

## **Federal Securities Exemptions Relating to Small Business Capital Formation-- SEC Takes Inventory**

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### **First RASA & Then Federal Inventory--**

First, it was Alaska throwing out the old (the Alaska Securities Act) and replacing it with a new suit of clothes! In 2018, Alaska became the most recent state to adopt Uniform Securities Act 2002 in the form of the *revised* Alaska Securities Act (AS 45.56, "RASA").<sup>1</sup> RASA became effective January 1, 2019.

Now, the feds, although awash in securities offering registration exemptions, are reassessing those exemptions specifically pertaining to small business capital formation ("Exemptions")! The Exemptions are from registration under the Securities Act of 1933, as amended ("SA").

### **The Release, Framework & Capital Formation--**

On June 18, 2019, the Securities and Exchange Commission, the federal entity charged with administering SA ("SEC"), issued a concept release on *harmonizing, simplifying and improving* securities exemptions under SA ("Release").<sup>2</sup> The Release solicits public comment, to be received no later than September 24, 2019.

Origin of the Exemptions stems, in part, from amendments to SA through the years. Some of the Exemptions arise through SEC administrative actions.

Reasons given in the Release for soliciting public comment are that, with the numerous amendments to SA and actions taken by the SEC directly, the overall framework of the Exemptions ("Framework") has changed significantly. It raises a question as to whether that Framework has strayed from that which United States capital markets can best take advantage in small business capital formation and from that which allows continued investment opportunities to prospective investors in that arena (collectively, "Capital Formation").

The Release suggests that the process may have caused gaps and complexities in the Framework. It suggests further that these shortcomings may be identified by stepping back to view the overall effect of the current Framework on Capital Formation. However, the Release cautions that, in doing so, one must not lose sight of another important purpose of SA--to maintain appropriate investor protection.

The Release is comprehensive, consisting of over 200 pages, in describing the Framework. The purpose in this article is not to attempt to address any one or more of the Exemptions in any amount of detail. Rather, it highlights several of the issues pertaining to the Framework. The interested reader ought to review the full Release to get an appreciation for the scope and depth of the SEC's contemplated action regarding the Exemptions and its possibly profound effect on Capital Formation.

## **Federal Regulation & Capital Formation--**

To understand the importance of the Release, let's pause for a moment to consider how securities regulation affects Capital Formation. The SA requires that every offer and sale of securities must be registered with the SEC, with limited exception. That exception is where there is an available exemption from registration under SA.

Under SA, a security is defined by identifying a number of instruments and transactions which by their nature are included within the definition. Examples of those instruments are stocks and bonds. Similarly, examples of those transactions are investment contracts and options.

The Release further states the purpose of registration as providing full and fair disclosure of material facts to investors. This information is necessary to enable those investors, in part, to make informed investments.

The Release also states the United States Congress realized in enacting SA, that, as a practical matter, certain situations do not need registration or otherwise fall outside the scope of benefits of registration. As a result, SA contains a number of securities registration exemptions, including the Exemptions. The Release further notes SA specifically authorizes the SEC (at Section 28 of SA) to adopt additional Exemptions by administrative action.

The Release notes that Exemption requirements may exempt an offering if it is restricted to sales to certain sophisticated or "accredited" investors, as the term is defined in Regulation D, adopted by the SEC ("Regulation D"). Here, the investor is presumed to possess sufficient financial sophistication and ability to withstand the risk of loss of the investor's entire investment or otherwise able to hire that expertise, rendering SA registration protections unnecessary.

So, the Exemptions are then divided into three categories:

- *Certain securities as identified in Section 3 of SA--* Ones, most of which are included based upon characteristics of the instruments, e.g., securities issued or guaranteed by the United States or a state or territory thereof.
- *Certain transactions as identified in Section 4 of SA--* Ones falling outside of that which the Congress determined as needing registration protection, e.g., issuer transactions not involving any public offering.
- *Certain exemptions as identified by the SEC under authority of Section 28 of SA--* Ones identified by the SEC as exempt persons, securities or transactions, e.g., offerings under Regulation D, Rule 506(c), freeing the issuer of the Regulation D limitation on manner of offering.

## **Blue Sky Law & Capital Formation--**

As an aside, securities regulation in the United States is not just on the federal level through the SEC. It is also accomplished through separate security laws of the various states and territories of the country. This level of regulation is traditionally called-- *Blue Sky Law*. In the case of Alaska, that Blue Sky Law is manifested as RASA and actions taken by the state in administering RASA, e.g., regulations, rules, orders, etc. Generally, and in the context of securities offerings, Blue Sky Law takes the form of

requiring registration of those offerings, with limited exception. That exception is where there is an available exemption from registration under the Blue Sky Law of that state or territory, as the case may be.

### **Back to the Release--**

The Release addresses, from the perspective of investor protection, limitations on who can invest in certain exempt offerings and the amount of investment per investor as set forth in the Framework. It looks to whether existing limitations are insufficient, appropriate or excessive in the Framework. At the same time, the Release seeks comment whether those limitations pose undue obstacles to, or limit access by prospective investors to, Capital Formation.

The Release specifically addresses whether investor eligibility limitations ought to be revised. It suggests further whether the more appropriate focus ought to be on the sophistication of the investor, the amount of the investment per investor or other criteria, rather than simply focusing on the income or wealth of the investor.

It also acknowledges that the Exemption requirements might limit the amount of securities that may be offered or sold, while others might limit the manner in which the offering is made. For example, the Exemptions might prohibit the use of general solicitation or general advertising to solicit investors.

### **Covered Securities & Qualified Purchasers--**

One of the more recent amendments to SA provides that the SEC may preempt state registration and review of transactions involving “covered securities.” That amendment identified specific categories of covered securities (addressed in Section 18 of SA). One of those categories is a security offered or sold to a “qualified purchaser.” Furthermore, that amendment gives the SEC authority to define a qualified purchaser, with little restriction on that effort.

While the SEC had previously considered a proposed definition of qualified purchaser, it did not adopt it. Now, the SEC is, through the Release, apparently revisiting the need of a definition of the term in the context of Capital Formation.

### **Summary--**

In summary, the scope of the Release is broad and significant. The resulting Exemption reorganization, coupled with the SEC authority under Section 28 of SA, could result in a far more expansive role for the SEC in regulating securities offerings in the United States, e.g., through a new definition of qualified purchaser. If this expansion occurs, the role played by Blue Sky Law in regulating Capital Formation securities offerings would be significantly reduced, if not eliminated.

Whether the Exemption reorganization provides a net benefit to Capital Formation remains to be seen. However, it may result in substantial encroachment on RASA and Blue Sky Laws, generally.

While the Release is lengthy, it behooves those persons who practice in the securities law area or otherwise advise small business to be aware of its nature and scope. Best wishes in your read of the Release!

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<sup>1</sup> Brecht, Julius J. "Revised Alaska Securities Act-- learning some new ropes." The Alaska Bar Rag April-June 2019: Page 22.

<sup>2</sup> "Concept Release on Harmonization of Securities Offering Exemptions," SEC Release Nos. 33-10649, 34-86129, IA-5256, IC-33512; File No. S7-08-19, RIN 3235-AM27; June 18, 2019.

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