SEC PROPOSES TO MODERNIZE RULE 147 INTRASTATE OFFERING EXEMPTION

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On October 30, 2015, the Securities and Exchange Commission (the "SEC") proposed a series of amendments to Rule 147 under the Securities Act of 1933, as amended, that, if adopted, could significantly reduce the barriers to capital formation for smaller companies. The proposed rules would, among other things, significantly increase the number of issuers that could rely on an intrastate offering exemption from registration, and could permit general solicitation or general advertising in the offering of their securities (including the use of the Internet and crowdfunding).

Rule 147 is a safe harbor under Section 3(a)(11) the Securities Act of 1933 for intrastate offerings. Rule 147, as adopted in 1974, currently limits both offers and sales to residents of the same state in which the issuer is both resident (organized or incorporated) and doing business. The SEC has acknowledged that Rule 147 is out of date with modern business practices and communications technology, and that the rule currently restricts offerings by issuers seeking to raise capital pursuant to recently adopted crowdfunding provisions under state securities laws.

The proposed amendments would permit an issuer to engage in any form of general solicitation or general advertising in the offer and sale of its securities (including the use of publicly accessible Internet websites), provided that all sales occur within the same state in which the issuer's principal place of business is located, if the offering is either registered in the state in which all of the purchasers are resident or is conducted pursuant to an exemption from state law registration in a state that limits the amount of securities an issuer may sell pursuant to an exemption to no more than $5 million in a twelve-month period.

Since many issuers incorporate or organize in states other than the state of their principal place of business, the SEC proposed to eliminate the requirement that the issuer be organized in the state in which it conducts the offering and, instead, would base the exemption on the location of the issuer's principal place of business. The proposed amendments to Rule 147 define an issuer's "principal place of business" as the location (a) in which the issuer's officers, partners, or managers issuer primarily direct, control, and coordinate the activities of the issuer, and (b) that meets at least one of the following requirements: (i) the issuer derived at least 80% of its consolidated gross revenues from the operation of a business or of real property located in the state; (ii) the issuer had at the end of its most recent semi-annual fiscal period prior to the first Rule 147 offer of securities, at least 80% of its consolidated assets within the state; (iii) the issuer intends to use, and uses, at least 80% of the net proceeds from the offering in connection with the operation of a business or of real property located within the state; or (iv) a majority of the issuer's employees are based in the state. Since Rule 147 currently requires issuers who rely on that exemption to meet all three of clauses (i), (ii) and (iii) above, the proposed amendment should make the exemption available to more issuers.

Current Rule 147 requires that offers and sales of securities pursuant to the rule be made only to persons who reside within the state in which the issuer is a resident. If an offer or a sale is made to even one investor who is not, in fact, a resident of the state, the intra-state exemption for the entire offering is lost. The SEC stated that requirement is unnecessarily restrictive and gives rise to uncertainty for issuers. Accordingly, the proposed amendments would merely require the issuer to have a "reasonable belief" that each investor is a resident of the issuer's state at the time of the sale of the securities. An issuer could satisfy this belief on evidence of an individual investor's home address based on a recently dated utility bill, a pay-stub, state or federal tax returns, or any state-issued documentation, such as a driver's license or identification card. The residence of an investor that is a legal entity (such as a corporation, partnership, or limited liability company) is defined as the investor's "principal place of business." That term is defined as the location in which the officers, partners, or managers of the entity primarily direct, control and coordinate the activities of the issuer.

Although the amendments to Rule 147 would slightly amend the current Rule 147 limitation on resales of securities, under the proposed rule resales by an investor will still only be permitted to be made to residents of the same state during the nine-month period following the sale by the issuer to the investor. However, under the proposed amendments, failure to comply with this limitation would not result in the loss of the exemption when the resale provisions are violated under circumstances that are beyond the issuer's control.

The principal limitation in the proposed amendments is the requirement that the exemption is only available to an offering that is either (i) registered in the state in which all of the purchasers are resident, or (ii) conducted pursuant to an exemption from state law registration in a state that limits the amount of securities an issuer may sell pursuant to the exemption to no more than $5 million in a twelve-month period and imposes an investment limitation on investors. The only state laws that currently have such an exemption are those with state-based crowdfunding statutes. According to the SEC, as of September 2015, 29 states and the District of Columbia have enacted state crowdfunding provisions that may qualify as an exemption; California has not enacted any such provisions. Unfortunately, however, of those 29 states only two currently satisfy the requirements of proposed amendments to Rule 147. The SEC acknowledged that most state-based crowdfunding statutes would have to be modified for the proposed Rule 147 amendments, but simply dismissed the issue by saying "states that have crowdfunding provisions based on compliance with Section 3(a)(11), or compliance with both Section 3(a)(11) and Rule 147, would need to amend these provisions in order for issuers to take full advantage of these amendments."

The SEC is accepting comments on the proposed amendments until January 11, 2016.

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