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SEC Proposes Amendments Related To Intrastate And Regional Securities Offerings- Part 1

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On October 30, 2015, the SEC published proposed rule amendments to facilitate intrastate and regional securities offerings. This rule proposal comes following the September 23, 2015, Advisory Committee on Small and Emerging Companies (the "Advisory Committee") recommendation to the SEC regarding the modernization of the Rule 147 Intrastate offering exemption. The SEC has proposed amendments to Rule 147 to modernize the rule and accommodate adopted state intrastate crowdfunding provisions. The proposed amendment eliminates the restriction on offers and eases the issuer eligibility requirements, provided however the issuer must comply with the specific state securities laws. In addition, the SEC has proposed amendments to Rule 504 of Regulation D to increase the aggregate offering amount from $1 million to $5 million and to add bad actor disqualifications from reliance on the rule. Finally, the SEC has made technical amendments to Rule 505 of Regulation D.

In this Part I of the blog, I will discuss the Rule 147 amendment and in Part II, I will discuss the changes to Rules 504 and 505.

Background on Rule 147 and Rationale for Amendments

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 as it exists is a safe harbor promulgated under Section 3(a)(11) and provides further details on the application of the Intrastate Exemption. Neither Section 3(a)(11) nor Rule 147 preempt state law. That is, an issuer relying on Section 3(a)(11) and Rule 147 would still need to comply with all state laws related to the offer and sale of securities.

Rule 147 was adopted in 1974 and has not been updated since that time. Rule 147 has limitations that simply do not comport with today's world. For example, 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 by out-of-state residents, as they naturally would be, they would violate the rule.

Also, the current Rule 147 requires that an issuer be incorporated in the state in which the offering occurs. In today's world, many companies incorporate in Nevada or Delaware (or other states) for valid business reasons even though all of their operations, income and revenue may be located in a different state. Moreover, the current Rule 147 requires that at least 80% of a company's revenues, assets and use of proceeds be within the state in which the offering is conducted. Many issuers find meeting all three thresholds to be unduly burdensome.

The topic of intrastate offerings has gained interest in the marketplace since the passage of the JOBS Act in 2012 and the passage of numerous state-specific crowdfunding provisions. It is believed that in the near future a majority of states will have passed state-specific crowdfunding statutes. However, the current statutory requirements in Section 3(a)(11) and regulatory requirements in Rule 147 make it difficult for issuers to take advantage of these new state crowdfunding provisions.

Recently the SEC Advisory Committee on Small and Emerging Companies made recommendations to the SEC related to amendments to the Rule 147 Intrastate offering exemption. The Advisory Committee made 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.

Considering the Advisory Committee's recommendations, as well as those of other market participants, the SEC has published proposed Rule 147 amendments related to intrastate offerings, and Rule 504 related to intrastate and regional offerings.

The proposed rule changes generally: (i) eliminate the offer restrictions while continuing to require that sales be made only to residents of the issuer's state; (ii) redefine "intrastate offering" to ease some issuer eligibility requirements; (iii) limit the availability of the Rule 147 exemption to offerings that are either registered or exempt at the state level and which offerings are limited to no more than $5 million; (iv) amend Rule 504 to increase the aggregate offering amount from $1 million to $5 million and to add bad actor disqualifications from reliance on the rule; and (v) make technical conforming amendments to Rule 505.

Proposed Rule Amendments

The proposed amendments to Rule 147 will allow an issuer to engage in any form of general solicitation or general advertising, including the use of publicly accessible 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. Moreover, the offering must be either registered or exempt in the state in which all of the purchasers are resident, and the state registration or exemption provision must limit the amount of securities an issuer may sell to no more than $5 million in a twelve-month period. Furthermore, the state statue must impose an investment limitation on investors. The proposed amendments define an issuer's principal place of business 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 that would help ensure the in-state nature of the issuer's business.

Interestingly, by amending Rule 147 to allow issuers that are not incorporated in a particular state to participate in intrastate offerings, the rule will no longer comply with the statutory provisions of Section 3(a)(11). Rather than amend Section 3(a)(11), the SEC is relying on its general authority under Section 28 of the Securities Act and making Rule 147 a stand-alone intrastate offering exemption that would no longer be a safe harbor or promulgated under Section 3(a)(11).

Section 3(a)(11) will remain a separate exemption for companies that wish to rely on its provisions, though practically speaking, I believe it will likely be rarely used, if ever.

In its rule release, the SEC points out that if the new rule is adopted in its proposed form, most states will need to amend their current intrastate offering exemptions to fully avail themselves of the new rule. In doing so, the states would be free to impose additional requirements or restrictions as deemed necessary or appropriate to facilitate local capital formation and investor protection.

Amendment to "Offer" Restrictions

Currently Rule 147 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 by out-of-state residents, as they naturally would be, they would violate the rule. One of the main concepts behind crowdfunding is the ability to use the internet and social media to solicit the crowd for an investment. Accordingly, state regulators and practitioners were concerned that internet advertisements made in accordance with state crowdfunding provisions would violate Rule 147.

To help alleviate the problem, the SEC issued guidance in its Compliance and Disclosure Interpretations (C&DI's) addressing the ability to advertise using the internet or social media in a state crowdfunding offering; however, the "offer" restriction remained.

Rule 147 as amended requires issuers to limit sales to in-state residents but no longer limits offers to in-state residents. Amended Rule 147 will permit issuers to engage in general solicitation and advertising without restriction, including offers to sell securities using any form of mass media and publicly available websites, so long as all sales of securities are limited to residents of the state in which the issuer has its principal place of business and which state's intrastate registration or exemption provisions the issuer is relying upon. As offers are not limited but sales are, all solicitation and offer materials will need to include prominent disclosures stating that sales may only be made to residents of a particular state.

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

Rule 147 currently provides that 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.

This provision is problematic in today's corporate world, where many entities decide to incorporate in a particular state, such as Nevada or Delaware, for valid business purposes, even though all of their operations and offices may be located in a different state. The SEC agrees that the state of entity formation should not affect the ability of an issuer to be considered a "resident" for purposes of an intrastate offering exemption at the federal level.

Accordingly, the proposed rule amendment eliminates the requirement related to state of incorporation while continuing to require that an issuer have its principal place of business in the offering state. In addition, the issuer must satisfy at least one of a list of four other requirements meant to satisfy the residence requirement. In particular, the issuer will need to meet one of the three 80% thresholds or the new majority-of-employees threshold test.

Under the current Rule 147, an issuer shall be deemed to be doing business within a state if the issuer meets ALL of the following requirements: (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; and (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. In addition, under the current rule, the principal office of the issuer must be located within that state.

The new rule retains the three 80% threshold tests and even adds a fourth threshold based on the location of a majority of the issuer's employees. Presumably a majority is satisfied by a greater than 50% determination. However, instead of having to comply with all of the threshold tests, the issuer need only comply with one of the four tests, in addition to maintaining its principal place of business in the state.

The amended Rule 147 further simplifies the "doing business in" standard by only requiring that the issuer's principal place of business be in the subject state regardless of where its principal office is located. An issuer's "principal place of business" will be defined as the "location from which the officers, partners or managers of the issuer primarily direct, control and coordinate the activities of the issuer." Issuers will be required to either register the offering in the state where all the purchasers are located or rely on a state registration exemption that limits the amount of the offering to no more than $5 million in any 12-month period and imposes investment limitations on investors. I note that concurrent with the proposed Rule 147 rule release, the SEC has proposed to increase the offering limit under Rule 504 to $5 million, allowing Rule 147 and Rule 504 to work together as an Intrastate Offering Exemption.

As discussed below, securities will need to "come to rest" in the hands of purchasers before resales will be allowed. Similarly, if an issuer changes its principal place of business to a new state, it would not be able to conduct an intrastate offering in reliance on Rule 147 in the new state until the securities sold in the prior state had "come to rest" in the hands of the purchasers. The "come to rest" period, both for resales and for second intrastate offerings, shall be a period of 9 months.

As with all provisions of the new Rule 147, in passing their own intrastate offering exemption, a state could impose additional requirements for use in their particular state.

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

Currently under Rule 147, 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.

The new proposed rule adds a qualifier such that if the issuer reasonably believes that the investor is a resident of the applicable state, the standard will be satisfied. The reasonable belief standard is consistent with other provisions in Regulation D including Rule 506(c) as the accreditation of an investor. In shifting the responsibility to require a reasonable belief as to residency, the SEC is eliminating the current requirement that the investor provide a written representation as to residency. The view is that a self-attestation from an investor, without more, is not enough to create a reasonable belief and so that technical requirement would not add to the rule, and in fact could deter as it would allow issuers to believe that they could rely on such written statement.

The SEC provides examples of proof of residency. For individuals, proof may be an established relationship with the issuer, documentation as to home address and utility or related bills, tax returns, driver's license and identification cards. The residency of an entity purchaser would be the location where, at the time of the sale, the entity has its principal place of business, which, like the issuer, is where "the officers, partners or managers of the issuer primarily direct, control and coordinate the activities of the [investor]."

Resale Restrictions

Even though securities issued relying on the Intrastate Exemption are not restricted securities for purposes of Rule 144, current 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. 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. Currently, in the case of an allowable in-state resale, the purchaser must provide written representations supporting their state of residence.

The proposed new Rule 147 provides that for a period of nine months from the date of sale to a particular purchaser, any resale by that purchaser may be made only to persons resident with the state of the offering. Accordingly resales out of state may only be made after the nine-month holding period. To ensure enforcement, an issuer must place a legend on the securities and stop transfer instructions to the transfer agent.

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.

Current Rule 147(b)(2) provides an integration safe harbor. That is, offerings made under Section 3 or Section 4(a)(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.

The proposed new Rule 147 amends the current integration safe harbor to be consistent with the new Regulation A/A+ safe harbor. In particular, under the proposed rule, offers and sales under Rule 147 would not be integrated with: (i) prior offers or sales of securities; or (ii) subsequent offers or sales of securities that are (a) registered under the Securities Act; (b) conducted under Regulation A; (c) exempt under Rule 701 or made pursuant to an employee benefit plan; (d) exempt under Regulation S; (e) exempt under Section 4(a)(6) – i.e., Title III Crowdfunding; or (f) made more than six months after the completion of the offering. The rule maintains that it is just a safe harbor and that issuers may still conduct their own analysis in accordance with the five-factor test.

Disclosure/Legend Requirements

Current Rule 147 requires written disclosure on resale limitations and requires that stop transfer instructions be given to the issuer's transfer agent. The new rule retains the requirement but provides more definitive instruction. In particular, a written disclosure would need to be given to each offeree and purchaser at the time of any offer or sale. However, the disclosure can be given in the same manner as the offer for an offeree (i.e., could be verbal) but must be in writing as to a purchaser.

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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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