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SEC Advisory Committee On Small And Emerging Companies Recommends Modernizing Rule 147 for Intrastate Crowdfunding Offerings

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On September 23, 2015, the SEC Advisory Committee on Small and Emerging Companies (the "Advisory Committee") met and finalized its recommendation to the SEC regarding the modernization of the Rule 147 Intrastate offering exemption. The recommendations are focused on facilitating recently enacted and future state-based crowdfunding initiatives.

I have written about the Advisory Committee on numerous occasions, but by way of reminder, the Committee was organized by the SEC to provide advice on SEC rules, regulations and policies regarding "its mission of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation" as related to "(i) capital raising by emerging privately held small businesses and publicly traded companies with less than $250 million in public market capitalization; (ii) trading in the securities of such businesses and companies; and (iii) public reporting and corporate governance requirements to which such businesses and companies are subject."

In formulating its recommendations, the Advisory Committee gave specific consideration to the belief that in the near future a majority of states will have enacted some form of state-based crowdfunding. Accordingly the North American Securities Administrators Association ("NASAA"), as of June 3, 2015: (i) 16 states and the District of Columbia have fully enacted some form of state-based crowdfunding pursuant to which 91 offerings have been undertaken in the last 12 months; (ii) 9 states have passed crowdfunding legislation and are engaging in rule making to finalize these statutory provisions; (iii) 12 states have pending crowdfunding legislation; and (iv) 3 states are investigating the adoption of crowdfunding provisions.

In addition, the Advisory Committee notes that Rule 147 promulgated under the Securities Act of 1933, and as further discussed below, was adopted in 1974 and has not been updated or amended since. Many state regulators and practitioners have indicated that Rule 147, in its current state, makes it difficult for issuers to take advantage of the new state crowdfunding provisions. In particular, the Rule does not allow offers to out-of-state residents at all. Most website advertisements related to an offering are considered offers and if same are viewable to out-of-state residents, as they naturally would be, they would violate the rule. The SEC has issued some helpful guidance in this regard, as discussed further below, but the Rule itself needs to be updated and conformed for clarity.

The Advisory Committee continue to note that current Rule 147 requires three 80% tests for issuers to be deemed "doing business" within a state: the issuer generates 80% of its revenue in the state, holds at least 80% of its assets in the state, and uses at least 80% of the offering proceeds within the state. These tests are difficult to satisfy. Moreover, the issuer must be incorporated in the subject state regardless of whether it otherwise meets the other 80% rule requirements. As most issuers choose to be incorporated in Delaware for valid business reasons not related to the actual state of operations, this provision of the Rule is incompatible with the reality of business in today's world.

Specific Advisory Committee Recommendations

The Advisory Committee makes the following specific recommendations to modernize Rule 147:

- Allow for offers made in reliance on Rule 147 to be viewed by out-of-state residents but require that all sales be made only to residents of the state in which the issuer has its main offices;
- Remove the need to use percentage thresholds for any type of issue eligibility requirements and evaluate whether alternative criteria should be used for determining the necessary nexus between the issuer and the state where all sales occur; and
- Eliminate the requirement that the issuer be incorporated or organized in the same state where all sales occur.

Federal Authority for State Crowdfunding Legislation

Both the federal government and individual states regulate securities, with the federal provisions often preempting state law. When federal provisions do not preempt state law, both federal and state law must be complied with. On the federal level, every issuance of a security must either be registered under Section 5 of the Securities Act, or exempt from registration. Section 3(a)(11) of the Securities Act of 1933, as amended (Securities Act) provides an exemption from the registration requirements of Section 5 for "[A]ny 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 resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." Section 3(a)(11) is often referred to as the Intrastate Exemption. Rule 147 promulgated under Section 3(a)(11) provides for further details on the application of the Intrastate Exemption.

On the federal level, issuers relying on state crowdfunding statutes rely upon the Intrastate Exemption together with Rule 147 promulgated thereunder. As indicated Rule 147, in its current form, makes it difficult for issuers to utilize state-based crowdfunding provisions. The Intrastate Exemption is only available for bona fide local offerings. That is, the issuer must be a resident of, and doing business within, the state in which all offers and sales are made, and no part of the offering may be offered or sold to non-residents. Because of the strict rules against any sales or offers to non-residents, issuers conducting concurrent or consecutive offerings need to be extra careful to avoid the integration of any non-intrastate transactions with the Intrastate Exemption.

Determining Whether an Issuer is a "Resident" of, and Doing Business in, a Particular State

For purposes of the Intrastate Exemption, an issuer shall be deemed to be a resident of the state in which: (i) it is incorporated or organized, if it is an entity requiring incorporation or organization; (ii) its principal office is located, if it is an entity not requiring incorporation or organization; or (iii) his or her principal residence is located, if an individual.

For purposes of the Intrastate Exemption, an issuer shall be deemed to be doing business within a state if: (i) the issuer, together with its subsidiaries, derived at least 80% of its gross revenues in the most recent fiscal year or most recent six-month period from that state, whichever is closer in time to the offering; (ii) the issuer had 80% of its assets located in that state in the most recent semiannual fiscal year; (iii) the issuer intends to use and uses at least 80% of the net proceeds from the Intrastate offering in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services in that state; and (iv) the principal office of the issuer is located within that state.

Determining Whether the Investors and Potential Investors are Residents of a Particular State

All offers, offers to sell, offers for sale and sales of securities in an Intrastate-exempted offering must be made to residents of the state in which the offering is conducted. For the purpose of determining the residence of an offeree or purchaser: (i) a corporation, partnership, trust or other form of business organization shall be deemed to be a resident of a state if, at the time of the offer and sale, it has its principal office within such state; (ii) an individual shall be deemed to be a resident of a state if, at the time of the offer and sale, his or her principal residence is within that state; and (iii) a corporation partnership, trust or other form of business organization formed specifically to take part in an Intrastate offering will not be resident of the state unless all of its beneficial owners are residents of that state.

Avoiding Integration While Using the Intrastate Exemption

The determination of whether two or more offerings could be integrated is a question of fact depending on the particular circumstances at hand. Rule 502(a) and SEC Release 33-4434 set forth the factors to be considered in determining whether two or more offerings may be integrated. In particular, the following factors need to be considered in determining whether multiple offerings are integrated: (i) are the offerings part of a single plan of financing; (ii) do the offerings involve issuance of the same class of securities; (iii) are the offerings made at or about the same time; (iv) is the same type of consideration to be received; and (v) are the offerings made for the same general purpose.

In addition, Rule 147(b)(2) provides an integration safe harbor. That is, offerings made under Section 3 or Section 4(2) of the Securities Act or pursuant to a registration statement will not be integrated with an Intrastate Exemption offering if such offerings take place six months prior to the beginning or six months following the end of the Intrastate Exemption offering. To rely on this safe harbor, during the six-month periods, an issuer may not make any offers or sales of securities of the same class as those offering in the Intrastate offering. Rule 147(b)(2) is merely a safe harbor. Issuers and practitioners may still conduct their own analysis in accordance with the five-factor test enumerated above.

Resale Restrictions

Even though securities issued relying on the Intrastate Exemption are not restricted securities for purposes of Rule 144, Rule 147(e) prohibits the resale of any such securities for a period of nine months except for resales made in the same state as the Intrastate Offering. Moreover, market makers or dealers desiring to quote such securities after the nine-month period must comply with all of the requirements of Rule 15c2-11 regarding current public information. Moreover, Rule 147 specifically requires the placing of a legend on any securities issued in an Intrastate offering setting forth the resale restrictions. In the case of an allowable in-state resale, the purchaser must provide written representations supporting their state of residence.

Advertising and Solicitation under State Crowdfunding

One of the main concepts behind crowdfunding is the ability to use the internet and social media to solicit the crowd for an investment. There is no prohibition in Section 3(a)(11) or Rule 147 regarding general advertising or general solicitation as long as such general advertising or solicitation complies with applicable state law and does not result in an offer or sale to nonresidents of such state. State crowdfunding legislation universally allows such advertisement and solicitations.

On April 10, 2014, and again on October 2, 2014, the SEC updated its Compliance and Disclosure Interpretations (C&DI's) addressing the ability to advertise using the internet or social media in a state crowdfunding offering. In particular in April, the SEC stated that "[A]ny such general advertising or solicitation, however, must be conducted in a manner consistent with the requirement that offers made in reliance on Section 3(a)(11) and Rule 147 be made only to persons resident within the state or territory of which the issuer is a resident."

In April, The SEC went further, addressing internet advertising via the use of a state-specific funding portal and said:

"Use of the Internet would not be incompatible with a claim of exemption under Rule 147 if the portal implements adequate measures so that offers of securities are made only to persons resident in the relevant state or territory. In the context of an offering conducted in accordance with state crowdfunding requirements, such measures would include, at a minimum, disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law, and limiting access to information about specific investment opportunities to persons who confirm they are residents of the relevant state (for example, by providing a representation as to residence or in-state residence information, such as a zip code or residence address). Of course, any issuer seeking to rely on Rule 147 for the offering also would have to meet all the other conditions of Rule 147."

On October 2, 2014, the SEC issued further guidance on the question of whether an issuing company may use its website to conduct state crowdfunding offerings. In particular, the SEC stated:

"Issuers generally use their websites and social media presence to advertise their market presence in a broad and open manner so that information is widely disseminated to any member of the general public. Although whether a particular communication is an "offer" of securities will depend on all of the facts and circumstances, using such established Internet presence to convey information about specific investment opportunities would likely involve offers to residents outside the particular state in which the issuer did business.

We believe, however, that issuers could implement technological measures to limit communications that are offers only to those persons whose Internet Protocol, or IP, address originates from a particular state or territory and prevent any offers to be made to persons whose IP address originates in other states or territories. Offers should include disclaimers and restrictive legends making it clear that the offering is limited to residents of the relevant state under applicable law. Issuers must comply with all other conditions of Rule 147, including that sales may only be made to residents of the same state as the issuer."

Basic Background on Crowdfunding

Crowdfunding generally is where an entity or individual raises funds by seeking small contributions from a large number of people. The crowdfunder sets a target amount to be raised from the crowd, with the funds to be used for a specific business purpose. In addition, a crowdfunding campaign allows the crowd to communicate with each other, thus adding the benefit of the "wisdom of the crowd." Small businesses can particularly benefit from crowdfunding as they are not limited by restrictions on general solicitation and advertising or purchaser qualification requirements.

Title III of the JOBS Act, called the Crowdfunding Act, amends Section 4 of the Securities Act of 1933 (the Securities Act), adding new Section 4(a)(6) to create a new exemption to the registration requirements of Section 5 of the Securities Act. The new exemption allows issuers to solicit "crowds" to sell up to $1 million in securities in any 12-month period as long as no individual investment exceeds certain threshold amounts.

The threshold amount sold to any single investor cannot exceed (a) the greater of $2,000 or 5% of the annual income or net worth of such investor if the investor's annual income or net worth is less than $100,000; and (b) 10% of the annual income or net worth of such investor, not to exceed a maximum of $100,000, if the investor's annual income or net worth is more than $100,000. When determining requirements based on net worth, an individual's primary residence must be excluded from the calculation. Clearly there is a conflict in the language determining threshold amounts; an investor could fall within both categories. The conflict has been pointed out in numerous letters to the SEC and will presumably be addressed in the rule making.

Section 302 of the Crowdfunding Act requires that all crowdfunding offerings be conducted through an intermediary that is a broker-dealer or funding portal that is registered with the SEC and a member of a registered self-regulatory organization (SRO). Currently that SRO is the Financial Industry Regulatory Authority (FINRA). Although funding portals will have to register with the SEC and become a member of FINRA, they will not have to register as a broker-dealer. FINRA has already published proposed rules to regulate funding portals.

In addition, the Crowdfunding Act requires that issuers and intermediaries provide certain information to investors, potential investors and the SEC. The ability to utilize crowdfunding will be subject to bad boy restrictions and other disqualifying events. All crowdfunding issuers must be United States entities. Crowdfunding issuers cannot be subject to the reporting requirements of the Securities Exchange Act of 1934 or an investment company as defined by the Investment Company Act of 1940.

The finalization and implementation of Regulation Crowdfunding is in the hands of the SEC. Many proponents are concerned that Regulation Crowdfunding as promulgated by the SEC will be cumbersome for small businesses, and the draft of proposed rules has done nothing to alleviate that concern.

The states are cognizant of this concern and the immediate need for a method for small businesses to raise local funds for local businesses using social media and other general solicitation and advertising without accredited investor restrictions. Accordingly, many states have recently either enacted or introduced state-specific crowdfunding legislation. Georgia, Kansas, Michigan and Idaho have already enacted legislation. California has granted at least one permit to allow for a crowdfunded offering. Washington and North Carolina have pending crowdfunding bills, and Nebraska and Maine are drafting bills.

Potential Positive Impact of Crowdfunding

In a study completed by Crowdfund Capital Advisors based on a review of entities completing crowdfunding capital raises either in the U.S. on a rewards basis or in Europe on an equity or debt basis, the following facts were reported:

- Crowdfunded companies increased quarterly revenues by an average of 24% post offering
- 39% of companies hired an average of 2.2 new employees
- Within 3 months of the crowdfunding campaign, 28% of the companies had closed an angel investor or venture capital round
- Every hour invested in a successful crowdfunding campaign returned $813

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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