to invest in exempt offerings, even when the individual is not practicing in an area related to the certification or designation." SEC Rel. No. 33-10824 at p. 28-29. The SEC left open the possibility of changing this list in the future.

The SEC expanded the definition of an individual accredited investor to include certain "knowledgeable employees" of a private fund, as defined under Rule 3c-5(a)(4) of the Investment Company Act, investing in the private fund (Rule 501(a)(11)). In justifying this expansion, the SEC contended that the employees "knowledge and active participation of the investment activities of the private fund" will lead to the employees "likely to be finally sophisticated and capable of fending for themselves in evaluating investment." SEC Rel. No. 33-10824 at 39. Moreover, the SEC noted that "[a]llowing these employees to invest in the funds for which they work (and other funds managed by their employer) as accredited investor also may help to align their interest with those of other investors in the fund." Id.

The SEC's August 2020 update also expanded the definition of accredited investors to various categories of entities. The expansion treats all SEC and state-registered investment advisors as well as certain exempt reporting advisers under the Investment Advisers Act as accredited investors (Rule 501(a)(1)). The SEC expanded the accredited investor definition to include certain rural business investment companies, as defined in the Consolidated Farm and Rural Development Act (Rule 501(a)(1)). The expansion also deems limited liability companies with total assets exceeding $5 million not formed with the specific purpose of acquiring the securities offered as accredited investors (Rule 501(a)(3)). Certain entities established by families to manage family assets ("family offices"), and family clients of family offices, are also deemed accredited investors so long as the family office has assets under management in excess of $5 million, was not formed with the specific purpose of acquired the offered securities, and "[w]hose 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 risk of the prospective investment." Rule 501(a)(12). Not content to expand the laundry list of entities eligible for accredited investor status one category at a time, the SEC also added a catch-all provision that includes any entity owning investments in excess of $5 million that is not formed for the specific purpose of acquiring the securities bring offered. Rule 501(a)(9). The SEC noted that entities that may take advantage of the catch-all include "Indian tribes", "federal, state, territorial, and local governmental bonds", and "entities organized or under the laws of foreign countries." SEC Rel. No. 33-10824 at 55.

HYPOTHETICAL THREE

Trendy decides to do a Regulation D offering under Rule 506 to raise capital for its contemplated expansion of the marketing and distribution of its Lean Green drink. Sales are made to 35 sophisticated, non-accredited purchasers. Trendy also makes sales to the following investors. Do these additional sales create any problems under Regulation D?

1. *Scenario One:* Trendy sells securities in the offering to all of its executive vice presidents, including to Alan, the VP for drink research and Laura, the VP for human resources.

2. *Scenario Two:* Trendy sells securities in the offering to Dale. Dale is a retiree who has a stock portfolio of $1.1 million; the entire portfolio is invested in index funds and Dale has no other significant assets or debts. Dale lives off the dividends from the portfolio (along with limited sales of capital) to pay for monthly expenses. (Dale lives in San Francisco where he pays $3,000 per month for his one-bedroom apartment.) Dale has no other source of income, but enjoys golfing.

3. *Scenario Three:* Trendy sells securities to Beth. Beth has a Ph.D. in financial economics from the University of California, Berkeley. Beth worked only one year for Morgan Stanley before being fired for insider trading. During that year, however, Beth made $2,000,000 from her trading efforts and has a net worth today of $700,000 (after paying stiff civil penalties to the SEC). Beth now froths milk for cappuccinos and makes $15.00 an hour.

4. *Scenario Four:* What if Beth shares an apartment with Andrei, one of the 35 sophisticated purchasers in the offering. If Beth and Andrei are simply good friends (but nothing more), does Beth count as a purchaser, thereby increasing the total to 36 purchasers?

5. *Scenario Five:* Trendy sells securities to the Trendy Investment Partnership. TIP was formed a month prior to Trendy's offering and has 50 partners. None of the partners, individually, is an accredited investor. TIP's total net assets are $1 million.

6. *Scenario Six:* Trendy's initial Rule 506 offering to 35 sophisticated, non-accredited purchasers all take place on March 1. Two months later, on May 1, Trendy sells $25 million of securities to an additional 30 sophisticated, non-accredited purchasers through a separate Rule 506 offering.

In comparing the two Regulation D offerings, issuers face a tradeoff between the restrictions on the aggregate offering price and the number of purchasers. Rule 504 imposes no limit on purchasers but restricts offerings to $10 million. Rule 506, in contrast, restricts the number of non-accredited purchasers to 35 (plus an unlimited number of accredited purchasers) and allows offerings with no aggregate offering price limit. But Rule 506 offerings face an additional regulatory constraint not present for Rule 504 offerings: Rule 506 purchasers who are not accredited investors must also meet a sophistication requirement. Purchasers must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." Rule 506(b)(2)(ii)

How are issuers supposed to determine whether an investor (alone or with a purchaser representative) is able to evaluate the merits and risks of an investment? Issuers could look to factors such as:

- Wealth and income (much like for accredited investor status for individuals)
- Experience (general business or more specific to the particular investment?)
- Education
- Present investment status (well-diversified)
- Performance on an investment test (like qualifying for a driver's license)

Among these factors, which ones are most likely to correlate with an investor's ability to assess the merits and risks of investments? How expensive would it be for an issuer to administer such a screen for sophistication? What risk would the issuer run that a court or the SEC may later question the accuracy and reasonableness of the screen? In practice, because Rule 506's sophistication requirement is somewhat vague, many Rule 506 offerings exclude non-accredited investors altogether and sell only to accredited investors.

The following table summarizes the tradeoff between aggregate offering price and purchaser restrictions for the two types of Regulation D offerings:

	Rule 504 (§§ 3(b)(1), 28)	**Rule 506 (§ 4(a)(2))**
Aggregate Offering Price	≤ \$10 million (Rules 504(b)(2), 501(c)) prior 12 mo. and during offering aggregation with other Rule 504 offerings and § 5(a) violations	Unlimited
Number of Purchasers	No limit on purchasers	≤ 35 non-accredited purchasers; Unlimited accredited purchasers (Rules 506(b)(2)(i), 501(a), 501(e)) Sophistication requirement (Rules 506(b)(2)(ii), 501(h))

Add after the last full paragraph at the bottom of p. 687:

The SEC provides an exemption from general solicitation or general advertising for so-called "demo days." According to the SEC: "'Demo days' and similar events are generally organized by a group or entity (such as a university, angel investors, an accelerator, or an incubator) that invites issuers to present their businesses to potential investors, with the aim of securing investment." SEC Rel. No. 33-10884 at 76. To promote the ability of issuers to participate in such demo days and allow investors to learn more about the issuers through demo days, the SEC provides in Rule 148 of the Securities Act that general solicitation or general advertising does not include seminars and meetings in which more than one issuer participates that are sponsored by "a college, university, or other institution of higher education, a local government, a nonprofit organization, or an angel investor group, incubator, or accelerator." Rule 148(a). In justifying the list of potential sponsors, the SEC wrote that it sought to limit "the potential for a sponsor to profit from its involvement or to have a potential conflict of interest due to its relationships with either the issuer or investors attending the event." SEC Rel. No. 33-10884 at 83.

Among other things, Rule 148 prohibits advertising for the seminar or meeting that references a specific offering of securities by an issuer. Rule 148(a)(1). Rule 148 limits the ability of sponsors of a demo day to engage in certain communications including making investment recommendations or providing investment advice to attendees of the event and engaging in any investment negotiations between the issuer and investors attending the events. Sponsors may also not charge attendees of the event any fees other than "reasonable" administrative fees. Rule 148(a)(2). Rule 148 allows issuers to provide "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 proceeds of the offering, and the unsubscribed amount in an offering." Rule 148(a)(3). In allowing limited information on securities offerings, the SEC noted that "the rule is intended to allow issuers, in discussing their business plans with potential investors at these events, the flexibility to note that they are seeking capital without uncertainty as to whether they have jeopardized their ability to rely on a certain exemption from registration." SEC Rel. No. 33-10884 at 85.

Out of a concern that non-accredited investors may by more likely to participate in virtual demo day events, the SEC limited Rule 148's to virtual demo day events to the following: "(a) individuals who are members of, or otherwise associated with the sponsor organization (for example, members of an angel investor group or students, faculty, or alumni of a college or university); (b) individuals that the sponsor reasonably believes are accredited investors; or (c) 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." SEC Rel. No. 33-10884 at 83-84; Rule 148(a)(4).

Replace Hypothetical Five on p. 688

HYPOTHETICAL FIVE

Trendy moves forward with a Rule 506 offering to raise $20 million for its expansion campaign for the Lean Green drink. Eager to find investors for the offering, Kim, the CEO of Trendy, employs West Securities to help sell the offering. Mark, the managing partner of West Securities, is working to sell the securities. Are these sales practices permissible under Rule 502(c)?

1. *Scenario One:* Mark walks up and down his alma mater's health club locker room, the Yale Club in New York, telling everyone about his offering, passing out offering circulars, and collecting purchase requests. Mark, a gregarious fellow, knows everyone in the health club on a first-name basis.

2. *Scenario Two:* Suppose Trendy tells West Securities that it will reduce its offering down to $10 million in order to fit within Rule 504. Mark again goes to solicit interest from among his friends at the health club.

3. *Scenario Three:* Mark goes to the financial district in Boston and drops in unannounced at the offices of large mutual fund managers for Fidelity, Scudder, Dreyfus, and other prominent mutual funds (all very sophisticated investors). Mark again passes out offering circulars and collects purchase requests. Mark only knows of the mutual fund managers by reputation, having seen their names repeatedly in the *Wall Street Journal*.

4. *Scenario Four:* Trendy completes a Rule 506(b) offering on January 1 for $10 million in common stock, selling to ten accredited investors and twenty sophisticated purchasers (none of whom are accredited). Later in the year, Trendy makes a Rule 504 offering for $4 million of common stock from July 1 to July 30, selling to 30 unsophisticated purchasers. Trendy makes another Rule 504 offering for $1 million of common stock from December 1 to December 15 of the same year, selling to five unsophisticated purchasers. If Trendy engaged in general solicitation in all three offerings, is Trendy able to qualify for Rule 504 for the latter two offerings? (Assume no integration of the offerings.)

5. *Scenario Five:* NYU Stern School of Business invites Trendy to a conference on pre-IPO companies. The conference aims to connect several pre-IPO companies, angel investors, and academics to discuss issues companies face in raising capital through private placements. Trendy plans on discussing its fruity drink business and also its plans to raise at least $50 million over the next year to finance the production of new drink products. At the end of the conference, Trendy is awarded the "best new investment" prize by the group of Stern professors sponsoring the event.

Replace starting with the table at the top of p. 690:

	Non-Exchange Act Reporting Company	**Exchange Act Reporting Company**
Offerings up to $20 million	Non-financial info under Rule 502(b)(2)(i)(A) Financial info under Rule 502(b)(2)(i)(B)(1)	Rule 502(b)(2)(ii)
Offerings over $20 million	Non-financial info under Rule 502(b)(2)(i)(A) Financial info under Rule 502(b)(2)(i)(B)(2)	Same as above

The disclosure for Exchange Act reporting issuers does not vary by offering amount. Instead, Exchange Act reporting issuers have a choice. They may either provide a combination of the most recent annual report, the definitive proxy statement, and (only if requested by the purchaser in writing) the most recent Form 10-K or just the most recent Form 10-K if it contains the information found in the annual report. Rule 502(b)(2)(ii)(A) & (B). In either case, issuers must also disclose any more recent Exchange Act filings made since those filings. Also, issuers must provide a brief description of the securities, the use of the proceeds, and "any material changes in the issuer's affairs that are not disclosed in the documents furnished." Rule 502(b)(2)(ii)(C).

For non-Exchange Act reporting issuers, Rule 502(b)(2)(i)(A) provides for the same non-financial disclosure regardless of offering amount. Rule 502(b)(2)(i)(A) refers to the "same kind" of information contained in Part II of Form 1-A for issuers eligible to use Regulation A or, alternatively, contained in Part I of a public offering registration statement for issuers not eligible to use Regulation A. We discuss the Regulation A exemption from § 5 later in this chapter.

The offering amount becomes important only for disclosure of financial information by non-Exchange Act reporting issuers. Rules 502(b)(2)(i)(B)(1) & (2) mandate different levels of financial disclosure. As the offering amount increases, the level of financial disclosure increases (with a greater audit requirement). Students can trace the requirements through the following referenced forms:

- Up to $20 million: The financial statement information required by paragraph (b) of Part F/S of Form 1-A (the Regulation A offering statement). Paragraph (b) of Part F/S of Form 1-A provides that the financial statements need not be prepared in accordance with Regulation S-X. In addition, the financial statements need not be audited (but if not audited must be labeled as "unaudited").
- Over $20 million: The financial statement information required by paragraph (c) of Part F/S of Form 1-A (the Regulation A offering statement). Paragraph (c) of Part

F/S of Form 1-A requires audited financial statements except for interim financial statements which are not required to be audited.

In addition, Rule 502(b) provides a catchall provision to ensure that non-accredited investors receive notice of information given to accredited investors. The issuer must give non-accredited investors a brief written description of "any material written information concerning the offering that has been provided by the issuer to any accredited investor" not already given to the non-accredited investors. Rule 502(b)(2)(iv). Also, if the non-accredited investor provides a written request for the information, the issuer must furnish the information to the non-accredited investor within a reasonable time prior to the purchase.

The issuer must also give each purchaser the "opportunity to ask questions and receive answers" relating to the offering. Rule 502(b)(2)(v). The issuer must also supply any additional information necessary to verify the accuracy of the specific mandatory disclosure items in Rules 502(b)(2)(i) and (ii) upon a purchaser's request if the "issuer possesses or can acquire without unreasonable effort or expense" the information. Rule 502(b)(2)(v).

Replace the first paragraph under E. Resale Restrictions on p. 691

Securities sold through Regulation D generally cannot be freely resold. The exception is that investors that purchase securities sold through a Rule 504 offering that complies with the state law registration requirement specified by Rule 504(b)(1) may freely resell the securities. A liquid public secondary market is possible immediately after a Rule 504 offering. The small size of the Rule 504 offering (limited to $10 million) and state law restrictions, however, may limit the development of any secondary market in the Rule 504 securities.

Replace F. Integration on p. 693

F. INTEGRATION

Issuers must meet a number of requirements to qualify for the Regulation D exemptions from § 5. If an issuer could arbitrarily split apart one offering into separate offerings, that would allow the issuer to avoid many of these requirements. In particular, there are three key requirements of Regulation D offerings that issuers might attempt to avoid by artificially splitting offerings.

1. *Aggregate offering price*. Rule 504 limits the aggregate offering price to $10 million. Rule 504(b)(2). Without more, an issuer could get around this limit and sell an unlimited amount of securities by splitting an offering into multiple Rule 504 offerings, each of which is for $10 million or less.

2. *Number of purchasers*. Rule 506(b)(2)(i) limits the number of non-accredited purchasers to 35 or fewer. If an issuer wants to sell to 70 non-accredited investors, the issuer could split the offering into two separate Rule 506 offerings of 35 non-accredited investors each. Without more, an issuer could easily avoid Rule 506(b)(2)(i)'s limit.

3. *General solicitation*. An issuer worried about Rule 502(c)'s limitation on general solicitation may attempt to split a private placement into two separate offerings. In offering one, the issuer offers and sells through general solicitation only to accredited investors, allowing the issuer potentially to use Rule 506(c)'s exception from the general solicitation limitation. In offering two, the issuer sells under Rule 506(b) to non-accredited investors with whom the issuer has a pre-existing relationship, complying with 502(c)'s limitation on general solicitation.

The securities laws rely on the concept of "integration" to prevent issuers from artificially splitting apart offerings to avoid the offering requirements. When integration applies, the securities laws treat two otherwise separate offerings as one offering. Integration applies not only to exempt offerings but also to registered offerings. An IPO issuer, for example, must consider whether a prior private placement may be integrated into the IPO, leading any general solicitation in the private placement to be treated as offers in the pre-filing period for the IPO.

We saw earlier in this Chapter that some requirements of Regulation D offerings contain built-in aggregation across multiple offerings that function similar with integration to limit the ability of issuers to avoid specific requirements by artificially separating offerings. Rule 504's aggregate offering price ceiling is $10 million. However, the ceiling is reduced for all sales in the prior 12 months either under Rule 504 or in violation of § 5. Rule 504(b)(2). Similarly, the limit in Rule 506 to 35 or fewer non-accredited purchasers also has a built-in mechanism to aggregate across separate offerings. Under Rule 506(b)(2)(i), the 35 or fewer non-accredited investor limit is applied to "any 90-calendar-day period," automatically aggregating across all Rule 506 offerings in this time period.

Unlike the built-in aggregation provisions, integration is more difficult to apply. But once integration applies, separate offerings are combined and are treated as a single offering for purposes of determining whether there is an exemption from § 5. No built-in aggregation exists for general solicitation, so integration limits the ability of issuers to split apart offerings to engage in general solicitation in one offering (such as under Rule 506(c)) while selling in a second offering that prohibits general solicitation (such as under Rule 506(b)).

When will offerings be integrated? In Rule 152(a), the SEC sets forth the "general principle" for when integration does *not* occur:

> [I]n determining whether two or more offerings are to be treated as one for the purpose of registration or qualifying for an exemption from registration under the Act, offers and sales 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 Act, or that an exemption from registration is available for the particular offering.

Rule 152(a)(1) provides additional guidance in applying the general principle against integration for an offering that prohibits general solicitation. Rule 152(a)(1) states that for an exempt offering that prohibits general solicitation, the issuer must have "reasonable belief" based on the "facts and circumstances" that the issuer, or those acting on the issuer's behalf, either: "(i) Did not solicit each purchaser using general solicitation; or (ii) Established a substantive relationship with each purchaser prior to the commencement of the exempt offering." Rule 152(a)(1). Similar with the importance of a pre-existing relationship in avoiding general solicitation discussed earlier in this Chapter, the SEC has defined a substantive relationship as follows: "A 'substantive' relationship is one in which the issuer (or a person acting on its behalf, such as a registered broker-dealer or investment adviser) has sufficient information to evaluation, and does, in fact, evaluate, an offeree's financial circumstances and sophistication, in determining his or her status as an accredited or sophisticated investors." SEC Rel. No. 33-10884 at 31.

Rule 152(a)(2) further provides guidance in the case of two concurrent exempt offerings where at least one of the offerings allows for general solicitation (call this the "anchor offering"). When the issuer for the anchor offering includes in the offering materials information on the material terms of an "other" concurrent offering, Rule 152(a)(2) provides that the information on the other offering may constitute an offer for the other offering to the recipients of the information in the anchor offering. As a result, with respect to the anchor offering, the issuer must "comply with all the requirements for, and restrictions on, offers under the exemption being relied on for such other offering, including any legend requirements and communications restrictions." Rule 152(a)(2).

The general principle in Rule 152 allows issuers considerable latitude in avoiding integration. Suppose an issuer seeks to conduct a Rule 506 offering to both accredited and non-accredited investors using general solicitation. The issuer enjoys a pre-existing relationship with only the non-accredited investors. In a single offering, the promoter likely cannot use Rule 506 for such an offering because of the need for general solicitation to the accredited investors. The promoter can artificially split the offering into one with only the accredited investors using general solicitation under Rule 506(c) and a second concurrent offering with only the non-accredited investors with no general solicitation under Rule 506(b). According to the general principle all the issuer must do to avoid integration is "establish that each offering complies with … an exemption from registration." In this example, the promoter can say that under the "facts and circumstances" the first offering complies with Rule 506(c) and the second offering complies with Rule 506(b) even though the combined offering would comply with neither.

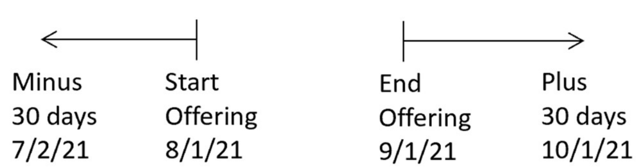
The general principle leaves open the question of when two or more offerings will be integrated. The SEC's promulgating release for Rule 152 states that the general principle provides a framework "for determining whether two offerings occurring *close in time* may be considers as integrated." SEC Rel. No. 33-10884 at 27 (emphasis supplied). If the general principle for when integration does not occur is inapplicable, issuers are left to consider whether two separate offerings are "close in time" enough to become integrated under the "facts and circumstances."

Suppose that an issuer has two separate exempt offerings purporting to meet the requirements of Rule 506(b) (no general solicitation) and 506(c) (general solicitation allowed). Only the Rule 506(c) offering, however, meets the requirements of Rule 506(c), while the attempted Rule 506(b) fails to satisfy that rule's requirements. In this case, since the issuer fails to establish that "each" offering meets the requirements of their respective exemptions, the general principles no longer provide that the offerings are "not" integrated. But does this mean the two offerings are automatically integrated? What if the two offerings are for different purposes, not part of the same plan of financing, and are far apart in time?

This ambiguity is substantially limited by a series of safe harbors from integration in Rule 152(b). The safe harbors provide certainty to an issuer seeking to avoid the integration of two offerings. The safe harbors are as follows.

> *Rule 152(b)(1).* Any offering 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, will not be integrated with such other offering; provided that, for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation, the provisions of Rule 152(a)(1) shall apply.

To illustrate, imagine that a Regulation D private placement occurs from 8/1/21 to 9/1/21. The safe harbor under Rule 152(b)(1) will apply prior to 7/2/21 and after 10/1/21 as depicted below:



The Rule 152(b)(1) safe harbor focuses on time between the termination or completion of one offering and the commencement of another offering. The further apart two offerings are in time, the less likely that an issuer is separating two offerings for the purpose of avoiding the requirements of an exempt offering. Delay imposes costs on an issuer. An issuer with a specific need for capital must wait in order to raise the desired amount of capital in order to qualify for the Rule 152(b)(1) safe harbor. Of course, 30 calendar days does not impose the same costs of delay as 90 days or 12 months. The longer aggregation period for the limit of 35 non-accredited purchasers in Rule 506 (90 days) and the aggregate offering price ceiling of Rule 504 (12 months) suggests that the SEC was more concerned with issuers manipulating offerings to avoid these limits. The Rule 152(b)(1) safe harbor nonetheless emphasizes that the issuer must comply with the Rule 152(a)(1) guidance discussed above with respect to exempt offering for which general solicitation is not permitted.

> *Rule 152(b)(2).* Offers and sales made in compliance with Rule 701, pursuant to an employee benefit plan, or in compliance with Regulation S will not be integrated with other offerings.

For offers and sales related to an employee benefit plan under Rule 701 the SEC justified the safe harbor against integration as follows: "Offers and sales pursuant to Rule 701 and employee benefit plans are limited to investors, such as employees, consultants, and advisors, with whom the issuer has written compensation plans or agreements … given the relationships between these investors and the issuer, that these offers and sales do not raise the same level of investor protection concerns as offerings to other investors." SEC Rel. No. 33-10884 at 50. For offerings outside the United States, Rule 152(b)(2) codified the SEC's long-standing position against integration for Regulation S offerings.

> *Rule 152(b)(3).* An offering for which a Securities Act registration statement has been filed will not be integrated if it is made subsequent to: (i) a terminated or completed offering for which general solicitation is not permitted; (ii) a terminated or completed offering for which general solicitation is permitted that was made only to qualified institutional buyers and institutional accredited investors; or (iii) an offering for which general solicitation is permitted that terminated or completed more than 30 calendar days prior to the commencement of the registered offering.

Rule 152(b)(3) provides a safe harbor against integration between a particular registered public offering (call it the "anchor public offering") and prior terminated or completed offerings. In such a situation, the typical issuer's concern is that the pre-filing period of the anchor public offering may overlap with a prior offering. Integration in such a situation may result in communications from the prior offering that condition the market in the pre-filing period for the anchor public offering, a possible § 5(c) violation. This concern may lead issuers to eschew raising capital through a private placement prior to commencing a registered public offering. The SEC wrote: "capital raising around the time of a public offering, in particular an initial public offering, including immediately before the filing of a registration statement, is often critical if issuers are to have sufficient funds to continue to operate while the public offering process is ongoing." SEC Rel. No. 33-10884. at 56.

Rule 152(b)(3) contemplates three types of offerings prior to a particular anchor public offering. First, if the prior offering prohibits general solicitation, then the issuer is unlikely to use the prior offering as a backdoor way to condition the market for the anchor offering. Rule 152(b)(3) provides a broad safe harbor against integration for a prior offering for which general solicitation is prohibited regardless of the time between the anchor public offering and the prior offering. If the prior offering is either terminated or completed, there is no integration. Second, if the prior offering allows for general solicitation but only to qualified institutional buyers or institutional accredited investors then the issuer will similarly have little incentive to use the prior offering as a backdoor way to condition the market for the anchor offering. The issuer already could have solicited qualified institutional buyers and institutional accredited investors during the pre-filing period of the anchor public offering under Rule 163B. Accordingly, Rule 152(b)(3) blocks integration regardless of the time between the offerings so long as the prior offering is either terminated or completed. Third, some prior offering exemptions permit general solicitation. In this case, there is a risk that an issuer may use the prior offering to condition the market for the anchor public offering through solicitations in the prior offering. For example, individual accredited investors can be solicited under Rule 502(c) in a way that is not allowed under Rule 163B for the anchor public offering. Rule 152(b)(3) imposes a 30-day calendar day delay after the prior offering. According to the SEC, thirty days is sufficient to dispel any prior conditioning of the market.

> *Rule 152(b)(4).* Offers and sales made in reliance on an exemption for which general solicitation is permitted will not be integrated if made subsequent to any terminated or completed offering.

Rule 152(b)(4) provides an integration safe harbor for an exempt offering for which general solicitation is allowed (call it the "anchor general solicitation offering"). For an anchor general solicitation offering, there is little risk that an issuer would artificially separate offerings to allow for general solicitation; the issuer already can engage in general solicitation. Rule 152(b)(4) accordingly provides that the anchor general solicitation offering will not be integrated with any prior terminated or completed offerings. The SEC provided the following example:

> an issuer may rely on the safe harbor in new Rule 152(b)(4) if, for example, the issuer commences an offering under Rule 506(b) and thereafter engages in general solicitation in reliance on Rule 506(c) so long as once the issuer engages in general solicitation, it relies on Rule 506(c) for all subsequent sales, thereby effectively terminating the Rule 506(b) offering, including by selling exclusively to accredited investors and taking reasonable steps to verify the accredited investor status of each purchaser. The use of general solicitation in reliance on Rule 506(c) will not affect the exempt status of prior offers and sales of securities made in reliance on Rule 506(b).

SEC Rel. No. 33-10884 at 60-61.

The combination of the general principle in Rule 152(a) and the safe harbor provisions in Rule 152(b) makes it easy for an issuer to avoid integration of separate offerings. Rule 152 provides an important caveat, stating that "the provisions of this section will not have the effect of avoiding integration for any transaction or series of transactions that, although in technical compliance with the section, is part of a plan or scheme to evade the registration requirements of the Act."

HYPOTHETICAL EIGHT

1. *Scenario One:* Trendy is contemplating a private placement to raise $10 million to fund its Lean Green drink expansion campaign. Trendy wants to raise this money through sales using a broker-dealer that has contacts with 35 individual investors (non-accredited but sophisticated) who want in the aggregate to purchase $5 million of common stock. Trendy also plans on making cold calls to 35 individual investors (assume accredited) to sell the remaining $5 million of common stock. How can Trendy structure its transactions within Regulation D, allowing it to raise all this money in the next month?

2. *Scenario Two:* Suppose Trendy instead decides to do the following two offerings:

> On January 1, Trendy conducts a Rule 506 offering of preferred stock sold through its brokers to accredited investors through the use of general solicitation. The general solicitation includes a glossy brochure detailing the bright prospects for Trendy's business and how offering proceeds will be the "rocket fuel" that will cause profits to increase. The offering raises $35 million and the proceeds are used to expand its Lean Green production facilities. Forty individual accredited investors participate in the offering.
>
> One day after the completion of the Rule 506 offering, Trendy begins the process for an initial public offering and eventually files a registration statement for the IPO with the SEC.

Replace the second paragraph under 2. Rule 504 on p. 703

There are two caveats, however, to this observation. First, Rule 504 limits the aggregate offering price to $10 million and it excludes Exchange Act reporting issuers. The mini-public offering allowable under Rule 504 therefore is primarily of use for small, less well-followed issuers raising small amounts of capital. The ability to engage in general solicitation and avoid disclosure may not matter if only more sophisticated investors participate in the market for such offerings. Sophisticated investors will presumably demand disclosure and will have the wherewithal to fend for themselves despite receiving a general solicitation. But are such investors interested in such small-scale offerings?

Replace the introductory section under IV. Regulation A

Small business issuers enjoy a number of routes to raise capital in the securities markets with relaxed disclosure requirements and regulations. For "emerging growth companies" doing public offerings, the JOBS Act eases the burden of disclosure requirements as we discuss in Chapter 7. Although emerging growth companies must comply with § 5's gun-jumping regime, less stringent disclosure reduces the cost of preparing the registration statement for a public offering.

Non-Exchange Act reporting companies (typically smaller issuers with fewer than 2,000 shareholders or less than $10 million in assets) may also take advantage of Rule 504 to do a public offering of securities that can be freely resold. Rule 504, however, imposes a $10 million limit on the aggregate offering price and requires issuers to comply with state law registration requirements in order to avoid the general solicitation and resale limitations of Regulation D. Rules 502(c) and (d).

Standing in between registered public offerings on the one hand, and Rule 504 on the other, is Regulation A, promulgated pursuant to § 3(b)(2) of the Securities Act, which provides an offering exemption from § 5 for private issuers (non-Exchange Act reporting issuers). Like offerings under Rule 504 and § 5, Regulation A allows for the free resale of securities, which creates the possibility of a liquid secondary market following an offering.

Historically, Regulation A was of little economic significance, hamstrung by a $5 million ceiling on the offering amount. Issuers were also put off by the time and expense of complying with Regulation A's gun jumping rules and disclosure requirements. Finally, issuers seeking to use Regulation A were required to comply with state "Blue Sky" securities law requirements in every state in which securities were offered and sold. As a consequence, Regulation A was largely ignored.

Congress boosted the appeal of Regulation A as part of the JOBS Act of 2012, raising the statutory exemption authority to $50 million. Section 3(b)(5) provides for SEC review of the offering amount limitation every 2 years to determine whether to increase the amount. Another key change for Regulation A is Securities Act § 3(b)(4), which provides for ongoing periodic disclosure after the offering. Rather than piggyback onto the existing disclosure regime, Congress instructed the SEC to create a new set of disclosure rules for Regulation A issuers.

The SEC implemented this new exemption authority with a two-tiered "Regulation A+" regime. Tier 1, largely carries forward the prior Regulation A regime, albeit with a more generous $20 million limit for the securities being offered ("aggregate offering price") plus the gross proceeds for all securities sold pursuant to other Regulation A offerings within the 12 months before the start of and during the current offering of securities ("aggregate sales"). In other words, prior aggregate sales in Regulation A offerings count against the limit for subsequent Regulation A offerings. Tier 2 provides for offerings of up to $75 million; the SEC used its general exemptive authority under Securities Act § 28 to raise the ceiling. As we discuss below, issuers of Tier 2 offerings are not required to register or qualify the offering under state law, partially removing the burden of state "Blue Sky" regulation, but remain subject to state filing requirements and state antifraud laws. We briefly summarize here the main contours of Regulation A offerings, highlighting the differences between Tier 1 and Tier 2.

A note on Regulation A's terminology: Regulation A is a mini-public offering. Consequently, many of the terms used in Regulation A have direct counterparts from the registered public offering process. Issuers file an offering statement (registration statement) with the SEC of which a key part is the offering circular (prospectus). Issuers go through a three time period sequences in a Regulation A offering, going from the time prior to the filing of the offering statement with the SEC (the Pre-Filing Period), to the period during which the issuer waits for the SEC to declare the offering statement qualified (the equivalent of effectiveness for a registration statement) (the Waiting Period), to the period after the SEC has qualified the offering statement and sales may commence (the Post-Qualification Period).

Since the SEC's implementation of Regulation A+, a number of companies have raised capital through a Regulation A+ offering and in the aggregate have raised several hundreds of millions of dollars of capital from 2015 through the end of 2017. One of the first companies to use Regulation A+ was Elio Motors, a U.S.-based manufacturer of high fuel efficiency three-wheel cars. Elio Motors turned to CrowdfundX to assist Elio Motors in utilizing crowdfunding to raise capital through Regulation A+. Elio Motors' Regulation A+ offering was marketed widely to investors through StartEngine (located at www.startengine.com) and 6,345 investors invested money in the offering for a total of $16.9 million in 2015. Unfortunately for enthusiasts of three-wheeled cars, as of 2022, Elio Motors has yet to sell any cars, having shifted its efforts to producing an electric version.

Another example of a Regulation A+ offering is Longfin Corp. Longfin Corp., a financial technology company doing business primarily in Singapore, sold $5.7 million of stock in an initial public offering through Regulation A+ in December 2017. Relatively few private companies raising capital through Regulation A+ go on to list their shares for public trading on a U.S. securities exchange. Longfin was one of the exceptions, listing its shares on Nasdaq. Unfortunately for Longfin and its investors, the SEC initiated an investigation into Longfin in early 2018 and the company reported weaknesses in its internal controls. After large declines in its stock price, Longfin Corp. announced in May 2018 that it was voluntarily delisting from Nasdaq.

The problems for investors investing in Regulation A+ offerings perhaps should not come as a surprise. On the one hand, Regulation A+ helps early stage companies raise capital without going through the burdensome registered public offering process while at the same time enjoying the ability to "test the waters" through communications directly to retail investors. On the other hand, the lack of the protections afforded by the registered public offering process coupled with the ability to appeal directly to retail investors, regardless of financial sophistication, allows more "bad apples" type issuers into the market.

Add the following after the first paragraph under A. Eligible Issuers and Securities on p. 708

In 2018, Congress enacted the Economic Growth, Regulatory Relief, and Consumer Protection Act which, among other things, required the SEC to make Regulation A+ available to Exchange Act reporting issuers. Public companies potentially pose lower risk to investors given the presence of periodic disclosures for public companies and thus may experience greater success in raising capital through Regulation A+ compared with private companies.

Replace B. "Bad Actor" Disqualification at p. 709 with the following

B. "BAD ACTOR" DISQUALIFICATION

Regulation A has a disqualifying provision in Rule 262 that tracks the disqualification provision in Rule 506(d), targeting bad acts by two groups of potential participants in a Regulation A offering:

- The issuer, including any predecessors or any affiliated issuer (termed the "issuer" here).
- Key individuals and entities connected with the issuer or the offering ("related participants"). These include any director or officer of the issuer, beneficial owner of 20 percent or more of any class of its voting equity securities, and any promoter connected with the issuer in any capacity at the time of filing, any offer after qualification, or such sale. Also included is any person that is paid to solicit purchasers in connection with the offering (typically a broker-dealer assisting the issuer in the offering) as well partner, director, or officer of the soliciting agent.

Rule 262 then delineates a list of bad acts similar to the list of bad acts in Rule 506(d). The past wrongdoing must be in connection with the purchase or sale of any security, relate to a false filing with the SEC, or involve the "conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities." Rule 262 disqualification follows if the bad act has led to (among other consequences):

- A conviction for any felony or misdemeanor in the ten years prior to the Regulation A offering statement filing or sale pursuant to Regulation A. For issuers, the time period is shortened to five years. Rule 262(a)(1).
- A court order, judgment, or decree entered within five years of the Regulation A offering statement filing or sale pursuant to Regulation A restraining or enjoining the individual or entity from engaging or continuing to engage in any conduct or practice related to the past wrongdoing. Rule 262(a)(2).

Beyond these specific past securities-related violations, issuers are also disqualified under Rule 262 if either the issuer or related participant is subject to one of the following restrictions:

- A final order from state securities commissions, a state authority that supervises or examines financial institutions, a state insurance commission, an "appropriate" federal banking agency, the U.S. Commodity Futures Trading Commission, or the National Credit Union Administration that, among others, bars the specific party from association with the other regulator, bars the specific party from engaging in the business of securities, insurance or banking, or "[c]onstitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such filing of the offering statement or such sale." Rule 262(a)(3).
- Certain SEC orders that at the time of the Regulation A offering statement filing or sale pursuant to Regulation A, suspend or revoke the party's registration as a broker, dealer, municipal securities dealer, or investment advisor or otherwise limits their activities. Rule 262(a)(4).
- An SEC order entered into within five years of the Regulation A offering statement filing or sale pursuant to Regulation A that orders the specific party to "cease and desist from committing or causing a violation or future violation of" any scienter-based antifraud provision of the federal securities laws (including Rule 10b–5), or § 5 of the Securities Act. Rule 262(a)(5).
- A suspension or expulsion from FINRA or a national securities exchange "for any act or omission to act constituting conduct inconsistent with just and equitable

principles of trade." Rule 262(a)(6). This restriction also covers individuals who are barred from associating with a member for such conduct.

- "Has filed (as a registrant or issuer), or was or was named as an underwriter in, any registration statement or offering statement filed with the Commission that, within five years before the filing of the offering statement or such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such filing or such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued." Rule 262(a)(7).

Rule 262 gives discretion to the SEC to waive the disqualification. Rule 262(b)(2). Prior to the filing of the Regulation A offering statement or sale of securities pursuant to Regulation A, the court or regulatory authority that entered the order, judgment or decree that otherwise may lead to disqualification may provide in writing that disqualification should not arise as a consequence of such order, judgment, or decree. Rule 262(b)(3). Lastly, the issuer may avoid disqualification if: "the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed under [Rule 262(a)]." Rule 262(b)(4). The instructions to Rule 262(b)(4) then state: "An issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist."

Replace C. Aggregate Offering Price at p. 711 with the following

C. AGGREGATE OFFERING PRICE

Regulation A establishes two aggregate offering price ceilings. In a Tier 1 offering, issuers may sell up to $20 million, minus aggregate sales in other Regulation A offerings "within the 12 months before the start of and during the current offering of securities." As we discuss in Chapter 10, securities that were not initially sold through a public offering (restricted securities) as well as securities held by affiliates (those in a control relationship with the issuer) may not generally be resold in the public capital markets without complying with § 5 of the Securities Act. Unlike Regulation D, Regulation A allows selling securityholders to sell their restricted securities in a transaction exempt from § 5. Of the $20 million limit for a Tier 1 offering, investors may sell up to $6 million. (So if investors use the Regulation A offering to resell $6 million of securities that otherwise would have to comply with § 5, the issuer may sell up to $14 million in a Tier 1 Regulation A offering). In a Tier 2 offering, issuers may sell up to $75 million in aggregate offering price less any aggregate sales in other Regulation A offerings. Of this $75 million, investors can sell up to $22.5 million in secondary sales.

Unlike Regulation D, only securities sold pursuant to other Regulation A offerings are counted as aggregate sales to reduce the amount that can be sold in a particular Regulation A offering. Compare this with the aggregate offering price for Rule 504 offerings; under those Regulation D exemptions, the aggregate offering price limit is reduced by securities sold under other Rule 504 offerings as well as violations of § 5 within the prior 12 months.

The SEC added another offering amount restriction for secondary securities sales if an issuer is selling in an initial Regulation A offering. The worry is that pre-offering investors holding restricted securities may use Regulation A as a backdoor method of selling. For that initial offering, and any subsequent sales in a Regulation A offering for one year following the qualification date of the issuer's first Regulation A offering, investors cannot exceed 30% of the aggregate offering price for that offering. After twelve months from the first Regulation A offering, this 30% limit only applies to affiliate resales through Regulation A.

The table below compares Regulation A to registered public offerings (which have no offering price limit) and Rule 504.

	Public Offering	**Regulation A**	**Rule 504**
Offering Price Limitation	None	Tier 1: $20 million (No more than $6 million from selling securityholders) Tier 2: $75 million (No more than $22.5 million from selling securityholders)	$10 million Not available for selling securityholders
Aggregation	None	Prior 12-month aggregation with Reg. A offerings only (Rule 251(a)(1))	Prior 12-month aggregation with Rule 504 offerings and § 5(a) violations (Rule 504(b)(2))

HYPOTHETICAL ELEVEN

Trendy Inc. decides to make the following series of offerings (each taking place in one day). Assume that the offerings are for distinct and separate purposes (e.g., research and development, construction of Lean Green factory, advertising) and will not be integrated:

> January 1: Sale of $6 million of common stock under Rule 506 to 30 accredited individual investors (all making more than $400,000 per year).
>
> February 1: Sale of $30 million of common stock under a Tier 2 Regulation A together with $22.5 million of common stock sold by selling securityholders. Assume this is Trendy's first Regulation A offering.
>
> December 1: Sale of $8 million of securities under Rule 504 of Regulation D to 30 non-accredited investors.

The January 1st offering under Rule 506 was sold using broad-based solicitations to reach investors. Neither Trendy nor its placement agent verified the accredited investor status of the January 1st investors but instead "took them at their word." Are the offers exempt from § 5?

Replace 1. Pre-Filing Period at p. 718 with the following

1. PRE-FILING PERIOD

The rules governing the Pre-Filing Period for a Regulation A offering are analogous to the Pre-Filing Period under § 5. No sales are permitted in the Pre-Filing Period, Rule 251(d)(2), and no offers can be made until the offering statement is filed, Rule 251(d)(1)(i). Issuers in a public offering may "test the waters" through solicitations of Qualified Institutional Buyers or Institutional Accredited Investors pursuant to Rule 163B. Similarly, Rule 255 allows issuers to "test the waters" and determine the appetite of investors for the offering. Rule 255(a) provides that: "At any time before the qualification of an offering statement . . . an issuer or any person authorized to act on behalf of an issuer may communicate orally or in writing to determine whether there is any interest in a contemplated securities offering." No binding commitment, however, can be made until the offering is qualified.

To take advantage of testing the waters, the SEC requires that the communication meet certain conditions. Among other things, the communication must contain a disclaimer of any binding commitment or sale prior to qualification. Rule 255(b)(3). Rule 255(a) also provides that: "Such communications are deemed to be an offer of a security for sale for purposes of the antifraud provisions of the federal securities laws." Testing the waters communications are thus subject to potential Rule 10b–5 and § 12(a)(2) liability.

Issuers that have not sold securities in a prior Regulation A offering may worry about compliance with the Regulation A disclosure requirements. To address this concern, Regulation A gives issuers that have not previously sold securities under Regulation A or a registered public offering a non-public review of a draft offering statement before the filing of the offering statement with the SEC. Rule 252(d).

HYPOTHETICAL THIRTEEN

Suppose Kim, the CEO of Trendy, decides to have Trendy do a Regulation A offering. Kim is uncertain about the potential market for Trendy's stock and the possible offering price. Prior to filing the offering statement, she decides to contact a dozen institutional investors to gauge their interest in Trendy. In her conversations with the institutional investors, Kim conveys her positive forecasts for Trendy's earnings growth over the next several years. She tells them a Regulation A offering would act as the "rocket fuel" to launch Trendy's earnings even further upward. Is there any problem with Kim's conversations with the institutional investors?

Replace J. Integration at p. 723 with the following

J. INTEGRATION

Regulation A uses the unified integration general principle and safe harbors in Rule 152. Rule 251(c). As we discussed above, under the general principle against integration, two offerings will not be integrated if the issuer can demonstrate, bearing the burden of proof, that based on the "particular facts and circumstances," each offering either complies with § 5's registration requirements or complies with an exemption § 5. Rule 152(a). Rule 152(b), in turn, provides four safe harbors against integration. Rule 152(b)(1) provides a time based safe harbor against integration for offerings more than 30 calendar days before the commencement or 30 calendar days after the termination or completion of a particular offering. (Rule 152(a)(1) permits an offering that allows general solicitation if followed by an offering that prohibits general solicitation, but only if general solicitation was not used in the prior offering). Rule 152(b)(2) provides a safe harbor for offers and sales pursuant to certain employee benefit plans or under Regulation S (offshore offerings). Rule 152(b)(3) provides registered public offerings a safe harbor against integration with prior terminated or completed offerings. Lastly, Rule 152(b)(4) provides exempt offerings that allow general solicitation a safe harbor against integration with prior terminated or completed offerings.

One concern with Regulation A is the possibility of opportunistic testing of the waters. Consider the following scenario. An issuer could (a) initiate a Regulation A offering; (b) test the waters, thereby priming the market for the company's securities—an activity that could be considered as general solicitation; (c) withdraw the Regulation A offering (leading to an "abandoned Regulation A offering"); and finally, (d) commence a registered public offering. To the extent investors are "aroused" by the initial, non-regulated disclosures, Regulation A could provide a backdoor way for issuers to condition the market for a § 5 public offering.

Issuers offering or selling securities in sequential offerings have to worry about integration. Any abandoned Regulation A offering followed by a registered public offering would thus pose the risk that any solicitations made as part of the Regulation A offering would be integrated with the later registered public offering which causes the issuer to violate § 5(c) and face possible § 12(a)(1) liability. Rule 152(b)(3) provides a safe harbor for registered public offerings that commence after a prior terminated or completed exempt offering. For example, under Rule 152(b)(3)(ii) the SEC says: "where an issuer has solicited interest in a contemplated, but subsequently abandoned Regulation A offering only to QIBs or IAIs, the abandoned Regulation A offering would not be subject to integration with a subsequently filed registered offering." SEC Rel. No. 33-10884 at 55 n.161. In comparison, where the abandoned Regulation offering solicited investors more generally, the abandoned Regulation A offering would not be integrated with a subsequent filed registered offering if the time between the termination of the Regulation A offering and the commencement of the registered offering is greater than 30 calendar days. Rule 152(b)(3)(iii).

HYPOTHETICAL SEVENTEEN

Trendy makes the following offerings:

1/1 to 1/30: Sale of $10 million of common stock pursuant to Rule 504 to 25 unsophisticated purchasers to fund expansion of the Lean Green product.

2/1 to 2/28: Testing the waters offers for a $70 million Tier 2 offering of common stock pursuant to Regulation A. On 3/1, the offering statement is filed with the SEC. On 4/1, sales begin and by 4/15 all $70 million of common stock has been sold. Proceeds will be used to fund expansion of the Lean Green product.

Will the two offerings be integrated?

Replace B. Integration at p. 728 with the following

B. INTEGRATION

Regulation Crowdfunding uses the unified integration general principle and safe harbors in Rule 152. Rule 100(e). As we discussed above, under the general principle, two offerings will not be integrated if the issuer can demonstrate, bearing the burden of proof, that based on the "particular facts and circumstances," each offering either complies with § 5's registration requirements or complies with an exemption from § 5. Rule 152(a). Rule 152(b), in turn, provides four safe harbors against integration. Rule 152(b)(1) provides a safe harbor against integration for offerings more than 30 calendar days before the commencement or 30 calendar days after the termination or completion of a particular offering. (Rule 152(a)(1) permits an offering that allows general solicitation followed by an offering that prohibits general solicitation, but only if general solicitation was not used in the prior offering.) Rule 152(b)(2) provides a safe harbor for offers and sales pursuant to certain employee benefit plans or under Regulation S (offshore offerings). Rule 152(b)(3) provides registered public offerings a safe harbor against integration with prior terminated or completed offerings. Lastly, Rule 152(b)(4) provides exempt offerings that allow general solicitation a safe harbor against integration with prior terminated or completed offerings.

Replace the first paragraph under C. Investors at p. 728 with the following

In addition to the aggregate offering amount limit, Regulation Crowdfunding also limits the aggregate amount that may be sold to non-accredited investors across all issuers in reliance on § 4(a)(6) during a 12-month period. The SEC specified the limit for any particular investor as: "(i) The greater of $2,200, or 5 percent of the greater of the investor's annual income or net worth, if either the investor's annual income or net worth is less than $107,000; or (ii) Ten percent of the greater of the investor's annual income or net worth, not to exceed an amount sold of $107,000, if both the investor's annual income and net worth are equal to or more than $107,000." Rule

100(a)(2). For example, if an investor has an annual income of $150,000 and a net worth of $50,000 then the limit would equal $15,000 (10% of $150,000, the greater of the two thresholds). Notably, the individual investor's limit is aggregated during any 12-month period for all issuers using the § 4(a)(6) crowdfunding exemption. In establishing the limits for non-accredited investors, the SEC recognized that the "startups and small business that we expect will rely on the crowdfunding exemption are likely to experience a higher failure rate than more seasoned companies" and that the limits will "potentially limit investment losses in crowdfunding offerings for investors who may be less able to bear the risk of loss." Sec. Act Rel. 33–9974, at 26. Accredited investors are excluded from the limits.

The computation of the annual income and net worth of an investor is the same as accredited investor status under Rule 501 of Regulation D. Rule 100(a)(2), Instruction 1. For example, in determining the net worth of a natural person, the person's primary residence is not included as an asset. Spouses are also allowed to calculate their net worth or annual income jointly. When computed jointly, the aggregate investment of the spouses may not exceed the limit that would apply to an individual investor with the same income and net worth level. To illustrate, if two spouses utilize joint calculation and have a joint income of $200,000 and joint net worth of $500,000, then they would be limited to investing $50,000 (the same investment cap as for individuals) in any 12-month period across all § 4(a)(6) crowdfunding offerings. Issuers may rely on crowdfunding intermediaries to determine that the aggregate amount of securities purchased by any particular investor through crowdfunding does not exceed the investment limit unless the issuer knows that the investor has exceeded the investor limits or would exceed the investor limits by purchasing securities in the issuer's offering. Rule 100(a)(2), Instruction 3. To account for inflation, § 4A(h) of the Securities Act provides that the SEC must adjust the individual investment dollar limits periodically along with the limits for accredited investor status.

Replace the carryover paragraph at the bottom of p. 730 with the following

The SEC relies on the intermediary in a crowdfunding transaction to screen issuers. The intermediary must have a reasonable basis for believing that the issuer complies with the crowdfunding disclosure requirements. Rule 301(a). The intermediary must also have a reasonable basis for believing that the issuer has established means to keep accurate records of the holders of its securities offered and sold through the intermediary's platform. Rule 301(b). The intermediary must conduct a background check as well as check the securities enforcement regulatory history of those individuals. Rule 301(c)(1). The intermediary must deny access to its platform if the intermediary has reason to know that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection. Rule 301(c)(2).

Insert the following before 1. Offering Statement and Progress Updates at p. 732

1. TESTING THE WATERS PRIOR TO FILING

Rule 206 provides that prior to the filing of the Regulation Crowdfunding offering statement with the SEC, an issuer may communicate either orally or through writing to determine whether investors have any interest in the offering. Rule 206(a). An issuer can obtain indications of interest in a crowdfunding offering, but may not solicit or accept "money or other consideration." Rule 206(a). The issuer also may not solicit or accept "any commitment, binding or otherwise, from any person" until the offering the offering statement is filed. Rule 206(a).

Rule 206(b) requires that the issuer include statements with test the waters communications as follows: (1) "no money or other consideration is being solicited, and if sent in response, will not be accepted", (2) "no offer to buy the securities can be accepted and no part of the purchase price can be received until the offering statement is filed and only through an intermediary's platform", and (3) "person's indication of interest involves no obligation or commitment of any kind."

Test the waters communications are considered an offer of a security of sale for purposes of the antifraud provisions of the securities laws, including in particular Rule 10b-5. Rule 206(a).

Replace F. Limits on Issuer Communication at p. 734 with the following

F. Limits on Issuer Communication

Crowdfunding issuers, although subject to mandatory disclosure requirements, also face limits on their ability to communicate directly with investors. Issuers are prohibited from advertising a crowdfunding offering except for allowable test the waters under Rule 206 or notices with the name of the crowdfunding intermediary directing investors to the intermediary's platform. Rule 204. Such notices may include the terms of the offering, the amount of securities offered, the nature of the securities, the price of the securities, the closing date, and factual information about the legal identity and business location of the issuer. The issuer and those acting on its behalf, who must identify their affiliation with the issuer, may also communicate with investors and potential investors about the terms of the offering through the intermediary on the intermediary's platform, as long as an issuer identifies itself in those communications. Rule 204(c). Issuers can also compensate others to promote crowdfunding through channels in an intermediary's platform as long as the compensation is disclosed. Rule 205.

Replace I. "Bad Actor" Disqualification at p. 736 with the following

I. "Bad Actor" Disqualification

Rule 503 addresses disqualification of issuers, brokers, and funding portals. The disqualification sweeps broadly: "issuer; any predecessor of the issuer; any affiliated issuer; any director, officer, general partner or managing member of the issuer; any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; any promoter connected with the issuer in any capacity at the time of filing, any offer after filing, or such sale; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; or any general partner, director, officer or managing member of any such solicitor." Rule 503(a). If disqualification under Rule 503 applies then the § 4(a)(6) exemption is not available. In other words, if any of the delineated entities or persons eligible for disqualification in fact is disqualified under Rule 503 then the entire crowdfunding offering loses its exemption from § 5.

Rule 503 then proceeds to provide a laundry list of events that lead to disqualification. One path to disqualification focuses on activities (a) in connection with the purchase or sale of any security, (b) involving the making of any false filing with the Commission, or (c) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, funding portal or paid solicitor of investors (collectively termed "securities related activities"). Disqualification occurs if the person was convicted of any securities related activities within ten years before the filing of the "offering statement" or sale of securities under § 4(a)(6) (or five years, in the case of issuers, their predecessors and affiliated issuers), or is subject to any court order, judgment or decree within five years before the filing of the information required by § 4A(b) or sale of securities under § 4(a)(6) that restrains or enjoins such person from engaging or continuing to engage in any conduct or practice involving securities related activities.

Disqualification also occurs if a person is subject to a certain final orders of various regulators at the time of the filing of the information required by § 4A(b) or sale of securities under § 4(a)(6) including state securities commissions, banking regulators, the Commodity Futures Trading Commission, and the National Credit Union Administration. The final order must bar the person from, among other things, associating with an entity regulated by the particular institution or engaging in the business of securities, insurance, or banking. The final order must be based on a violation of any law or regulation that "prohibits fraudulent, manipulative or deceptive conduct entered within ten years before such filing of the offering statement."

Disqualification also results from SEC administrative proceedings. A person is disqualified if he or she is subject to an administrative order at the time of the filing of the information required by § 4A(b) or sale of securities under § 4(a)(6) that suspends or revokes such person's registration as a broker, dealer, municipal securities dealer, investment adviser or funding portal, places limitation on the activities, functions or operations of such person, or bars the person from being associated with any entity or from participating in the offering of any penny stock. Persons are also disqualified if within five years before the filing of the information required by § 4A(b) or sale of securities under § 4(a)(6) they are subject to any administrative order to cease and desist from committing or causing a violation or future violation of § 5 of the Securities Act or any scienter-based antifraud provision of the federal securities laws. Disqualification can result from disciplinary actions from a self-regulatory organization if a person is suspended or expelled from membership in, or suspended or barred from association with a member, of an SRO for conduct inconsistent with "just and equitable principles of trade." Disqualification also follows if, within five years before the filing of the information required by § 4A(b) or sale of securities under § 4(a)(6), a person has filed as a registrant or issuer or was an underwriter in any registration statement or Regulation A offering statement that was the subject of an SEC refusal order, stop order, or order suspending the Regulation A exemption or is the subject of an investigation or proceeding to determine whether such an order should be issued; or is subject to certain U.S. Postal Service false representation orders.

The SEC can waive disqualification upon "a showing of good cause," Rule 503(b)(2), but the SEC is likely to use this waiver authority sparingly. Prior to the filing of the information required by § 4A(b) or sale of securities under § 4(a)(6), the court or regulatory authority that entered the order, judgment or decree that otherwise may lead to disqualification may provide in writing that disqualification should not arise as a consequence of such order, judgment, or decree. Rule 503(b)(3). Lastly, issuers may avoid disqualification if the issuer can establish that it "did not know and, in the exercise of reasonable care, could not have known" about a disqualification under Rule 503(a). Rule 503(b)(4).

Replace the text before Hypothetical 19 at p. 747 with the following

Section 3(a)(11) defines none of these items with precision. Instead, we are left with somewhat vague standards. Similarly, if investors within the state resell their securities to out-of-state investors, does this result in a loss of the exemption? The answer depends on whether the in-state investors had "investment intent." Although the passage of time (in particular over two years) before a resale suggests initial investment intent, the SEC does not favor reliance upon the mere passage of time as evidence of investment intent. Consider how you would resolve these ambiguities in the following hypothetical.

Replace 6. Integration Safe Harbor at p. 754 with the following

6. INTEGRATION SAFE HARBOR

Rule 147 and 147A both use the unified integration general principle and safe harbors in Rule 152. Rule 147(g) and 147A(g). As we discussed above, under the general principle, two offerings will not be integrated if the issuer can demonstrate, bearing the burden of proof, that based on the "particular facts and circumstances," each offering either complies with § 5's registration requirements or complies with an exemption from § 5. Rule 152(a). Rule 152(b), in turn, provides four safe harbors against integration. Rule 152(b)(1) provides a time based safe harbor against integration for offerings more than 30 calendar days before the commencement or 30 calendary days after the termination or completion of a particular offering. (The provisions of Rule 152(a)(1) allow an offering that permits general solicitation is followed by an offering that prohibits general solicitation, but only if general solicitation was not used in the prior offering.) Rule 152(b)(2) provides a safe harbor for offers and sales pursuant to certain employee benefit plans or under Regulation S (offshore offerings). Rule 152(b)(3) provides registered public offerings a safe harbor against integration with prior terminated or completed offerings. Lastly, Rule 152(b)(4) provides exempt offerings that allow general solicitation a safe harbor against integration with prior terminated or completed offerings.

Replace the last paragraph before D. Resales at p. 768 with the following

The SEC provides comfort to issuers offering and selling through a Regulation S offering who are worried about integration. In addition to the general principle against integration in Rule 152, the SEC provides a blanket safe harbor in Rule 152(b)(2) for Regulation S offerings. Rule 152(b)(2) provides that: "Offers and sales made in compliance with … §§ 230.901 through 230.905 (Regulation S) will not be integrated with other offerings." Rule 152(b)(2).

Replace the second paragraph after E. Global Regulation S Offerings with the following

Issuers will typically offer and sell the U.S. tranche of securities pursuant to Rule 144A (covered in Chapter 10). Technically such an offering involves an initial sale by the issuer on a firm commitment basis to a broker-dealer under a § 4(a)(2) or Regulation D exemption from § 5. The placement agent will then turn around and resell the securities to "qualified institutional buyers," primarily large institutional investors, pursuant to the resale exemption in Rule 144A. Issuers will use Regulation S to offer and sell the non-U.S. tranches of securities. The anti-integration safe harbor under Rule 152(b)(2) for Regulation S offerings allows the issuer to make concurrent Rule 144A/Regulation S offerings. Although securities sold abroad under Regulation S escape the registration requirements of § 5, issuers and other participants must still comply with the applicable securities laws of the markets in which they offer and sell securities.

Insert the following at the end of the chapter at p. 771

IX. TESTING THE WATERS WITH GENERIC SOLICITATION

Issuers in the Pre-Filing Period of a registered public offering may "test the waters" about the potential public offering through communications with qualified institutional buyers and institutional accredited investors. Rule 163B. Test the waters allows an issuer that is uncertain about the market for it securities to find out sooner rather than later that the market may in fact not exist for the issuer's securities at an acceptable price to the issuer. But what about an issuer contemplating a possible exempt offering, such as a private placement under Regulation D or § 4(a)(2) or an intrastate offering under Rule 147. The issuer may face uncertainty about which type of exempt offering investors prefer and the possible pricing of such an offering. Such uncertainty exposes the issuer to the possibility of initiating an exempt offering only to find a lack of investor interest in the offering. Alternatively, an issuer may be unsure whether to sell through a private placement or through a public offering. Such an issuer may benefit from learning sooner rather than later about investor preferences in choosing whether to sell through an exempt offering and, if so, which type of offering exempt from § 5.

In response to the benefits of allowing test the waters for issuers contemplating an exempt offering, the SEC allows for "generic" solicitations prior to the decision by an issuer on a specific type of offering. Under Rule 241 of the Securities Act, these "generic" solicitations are exempt from the registration requirements of Section 5. According to the SEC, allowing for testing the waters benefits "issuers that find after testing the waters that their offering is unlikely to be successful and choose not to proceed with an offering, thus saving disclosure preparation and filing costs (including, where applicable, the cost of review or audit of financial statements by an independent accountant), lowering the risk of disclosure of potentially sensitive proprietary information to competitors and mitigating the reputational cost from a failed offering." SEC Rel. No. 33-10884 at 226. The SEC noted that the benefit from testing the waters accrues in particular to smaller, less well known issuers that "may lack an accurate understanding of prospective investor demand for their securities." SEC Rel. No. 33-10884 at 226.

Rule 241 applies prior to when an issuer makes a determination as to which exemption from the prohibition on offers under § 5(c). Prior to this determination, an issuer, or any person authorized to act on behalf of an issuer, may communicate either orally or in writing to determine the existence of "any interest in a contemplated offering of securities exempt from registration." Rule 241(a). This communication may not contain any solicitation or acceptance of (1) "money or other consideration" or (2) "any commitment, binding or otherwise, from any person" with respect to an exempt offering. Rule 241(a). Solicitations of indications of investor interest under Rule 241 must contain a number of mandatory statements to, among other things, inform investors that:

> (1) The issuer is considering an offering of securities exempt from registration under the 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;
>
> (2) No money or other consideration is being solicited, and if sent in response, will not be accepted;
>
> (3) 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
>
> (4) A person's indication of interest involves no obligation or commitment of any kind.

Rule 241(b).

The SEC also allows written communications under Rule 241 to include "a means by which a person may indicate to the issuer that such person is interested in a potential offering." Rule 241(c). The issuer may require certain identifying information from solicited investors including the investor's name, address, telephone number, and email address. Rule 241(c).

Although exempt from § 5, communications that are allowable under Rule 241 are nonetheless considered an offer of a security for sale for purposes of antifraud liability under the securities laws, including Rule 10b-5 liability.

After making a determination to offer and sell securities through a Regulation A offering or a Regulation Crowdfunding offering, the issuer may no longer use Rule 241 but instead may use the specific test-the-waters provisions of the respective exempt offering provisions. SEC Rel. No. 33-10884 at 91.

Issuers that choose either a Regulation A or Regulation Crowdfunding offering after engaging in generic solicitation must make the generic solicitation materials publicly available as an exhibit to the offering materials filed with the SEC if either type of exempt offering is commenced within 30 days of the generic solicitation. See Rule 201(z) and paragraph 13 of Form

1-A, Part III, Item 17. Similarly, issuers that choose Rule 506(b) offering that prohibits general solicitation must provide purchasers with any written generic solicitation materials used under Rule 241 if the issuer sells securities under Rule 506(b) within 30 days of the generic solicitation of any purchaser that is not an accredited investor. Rule 502(b)2)(viii).

What if the issuer chooses an exempt offering that does not allow for general solicitation, such as a Rule 506(b) offering? In this case, the issuer must consider whether the generic solicitation may also be considered general solicitation for the Rule 506(b) offering. Is generic solicitation to investors with whom an issuer does not have a pre-existing relationship to assess financial sophistication automatically general solicitation? In answering this question, the SEC referred to general principle against integration in Rule 152:

> an issuer will not be able to follow a generic solicitation of interest that constituted a general solicitation with an offering pursuant to an exemption that does not permit general solicitation, such as Rule 506(b), unless the issuer has a 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 did not solicit such purchaser through the use of general solicitation or established a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation.

SEC Rel. No. 33-10884 at 92.

Supplement for Chapter 10

Add to p. 805, just prior to B. Purchaser Awareness of Exemption

Parallel with the SEC's August 2020 update to the definition of an accredited investor discussed in Chapter 9, the SEC also updated the definition of a qualified institutional buyer in Rule 144A. The SEC modified Rule 144A(a)(1)(i), which provides a list of entities that are deemed QIBs so long as the entity" in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity." To the list of possible QIB entities, the SEC added rural business investment companies, as defined in the Consolidated Farm and Rural Development Act (Rule 144A(a)(1)(i)(C)) and limited liability companies (Rule 144A(a)(1)(i)(H)). The SEC also added any institutional accredited investor as defined in Rule 501(a)(1) that otherwise is not already in the list of potential QIBs in Rule 144A in a new catch-all provision under Rule 144A(a)(1)(i)(J)) as a potential QIB. The SEC specifically noted that the institutional accredited investor could be considered a QIB even if "formed for the purpose of acquiring the securities being offered under this section." Note to Rule 144A(a)(1)(i)(J).

Supplement for Chapter 11

p. 836 Replace the first full paragraph on the page with the following.

Universal Proxy

For most public companies, shareholders who attend the company's annual meeting may vote separately for the nominated candidates for each director position. Suppose a company faces a proxy contest and that three director positions are on the ballot with a management sponsored nominee and a dissident sponsored nominee for each position. A shareholder at the annual meeting may cast her ballot for the management nominee for two of the positions and for the dissident nominee for the third. Shareholders who voted by proxy, however, traditionally did not have such a choice. Instead, in a proxy contest, management would solicit shareholders, seeking the consent of shareholders for management to vote the shares by proxy only for the management's slate of nominees. Concurrently, the dissident would also solicit shareholders, seeking the consent of shareholders for the dissident to vote the shares by proxy for the activist's slate of nominees. Shareholders voting by proxy thus had an all-or-nothing choice between the management and dissident slates.

In late 2021, the SEC promulgated new proxy rules that implemented what is commonly referred to as "universal proxy" voting. SEC Rel. No. 34-93596. The universal proxy rules apply to all non-exempt solicitations in director elections contests for operating public companies. (Investment companies and business development companies are excluded.) The universal proxy rules provide shareholders voting by proxy the same degree of choice as shareholders who vote in person. To be eligible for universal proxy, a dissident sponsor must solicit at least 67% of the voting power of shares entitled to vote on the election of directors. The sponsor must also give notice to the company and file a definitive proxy statement with the SEC. Rule 14a-19(a)(3). The SEC noted that: "a universal proxy requirement without a minimum solicitation requirement could enable dissidents to capitalize on the registrant's solicitation efforts while relieving dissidents of the time and expense necessary to undertake meaningful solicitation efforts, thereby potentially exposing registrants to frivolous proxy contests." SEC Rel. No. 34-93596 at 37. In contrast, the SEC also noted the potential cost to sponsors of broad-based solicitations and wrote that the universal proxy rules, "do not mandate a specific method of furnishing the proxy materials. A dissident may choose to use the less costly e-proxy delivery method (i.e., the "notice and access" method of mailing a notice of internet availability and posting the proxy materials on a website) should it wish." SEC Rel. No. 34-93596 at 42.

Under the universal proxy rules, management must include in its proxy card the nominees from a sponsor eligible for a universal proxy. Rule 14a-19(e). Similarly, the sponsor must include the management's nominees in the sponsor's own proxy card. Regardless of whichever proxy card a shareholder submits, the shareholder can split her vote between management and activist nominees for different director positions. Rule 14a-19(e). Each side in a contested director election must refer shareholders to the other sides' proxy statement to obtain information on the other sides' nominees and explain that the proxy statements are available on the SEC's public website. Schedule 14A, Item 7(f).

The SEC's proxy rules specify certain requirements for each proxy card to ensure that each nominee, whether from management or a dissident sponsor, is displayed in a uniform manner. These include clearly distinguishing between management and dissident nominees for a director position, listing the nominees for each group in alphabetical order by last name, and using the same font type, style and size to present all nominees on the proxy card. Rule 14a-19(e). Outside of the specified requirements, management and dissident sponsors are free to choose the design of their respective proxy cards. Because universal proxy makes short slate proxies for a minority of positions on the board redundant, the SEC eliminated the ability of investors to nominate a short slate of candidates for operating public companies. SEC Rel. No. 34-93596 at 59.

How will the universal proxy rules affect director elections? It is possible that shareholders, particularly those who tend to focus only on the management's proxy statement and proxy card, will vote more frequently for dissident nominees once the dissident nominees are on management's proxy card. It is also possible that universal proxies could *decrease* the amount of support for dissident nominees. Consider shareholders who, prior to universal voting, may have been inclined to submit a dissident's proxy card slate of nominees. Did the shareholders do so because they wanted all the dissident nominees to be elected and shift control of the firm to the dissident? Or did the shareholders do so because, while they did not necessarily want to shift control to the dissident, the shareholders did want to send a signal to incumbent management and would have preferred an intermediate outcome of leaving incumbent management in control but with a minority representation for the dissident on the board of directors? If it is the latter, then universal voting could reduce votes for the full slate of dissidents.

The universal proxy rules could lead dissidents to shift their focus toward obtaining a minority of board seats. The SEC recognized that: ""Under current rules, a shareholder may be forced to make an "all or nothing" choice between one or the other soliciting party's proxy card. However, a universal proxy card may result in increased split votes where dissidents do not gain majority control of a board of directors in one election." SEC Release No. 34-93596 at19. Even if control does not shift, putting dissident nominees onto the board can increase the dissident's access to information and ability to monitor the company's activities. More "mixed" boards containing management and activist shareholder representatives, however, could chill communications leading to board balkanization. A mix of directors also could decrease the amount of complementary skill sets. In response, one could argue that rational shareholders can weigh these costs for themselves in deciding whether to vote for a unified slate of board members from management (or a dissident) or, alternatively, to split votes in a proxy contest.

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Add the following, before 2. Management Defensive Tactics.

2. Proxy Advisory Firms

The growing influence of proxy voting advisory businesses ("PVABs") over the past two decades led to concerns about this influence. Companies, worried about the specific voting advice a PVAB may make on the election of a director or other voting issue, wanted an opportunity to respond to the PVAB's advice. Companies were also worried about factual or analytical errors by the PVAB and wanted the opportunity to correct such errors, potentially changing the advice.

In 2020, the SEC implemented rules (the "2020 Proxy Advisor Rules") imposing certain requirements on PVABs seeking to provide their clients, typically institutional investors, advice on a particular corporate voting issue, such as the election of corporate directors. SEC Rel. No. 34-95266. The 2020 Proxy Advisor Rules provide that proxy voting advice constitutes a "solicitation" under Rule 14a-1(l) of the Exchange Act. Once proxy voting advice is deemed a solicitation then Rule 14a-3 of the Exchange Act normally requires the party making the solicitation, in this case the PVAB, to meet proxy disclosure and filing requirements. The 2020 Proxy Advisor Rules provided an exemption for proxy advisory firms if certain conditions were met. Among the conditions for the exemption, the 2020 Proxy Advisor Rules required that PVABs disclose potential conflicts of interest. Rule 14a-2(b)(9)(i). As another condition for the exemption, the 2020 Proxy Advisor Rules required that PVABs adopt and publicly disclose policies and procedures reasonably designed to provide the advisor's voting advice to the company in question at or prior to the time the advice is made available to the advisor's investor-clients (the "Review" condition). The 2020 Proxy Advisor Rules similarly required PVABs to adopt and publicly disclose policies and procedures reasonably designed to provide the investor-clients of the proxy advisors a mechanism to view the company's written response, if one is made, to the voting advice prior to the vote (the "Feedback" condition).

The 2020 Proxy Advisor Rules also modified Rule 14a-9 of the Exchange Act, which prohibits false or misleading statements related to a proxy solicitation. The 2020 Proxy Advisor Rules adopted Note (e) to Rule 14a-9, providing various "examples" of material misstatements or omissions relating to proxy voting advice. One example in Note (e) provided that "failure to disclose material information regarding proxy voting advice, 'such as the [PVAB's] methodology, sources of information, or conflicts of interest,' may, depending upon particular facts and circumstances, be misleading within the meaning of the rule." SEC Rel. No. 34-95266 at 6.

The 2020 Proxy Advisor Rules arguably opened a channel of communication for companies to learn about upcoming advice from PVABs and respond. In theory, investors could benefit from weighing for themselves the advice from a PVAB against the company's response. To the extent PVABs made mistakes or based their advice on factually incorrect information, the company could inform the proxy advisor of such mistakes or incorrect information to change the advisor's voting advice. Alternatively, the company could provide written feedback to investors informing the investors of the PVAB's errors.

Critics of the 2020 Proxy Advisor Rules argued that many PVABs already provided their voting advice to companies and provided a mechanism for such companies to provide feedback. The SEC noted that: "As one commenter pointed out, PVABs already are incentivized to engage with registrants regarding their proxy voting advice, as evidenced by the fact that some PVABs voluntarily implemented means for registrants to communicate their views or concerns regarding the PVABs' advice even before the Commission adopted the 2020 Final Rules (e.g., Glass Lewis' Report Feedback Service)." SEC Rel. No. 34-95266 at 35. Companies that wish to send their feedback to investors could also file supplemental proxy materials with the SEC. Critics contended that the 2020 Proxy Advisor Rules only had the effect of slowing down the process of giving advice and increasing compliance costs for proxy advisory firms. The SEC cited one commentator who noted that PVABs "'may engage with hundreds of issuers regarding thousands of shareholder proposals during a critical shareholder season" and that "additional compliance burdens not only muddle the timely delivery of materials to fund managers making it difficult to use the advice in advance of a shareholder meeting, but also increase compliance costs which get passed on to clients.'" SEC Rel. No. 34-95266 at 17 (citing letter from MFA).[1] In addition, critics argued that the addition of Note (e) to Rule 14a-9 increased uncertainty and created confusion over when PVABs might face Rule 14a-9 liability, causing proxy advisors to think twice before going against corporate management lest they risk being sued. That threat might undermine the independence of the proxy advisors from management. SEC Rel. No. 34-95266 at 45.

After a change in administrations, in mid-2022 the SEC revisited the 2020 Proxy Advisor Rules, seeking a "different and improved policy balance." SEC Rel. No. 34-95266 at 10. The SEC removed two specific aspects of the 2020 Proxy Advisor Rules. First, the SEC removed the company Review and Feedback conditions to the Rule 14a-2 exemption from the Rule 14a-3 disclosure and filing requirements (as well as various safe harbors to these conditions). SEC Rel. No. 34-95266 at 29. Second, the SEC amended Rule 14a-9 to remove Note (e) containing examples

[1] The SEC cited another commentator who noted that the review and feedback requirements of the 2020 Proxy Advisor Rules "'tilt the playing field in favor of company management and create unequal access to the proxy solicitation process' because those conditions 'do[] not require a PVAB to afford these opportunities to any other stakeholders,' including shareholder proponents." (citing letter from NASAA).

of material misstatements or omissions relating to proxy advice. Despite the removal of Note (e), the SEC stressed that the deletion of Note (e) did not change the scope of Rule 14a-9 or how it applied to proxy voting advice. Despite the removal of Note (e), the SEC emphasized that: "As with any other person engaged in a solicitation as defined in Rule 14a-1(l), a PVAB may be liable under Rule 14a-9 for a material misstatement of fact, or an omission of material fact, including, depending on the facts and circumstances, with regard to its methodology, sources of information, or conflicts of interest." SEC Rel. No. 34-95266 at 11.

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Change "2. Management Defensive Tactics" to "3. Management Defensive Tactics"

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Change "3. Reimbursement of Expenses" to "4. Reimbursement of Expenses"

Substitute for III, A, 1 at pp. 839-840

1. ELIGIBILITY AND PROCEDURAL REQUIREMENTS

Rule 14a–8 sets eligibility requirements for shareholders who want to include a proposal in the company's proxy statement. A shareholder sponsor seeking to submit a Rule 14a-8 proposal must demonstrate continuous ownership of the company's securities entitled to vote. These thresholds vary with amount and duration of ownership, all measured at the time that the proposal is submitted:

- at least $2,000 of the company's securities entitled to vote on the proposal for at least three years
- at least $15,000 of the company's securities entitled to vote on the proposal for at least two years
- at least $25,000 of the company's securities entitled to vote on the proposal for at least one year

Rule 14a-8(b)(1)(i). The SEC specifies different methods for shareholders to verify their eligibility including "a written statement from the 'record' holder of [the] securities (usually a broker or bank)." Rule 14a-8(b)(2)(ii)(A). Where shareholders combine to file a joint proposal, each shareholder must separately demonstrate that the shareholder meets one of the three alternative requirements. Rule 14a-8)(b)(1)(vi). Sponsors must continue to hold onto these securities through the date of the shareholders' meeting. Rule 14a–8(b)(1)(ii).

Why does the SEC impose minimum ownership and holding period requirements? When a shareholder submits a proposal, both the company and other shareholders may bear costs. The company bears costs related to assessing and possibly challenging or responding to the proposal. In 2020, the SEC noted that market participants estimated these costs to range from $50,000 to $150,000 per proposal for the company. SEC Rel. No. 34-89964 at 21. Other shareholders bear costs reading and analyzing the proposal. According to the SEC, "the required dollar amount and holding period should be calibrated such that a shareholder has some meaningful 'economic stake or investment interest' in a company—and therefore is more likely to put forth proposals reflecting an interest in the company and its shareholders than to use the proxy process to promote a personal interest or general cause—before the shareholder may draw on company and shareholder resources to require the inclusion of a proposal in the company's proxy statement, and before the shareholder may use the company's proxy statement to command the time and attention of other shareholders to consider and vote on the proposal." SEC Rel. No. 34-89964 at 18.

Although shareholder sponsors of a Rule 14a-8 proposal may themselves draft and submit the proposal, sometimes a third-party entity will take charge and the nominal shareholder sponsor will remain passively in the background. The SEC allows such third-party entities to act as the representative for a passive shareholder sponsor, but the agency has raised the concern that "[w]hen a representative speaks and acts for a shareholder, there may be a question as to whether the shareholder has a genuine and meaningful interest in the proposal, or whether the proposal is instead primarily of interest to the representative, with only the acquiescent interest by the shareholder." SEC Rel. No. 34-89964 at 39.

To address concerns about representatives, the SEC imposes specific documentation requirements when a shareholder relies on a representative to make clear when a third party is designated in fact to act as a representative and to provide "a meaningful degree of assurance as to the shareholder- proponent's identity, role, and interest in a proposal that is submitted for inclusion in a company's proxy statement." Exchange Act Rel. No. 34-89964, at 39. A shareholder sponsor relying on a representative to submit the proposal must provide documentation to the company that:

- Identifies the company to which the proposal is directed
- Identifies the annual or special meeting for which the proposal is submitted
- Identifies the shareholder sponsor submitting the proposal and the shareholder sponsor's designated representative
- Includes the shareholder sponsor's statement authorizing the designated representative to submit the proposal and otherwise act on the shareholder sponsor's behalf
- Identifies the specific topic of the proposal to be submitted
- Includes the shareholder sponsor's statement supporting the proposal; and
- Is signed and dated by the shareholder sponsor

Rule 14a-8(b)(1)(iv). The SEC provides an exclusion from the Rule 14a-8(b)(1)(iv) documentation requirement for shareholder sponsors that are entities "so long as the representative's authority to act on the shareholder's behalf is apparent and self-evident such that a reasonable person would understand that the agent has authority to submit the proposal and otherwise act on the shareholder's behalf." Rule 14a-8(b)(1)(v). One example the SEC has given of such a representative is the CEO of a corporate shareholder submitting a proposal on the corporation's behalf.

Rule 14a-8 also provides that "each person" is limited to submitting "no more than one proposal, directly or indirectly, to a company for a particular shareholders' meeting." Rule 14a-8(c). "Each person" includes third parties acting as a representative for a shareholder-proponent. Accordingly, a representative may not submit more than one proposal for the same meeting even if the representative acts on behalf of different shareholders. The SEC justified this limit on representatives because, "permitting representatives to submit multiple proposals for the same shareholders' meeting can give rise to the same concerns about the expense and obscuring effect of including multiple proposals in the company's proxy materials, thereby undermining the purpose of the one-proposal limit." SEC Rel. No. 34-89964 at 58.

Shareholder proposals under Rule 14a-8 are only one method by which shareholders communicate their concerns to a company and other shareholders. The SEC has noted that: "Today's investors are able to engage with companies and other investors in a variety of ways, including via email, video conference calls, one-on-one 'sunny day' meetings, shareholder surveys, and e-forums." SEC Rel. No. 34-89964, at 28. To encourage resolution of a shareholder proposal prior to a formal vote, the SEC requires a shareholder sponsor seeking to use Rule 14a-8 to provide the company a written statement with the shareholder's contact information and availability to meet with the company in person or through teleconference at two or more specific business days and times that are "no less than 10 calendar days, nor more than 30 calendar days, after submission of the shareholder proposal." Rule 14a-8(b)(2)(iii). Importantly, the contact information and availability requirement apply to the shareholder sponsor and not to any representative of the sponsor, although the representative may participate in any meeting. Despite the requirement for contact information and availability, the SEC has made clear that there is no requirement that the shareholder sponsor actually make a good faith effort to meet with the company and no penalty for failure to have such a meeting. Moreover, the company has no obligation to meet with the shareholder sponsor.

Rule 14a-8 imposes several other requirements on eligible shareholders including:

- The proposal must not exceed 500 words. Rule 14a–8(d).
- Sponsors must submit the proposal to the company no later than 120 days prior to the calendar date corresponding to when the company sent out its proxy statement for the previous year's annual meeting. Rule 14a–8(e).
- Sponsors (or their representatives) must appear at the annual shareholder meeting. Rule 14a–8(h).

The company bears the burden of proof if it rejects a shareholder proposal. Rule 14a–8(g). If the company believes that a proposal or its sponsor violates any of the eligibility or procedural requirements, the company generally must notify the sponsor of the deficiency and allow the sponsor to correct the deficiency. Rule 14a–8(f). If the deficiency cannot be remedied (e.g., if the proposal was submitted after the 120 days deadline) then the company does not need to give notice to the sponsor before rejecting the proposal.

Companies that intend to include a statement opposing the shareholder proposal in the company proxy statement must send the opposing statement to the sponsor of the proposal no later than 30 calendar days before they file the definitive proxy statement. Rule 14a–8(m). Rule 14a–8(m) tells shareholder sponsors that "if you believe that the company's opposition to your proposal contains materially false or misleading statements that may violate our anti-fraud rule, Rule 14a–9, you should promptly send to the Commission staff and the company a letter explaining the reasons for your view."

Replace the paragraph at the bottom of p. 841

2. SUBSTANTIVE EXCLUSIONS

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Rule 14a–8(i)(12) provides a numerical standard for excluding previously-submitted proposals. If a proposal deals with "substantially the same subject matter" as a previous proposal that was included in the company's proxy material within the prior five calendar years then the company may exclude the proposal if the most recent vote occurred within the prior five calendar years and the vote in favor was less than the following thresholds:

- 5% of the votes cast if the proposal was previously voted on once
- 15% of the votes cast if the proposal was previously voted on twice
- 25% of the votes cast if the proposal was previously voted on three or more times