Client Alert

November 5, 2015

SEC Proposes Rule Changes to Pave the Way for Intrastate and Regional Offerings

By David Lynn

At the same time the Securities and Exchange Commission (the "SEC") adopted rules implementing Regulation Crowdfunding pursuant to Title III of the Jumpstart Our Business Startups Act (the "JOBS Act"), the agency proposed rule changes that could potentially facilitate intrastate and regional offerings that are subject to state blue sky regulation. In particular, the SEC proposed to modernize Rule 147 under the Securities Act of 1933, as amended (the "Securities Act"), and establish a new exemption to facilitate offerings relying upon recently adopted intrastate crowdfunding exemptions under state securities laws. The SEC also proposed amendments to Rule 504 of Regulation D under the Securities Act to increase the aggregate amount of securities that may be offered and sold in any twelve-month period from $1 million to $5 million and to disqualify certain bad actors from participating in Rule 504 offerings. The SEC indicated in the proposing release that these proposals are "part of the Commission's efforts to assist smaller companies with capital formation consistent with other public policy goals, including investor protection."

PROPOSED AMENDMENTS TO RULE 147

Rule 147 is a safe harbor for intrastate offerings exempt from registration pursuant to Securities Act Section 3(a)(11), which exempts "any security which is a part of an issue offered and sold only to persons resident within a single state or territory, where the issuer of such security is a person residing and doing business within, or, if a corporation, incorporated by and doing business within such state or territory." The proposed amendments would eliminate the restriction on offers, while continuing to require that sales be made only to residents of an issuer's state or territory. The proposed amendments also would redefine "intrastate offering" and ease issuer eligibility requirements. The SEC proposes to limit the availability of the exemption to offerings that are either registered in the state in which all of the purchasers are resident, or conducted pursuant to an exemption from state law registration in such state that limits the amount of securities an issuer may sell pursuant to such exemption to no more than $5 million in a twelve-month period and imposes an investment limitation on investors.

The SEC noted that over time it has been observed that the statutory limitation on offers in Section 3(a)(11) and the prescriptive threshold requirements that an issuer must satisfy in order to be considered "doing business" in-state as specified in Rule 147 have combined to limit the availability of the exemption for companies that otherwise might have considered using the exemption in order to conduct intrastate offerings. In particular, these provisions make it difficult to conduct intrastate offerings utilizing the Internet. The SEC also noted that a number of states have adopted and/or enacted crowdfunding provisions, or currently have crowdfunding legislation pending. These state-based crowdfunding provisions generally require that an issuer, in addition to complying with various state-specific requirements to qualify for the exemption, also comply with Section 3(a)(11) and Rule 147. State securities regulators have indicated to the SEC that Section 3(a)(11) and Rule 147 make it difficult for companies to take advantage of these new crowdfunding provisions.

The proposed amendments to Rule 147 would permit an issuer to engage in any form of general solicitation or general advertising, including the use of publicly accessible Internet websites, to offer and sell its securities, so long as all sales occur within the same state or territory in which the issuer's principal place of business is located, and the offering is registered in the state in which all of the purchasers are resident, or is conducted pursuant to an exemption from state law registration in such state that limits the amount of securities an issuer may sell pursuant to such exemption to no more than $5 million in a twelve-month period and imposes an investment limitation on investors. The proposed amendments would also define an issuer's principal place of business (as opposed to its "principal office" as defined in current Rule 147) as the location in which the officers, partners, or managers of the issuer primarily direct, control, and coordinate the activities of the issuer and further require the issuer to satisfy at least one of four threshold requirements discussed below regarding the in-state nature of the issuer's business. As defined, an issuer would only be able to have a "principal place of business" within a single state or territory and would therefore only be able to conduct an offering pursuant to amended Rule 147 within that state or territory. Further, as proposed, the provisions of Rule 147 regarding legends and mandatory disclosures to purchasers and prospective purchasers would be retained.

Rule 147, as it is proposed to be amended, would no longer fall within the statutory parameters of Section 3(a)(11); therefore, the SEC proposed to amend Rule 147 to create an exemption pursuant to the SEC's general exemptive authority under Section 28 of the Securities Act. As proposed to be amended, Rule 147 would function as a separate exemption rather than as a safe harbor under Section 3(a)(11), and Section 3(a)(11) would still be available as a potential statutory exemption in and of itself.

Based on its belief that the rules should continue to require that the securities sold in an intrastate offering in one state should come to rest within such state before sales are permitted to out-of-state residents, the SEC proposes to limit the ability of an issuer that has changed its principal place of business to conduct an intrastate offering in a different state until such time as the securities sold in reliance on the proposed exemption in the prior state have come to rest in that state. For this purpose, the SEC proposes that issuers that have changed their principal place of business after making sales in an intrastate offering pursuant to proposed Rule 147 would not be able to conduct an intrastate offering pursuant to proposed Rule 147 in another state for a period of nine months from the date of the last sale in the prior state, which is consistent with the duration of the resale limitation period specified in proposed Rule 147(e), discussed below.

For the purpose of determining the "in-state" nature of the issuer utilizing Rule 147, the rule as proposed would require that, in addition to the requirement that an issuer have its principal place of business in-state, the issuer must meet at least one of the following requirements (instead of all requirements, as currently specified in Rule 147): (i) the issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in or from the rendering of services within such state or territory; (ii) the issuer had at the end of its most recent semi-annual fiscal period prior to the first offer of securities pursuant to the exemption, at least 80% of its consolidated assets located within such state or territory; (iii) the issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to the exemption in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory; or (iv) a majority of the issuer's employees are based in such state or territory (this fourth prong is proposed to be added to the list).

While current Rule 147(d) requires that offers and sales of securities pursuant to the rule be made only to persons resident within the state or territory of which the issuer is a resident, so that the exemption would be lost for the entire offering if securities are offered or sold to one investor that was not in fact a resident of the state, the proposed amendments would add a reasonable belief standard to the issuer's determination as to the residence of the purchaser at the time of the sale of the securities. An issuer would satisfy this by either the existence of the fact that the purchaser is a resident of the applicable state or territory, or by establishing that the issuer had a reasonable belief that the purchaser of the securities in the offering was a resident of such state or territory. The SEC also proposes to eliminate the current requirement in Rule 147 that issuers obtain a written representation from each purchaser as to his or her residence.

The proposed amendments also would define the residence of a purchaser that is a legal entity (i.e., a corporation, partnership, trust, or other form of business organization) as the location where, at the time of the sale, the entity has its principal place of business. The proposed amendments would define a purchaser's "principal place of business," consistent with the proposed definition for issuer eligibility purposes, as the location in which the officers, partners, or managers of the entity primarily direct, control and coordinate the activities of the issuer.

Under current Rule 147(e), "during the period in which securities that are part of an issue are being offered and sold by the issuer, and for a period of nine months from the date of the last sale by the issuer of such securities, all resales of any part of the issue, by any person, shall be made only to persons resident within such state or territory." This limitation on resales is designed to help ensure that the securities issued in an intrastate offering have come to rest in the state of the offering before any potential redistribution out-of-state. The SEC proposes to amend the limitation on resales in Rule 147(e) to provide that "for a period of nine months from the date of the sale by the issuer of a security sold pursuant to this rule, any resale of such security by a purchaser shall be made only to persons resident within such state or territory, as determined pursuant to paragraph (d) of this rule." The SEC believes that a nine-month limitation on resales by resident purchasers to non-residents would ensure that the securities purchased by such residents were purchased without a view to further distribution to non-residents. In addition, Rule 147 would be revised so that compliance with Rule 147(e) would not be a condition for the issuer relying on the exemption.

The SEC also proposes to align the integration safe harbor in Rule 147 with the recently adopted integration safe harbor in Rule 251(c) of Regulation A. As proposed, offers and sales made pursuant to Rule 147 would 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);
    - Exempt from registration under Regulation A;
    - Exempt from registration under Rule 701;
    - Made pursuant to an employee benefit plan;
    - Exempt from registration under Regulation S;

- Exempt from registration under Section 4(a)(6) of the Securities Act; or
- Made more than six months after the completion of an offering conducted pursuant to Rule 147.

As with Rule 251(c) of Regulation A, the proposed integration safe harbor would expressly provide that any offer or sale made in reliance on the rule would not be integrated with any other offer or sale made either before the commencement of, or more than six months after, the completion of the Rule 147 offering. There would be no presumption that offerings outside the integration safe harbor should be integrated.

The proposing release also indicates that an offering made in reliance on Rule 147 would not be integrated with another exempt offering made concurrently by the issuer, provided that each offering complies with the requirements of the exemption that is being relied upon for the particular offering. Further, consistent with the approach that the SEC took to integration in Rule 251(c), the proposed rules provide that, subject to certain exceptions specified in the rule, offers or sales made in reliance on Rule 147 should not be integrated with subsequent offers or sales that are registered under the Securities Act, or qualified by the SEC pursuant to Regulation A.

PROPOSED REGULATION D AMENDMENTS

Rule 504 of Regulation D currently provides issuers with an exemption from registration for offers and sales of up to $1 million of securities in a twelve-month period, provided that the issuer is not:

- subject to reporting pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act");
- an investment company; or
- a blank check company.

Additionally, Rule 504 imposes conditions for the availability of the exemption, including limitations on the use of general solicitation or general advertising in the offering and the restricted status of securities issued pursuant to the exemption, with limited exceptions in this regard for offers and sales made:

- exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale that are made in accordance with state law requirements;
- in one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before the sale, if the securities have been registered in at least one state that provides for such registration, public filing, and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure); or
- exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to "accredited investors" as defined in Rule 501(a) of Regulation D.

Offerings conducted pursuant to Rule 504 must be registered in each state in which they are offered or sold, unless an exemption to state registration is available under state securities laws. Most states require registration of Rule 504 offerings; however, Maine recently adopted a form of state-based crowdfunding that permits the use of general solicitation, but still exempts the issuances of securities from state registration where, in addition to satisfying various state-specific requirements to qualify for the exemption, an issuer also complies with Rule 504 of Regulation D.

The SEC proposes to amend Rule 504 of Regulation D to increase the aggregate amount of securities that may be offered and sold in any twelve-month period from $1 million to $5 million and to disqualify certain bad actors from participation in Rule 504 offerings by referencing the disqualification provisions of Rule 506 of Regulation D. The SEC also seeks public comment on whether additional changes to Rule 504 should be adopted. The SEC noted that if the proposed amendments to Rule 504 were adopted, Rule 505 of Regulation D would become less useful, and, therefore, the SEC requests comment on whether Rule 505 should be retained in its current form or in a modified form, or repealed in its entirety.

The SEC believes that the proposed amendments to Rule 504 could provide state securities regulators with greater flexibility to develop regional coordinated review programs that would rely on Rule 504 at the federal level, given that the proposed changes would increase the maximum amount of capital that could be raised while providing states with assurance that certain bad actors would be excluded from such offerings. The SEC believes that the proposed increase in the offering limitation would increase the flexibility of state securities regulators to set their own state offering limitations and to consider whether any additional requirements should be implemented at the state level. In addition, the SEC believes that the proposed changes "would facilitate state efforts to increase the efficiencies associated with the registration of securities offerings in multiple jurisdictions through regional coordinated review programs."

CONCLUSION

The proposed amendments to Rule 147 and Rule 504 represent the SEC's first efforts since the enactment of the JOBS Act to address, through rulemaking, some of the other areas of concern for small company capital-raising that were not specified in the JOBS Act. Rather than utilizing preemption of state laws, as was done in Regulation A and Regulation Crowdfunding, the SEC's proposed amendments recognize the role of state regulation and seek to utilize that regulation as a basis for exempting smaller offerings at the federal level. The proposals further recognize the work of the states in adopting their own crowdfunding exemptions and in coordinating blue sky review efforts.

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