PUBLICATION

505 Is Not Alive: SEC Adopts New and Amended Rules Governing Intrastate and Small Offerings [Ober|Kaler]

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A periodic bulletin keeping small businesses informed about current developments in securities law and related matters.

Background

As we have discussed in prior Bulletins, pursuant to Section 5 of the Securities Act of 1933 (Securities Act) and state securities laws, any offer and sale of a security must be registered with the Securities and Exchange Commission (SEC) and any applicable state securities regulators, or exempt from such registration. Currently, Rule 504 of Regulation D promulgated under the Securities Act (Regulation D) provides an exemption for non-SEC reporting companies for offerings of up to $1 million of securities in any 12-month period to an unlimited number of investors, and Rule 505 of Regulation D provides an exemption for offerings of up to $5 million of securities in any 12-month period to an unlimited number of "accredited investors" and up to 35 non-accredited but "sophisticated" investors, as long as non-accredited investor are provides certain prescribed information about the issuer and the securities, in both cases as long as certain other requirements are complied with. Section 3(a)(11) of the Securities Act and Rule 147 thereunder provide an exemption from Securities Act registration for offerings within a single state or territory (state) by issuers incorporated or organized, having their principal office and doing business in such state.

Late last month, the SEC adopted amendments to these rules that will (i) increase the amount that can be issued under Rule 504 in any 12-month period to $5 million and disqualify certain "bad actors" from participation in such offerings and (ii) modernize Rule 147. The SEC also adopted a new Rule 147A, which is similar to Rule 147 but will have no restriction on offers and allow issuers organized or incorporated outside the state in which the offering is conducted to qualify for the exemption. As is currently the case, none of the changes obviate the need for issuers to comply with the registration or exemption requirements of applicable state securities laws, and federal and state antifraud provisions continue to apply to offerings and sales of securities under the new and amended rules.

Amendments to Rule 504; Rule 505 Repealed

As noted above, amended Rule 504 will exempt offerings of up to $5 million of securities in any 12-month period. In addition, certain bad actors will be disqualified from conducting or participating in Rule 504 offerings; these "bad actor" provisions are the same "bad actor" disqualification provisions applicable to Rule 506 offerings under Regulation D, which we have discussed in prior Bulletins.

Currently, general solicitation and advertising is prohibited with respect to Rule 505 offerings. Rule 504 permits general solicitation and advertising only if the offer is registered in a state requiring use of a substantive disclosure document or if sales are made solely to accredited investors and the state exemption utilized allows general solicitation and advertising. These provisions will not be altered, nor will the existing restrictions on issuers that can utilize Rule 504. As a result, issuers that are SEC reporting companies will not be able to use

amended Rule 504, and if conducting a private offering under Regulation D will be limited to selling to accredited and ”sophisticated” investors.

Amended Rule 504 will be effective 60 days, and the repeal of Rule 505 will be effective 180 days, after publication of the adopting release(available here) with respect to the new and amended rules in the *Federal Register*.

Intrastate Offerings - Rules 147 and 147A

Section 3(a)(11) of the Securities Act exempts from registration “[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.” Rule 147 provides a safe harbor for the Section 3(a)(11) exemption by, among other things, defining when an issuer is “resident” and “doing business” in a state. Amended Rule 147 and Rule 147A preserve the intrastate exemption but make it more useful in light of modern business practices and communications technology.

Rule 147A provides a new intrastate offering exemption under the Securities Act. Rule 147A is substantially similar to Rule 147 but includes two key differences that make this intrastate exemption useful to a greater number of issuers as a result of the significant number of issuers that are incorporated in a state (usually Delaware) that is not its principal place of business and the challenges of limiting offers to in-state residents in light of the Internet and social media. In particular: (i) Rule 147A has no restriction on offers being made to residents outside of the issuer's state of residence, although all sales must be made only to residents of the issuer's state of residence; and (ii) an issuer need not be incorporated or organized in the state where it has its principal place of business in order to conduct an intrastate offering in such state.

The allowance for offers to be made to out-of-state residents will permit issuers to use the Internet or any other form of mass media (i.e. engage in general solicitation and advertising) to make offers and sales of securities under Rule 147A (to the extent permitted by the state exemption utilized); as Rule 147 still restricts offers to in-state residents, such use of the Internet or other mass media will still not be permitted under Rule 147.

Under both amended Rule 147 and new Rule 147A, the issuer of the securities must be “resident” and “doing business within” the state in which all sales are made, and in the case of Rule 147, in which all offers are made. Under amended Rule 147, an issuer is a resident of the state in which it is incorporated or organized, as is currently the case, and in which it has its principal place of business, which will replace Rule 147's “principal office” requirement. By contrast, under Rule 147A an issuer is a resident of the state in which it has its principal place of business (as noted above, without the incorporation or organization requirement). Under both rules, the issuer's principal place of business is the state “in which the officers, partners, or managers of the issuer primarily direct, control and coordinate the activities of the issuer.” An issuer is considered doing business in a particular state under amended Rule 147 and Rule 147A if: (i) it derives at least 80% 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; (ii) at least 80% of its consolidated assets at the end of its most recent semi-annual fiscal period were located within such state; (iii) it intends to use and uses at least 80% of the net proceeds of the offering in connection with the operation of a business or of real property located in, the purchase of real property located in, or the rendering of services within such state; or (iv) a majority of its employees are based in such state. This new alternative test will be easier for issuers to meet than the current Rule 147 “doing business in” requirement, which requires compliance with all three of the 80% tests retained in the amended and new rules.

With respect to issuers that change their state of residence, amended Rule 147 and new Rule 147A both provide that such an issuer may not conduct another offering pursuant to either rule for at least six months from the date of last sale in its prior state of residence.

Both amended Rule 147 and Rule 147A require issuers to include prominent disclosure in all offering materials that sales will only be made to residents of the issuer's state, which may be made through the use of a hyperlink when using twitter or similar character-limited mediums and the legend would cause the character limit to be exceeded.

Purchasers of securities sold under both amended Rule 147 and new Rule 147A may not resell such securities for six months after the date of sale, except to other residents of the issuer's state of residence at the time of sale by the issuer. Issuers will be required to provide disclosure about the resale limitations to purchasers (as well as indicating the state of its residence in which sales are so limited), include a restrictive legend on any certificates or other documents evidencing the securities sold, and issue stop transfer instructions with respect to such securities.

Finally, both amended Rule 147 and new Rule 147A: (i) include a “reasonable belief” standard with respect to issuers' determination of the state of residence of a purchaser, , consistent with the determination of accredited investor status under Regulation D, and require issuers to obtain a written representation from each purchaser as to his, her or its state of residency; (ii) provide that an individual is resident in the state in which he or she has his or her principal residence (identical to current Rule 147), and the residence of an entity (unless formed for the purpose of acquiring the securities offered) is the state of its “principal place of business” (as set forth above), in each case at the time of sale; and (iii) provide an integration safe harbor, including for offers and sales prior to the commencement of or more than six months after completion of the intrastate offering or made pursuant to offerings registered (with limited exceptions) or exempt under certain exemptions from registration under the Securities Act. It is important to note that while the SEC believes the written representation may be maintained and considered as evidence of residency, it is not dispositive in this regard. An issuer must consider all relevant facts and circumstances in forming a reasonable belief as to a purchaser's state of residency, and “obtaining a written representation from purchasers of in-state residency status will not, without more, be sufficient to establish a reasonable belief that such purchasers are in-state residents.” The adopting release for the new rules provides examples of facts and circumstances that issuers can consider in forming a reasonable belief as to a purchaser's state of residency, including a pre-existing relationship that provides the issuer with such knowledge, evidence of the purchaser's home address (utility bill, pay stub, driver's license) and public or private databases the issuer has determined are reasonably reliable.

Amended Rule 147 and new Rule 147A will be effective 150 days after publication of the final release in the *Federal Register*.