SEC Proposes Rule Changes to Facilitate Intrastate and Regional Securities Offerings

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On October 30, the SEC voted 3-1 to propose amendments to Securities Act Rule 147 and Rule 504 of Regulation D. The **proposed rule amendments** are intended to modernize and expand the capital-raising options available to startups and small businesses, including through the use of intrastate and regional securities offerings, and to enhance investor protection in such offerings.

Specifically, the proposed amendments to Rule 147 would, among other things, eliminate the current intrastate restriction on offers (but not sales) to enable issuers to utilize a wider array of options to advertise their offerings—including the Internet and social media platforms—and ease the existing issuer residency and eligibility requirements to make the rule available to a greater number of businesses seeking financing in-state. The proposed amendments to Rule 504 would increase the aggregate amount of securities that may be offered and sold in any 12-month period from $1 million to $5 million to help make this exemption more attractive for early-stage issuers. The SEC is seeking public comment on the rule proposals until January 11, 2016.

Proposed Amendments to Rule 147

Rule 147 currently provides a safe harbor for complying with the intrastate offering exemption under Section 3(a)(11) of the Securities Act, which exempts offers and sales of securities by an issuer to residents of the same state in which it is a resident and doing business. Rule 147 has not been substantively changed since it was adopted in 1974, and many observers have expressed concerns that the current requirements of Rule 147 have not kept pace with technological developments and modern business practices. This has limited the usefulness of the exemption, particularly for issuers seeking to raise capital pursuant to recently adopted intrastate crowdfunding provisions under state securities laws. 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. Market participants and state securities regulators have indicated that certain aspects of Section 3(a)(11) and Rule 147 are unduly restrictive and make it difficult for companies to take advantage of these new crowdfunding provisions.

The proposed amendments seek to modernize Rule 147 by establishing a new exemption to facilitate capital formation through intrastate offerings. The exemption would retain the key feature of existing Rule 147—its intrastate character—which permits local issuers to raise money from investors within their state without having to register the securities at the federal level. Specifically, the proposed amendments would:

- eliminate the restriction on offers to in-state residents only, while continuing to require that sales be made exclusively to in-state residents;
- eliminate the requirement that issuers be incorporated in-state, and revise the residency requirement to focus on the issuer's "place of business" (defined as the location in which the officers, partners or managers of the issuer primarily direct, control and coordinate the activities of the issuer) rather than its "principal office";
- for purposes of determining the in-state nature of the issuer's business, replace the current requirement that issuers satisfy three 80% threshold tests concerning their revenues, assets and use of offering proceeds with a requirement that they satisfy any one of four specified eligibility

tests, including a new alternative test whereby issuers can qualify if a majority of their employees are located in-state; and

- 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 12-month period and imposes an investment limitation on investors.

Significantly, the elimination of the existing intrastate restriction on offers would enable Rule 147 issuers to engage in any form of general solicitation or general advertising to conduct their offerings, including through the Internet and social media platforms, in order to successfully attract potential in-state investors, so long as all sales of securities are made to in-state residents. In this regard, the proposed amendments may be particularly effective at facilitating state-based crowdfunding offerings that rely heavily on online platforms to bring issuers and investors together.

In addition, by relaxing the residency and eligibility requirements for issuers, the proposed amendments would significantly ease the burden for potential Rule 147 issuers in complying with the exemption, while also modernizing the rule to better align with contemporary business practices. In particular, the elimination of the requirement that an issuer be incorporated in-state could increase the number of businesses seeking intrastate financing that are able rely on the exemption, including local issuers with local operations that choose to incorporate in a different state (such as Delaware) for valid business reasons. The proposed modifications to the existing quantitative tests issuers must satisfy in order to be considered “doing business” in-state would similarly provide greater flexibility to potential Rule 147 issuers.

Importantly, Rule 147, if adopted as proposed, would no longer fall within the statutory parameters of Section 3(a)(11). Accordingly, Rule 147, as proposed to be amended, would function as a separate exemption from Securities Act registration rather than as a safe harbor under Section 3(a)(11). The proposing release notes that the Section 3(a)(11) statutory exemption would continue to be a capital-raising option for issuers with local operations seeking local financing (although issuers would likely find it easier to satisfy the requirements of the amended Rule 147 exemption than those of Section 3(a)(11) since the requirements of Section 3(a)(11) are more restrictive).

The proposing release further notes that in light of the proposed changes to Rule 147, the inclusion in the rule of a maximum offering amount limitation and investor investment limitations applicable to state exempt offerings would provide investors with additional protection and would be consistent with existing state law crowdfunding provisions. As proposed, there is no limit on the aggregate offering amount or individual investment amount for Rule 147 offerings that are registered in-state. The current rule imposes no maximum offering size or individual investment limitations.

Additional proposed amendments to Rule 147 would, among other things:

- remove the requirement that issuers obtain a written representation from prospective investors as to their in-state residency status, and establish a reasonable belief standard for ascertaining the in-state residency of purchasers at the time of sale of the securities;
- modify the limitation on resales to create greater liquidity for Rule 147 securities by providing that such securities could be immediately resold to in-state residents, but would be subject to a nine-month resale restriction for sales to out-of-state residents; and
- expand the scope of the integration provisions to align with the SEC’s most recently adopted integration safe harbor in Rule 251(c) of Regulation A, such that Rule 147 offerings would not be integrated with any offers or sales of securities made either before the commencement of, or more than six months after, the completion of the Rule 147 offering, or with any subsequent offers or sales made within six months after the completion of the Rule 147 offering that are either registered under the Securities Act (subject to certain exceptions); exempt from registration

pursuant to Regulation A, Regulation S, Regulation Crowdfunding or Rule 701; or made pursuant to an employee benefit plan. Additionally, an issuer would be required to wait at least 30 calendar days between its last offer made in reliance on Rule 147 to persons other than qualified institutional buyers and institutional accredited investors and the filing of a registration statement with the SEC to avoid the offer being subject to integration.

Proposed Amendments to Rule 504

The SEC is proposing to amend 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; and
- to disqualify certain felons and other “bad actors” from participation in Rule 504 offerings.

As noted in the proposing release, the SEC has not raised the aggregate offering amount limitation in Rule 504 since 1988, when it increased the original Rule 504 offering limitation of $500,000 to the current $1 million. Reliance on the Rule 504 exemption has been declining over time, and this exemption now constitutes only a very small percentage of overall offerings based on the Regulation D exemptive regime. Issuers have overwhelmingly relied on Rule 506 instead of Rule 504 for offerings of $1 million or less (likely due, at least in part, to the preemption of state registration requirements available to Rule 506, but not Rule 504, offerings). The SEC believes the increase in the maximum amount of capital that can be raised in Rule 504 offerings to $5 million could help make this exemption more attractive for startups and small businesses while also facilitating regional offerings.

The proposing release notes that state securities regulators have been working to establish regional coordinated review programs in order to facilitate regional offerings. Coordinated review programs are undertaken by states to streamline the state registration process for issuers seeking to effect multi-state registrations of securities offerings. The programs establish uniform review standards and are designed to expedite the registration process, thereby potentially saving issuers time and money. The SEC believes the proposed amendments would increase the flexibility of state securities regulators to develop and implement (or revise existing) regional coordinated review programs that would rely on Rule 504 at the federal level to facilitate regional offerings. The amendments would also give state regulators greater flexibility to set their own state offering limitations and to consider whether any additional requirements should be implemented at the state level.

The proposed “bad actor” disqualification provisions would be implemented by reference to the disqualification provisions of Rule 506 of Regulation D and are intended to provide for greater consistency across Regulation D and additional investor protection. As proposed, and consistent with the SEC’s treatment of disqualification in Rule 506, disqualification would only occur for triggering events that occur after effectiveness of any final rule amendments, but disclosure would be required for preexisting triggering events. In addition, the proposed amendments would allow for a waiver from, and a reasonable care exception to, the disqualification provisions.

Rule 505

Rule 504, as proposed to be amended, would have the same offering limitation as current Rule 505 ($5 million) and would include “bad actor” disqualification provisions, which would reduce the distinctions between these rules across Regulation D if the rule amendments are adopted as proposed.

If adopted, the amendments to Rule 504 could result in the diminished utility of Rule 505 (which historically has been little utilized in comparison to Rule 506, including for offerings of up to $5 million). Accordingly, the SEC is also seeking comment on whether Rule 505 should be retained in its current or a modified form as an exemption from registration, or repealed.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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