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DIRECT FROM THE EXPERTS

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Virtual Reality: Investors Want More from 2021 Virtual Meetings

The onset of the COVID-19 pandemic in 2020 coincided with the beginning of the annual meeting season and left companies scrambling to replace their physical annual meetings with an entirely virtual format. This did not always go smoothly, but investors were willing to cut companies some slack in light of the extraordinary situation they found themselves in and the short period of time that companies had to shift to a virtual format.

In 2021, many companies are likely to find themselves in a position where their only prudent choice may be to again hold their annual meetings in a virtual-only format.

But this year, those companies are likely to find that their investors are much less forgiving of virtual meetings that do not replicate as much as possible the in-person meeting experience.

That point was brought home in the "*Report of the 2020 Multi-Stakeholder Working Group on Practices for Virtual Shareholder Meetings,*" which was issued in December 2020 by Rutgers University, the Council of Institutional Investors and the Society for Corporate Governance. The Working Group Report reflects the collaborative efforts of representatives of public companies and investors, and the group's objective was made clear in the introduction:

> The aspiration of the 2020 Working Group is for companies, investors, and service providers to conduct VSMs in ways that replicate the in-person annual meeting experience for the shareholder as closely as possible in order to foster effective corporate governance.

In other words, companies planning to hold their 2021 annual meetings in virtual format need to understand that, this year, investors are looking for them to "get real." When it comes to meeting those demands, companies should expect to be judged on their responses to shareholder concerns about the 2020 virtual annual meeting experience, and their efforts to enhance the process and move closer to a "virtual reality" meeting.

Addressing 2020 Virtual Meeting Issues

The Working Group Report and commentary from the panelists in TheCorporateCounsel.net's October 2020 webcast, "Virtual Annual Meetings: What To Do Now," make it clear that investors' biggest concerns about 2020 virtual meetings relate to problems with accessing and participating in virtual meetings and perceived shortcomings in the manner in which those meetings were conducted.

<u>*2020 Access Issues.*</u> Companies took a lot of heat in 2020 for difficulties that shareholders experienced in accessing virtual meetings. One of the recurring problems was the need for beneficial owners to obtain legal proxies in order to attend some meetings, and a lack of coordination between service providers.

For example, at one meeting, Soundboard Governance's Doug Chia found that he needed one control number to vote his shares, and another to access the virtual meeting:

> What I needed to do to get the meeting attendance control number was go through the steps to (1) ask for and get a legal proxy from my broker, (2) scan and email it to the transfer agent at least six days before the meeting, (3) watch for an email back from the transfer agent with the control number, and then (4) use that number along with the password listed on the notice to enter the meeting site on the day-of.

Doug Chia, Soundboard Governance Blog, May 6, 2020, https://www.soundboardgovernance.com/blog.

As some of our members pointed out, this access problem sometimes resulted from the need to transition to a virtual format after companies mailed their proxy materials. For instance, one company that used Broadridge to mail to its beneficial owners and another provider to mail to record holders found itself having to choose Broadridge to host the virtual meeting, or having the other provider host it using the same access rules that they would have applied under their physical meeting attendance policies (*i.e.,* requiring beneficial owners to obtain a legal proxy from their brokers).

If the company opted to use Broadridge's platform, its beneficial owners could have accessed the meeting with a single control number, but Broadridge would have had to re-mail a new proxy card to registered holders, which would have required them to re-vote their shares. The company concluded that the alternative of using the same access rules that had applied to its physical meetings was the less disruptive option.

Addressing Access Issues. With more time to plan and coordinate between service providers this year, this kind of problem may be avoidable – and as our webcast panelists pointed out, it is one that intermediaries have been working to address moving forward. But the key point is that investors expect that companies will make it easy for their shareholders to access the virtual meeting. That starts with clear instructions on how to access and vote prior to or at the meeting.

Conduct of the Meeting. Investors identified several issues relating to the manner in which virtual meetings were conducted last year. The most prominent of these concerns relate to the Q&A portion of the meeting. This was an area in which the Working Group Report's critique was particularly blunt:

> [There was a] general sense that companies had much tighter control over the structure and flow of the Q&A sessions than at in-person meetings, including a feeling that some companies were "cherry picking" innocuous questions and favorable comments over difficult questions and critiques.

Investors were unhappy with the lack of transparency some companies displayed when it came to the use of discretion to paraphrase or reword questions. There were also suspicions about the use of planted questions to "run out the clock" on the Q&A session and avoid more difficult questions. Other concerns related to the inability to ask follow-up questions as investors could during in-person meetings.

Treatment of shareholder proponents was also occasionally a source of concern. According to a letter from the CII to the SEC's Investor Advocate, issues involving proponents included conflicting channels for shareholder participation, with proponents being required to be on a line different than that used for general shareholder Q&A. The CII letter also observed that in at least one instance, shareholder proponents were prohibited from presenting proposals, and instead had to submit written statements that company representatives read during the meeting.

Addressing Conduct of the Meeting Issues. Responding to investor concerns about the Q&A sessions at virtual meetings will require a multi-faceted approach involving better communication, increased transparency and improved technology.

As was the case with access issues, some of the problems with the Q&A process arose out of technological limitations. Companies and service providers have learned from their experience with virtual meetings last year. Our webcast panelists noted that technological developments in virtual meeting platforms provide an opportunity for companies to address some of the concerns that arose last year.

Improved communication is as important as improved technology. The Working Group Report calls for companies to take a number of communication-related steps to enhance the Q&A portion of the meeting. These include providing instructions on how and when shareholders will be able to ask questions prior to or at the meeting, clarifying that only verified shareholders may ask questions and vote at the meeting, and addressing issues such as the time allotted for the session, the number of questions permitted per shareholder, and how the company will use discretion to select questions to answer and to paraphrase questions.

The Working Group Report also calls for the company to ensure that members of the executive team and committee chairs, in addition to the board chair and CEO, have the ability to audibly answer appropriate questions during the Q&A session. In addition, the Working Group Report calls for the company to explain whether and how it will respond to questions that management was unable to address during the meeting.

In terms of the treatment of shareholder proponents, the Working Group's assessment of the 2020 virtual meeting process was positive overall. However, the report recommends that companies take further steps to ensure that shareholder proponents have an opportunity to be heard at virtual meetings.

Specific recommendations include coordinating with proponents in advance of the meeting to address logistical issues associated with the timing and manner of their presentation, providing dedicated communication resources to permit them to present their proposals in real time, and offering proponents alternatives to virtual attendance, such as the option to provide a pre-recorded statement or a written statement to be read by management. The Working Group Report also calls for contingency plans in the event the proponent faces technical difficulties attending the meeting should also be addressed.

Speaking of technical difficulties, the Working Group Report recommends that companies prioritize efforts to assist shareholders, many of whom will have not attended an annual meeting in the past and are unfamiliar with the technology platform used to conduct a virtual meeting. The report recommends that companies provide information in the proxy statement about how to contact the company or the service provider with questions about attending the meeting.

In addition, the report calls for companies to provide a visible mechanism on each page of the VSM platform for attendees to contact a live operator for real-time assistance via phone, online "chat" or other function.

From Virtual Meetings to Virtual Reality Meetings

Merely addressing the shortcomings of last year's virtual meetings will not be enough to satisfy investor desires that companies replicate the in-person annual meeting experience. Instead, companies planning their 2021 shareholder meetings need to establish a goal of transforming a virtual meeting into a virtual *reality* meeting. Here are some things that companies should focus on to help them move closer to achieving the virtual reality objective:

- *Make Your Virtual Meeting User-Friendly*. Last year, shareholders were confronted with unfamiliar technology and uncertainties about how to resolve access and other issues. Many of them, and retail shareholders in particular, found the process of accessing and participating in the meeting decidedly user-unfriendly – and sometimes downright intimidating.

  Many of the Working Group Report's recommendations for addressing the access and meeting conduct issues will help make the virtual meeting process more user-friendly, but companies can and should do more.

  Part of the problem in 2020 was companies' own unfamiliarity with the VSM platform. That was understandable last year, but it is unforgivable this year. Reducing the virtual meeting's intimidation factor starts with ensuring that all executives and directors participating in the meeting know their way around the VSM platform, that they understand the full range of its capabilities, and that meeting planners use this year's enhanced capabilities to their shareholders' advantage.

  Efforts to familiarize company participants with the platform will help them identify the types of procedural and technical issues that shareholders may experience so that they can be prevented and, if necessary, addressed quickly and efficiently. But perhaps the most important way getting to know the platform can help is by enabling companies to prepare the clear and accessible instructions about all aspects of the meeting that are essential to making shareholders' experience more user friendly.

  As the Working Group Report observes, providing ready access to assistance on your VSM home page is a key element of making the virtual meeting process more user-friendly. During the planning process, companies should see to it that shareholders experiencing issues will be able to access help from qualified personnel quickly and efficiently.

- *Be Transparent*. Shareholders do not like virtual meetings, and while they acknowledge the need for them under pandemic conditions, they remain highly suspicious of the way in which company management has conducted these meetings. In order to address those concerns, companies need to prioritize efforts to make the proceedings as transparent as possible.

  When it comes to transparency, shareholders' main concerns appear to be the voting and Q&A process. The Working Group Report says that the main VSM page should include a prominent and simple mechanism for shareholders to vote and change votes when the polls are open – and that mechanism must maintain the integrity of the voting process and permit the inspector to certify the votes cast at the meeting.

  The fundamental issue with Q&A is that the virtual process simply does not replicate what shareholders have come to expect at a physical meeting, which raises suspicions about its integrity. The Working Group Report offers several recommendations on the Q&A process. These include providing a prominent and simple mechanism on the main VSM page to submit questions throughout the meeting, and clearly instructing shareholders to identify themselves and provide contact information in case the company needs to address their question after the meeting.

The report also recommends requesting the service provider to authenticate the shareholder's identity, and make all questions visible to the company verbatim and in real time. In addition, it calls for permitting shareholders to see all appropriate questions submitted and track prioritization of the questions in the queue, and providing them with the ability to indicate their level of interest in particular questions.

Efforts at transparency should extend beyond adjournment. The Working Group Report calls for companies to post a recording of the entire meeting (including the Q&A session) on their websites for a specified, extended period of time. In addition, the report says that companies should consider posting all questions received both before and during the meeting, and corresponding answers, on the company's website following the meeting.

- *Prioritize the Shareholder Experience*. Shareholders want to replicate the experience of participating in a physical meeting. In planning this year's virtual meetings, companies should seek as much as possible to give shareholders what they want. Making the meeting more user-friendly and prioritizing transparency are part of that, but companies should look to do more.

  For example, the vast majority of last year's virtual meetings were audio-only. During TheCorporateCounsel.net's webcast, Amy Borrus of the CII noted that shareholders want to be able to see as well as hear the proceedings. However, public company participants in the Working Group Report expressed concerns about the cost, complexity and technical limitations associated with using video on existing VSM platforms.

  These concerns may result in most companies opting not to provide a true "video" meeting in 2021, but they should incorporate video into their virtual meetings as much as possible. The more video they use, the closer they will be able to replicate the look and feel of a physical meeting. Specific recommendations from the Working Group Report include having all directors and executive officers at the meeting appear on video, and allowing for shareholder proponents and questioners to appear on video.

  Companies seeking to replicate the physical annual meeting experience ought to take a hard look at any ways in last year's virtual meeting departed from the manner in which meetings have been conducted in the past. Do not just dust off last year's agenda. Instead, revisit decisions that were made to "streamline" the meeting in 2020, including abbreviated management presentations, shortened or modified Q&A periods, and other departures from the physical meeting norm. To the extent these aspects of the meeting can be made to replicate the physical meeting experience, consider doing that as well.

Conclusion: This Time It Counts

Virtual meeting platforms were a new environment for everyone last year, and the lack of familiarity with them by both shareholders and companies contributed to the problems.

Recognizing the extraordinary circumstances with which companies were confronted last year, shareholders cut them a fair amount of slack. But shareholders also have made their concerns clear, and since companies have had time to address them, they should expect their shareholders to be less forgiving this time around.

Realistically, virtual reality is probably not attainable in 2021, and for some companies – particularly small caps – their efforts may be subject to significant resource constraints. But the companies that make a serious effort to improve on the way in which their virtual meetings were conducted last year are likely to get some credit from their shareholders, while those that do not will likely pay a price.

Form 10-K Tidbit: Can You Drop Rule 3-09 Financial Statements?

As we discussed in our September-October 2020 issue at page 18, back in May 2020 the SEC adopted amendments to the financial statement and other disclosure requirements related to acquisitions and dispositions of businesses. These amendments became effective on January 1, 2021. The amendments principally relate to the significance tests that are set forth in the definition of "significant subsidiary" in Rule 1-02(w) of Regulation S-X, 1933 Act Rule 405 and 1934 Act Rule 12b-2. While the primary focus has been on how these amendments will affect whether target financial statements and pro forma financial information will be required when a company is considering an acquisition, the new definition of significant subsidiary could affect whether a company has to provide financial statements of an equity-method investee in this year's Form 10-K pursuant to Rule 3-09 of Regulation S-X.

When Are Equity-Method Investee Financial Statements Required?

Rule 3-09 generally requires the inclusion of separate audited financial statements for 50% or less owned entities that are accounted for under the equity method of accounting and that are deemed to be significant. Generally, to determine significance under Rule 3-09, a company would apply the investment test and the income test. If either test is greater than 20%, separate financial statements of the equity method investee must be filed. For equity method investees at the 10%-20% level, summary financial information may be required under Rule 4-08(g) of Regulation S-X.

Rule 3-09 requires separate annual financial statements of equity method investees if certain significance thresholds are met for any of the company's fiscal years required to be presented in the filing, using both the investment and income tests. As a result, if it is determined that the equity method investee is not significant in the past two fiscal years, but was significant when compared to the financial statements for the third (and oldest) fiscal year, the company would need to include the separate financial statements of the equity method investee in the Form 10-K.

Only Amendments to the Income Test Apply for Rule 3-09 Purposes

The SEC's amendments to the investment test in the significant subsidiary definition are only to be used when computing significance for business acquisitions and dispositions, including real estate operations. As amended, the significant subsidiary definition retains the pre-existing investment test for all other purposes, including determining the significance of an equity method investee under Rules 3-09 or 4-08(g). Unlike the investment test, the amendments that the SEC adopted to the income test that is included in the definition of significant subsidiary do apply to situations other than business acquisitions and dispositions, so the amended income test is now used to determine the significance of equity method investees under Rules 3-09 and 4-08(g) of Regulation S-X.

The SEC amended the income test to add a new revenue component. The revenue component compares the company's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenues from continuing operations (after eliminating intercompany transactions) to the company's consolidated total revenue for the relevant fiscal year. Further, the revenue component applies only when both the company and the tested subsidiary have material revenues in each of the two most recently completed fiscal years. Under the amended rule, the tested subsidiary must meet the requisite significance threshold for both the new revenue component and the net income component in order to be considered significant.

For the net income component of the income test (which remains unchanged after the SEC's amendments), the numerator is the absolute value of the company's and its other subsidiaries' equity in the tested subsidiary's consolidated income or loss from continuing operations before income taxes (after eliminating intercompany transactions) attributable to the controlling interests for the relevant completed fiscal year, and the denominator is the absolute value of the company's and its subsidiaries' consolidated income or loss from continuing operations before income taxes (after eliminating intercompany transactions) for the relevant fiscal year.

Applying the Amended Test Now

The amended rules went into effect at the beginning of 2021, so companies that have a 50% or less owned entity that is accounted for under the equity method of accounting must now apply the revised income test (in addition to the "old" investment test) to determine whether that entity is significant above the 20% level, or between the 10% to 20% level. At the annual AICPA Conference in December 2020, the Staff indicated that all of the prior year tests must be recalculated under the rules as revised after the effective date. Under this approach, a company that presents three years of financial statements in the Form 10-K would need to go back and evaluate significance for each of those past three years using the "old" investment test and the "new" income test. If the equity method investee is significant at the 20% level in any of those years, the Rule 3-09 financial statements would need to be provided (or summary financial information may need to be provided if the significance level falls in the 10% to 20% range).

The SEC's intent in adding the revenue component to the income test was to generally make it less likely that an entity would be determined to be significant. However, it is conceivable that, in some rare situations, the amendments will increase the chance that an equity method investee is significant in a particular period. In those situations, we suggest reaching out to the Staff of Corp Fin's Office of Chief Accountant to determine if any relief is possible. The Staff has historically been amenable to granting relief when the application of the significance tests under Rule 3-09 results in anomalous outcomes.

A Form 8-K Pitfall: Fallout from Changes to Section 162(m)

In our March-April 2018 issue at page 9, we revisited the sometimes perplexing approach to the disclosure required by Item 5.02(e) of Form 8-K, which generally requires current disclosure, with respect to a company's principal executive officer, principal financial officer or named executive officers, of any material new compensatory plan, contract or arrangement (or any material modification), including any material grant or award under such a plan, contract or arrangement (or any material modification). An instruction to Item 5.02(e) provides that grants or awards (or modifications) will not be required to be disclosed on Form 8-K if they are "materially consistent" with the previously disclosed terms of such plans, contracts or arrangements, and they are disclosed the next time the company is required to provide disclosure under Item 402 of Regulation S-K.

Evaluating the Total Mix of Information for the "Materially Consistent" Test

Fortunately, the Staff has published several Regulation S-K CDIs that have gone a long way to explain the disclosures that are expected to be provided under Item 5.02(e) of Form 8-K, generally recognizing from a policy perspective that disclosure regarding some compensation developments for the covered officers is best left to the executive compensation disclosure included in the proxy statement, rather than in a Form 8-K.

In Regulation S-K CDI Question 117.10, the Staff indicates that, in the context of a material cash bonus plan, if prior disclosure indicates the potential performance criteria upon which awards may be based, there is no need to file a Form 8-K when the actual targets under the plan are set. Further, in Question 117.11, the Staff states that when the material payout under a cash plan is materially consistent with the previously disclosed terms of the plan, no Form 8-K would be required. However, if the issuer exercised discretion to pay the bonus even though the specified performance criteria were not satisfied, a Form 8-K would be required, even if the plan provided for the exercise of such discretion.

Further, in Question 117.12, the Staff notes that when reporting the adoption of an annual non-equity incentive plan award, the issuer is not required to disclose the target levels with respect to specific quantitative or qualitative performance related factors, or any factors or criteria involving confidential trade secrets or commercial or business information, the disclosure of which would result in competitive harm for the issuer. The Staff's position is consistent with Instruction 4 to Item 402(b) of Regulation S-K and Instruction 2 to Item 402(e)(1) of Regulation S-K. These CDIs have generally been applied by analogy in the context of equity incentive compensation programs.

Finally, in Question 117.13, the Staff states that if a previously disclosed employment agreement provides that the principal executive officer is entitled to receive a cash bonus in an amount determined by the compensation committee in its discretion, an Item 5.02(e) Form 8-K would not be required when the compensation committee makes an ad hoc determination of the bonus amount.

The Staff notes that material information about the bonus award should be included in the company's CD&A and related disclosures under Item 402 of Regulation S-K. Subsequent to the publication of this interpretation, members of the Staff informally indicated that this same "no triggering event" position should equally apply for completely discretionary bonuses that are paid when no employment agreement is in place, as well as discretionary salary increases. These interpretive outcomes are consistent with the overall desire of the Commission and the Staff to require only "unquestionably or presumptively material" information to be disclosed on Form 8-K.

As we have previously noted, it is important to consider the totality of the disclosure that has been provided regarding the relevant compensation item, plan, contract or arrangement. The analysis requires consideration of disclosure that was previously provided in a wide range of sources, including proxy statements, Form 8-K filings, the exhibits to SEC filings, periodic reports and registration statements. The analysis requires a careful consideration of the total mix of information that is available regarding a company's compensation plans and how they are implemented. After examining the information that is publicly available, a company can then determine whether any Form 8-K triggering events occur as a result of payouts, grants, awards or other compensation changes.

Considering the Plan and Related Award Agreements

An important source of information that is often considered when evaluating whether payouts, grants, awards or other compensation changes are materially consistent with previously disclosed information is the company's incentive compensation plan. The plan is filed as an exhibit to the company's Form 10-K or Form 10-Q and is often included as an appendix to the proxy statement when the plan, or amendments to the plan, are approved by shareholders. The plan sets forth important information about potential payouts, grants or awards or potential compensation changes, and, when combined with individual forms of award agreements that are also filed as exhibits to periodic reports under Item 601(b)(10) of Regulation S-K, can often serve as the basis for determining if payouts, grants, awards or compensation changes are materially consistent with the publicly available information about the terms of the plan and grants or awards under the plan.

Enter the Changes to Section 162(m)

In December 2017, the Tax Cuts and Jobs Act was enacted (see the January-February 2018 issue of *The Corporate Executive* at page 1). Most significantly, the TCJA eliminated the performance-based compensation exception from Section 162(m). This was a very frequently used exception, because it allowed public companies covered by Section 162(m) to deduct significant amounts of compensation expense each year. In general, except for certain grandfathered amounts, public companies were not able to deduct any amount of annual equity or cash compensation paid to covered employees after December 31, 2017 that was in excess of $1 million.

When the performance-based compensation exception in Section 162(m) went away, a number of practices that had been associated with satisfying the conditions of the exception also went away. For example, in order to qualify as performance-based compensation under the pre-TCJA Section 162(m), the performance goals were required to be established by a compensation committee comprised solely of two or more "outside directors." With the elimination of the performance-based exception, companies no longer need to comply with the "outside director" requirement (except with respect to any grandfathered amounts).

Further, in order to comply with the rules for qualified performance-based compensation under pre-TCJA Section 162(m), companies had adopted specific types of performance-based compensation plans, which were known as "menu plans" or "umbrella plans." These plans were drafted to satisfy several procedural conditions under pre-TCJA Section 162(m), including the requirement that shareholders approve the performance criteria on which performance goals are based, a limitation on deviating from the objective formulas (other than by the exercise of negative discretion) and a requirement that the company's compensation committee certify the performance results.

Menu plans generally included a list of potential performance criteria, which were approved by the company's shareholders and reapproved every five years. With a menu plan in place, the compensation committee could look to the approved menu of performance criteria when granting awards under the plan and then establish an objective performance payout formula that was based on one or more of the approved criteria.

An umbrella plan would typically provide for an annual pool of compensation, based on an established objective performance formula set forth in a plan that was approved by shareholders. The objective performance goal qualified as substantially uncertain, but was considered likely to be achieved. Separately, the compensation committee would establish a second set of performance goals, which did not need to meet the requirements in Section 162(m) of being objective, performance-based, and pre-established. At the end of the performance period, the umbrella plan generated an incentive compensation amount based on the objective goals, and then the compensation committee would use its permissible negative discretion to adjust that amount to an appropriate level based on the executive's performance relative to the second set of performance goals.

In a post-TCJA world, all of that Section 162(m) infrastructure is no longer needed. For example, as companies adopt new incentive compensation plans or amend incentive compensation plans, they no longer need to specify an extensive laundry list of potential performance criteria, because, with the elimination of the performance-based exception, that shareholder-approved laundry list of performance criteria is no longer required.

Revisiting the Form 8-K Requirement

As plans are now being filed with the SEC without the laundry list approach, companies may need to revisit their analysis as to whether potential payouts, grants or awards or other compensation changes are materially consistent with previously disclosed information. It may also be the case that companies are not able to rely on forms of award agreements that are on file with the SEC, because they often lack specificity about the performance metrics utilized in actual grants or awards.

Those companies that are transitioning to post-TCJA incentive plans may want to reconsider removing the laundry list of potential performance criteria, and instead recast that list as a non-exclusive list of performance criteria that the compensation committee may utilize when making awards. As an alternative, a company may want to preemptively disclose the potential performance criteria that the compensation committee has determined to use under the incentive plan in its upcoming CD&A disclosure, in a Form 8-K or in some other SEC filing. This approach would serve to ensure that the total mix of information that is on file with the SEC provides a sufficient basis for determining that the materially consistent test has been satisfied upon the occurrence of payouts, grants or awards or other compensation changes.

Wither the Integration Doctrine? A New Approach Dawns this Spring

The Path to a Better Integration Doctrine: A Tribute to Marty Dunn

To our dearly departed Editor and friend Marty Dunn, reforming the integration doctrine was a personal mission. Marty really wanted the integration doctrine to make sense and work in a practical way for companies seeking to conduct securities offerings. Marty's view of the integration doctrine was particularly affected by some of the integration policy that emerged in the 1990s, which was pejoratively characterized by some (including this publication) as "metaphysics." His quest for clarity led to a moment when he drew up what he called an "integration manifesto" on a long airplane ride. Marty carried that integration manifesto around with him, whipping it out whenever some sort of integration policy decisions were being made in Corp Fin.

The integration manifesto contemplated a path for moving away from the traditional (and hard to apply) five-factor test and the unworkable six month safe harbor in Regulation D, toward a more rational way of approaching integration situations. At its core, the integration manifesto focused on examining whether the subject offering stood on its own as a valid exempt or registered offering, meeting all of the requirements of the exemption claimed or the registration process pursued, even though another offering was occurring close in time to the subject offering. This path made sense when you really focused on the reason for the integration doctrine in the first place, which is to address situations where an issuer divides an offering into discrete pieces as a way of making an end-run around the applicable requirements of exemptions from registration or the registration process itself.

For a long time and for a variety of reasons, Marty's integration manifesto did not advance too far from a regulatory perspective. The Staff in Corp Fin continued to toil away at reviewing responses to integration comments that walked through the traditional five-factor test, trying to draw appropriate regulatory lines in a wide variety of concurrent and successive offering situations, while at the same time grappling with numerous issues arising from PIPEs and equity line transactions.

By the mid-2000s, along came the issue of companies needing to raise capital when they got stuck in the registration process while trying to go public. The frothy IPO market of the late 1990s had long ago subsided, and companies were faced with the prospect of a potentially long path toward going public, as market windows opened and closed on an unpredictable basis. By this time, our dearly departed Editor had advanced to the position of Deputy Director of Corp Fin, and our Senior Editor Dave Lynn was serving as Chief Counsel of Corp Fin. Concerns about the integration doctrine potentially limiting the ability of companies to raise capital and discouraging IPOs presented an opportunity for the integration manifesto to be utilized.

Marty and Dave worked on language that was ultimately included in the 2007 Regulation D proposing release (Release No. 33-8828 (2007); see our January-February 2008 issue at page 1), which announced a new Commission approach for evaluating whether a concurrent private and public offering should be integrated.

The analysis described in the Regulation D proposing release noted that "if the company is able to solicit interest in a concurrent private placement by contacting prospective investors who (1) were not identified or contacted through the marketing of the public offering and (2) did not independently contact the issuer as a result of the general solicitation by means of the registration statement, then the private placement could be conducted in accordance with Section 4[(a)](2) while the registration statement for a separate public offering was pending." Marty's integration manifesto had become mainstream, and thus the chains that bound us all to the traditional five-factor test were broken, and a new age for examining integration issues had dawned.

Both Marty and Dave left the Commission in 2007 (with Dave joining this publication as a full-time Editor and Marty entering private practice), so it was entirely possible that the integration manifesto could have diminished in importance, and the Staff and the Commission could have gone back to the tried-and-true traditional five-factor test. Instead, the integration manifesto continued to flourish, unbound from its creator, and ultimately became enshrined in Commission rules that were adopted last year to harmonize the exempt offering framework.

Applying the New Integration Framework: Marty's Legacy Lives On!

As we noted in our November-December 2020 issue at page 6, in November 2020 the SEC adopted amendments to various rules under the 1933 Act governing exempt offerings. These rule changes are effective on March 15, 2021, barring any efforts by the Commission to delay the effective date of the rules or to otherwise revisit that rulemaking now that the political winds in Washington have shifted. Recognizing that we provided an overview of the new integration framework in our November-December 2020 issue, in this issue we delve into how the framework will be applied in specific situations.

New Rule 152(a) states the general principle that, if the safe harbors in Rule 152(b) do not apply, in 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 1933 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 1933 Act, or that an exemption from registration is available for the particular offering. In other words, Marty's integration manifesto applies.

Application of the General Principle to an Exempt Offering Prohibiting General Solicitation. New Rule 152(a)(1) codifies and expands on the guidance that the Commission had first issued in 2007 in the Regulation D proposing release (as it was updated through 2016), which sets forth a framework for analyzing how an issuer can conduct simultaneous registered and private offerings. New Rule 152(a)(1) relates to the application of this general principle to an exempt offering prohibiting general solicitation, and states that the issuer must have 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: (i) did not solicit such purchaser through the use of general solicitation; or (ii) established a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation.

Under these new integration principles in Rule 152(a), issuers may now conduct concurrent Rule 506(c) and Rule 506(b) offerings, or any other combination of concurrent offerings, involving an offering prohibiting general solicitation and another offering permitting general solicitation, without integration concerns, as long as the provisions of Rule 152(a)(1) and all of the other conditions of the applicable exemptions are satisfied.

The SEC notes in the harmonization adopting release that new Rule 152(a)(1)(ii) "codifies and expands the SEC's 2007 guidance that the existence of a pre-existing substantive relationship between the issuer, or its agent, and a prospective investor may be one means by which an investor may become interested in, or become aware of, a private placement conducted while a registration statement for a public offering is on file with the Commission that may be consistent with Section 4(a)(2)." The SEC confirms in the harmonization adopting release that "the existence of such a relationship prior to the commencement of an offering is one means, but not the exclusive means, of demonstrating the absence of a general solicitation in a Regulation D offering."

Accordingly, an offer of the issuer's securities to a person with whom the issuer, or a person acting on its behalf, has a pre-existing substantive relationship would not constitute a general solicitation, provided that the relationship was established prior to the commencement of the offering. Investors with whom the issuer has a pre-existing substantive relationship may include the issuer's existing or prior investors, investors in prior deals of the issuer's management, friends or family of the issuer's control persons, or customers of a registered broker-dealer or investment adviser with whom the broker-dealer or investment adviser established a substantive relationship prior to the participation in the exempt offering by the broker-dealer or investment adviser.

The SEC reiterates in the harmonization adopting release the guidance that was originally provided in the proposing release indicating that the SEC generally views a "pre-existing" relationship as one that the issuer has formed with an offeree prior to the commencement of the offering or, alternatively, that was established through another person (for example, a registered broker-dealer or investment adviser) prior to that person's participation in the offering, while 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 evaluate, and does, in fact, evaluate, an offeree's financial circumstances and sophistication, in determining his or her status as an accredited or sophisticated investor. The SEC notes in the harmonization adopting release that it does "not believe that self-certification alone (by checking a box) without any other knowledge of a person's financial circumstances or sophistication would be sufficient to form a 'substantive' relationship for these purposes."

The SEC also indicates in the harmonization adopting release that "[p]ersons other than registered broker-dealers and investment advisers may form a pre-existing, substantive relationship with an offeree as a means of establishing that a general solicitation is not involved in a Regulation D offering." Further, the SEC notes that whether a "pre-existing, substantive relationship" exists generally turns on procedures established by broker-dealers in connection with their customers, because traditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers, and, thus, implies that a substantive relationship exists between the broker-dealer and its customers. The SEC reiterates its long-standing position that "the presence or absence of a general solicitation is always dependent on the facts and circumstances of each particular case."

As a result, there may be facts and circumstances in which a third party, other than a registered broker-dealer, could establish a "pre-existing, substantive relationship" sufficient to avoid a general solicitation. The SEC also notes in the harmonization adopting release that there may be particular instances where issuers may develop pre-existing, substantive relationships with offerees; however, "in the absence of a prior business relationship or a recognized legal duty to offerees, it is likely more difficult for an issuer to establish a pre-existing, substantive relationship, especially when contemplating or engaged in an offering over the internet."

The SEC further notes that issuers "would have to consider not only whether they have sufficient information about particular offerees, but also whether they in fact use that information appropriately to evaluate the financial circumstances and sophistication of the offerees prior to commencing the offering."

Application of the General Principle to Concurrent Exempt Offerings that Each Allow General Solicitation. New Rule 152(a)(2) relates to the application of the general principle in new Rule 152(a) to concurrent exempt offerings that each allow general solicitation, and states that, in addition to satisfying the requirements of the particular exemption relied on, general solicitation offering materials for one offering that include information about the material terms of a concurrent offering under another exemption may constitute an offer of the securities in such other offering, and therefore the offer must comply with all of the requirements for, and restrictions on, offers under the exemption being relied on for such other offering, including any legend requirements and communications restrictions. The SEC notes in the harmonization adopting release that new Rule 152(a)(2) builds on the SEC's guidance in its Regulation A and Regulation Crowdfunding rulemakings, as well as the subsequent Rule 147 and Rule 147A rulemaking, "to provide issuers with greater flexibility and the ability to rely on existing 1933 Act exemptions more effectively without compromising the investor protections of each exemption."

The SEC notes that, under new Rule 152(a)(2), an issuer may undertake an offering in reliance on Rule 506(c), if the issuer meets all of the conditions of that exemption, including taking reasonable steps to verify that all purchasers in the Rule 506(c) offering are accredited investors, while conducting a concurrent offering in reliance on Regulation A, if that concurrent offering complies with all of the requirements of Regulation A. If the issuer were to discuss, in any general solicitation materials used for the Rule 506(c) offering, the material terms of the Regulation A offering, new Rule 152(a)(2) would require the Rule 506(c) general solicitation to comply with all the requirements for offers under Regulation A, including all necessary legends and compliance with any restrictions on the use of general solicitation imposed on issuers making offers under Regulation A. Similarly, an issuer undertaking a Rule 506(c) offering concurrently with a Regulation Crowdfunding offering would need to ensure sure that any general solicitation materials used in connection with the Rule 506(c) offering that mention the material terms of the Regulation Crowdfunding offering comply with the off-portal offering limitations in Rule 204 of Regulation Crowdfunding.

<u>The Integration Safe Harbors.</u> New Rule 152(b)(1) provides that 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, in the case where an exempt offering for which general solicitation is prohibited follows, by 30 calendar days or more, an offering that allows for general solicitation, 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.

The SEC notes in the harmonization adopting release that the 30-day safe harbor may not be used as a way to circumvent the prohibition on general solicitation in an exempt offering to which such prohibition applies. The SEC indicates that "regardless of whether an issuer meets the requirements of the 30-day safe harbor from integration, an issuer conducting an offering of securities under an exemption prohibiting general solicitation, such as Rule 506(b), must still ensure that it has not engaged in a general solicitation, and meets the other terms and conditions of the relevant offering exemption." The SEC also notes in the harmonization adopting release that "if an issuer waits less than 30 days after terminating or completing an offering before commencing a subsequent offering, and therefore cannot rely on the safe harbor in Rule 152(b)(1), it may still avoid integration if it meets the terms and conditions of the general principle of integration in Rule 152(a)."

New Rule 152(b)(3)(i) specifies that an offering for which a 1933 Act registration statement has been filed will not be integrated if it is made subsequent to a terminated or completed offering for which general solicitation is not permitted. New Rule 152(b)(3)(i) builds on the SEC's prior integration guidance relating to offerings for which general solicitation is not permitted. The SEC notes that "[o]ffers and sales preceding registered offerings that do not involve general solicitation are generally not the type of offerings that, when taken together, appear to be susceptible to concerns relating to the prior offers and sales conditioning the market for the registered offering."

Similarly, new Rule 152(b)(3)(ii) provides that an offering for which a 1933 Act registration statement has been filed will not be integrated if it is made subsequent to a terminated or completed offering for which general solicitation is permitted that was made only to qualified institutional buyers and institutional accredited investors. It is clear that new Rule 152(b)(3)

(ii) builds on current Rule 255(e) of Regulation A, and current Rules 147(h) and 147A(h), which provide that offerings limited to qualified institutional buyers and institutional accredited investors are not integrated with a subsequently filed registered offering. Similarly, where an issuer has solicited interest in a contemplated, but subsequently abandoned, Regulation A offering only to qualified institutional buyers or institutional accredited investors, the abandoned Regulation A offering would not be subject to integration with a subsequently filed registered offering.

New Rule 152(b)(3)(iii) provides that an offering for which a 1933 Act registration statement has been filed will not be integrated if it is made subsequent to an offering for which general solicitation is permitted that terminated or was completed more than 30 calendar days prior to the commencement of the registered offering. The SEC notes in the harmonization adopting release that new Rule 152(b)(3)(iii) does not impose an additional requirement beyond that set forth in the 30-day safe harbor of new Rule 152(b)(1), but rather is meant to clarify the application of that provision to subsequent registered offerings. The SEC notes in the harmonization adopting release that "if an issuer files a registration statement under the 1933 Act less than 30 calendar days after a terminated or completed offering for which general solicitation is permitted, although new Rule 152(b)(3)(iii) would not be available, integration would depend on the availability of the general principle of integration in Rule 152(a)." The SEC believes that a 30-day time frame "is sufficient to mitigate concerns that an exempt offering may condition the market for a subsequent registered offering."

Further, 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 under new Rule 152(b)(4). The safe harbor expands on the integration safe harbors in Regulation A and Rules 147 and 147A to include offerings relying on: (1) Regulation Crowdfunding; (2) Rules 504(b)(1)(i), (ii) or (iii) that, depending on state registration requirements, permit general solicitation; and (3) Rule 506(c).

The SEC notes in the harmonization adopting release that "exempt offerings that permit general solicitation and follow other offers and sales are generally not the type of offerings that appear to be susceptible to concerns about the prior offers and sales conditioning the market for the subsequent exempt offering." The SEC provides guidance in the harmonization adopting release about an issuer's ability to rely on Rule 152(b)(4) with respect to an offering that was commenced in reliance on an exemption that does not permit general solicitation, but that the issuer wishes to continue in reliance on an exemption that does permit general solicitation.

The SEC expresses the view that 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 a 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 SEC notes that 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), and that it is also not necessary for an issuer to use different offering materials for offerings that rely on different exemptions, so long as the issuer satisfies the disclosure and other requirements of each applicable exemption.

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 under new Rule 152(b)(2). The SEC did not adopt a proposed amendment to the definition of “directed selling efforts” in Rule 902 of Regulation S, and related proposed Rule 906. This amendment was proposed to address “certain perceived concerns about the ability of an issuer to conduct concurrent Regulation S and Rule 506(c) offerings, particularly when the offerings are conducted using the internet.” The SEC was persuaded by commenters who argued that the existing regulatory framework appropriately addresses concerns relating to the risk of flowback of Regulation S securities to the U.S. or the use of general solicitation in an exempt offering to condition the market in the U.S. for the Regulation S securities.

The SEC clarifies in the harmonization adopting release that it does not believe that general solicitation activity for exempt domestic offerings would preclude reliance on Regulation S for concurrent offshore offerings, and the SEC reaffirms its existing guidance with respect to concurrent Regulation S and domestic offerings.

The SEC notes that compliance with the terms of both Regulation S and another applicable exemption, such as Rule 506(c), will depend on the facts and circumstances of a particular situation. For example, the SEC indicates that “the use of the same website to solicit U.S. investors under Rule 506(c) and offshore investors under Regulation S could raise concerns about the issuer’s compliance with the prohibition on directed selling efforts in Regulation S because the offering material on the website could be deemed to have the effect of conditioning the market in the United States.” In such situations, the SEC believes that an issuer can take certain steps to distinguish the Regulation S and domestic offering materials, in accordance with existing SEC guidance.

An Integration Coda

Marty did have some concerns with the SEC’s proposed integration approach in the harmonization rulemaking, but unfortunately he never got a chance to express those concerns to the Commission due to his unexpected death in June 2020. We do think that Marty would be pleased to know that a new integration doctrine, based on the principles outlined in his integration manifesto written on an airplane all those many years ago, did become the law of the land and that, coming this March, we will have a much more rational and straight-forward way to evaluate integration issues. It is a fitting legacy to Marty’s hard work, perseverance and dedication to the securities laws.

- JJ, DL

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