November 2016

SEC Finalizes Exemption Rules for Intrastate and Small Issues Securities Offerings

On October 26, 2016, the US Securities and Exchange Commission (the SEC or Commission) finalized rules to modernize intrastate and small issues securities offering exemptions as part of the SEC's broader efforts to increase access to capital for smaller issuers.[1] These rules are focused on facilitating capital formation through regional securities offerings as well as intrastate securities offerings conducted under crowdfunding provisions of state securities laws.

The SEC proposed amendments to Rules 147 and 504 on October 30, 2015. The final rule adopts most of the proposed amendments, with some exceptions. Most notably, the proposed rule sought to amend Rule 147, a safe harbor under Section 3(a)(11) of the Securities Act, by replacing the existing safe harbor with a new intrastate offering exemption. However, the final rule adopts a new Rule 147A intrastate offering exemption and amends the Rule 147 safe harbor to modernize it. This decision was made, in part, to allow issuers to continue relying on the Rule 147 safe harbor for offerings pursuant to state law exemptions, including crowdfunding provisions, that are conditioned upon compliance with Section 3(a)(11) of the Securities Act and Rule 147.

The final rule:

- Amends Rule 147 to modernize the safe harbor for Section 3(a)(11) of the Securities Act.
- Establishes a new intrastate securities offering exemption, Rule 147A.
- Amends Rule 504 of Regulation D to increase the aggregate amount of securities that may be offered and sold in any 12-month period from $1 million to $5 million.
- Amends Rule 504 to include bad actor disqualifications, consistent with Rule 506 of Regulation D.
- Repeals Rule 505 of Regulation D.

Amended Rule 147 and new Rule 147A

Section 3(a)(11) of the Securities Act provides an exemption from registration for intrastate securities offerings. Under this exemption, companies are permitted to offer and sell securities within their state without being required to register with the SEC. Rule 147, adopted in 1974, is a safe harbor for the

[1] Exemptions to Facilitate Intrastate and Regional Securities Offerings, SEC Release No. 33-10238 (proposed Oct. 26, 2016) (to be codified in 17 C.F.R. pts. 200, 230, 239, 240, 249, 270, 275). *See also* Press Release, Securities and Exchange Commission, SEC Adopts Final Rules to Facilitate Intrastate and Regional Securities Offerings (Oct. 26, 2016); Mary Jo White, Statement at Open Meeting on a Universal Proxy System and Exemptions to Facilitate Intrastate and Regional Securities Offerings (Oct. 26, 2016); Kara M. Stein, Statement on Exemptions to Facilitate Intrastate and Regional Securities Offerings (Oct. 26, 2016); Michael S. Piwowar, Statement at Open Meeting on Adoption of Updated Rules regarding Intrastate Offerings and Small Business Capital Formation (Oct. 26, 2016).

statutory exemption for intrastate securities offerings. Issuers relying on the Rule 147 safe harbor may not offer securities to out-of-state residents.

New Rule 147A is substantially the same as Rule 147, except that Rule 147A eliminates restrictions on using general solicitations or advertising offers and allows issuers to be incorporated or organized outside of the state in which the intrastate offering is conducted if certain conditions are met. Thus, by way of example, a Delaware corporation can conduct a Rule 147A offering to Texas residents if the other requirements of the rule are satisfied. Under Rule 147A, offerings may be made to out-of-state residents if: (i) sales are made only to residents of the state of the issuer's principal place of business; and (ii) issuers demonstrate a meaningful presence in the state of the securities offering. Rule 147A is adopted under the SEC's general exemptive authority under Section 28 of the Securities Act and, therefore, is not subject to the limitations of Section 3(a)(11).

Both Rule 147 and Rule 147A:

- Require the issuer to be organized or have its "principal place of business" in the state where the securities are offered and sold.
- Require the issuer to satisfy at least one of four "doing business" threshold requirements demonstrating the in-state nature of the issuer's business.[2]
- Impose a new "reasonable belief" standard for issuers to rely on in determining the residence of the purchaser at the time of the sale of securities.
- Require that issuers obtain a written representation from each purchaser as to his or her residency.
- Limit resales to persons residing within the state of the offering for a period of six months from the date of the sale by the issuer to the purchaser.
- Require that an integration safe harbor includes any prior offers or sales of securities by the issuer made under another provision and certain subsequent offers or sales of securities by the issuer occurring after the completion of the offering.
- Impose disclosure requirements, including legend requirements, to offerees and purchasers about the limits on resales.

In addition, the SEC declined to adopt the provision in the proposed rule that imposed a substantive limitation on the type of intrastate offering satisfying the safe harbor. In particular, the proposed rule limited offerings under Rule 147 to those that are registered at the state level or that rely on a state exemption that limits the aggregate offering amount an issuer may sell under the exemption and imposes an investment limitation on investors. Many state regulators, as well as Commissioner Michael Piwowar, objected to the inclusion of this provision in the final rule on the grounds that state regulators are uniquely

[2] The four "doing business" threshold requirements demonstrating the in-state nature of the issuer's business include: (i) the issuer derived at least 80 percent of its consolidated gross revenues from the operation of a business or of real property located in or from the rendering of services within the 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 percent of its consolidated assets located within such state or territory; (iii) the issuer intends to use and uses at least 80 percent 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; and (iv) a majority of the issuer's employees are based in such state or territory. The fourth requirement was included in the final rule to provide issuers with greater flexibility, given the increasingly interstate nature of small business activities and the increasing difficulty for smaller companies that are physically located within a single state to satisfy the three percentage thresholds.

positioned to determine what, if any, additional requirements may be necessary or appropriate for the protection of their residents.

Rule 504 and Rule 505

Rule 504 of Regulation D currently provides an exemption from registration under the Securities Act for offerings up to $1 million of securities, in any 12-month period, for issuers that are not reporting companies, investment companies or blank check companies. Rule 504 does not place any limit on the number of non-accredited investors participating in the offering, and under limited circumstances permits general solicitation when the offer is qualified with state securities regulators. The final rule amends Rule 504 to increase the aggregate amount of securities that can be offered and sold in any 12-month period from $1 million to $5 million. The final rule also imposes bad actor disqualifications to Rule 504 offerings, consistent with Rule 506 of Regulation D.

Rule 505 of Regulation D provides an exemption from registration for offerings up to $5 million annually that must be sold solely to accredited investors or no more than 35 non-accredited investors. Due to the amendments to Rule 504, the final rule repeals Rule 505.

Next Steps

Amended Rule 147 and new Rule 147A become effective 150 days after publication in the Federal Register. Amended Rule 504 becomes effective 60 days after publication in the Federal Register. The repeal of Rule 505 becomes effective 180 days after publication in the Federal Register.

In light of some investor protection concerns regarding the amended Rule 147 and new Rule 147A, which relaxed certain capital raising rules, the SEC directed its staff to review information about data on the use of the new and amended rules and on the application of state bad actor disqualification provisions in intrastate crowdfunding offerings; offerings made under other federal exemptions concurrently or close in time to offerings made under these rules, fraud or non-compliance; and the role of intrastate broker-dealers and other intermediaries in offerings conducted under the rules, among other things. The staff is to report to the Commission in three years on how the new rules are working to facilitate capital formation and protect investors.

New Rule 147A and amended Rule 504 continue the welcome trend of the SEC's modernizing its rules to keep pace with technological developments, which in turn facilitates capital formation for start-up and emerging companies. The new rules will especially be useful to businesses seeking to raise capital using crowdfunding techniques. As supplements to Regulation Crowdfunding, Regulation A+, Rule 506(c) and various state crowdfunding regimes, new Rule 147A and amended Rules 147 and 504 add further tools to the private capital-raising toolbox.

Contacts

Sean P. Ducharme
sducharme@hunton.com

Brian L. Hager
bhager@hunton.com

Scott H. Kimpel
skimpel@hunton.com