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SEC Enhances Exemptions for Local Offerings

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Securities

The Securities and Exchange Commission (the "SEC") recently adopted rules to update and enhance registration exemptions for intrastate and regional securities offerings.[1] The final rules amend Rule 147, a safe harbor for exempt intrastate offerings under the Securities Act of 1933 (the "Securities Act"). In addition, the final rules establish a new offering exemption, Rule 147A under the Securities Act, which expands flexibility for intrastate offerings by (i) allowing issuers to make communications that would constitute offers through media that cannot practicably be limited to a single state and (ii) permitting use of the rule by companies that are incorporated or organized in a state other than the state where the securities are being sold. Aside from these two key differences, discussed in more detail below, amended Rule 147 and new Rule 147A are substantially similar.[2]

Finally, the rules amend Rule 504 of Regulation D under the Securities Act to increase the aggregate offering price of securities in offerings under the rule in any 12-month period from $1 million to $5 million and to disqualify bad actors from participating in Rule 504 offerings. The increase in maximum offering size is intended to facilitate coordination by state securities regulators in promoting regional (i.e., interstate) regulation of crowdfunding and other small business offerings. At the same time, the SEC repealed existing Rule 505 of Regulation D.

Rules 147 and 147A

Rule 147

Rule 147 provides a non-exclusive safe harbor under section 3(a)(11) of the Securities Act for intrastate securities offerings.[3] Section 3(a)(11) exempts from federal registration requirements certain offers and sales of securities made exclusively to persons resident within a single state or territory by an issuer residing or incorporated in and doing business within such state or territory. As amended, Rule 147 includes the following conditions, each discussed further below:

- an updated requirement that the issuer is incorporated or organized and also has its principal place of business in the state or territory in which the offering is being conducted;

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[1] *See* SEC Release No. 33-10238 (Oct. 26, 2016).

[2] Unlike Rule 147, Rule 147A was adopted based on the SEC's general exemptive authority under section 28 of the Securities Act. After the proposed rules were published, many commenters expressed support for retaining an amended version of Rule 147 as a safe harbor under section (3)(a)(11) of the Securities Act in order to allow issuers to take advantage of existing state crowdfunding provisions that, for the most part, are premised on the offering being made in compliance with section 3(a)(11).

[3] Revised Rule 147 will become effective on April 20, 2017.

- an updated requirement that the issuer satisfy at least one "doing business" requirement demonstrating the in-state nature of its business;
- a legacy requirement that offers and sales of securities be made only to residents of the state or territory in which the issuer is resident, which can now be satisfied on the basis of an issuer's "reasonable belief" of a purchaser's in-state residency;
- an updated ban on resales other than to persons resident within the relevant state or territory for a period of six months from the date of the sale of a security sold under the exemption;
- an updated requirement to take precautions against interstate sales and resales, including: (i) disclosing to each offeree and purchaser of securities, at the time of the initial offer and sale, the intrastate nature of the offering and the limits on resales; (ii) obtaining a written representation of residence from each purchaser at the time of the initial offer and sale; (iii) placing a prominent legend on the stock certificate (or other document evidencing the security) that notes the limitations on resales; and (iv) issuing stop transfer instructions to the issuer's transfer agent, if any, or, if the issuer transfers its own securities, noting such limitations in the records of the issuer; and
- a new integration safe harbor that covers both prior and subsequent offers and sales of securities by the issuer.

The revised rule generally follows the SEC's original proposal.[4]

Principal Place of Business

Under amended Rule 147, an issuer that is incorporated or organized in a particular state or territory will be deemed a "resident" of the state or territory in which it is both incorporated or organized and has its "principal place of business." Rule 147 defines an issuer's "principal place of business" as the location from which officers, partners, or managers of the issuer primarily direct, control, and coordinate the activities of such issuer. Previously, this requirement related only to the issuer's principal office.

Doing Business

In order to be considered "doing business" in a particular state or territory, an issuer is required to meet at least one of the following requirements:

- the issuer derived at least 80 percent of its consolidated gross revenues from operating a business or real property located in or rendering services within such state or territory;[5]

[4] *See* SEC Release No. 33-9973 (Oct. 30, 2015). The proposed rule included additional amendments to Rule 147 that would have (i) limited the dollar amount of securities an issuer may sell under such exemption to no more than $5 million in any 12-month period and (ii) imposed an investment limitation on investors. All commenters that addressed the issue opposed any limits at the federal level on the offering amount or investment size, and the SEC did not adopt these elements of the proposed rule.

[5] If the first offer of securities is made during the first six months of the issuer's current fiscal year, revenues must be calculated based on the issuer's most recently completed fiscal year. If the first offer of securities is made during the last six months of the issuer's current fiscal year, revenues must be based on the first six months of the issuer's current fiscal year or the 12-month period ending with such six-month period.

- the issuer had at least 80 percent of its consolidated assets located within such state or territory at the end of its most recent semi-annual fiscal period prior to the first offer of securities under the exemption;
- the issuer intends to use and uses at least 80 percent of the net proceeds in connection with the operation of a business or real property, the purchase of real property located in, or the rendering of services within such state or territory; or
- a majority of the issuer's employees are based in such state or territory.[6]

Issuers that have changed their principal place of business after making sales in an intrastate offering under Rule 147 will not be allowed to conduct another intrastate offering under Rule 147 or Rule 147A in another state for a period of six months after the date of the last sale in the prior state.

Resident Status of Offerees and Purchasers—"Reasonable Belief"

That offers and sales can only be made to in-state residents is a fundamental principle of Rule 147. However, an issuer will be deemed to comply with the residency requirement so long as the issuer had a reasonable basis for believing that the offeree or purchaser was a resident, even if the facts ultimately show that that this belief was mistaken. Whether the issuer had a reasonable basis for such belief will depend on the facts and circumstances.[7] Evidence to support the reasonableness of an issuer's belief may include (i) information obtained through a pre-existing relationship with the prospective purchaser that provides the issuer with sufficient knowledge about such prospective purchaser's principal residence or principal place of business; (ii) information contained in federal or state tax returns; (iii) any documentation issued by a federal, state, or local government authority, such as a driver's license or identification card; or (iv) a public or private database that the issuer has determined is reasonably reliable, such as a credit bureau database. Although Rule 147 requires that the issuer obtain a written representation from each purchaser as to its in-state residency, the rule is clear that a purchaser's written representation of residence, while offering an indicium of compliance, is not on its own sufficient to establish the reasonableness of an issuer's belief.

Limitation on Resales[8]

Any resale of a security initially sold under Rule 147 which is made in the first six months after the initial sale must be made only to persons resident in the same state or territory as the initial sale.[9]

Precautions Against Resales

Amended Rule 147 provides that certain precautions must be taken to prevent prohibited interstate resales, including (i) a legend prominently placed on each stock certificate (or other document evidencing the security) and (ii) disclosure of the resale restrictions made to each

[6] This final requirement was not included in Rule 147 prior to the current amendments.
[7] The residence of a legal entity purchaser is defined as the location where the entity had its principal place of business at the time of the sale.
[8] In order to increase the utility of the exemption, and to eliminate issuer uncertainty, an issuer's ability to rely on Rule 147 will not be conditioned on a purchaser's compliance with this limitation.
[9] The proposed rules included a nine-month resale limitation.

offeree and purchaser of securities at the time of the offer and sale. The new rule provides specific language to be used for both the legend and disclosure to offerees and purchasers.

Integration[10]

Under the final rules, offers, and sales made pursuant to Rule 147 will not be integrated with:

- prior offers or sales of securities; or
- subsequent offers or sales of securities that are:
  - registered under the Securities Act, except as provided in Rule 147(h);[11]
  - exempt from registration under:
    - Regulation A under the Securities Act;
    - Rule 701 under the Securities Act;
    - Regulation S under the Securities Act;
    - section 4(a)(6) of the Securities Act;
  - made under an employee benefit plan; or
  - made more than six months after the completion of an offering conducted under Rule 147.

Rule 147A

The SEC also adopted new Securities Act exemption Rule 147A.[12] The new rule is substantially similar to Rule 147, subject to two key differences.

First, Rule 147A was adopted based on the SEC's general exemptive authority under section 28 of the Securities Act and not under section 3(a)(11). Consequently, the rule is not subject to the statutory limitations of section 3(a)(11), and more specifically to the limitation that both offers and sales be made only to in-state investors. As adopted, Rule 147A permits offers to be accessible to out-of-state residents, which would be inconsistent with a safe harbor under section 3(a)(11). Under Rule 147A, it does not matter whether an issuer makes *offers* to out-of-state residents, so long as *sales* are made only to in-state residents. The principal benefit of this provision is that the issuer can market to in-state residents on web-based platforms and through other forms of electronic media where blockading information at the border is not practicable, or possible.

Second, Rule 147A permits an issuer to be incorporated or organized in a state or territory which is different from the state or territory in which the offering is being made, on the condition that it can demonstrate the in-state nature of its business under the "principal place of business" and "doing business" requirements discussed above.

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[10] This integration safe harbor aligns with the integration safe harbor available under Rule 251(c) of Regulation A under the Securities Act.

[11] Paragraph (h) provides that where an issuer decides to register an offering under the Securities Act after making offers in reliance on Rule 147 to persons other than qualified institutional buyers and institutional accredited investors, such offers will not be subject to integration *provided* the issuer waits at least 30 calendar days between the last such offer made in reliance on Rule 147 and the filing of the registration statement with the SEC.

[12] Rule 147A will become effective on April 20, 2017.

Taking into account these differences, the conditions to Rule 147A are as follows:

- a requirement that the issuer has its principal place of business in the state or territory in which the offering is being conducted;
- a requirement that the issuer satisfy at least one "doing business" requirement demonstrating the in-state nature of its business;
- the purchaser residency requirement described above, which can be satisfied on the basis of an issuer's "reasonable belief" of a purchaser's in-state residency;
- a ban on resales other than to persons resident within the state or territory of the offering for a period of six months from the date of the sale of a security sold under the exemption;
- a requirement to take precautions against interstate sales and resales, including: (i) disclosing to each offeree and purchaser of securities, at the time of the initial offer and sale, the intrastate nature of the offering and the limits on resales; (ii) obtaining a written representation of residence from each purchaser at the time of the initial offer and sale; (iii) placing a prominent legend on the stock certificate (or other document evidencing the security) that notes the limitations on resales; and (iv) issuing stop transfer instructions to the issuer's transfer agent, if any, or, if the issuer transfers its own securities, noting such limitations in the records of the issuer; and
- a new integration safe harbor that covers both prior and subsequent offers and sales of securities by the issuer.

Rule 504

Rule 504, one of three exemptions from offering registration in Regulation D, was amended to increase the aggregate amount of securities that may be offered and sold in any 12-month period from $1 million to $5 million. In conjunction with this change to Rule 504, the SEC repealed Rule 505 of Regulation D which had previously provided a safe harbor from registration for securities offered and sold in any 12-month period up to $5 million to accredited investors and no more than 35 non-accredited investors.[13]

In addition, Rule 504 was amended to disqualify certain bad actors from participation in Rule 504 offerings by referencing the disqualification provisions in Rule 506(d) of Regulation D.

Conclusions/Going Forward

The final rules adopted by the SEC are intended to facilitate capital formation for smaller companies by increasing the utility of the Securities Act exemptive framework. In the SEC's press release announcing the adoption of the rules, SEC Chair Mary Jo White stated, "[the rules], while continuing to provide investor protections, update and expand the capital raising avenues for smaller companies, allowing them to more fully take advantage of change in technology and business practices."[14]

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[13] The revised Rule 504 and the repeal of Rule 505 will become effective on January 20, 2017 and May 22, 2017, respectively.

[14] Mary Jo White, "SEC Adopts Final Rules to Facilitate Intrastate and Regional Securities Offerings" (Oct. 26, 2016).

Rule 147A, in particular, expands the universe of companies that may engage in intrastate offerings by allowing an issuer to conduct an offering in the state in which it does business, even if that is not the state in which it is organized. In addition, by allowing for offers to be made to out-of-state residents, Rule 147A eliminates the concerns previously associated with offers made on the internet.

Finally, the higher offering ceiling provided for in amended Rule 504 may provide the additional flexibility needed for state securities regulators to implement coordinated review programs to facilitate regional offerings. Any such benefit, however, may be offset in part by the addition of a bad actor disqualification condition, which comes with a compliance cost.

Overall, it is likely that some will look to these rules to complement recently adopted state law crowdfunding exemptions. Of course, the optimal approach in many financing scenarios is to use a federal exemption from registration which preempts all state securities registration requirements, such as Rule 506 of Regulation D or Tier 2 of Regulation A, something that will not be possible under section 3(a)(11), Rule 147 or Rule 147A.

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