SEC Revises Exemptions for Certain Offerings

On October 26, 2016, the US Securities and Exchange Commission (SEC) adopted rules making the following changes to certain exemptions:

- Amended Rule 147 under the Securities Act of 1933 (Securities Act) to modernize the safe harbor from the registration requirements for intrastate securities offerings contained in Section 3(a)(11) of the Securities Act;
- Adopted new Rule 147A under the Securities Act as a potentially more useful alternative to Rule 147 to provide a separate safe harbor from the registration requirements of the Securities Act, provided certain conditions are met;
- Amended Rule 504 of Regulation D under the Securities Act to increase the aggregate amount of securities that may be offered and sold in any 12-month period to $5 million and disqualify certain bad actors from participating in such offerings; and
- Repealed Rule 505 of Regulation D in light of the changes made to Rule 504.[1]

The SEC proposed the changes on October 30, 2015.[2] The rule changes become effective at varying times, with amended Rule 147 and new Rule 147A becoming effective on April 20, 2017, amended Rule 504 becoming effective on January 20, 2017 and the repeal of Rule 505 becoming effective on May 22, 2017.

Amended Rule 147

Section 3(a)(11) of the Securities Act exempts from the registration provisions of the Securities Act "[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." The SEC adopted Rule 147 in 1974 to provide objective standards that can be used to determine whether the exemption is available. There are two primary conditions that must be satisfied to be able to rely on Rule 147. First, the issuer must be a resident of (or if a corporation, incorporated in) and doing business within the state or territory in which all offers and sales are made. The practical effect of this first condition is that all offers and sales made in reliance on Rule 147 will be subject to state regulation, rather than federal regulation. Second, no part of the securities being issued can be offered or sold to non-residents during the six months preceding and following any offers or sales pursuant to Rule 147.

In light of the fact that numerous states have adopted provisions modeled on Rule 147 that facilitate intrastate crowdfunding offerings, the SEC determined not to make substantive changes to Rule 147 that would make these provisions unavailable until states were able to make conforming changes. However, the SEC did make a number of changes to Rule 147 to modernize the provisions in light of changes that have occurred in the market since Rule 147 was first adopted. There were three significant changes to modernize Rule 147.

- First, in recognition of the ways issuers communicate with potential investors, the SEC revised Rule 147(f)(3) to provide that an issuer must include prominent disclosure in all offering materials stating that sales will be made only to residents of the same state or territory as the issuer. This change was designed to allow issuers to communicate through the Internet, without being concerned about whether the communication was an offer being made to persons who were not residents of the same state as the issuer. In addition, this requirement may be satisfied by including an active hyperlink to the required disclosure in situations where the communication is made by space-constrained methods, such as Twitter.
- Second, the SEC revised Rule 147(c)(1) to change the wording of the residency requirement so that corporations and other legal entities will be viewed as having their place of business be the state or territory in which their principal business is conducted, rather than the state or territory in which their principal office is located as previously was the case, assuming the other conditions of the provision are also satisfied. The SEC also made clear that, for this purpose, an issuer will be deemed to have its principal place of business in a state or territory in which the officers, partners or managers of the issuer primarily direct, control and coordinate its activities.
- Third, the SEC has expanded Rule 147(d) to allow offers and sales to be made to persons the issuer reasonably believes to be residents of the same state or territory in which the issuer is resident. Previously Rule 147(d) required that offers and sales could only be made to persons resident within the state or territory of which the issuer is a resident. This meant that the ability to rely on the exemption for the entire offering was lost if a single investor was not a resident of the state or territory despite the fact that this could be due solely to actions on the part of the investor and not the issuer.

New Rule 147A

To address concerns that Section 3(a)(11) of the Securities Act and Rule 147 adopted thereunder limits the efficacy of those provisions, the SEC adopted new Rule 147A under its general exemptive authority contained in Section 28 of the Securities Act. As a result, new Rule 147A is not subject to the statutory restrictions contained in Section 3(a)(11) of the Securities Act. Generally, new Rule 147A and amended Rule 147 are very similar. But there are two main differences. First, new Rule 147A has no restrictions on offers. It only requires that all sales be made to residents of the issuer's state or territory. Second, new Rule 147A does not require issuers to be incorporated or organized in the same state or territory where the offering occurs so long as the issuer can demonstrate the in-state nature of its business. The practical implication of this second difference is to allow entities to use the exemption, even if they were formed in one state, Delaware for example, but conduct their business, and consequently a securities offering, in a different state or territory.

Common Provisions of Amended Rule 147 and New Rule 147A

In addition to the changes discussed above under "Amended Rule 147," which were also included in New Rule 147A, the SEC made several other changes to Rule 147 that were also included in New Rule 147A, including:

- Adding a fourth way that an issuer can show the in-state nature of its business and slightly modifying the previous three ways so that now an issuer has the ability to demonstrate the in-state nature of its business by
  - deriving 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 such state or territory,
  - having at least 80 percent of its consolidated assets located in such state or territory,
  - intending to use and using at least 80 percent of the net proceeds from the 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 within such state or territory or
  - having a majority of its employees based in such state or territory;
- Changing the requirement that all resales of any securities sold may only be to persons resident within the state or territory of the offering to a period of six months, from the previous nine months, after the date of sale by the issuer to the purchaser of the security and requiring prominent disclosure to investors of this limitation; and
- Amending the integration safe harbor to provide that offers and sales made under Amended Rule 147 and New Rule 147A will not be integrated with offers and sales made
  - prior to the commencement of offers and sales pursuant to the rules, or
  - after completion of offers and sales pursuant to the rules that are registered under the Securities Act, exempt from registration under Regulation A under the Securities Act, exempt from registration under Rule 701 under the Securities Act made pursuant to an employee benefit plan, exempt from registration under Regulation S under the Securities Act or exempt from registration under Section 4(a)(6) of the Securities Act and made more than six months after the completion of an offering conducted under the rules.

Amended Rule 504

Previously, Rule 504 of Regulation D provided issuers with an exemption from the registration requirements of the Securities Act for offers and sales of up to $1 million in any 12-month period, subject to certain conditions, including prohibition on general solicitation and treatment of any securities issued as restricted, unless the offers and sales were made:

- Exclusively in one or more states that provide for the registration of securities and require the public filing and delivery to investors of a substantive disclosure documents before sale, and in accordance with state law requirements;
- In one or more states that do not provide for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing and delivery requirements and if the disclosure document is delivered before sale to all purchasers; or
- Exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are only to accredited investors as defined in Rule 501(a) of Regulation D.

Consistent with other actions the SEC has taken in the last several years in order to facilitate smaller company capital formation and the development of "regional coordinated review programs at the state level," the SEC amended Rule 504 to increase the dollar threshold for offers and sales of securities from $1 million during any 12-month period to $5 million.

In addition to several minor technical changes, the SEC also amended Rule 504 to adopt provisions that will disqualify certain "bad actors" from participating in offerings made in reliance on Rule 504. The "bad actor"

disqualification provisions are the same as those the SEC adopted in 2013 with respect to Rule 506 of Regulation D and in fact are implemented by means of a reference to the Rule 506 provisions. The "bad actor" disqualification provisions are also similar to those contained in Regulation A and Regulation Crowdfunding. Disqualification will occur only for triggering events that arise after the effectiveness of amended Rule 504, but disclosure will be required for triggering events that pre-date the effectiveness date. For more information on the "bad actor" provision as it applies to Rule 506, see our Legal Update titled "SEC Disqualifies 'Bad Actors' From Participating in a Rule 506 Offering," dated July 17, 2013.[3]

Repeal of Rule 505

Previously, Rule 505 of Regulation D provided issuers with an exemption from the registration requirements of the Securities Act for offers and sales of up to $5 million in any 12-month period, subject to certain conditions. In light of the changes the SEC made to Rule 504 to increase the offering amount during any 12-month period from $1 million to $5 million, the SEC has repealed Rule 505.

Practical Considerations

The SEC did not provide any guidance in the adopting release for issuers conducting offerings that are ongoing at the time the changes to Rule 147 or Rule 504 or the repeal of Rule 505 is effective. Issuers in this situation should monitor whether any guidance from the SEC is forthcoming and, if so, how it affects their offerings. Issuers should also determine as far in advance as possible whether the effectiveness of the rule changes or repeal will raise issues and, if they will, to address them with the SEC staff.

Issuers conducting offerings in reliance on amended Rules 147 or Rule 504 or new Rule 147A should review applicable state law to make sure that compliance with the new provisions does not run afoul of applicable state law provisions as they relate to filing, offering requirements, exemptive relief or any other applicable provisions.

Unless an issuer conducting an offering in reliance on amended Rule 147 or New Rule 147A is confident that an investor is a resident of a state in question, the issuer will need to implement procedures to ensure that it has a reasonable basis for believing that a person is a resident of that state. Although issuers are required to obtain a residence certification from investors in connection with relying on amended Rule 147 or new Rule 147A, in the adopting release the SEC said that this certificate should be "considered evidence of, but not be dispositive of, the purchaser's residency" and that obtaining this certificate without more will not "be sufficient to establish a reasonable belief" that a purchaser is an in-state resident. Before the effective date of the rules, issuers should begin considering what additional steps they will need to implement for this purpose. It is important to note that the SEC did not provide any guidance as to what will be sufficient for this purpose as they believe it is to be based on the available facts and circumstances. In addition, issuers should keep records documenting the steps taken to support their reasonable beliefs and therefore it will be important for issuers to create policies and procedures for the creation, retention and ultimate destruction of those records.

Issuers and financial intermediaries, if any, that anticipate being involved in offerings relying on Rule 504 should develop due diligence procedures to determine that no covered persons for such offerings have any disqualifying events. This process should begin as soon as possible with respect to offerings that are intended to proceed under amended Rule 504 after its effective date. To the extent that an issuer is engaged in an offering that is ongoing in nature, it should develop an updating procedure

to confirm that no disqualifying events have arisen or been identified after the initial inquiry.

If an issuer anticipates that it will be relying on amended Rule 504 after its effective date and there is a covered person for such offering who had an event that would have triggered disqualification had it occurred after the effective date, the issuer should begin drafting appropriate disclosure and determine its placement and delivery method.

If you have any questions regarding these exemptions for certain offerings, please contact the author of this Legal Update, Michael L. Hermsen, at +1 312 701 7960, or any of the lawyers listed below, or any other member of our Corporate & Securities group.

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Endnotes

[1] Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 10238 (October 26, 2016), available at http://www.sec.gov/rules/final/2016/33-10238.pdf.

[2] Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 9973 (October 30, 2015), available at http://www.sec.gov/rules/proposed/2015/33-9973.pdf.

[3] Available at https://www.mayerbrown.com/files/Publication/ed7124a4-2a4f-44dc-8476-1b5f0d38ee6e/Presentation/PublicationAttachment/d7dc9c70-e79f-43c8-af7c-374b24d64c72/SEC-Disqualifies-Bad-Actors-Rule_506_071713.pdf