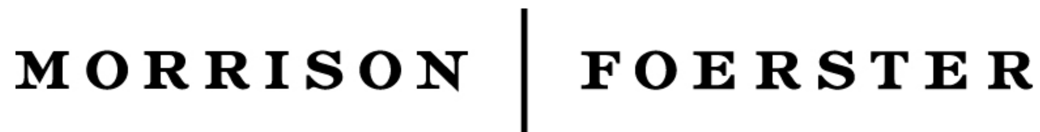

Securities Developments Medley
Session One

Teleconference

Wednesday, February 8, 2017

11:00 AM – 12:00 PM EST

Presenters:

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Anna Pinedo, Partner, Morrison & Foerster LLP

1. **Presentation**

2. **Morrison & Foerster Client Alert – "SEC Adopts Final Rules Regarding Intrastate and Regional Offerings"**

MORRISON | FOERSTER

Securities Law Medley
(Session One)

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February 8, 2017

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Agenda

- Regulation A experience to date
  - C&DIs
  - The DERA study
  - Areas to address
- Regulation CF experience to date
  - Crowdfunding statistics
  - C&DIs on Regulation CF
  - FINRA enforcement action
- Amendments to Rule 504 and Rule 147; New Rule 147A
- Integration C&DI
- Rule 701 C&DIs
- Guidance on Rule 144

Regulation A

Regulation A

- The Staff of the SEC's Division of Corporation Finance (the "Staff") issued several C&DIs regarding Regulation A offerings in November 2016 (Questions 182.12, 182.13 and 182.14), which provide that:
  - An issuer that seeks to qualify an additional class of securities by post-qualification amendment to a previously qualified offering statement would satisfy the requirements of Item 4 to Part I of Form 1 A by providing responses that relate only to the additional class of securities for which qualification is being sought
  - For purposes of calculating a change in the size of the offering, the Note to Rule 253(b) provides that a change in price representing no more than a 20% change in the maximum aggregate offering price in a qualified offering statement may be made pursuant to an offering circular supplement and does not require a post-qualification amendment. The 20% change may be measured from either the high end (in the case of an increase in the offering price) or the low end (in the case of a decrease in the offering price) of that range

Regulation A, cont'd.

- Consistent with the treatment of EGCs under the FAST Act, a company filing or non-publicly submitting an offering statement pursuant to Regulation A may omit financial information for historical periods otherwise required by Part F/S of the Form 1 A, including financial information of other entities required to be included in Part F/S, if it reasonably believes the omitted information will not be required to be included in a filing at the time of qualification, so long as the issuer amends the offering statement prior to qualification to include all financial information required to be included in Part F/S at the time of the qualification

Regulation A, cont'd.

- The SEC's DERA published a study regarding Regulation A offerings conducted from the June 19, 2015 effective date through October 31, 2016
- The paper notes that:
  - Prospective issuers filed with the SEC offering statements for 147 Regulation A+ offerings, covering approximately $2.6 billion of securities
  - Of those offering statements filed with the SEC, approximately 81, covering approximately $1.5 billion of securities, were qualified
  - $190 million was reported as raised in qualified offerings
  - With respect to qualified offerings, there were 10 issuers seeking quotation on the OTC Markets, 17 issuers indicating that they would seek quotation on the OTC Markets in the future and one issuer seeking an NYSE listing (no issuers indicated they were seeking a Nasdaq listing)
  - Issuers are availing themselves of both Tier 1 and Tier 2 offerings, but Tier 2 offerings were on the margin more common among qualified offerings, accounting for 60% of qualified offerings

- The offering amount varied with issuer's size, with the average issuer seeking up to approximately $18 million
- Issuers mainly offered equity securities, which accounted for over 85% of all Regulation A+ offerings
- The majority of Regulation A+ offerings were conducted on a best-efforts, self-underwritten basis (only 17% of Tier 2 offerings used broker-dealers)
- Only 20% of Regulation A+ offerings used testing the waters
- The average number of days for qualification was 93 days for Tier 1 offerings and 121 days for Tier 2 offerings

Regulation A, cont'd.

- On December 7, 2016, the NASAA proposed a model rule, a model statutory amendment and a Solicitation of Interest Form permitting testing the waters in Tier 1 offerings under the NASAA's coordinated review program.
- States are currently preempted from requiring registration for Tier 2 offerings, including those using testing the waters, but are not preempted from requiring such registration for Tier 1 offerings.
- Certain offerings are disqualified under the proposed model rule, including those involving bad actors, development stage companies, blank check companies, companies involved in petroleum or other mining or extractive industries and pooled investment vehicles.
- The proposed Solicitation of Interest Form, which contains basic information about the issuer and the offering, would be required to be filed with regulators prior to testing the waters and also must be provided to prospective investors.

Regulation A, cont'd.

- The proposed model rule allows an issuer that intends to register a Tier 1 offering to solicit indications of interest from prospective investors if the following conditions are satisfied:
  - the issuer is organized under the laws of a state or territory of the United States, the District of Columbia or a province of Canada;
  - the issuer files a solicitation of interest form and any advertising materials with the administrator at least 15 calendar days prior to the initial solicitation of interest;
  - neither the issuer nor any person acting on its behalf may solicit or accept any money or subscriptions;
  - neither the issuer nor any person acting on its behalf may make any sales until at least seven calendar days after delivering a final offering circular; and
  - certain legends must appear in any solicitation of interest materials.
- The comment period for the NASAA's proposal closed on January 6, 2017.

Regulation A, cont'd.

- There are a number of issues to address going forward with respect to Regulation A
  - State merit-based reviews, which often rely on standards that are outdated and inconsistent with current capital markets trends, such as policies relating to promoters
  - The ability to test the waters in connection with Tier 1 offerings
  - The lack of interest on the part of financial intermediaries to participate in Regulation A offerings, which tends to relegate issuers in Regulation A offerings to rely on internet-based offerings or affinity (or "consumer") offerings
  - The lack of a secondary market
  - The potential for investor confusion resulting from references to Regulation A offerings as "initial public offerings"

Crowdfunding

Crowdfunding Statistics

- Crowdfunding in 2016 (from January 2017 Crowdfund Capital Advisors report, except where noted)
  - 186 companies in 36 states launched campaigns across 21 crowdfunding portals (one of which has been shut down)
  - $19.6 million raised in 79 offerings that have successfully reached their minimum funding targets
    - For comparison, the first year of Title II of Dodd-Frank saw 4,712 offerings receiving capital commitments of $385.8 million (*source*: Crowdnetic)
  - $19.6 million raised consisted of over 21,000 individual investments with an average of $833 per investment and an average investor pool of 331 individuals per campaign

Crowdfunding Statistics, cont'd.

- Average funded campaign amounted to approximately $226,579, with issuers paying the platform an average fee of $11,329
  - For comparison, in the first year of Title II of Dodd-Frank, the average offering raised approximately $405,295 per successful issuer (*source*: Crowdnetic)
- Excluding outliers, the average valuation of funded companies was $5.3 million, which means that the price paid by VCs is comparable to the price paid by the crowd
- Potential creation of approximately 173.8 new jobs in Q1 2017 from all of 2016's funded companies (an average of approximately 2.2 jobs per successfully funded company)

C&DIs

- In May 2016, the Staff issued C&DIs on Rules 100 (Crowdfunding Exemption and Requirements), 201 (Disclosure Requirements), 204 (Advertising) and 205 (Promoter Compensation) of Regulation Crowdfunding. Highlights of the C&DIs include the following:
  - Information not constituting an offer of securities may be disseminated by an issuer prior to the commencement of an offering.
  - The investment limits under Rule 100(a)(2) apply to all investors, including non-natural persons.
  - If an offering is conducted during the period from inception until 120 days after reaching the annual balance sheet date for the first time, the issuer must include a balance sheet as of a date in that period, which may be the inception date. For an offering conducted more than 120 days after the issuer's first annual balance sheet date, the date of the most recent annual balance sheet determines the period for which statements of comprehensive income, cash flows and changes in stockholders' equity must be provided.

- An issuer may advertise the “terms of the offering,” but any such advertising that is made other than through communication channels provided by the intermediary on the intermediary’s platform will be limited to notices that include no more than the information described in Rule 204(b). “Terms of the offering” is defined to include the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period.
- The limitation on advertisement under Rule 204(b) applies only when the advertisement includes any of the “terms of the offering.”
- When an issuer is compensating a third party to promote the issuer’s offering outside of the intermediary’s communication channels, third-party communications need to comply with the notice requirements of Rule 204(b).

FINRA Enforcement Action

- In November 2016, FINRA terminated the registration for UFP, LLC, a crowdfunding portal
- FINRA's investigation into UFP alleged that from May through September 2016, UFP violated various Regulation CF rules and FINRA Funding Portal Rules
- FINRA alleged that UFP violated Rule 301(a) and Rule 301(c)(2) under Regulation CF, which are investor protection provisions that require a portal to have a reasonable basis for believing that issuers using its crowdfunding portal comply with applicable regulatory requirements and do not present the potential for fraud
- Quite a number of issuers on the UFP portal had failed to file certain requisite disclosures with the SEC and FINRA determined all of the issuers in question had impracticable business models and oversimplified and unrealistic financial forecasts

Rule 504 and Rule 147

Amendments

- In October 2016, the SEC adopted final rules on intrastate and regional offerings as follows:
  - The SEC amended Rule 147. Rule 147 continues as a safe harbor under Section 3(a)(11)
  - Section 3(a)(11) remains available on its own
  - The SEC established a new exemption, Rule 147A, which addresses out-of-state residents and companies incorporated or organized out-of-state
  - The SEC also amended Rule 504 and repealed Rule 505.
- Amended Rule 147 and new Rule 147A will take effect on April 20, 2017, amended Rule 504 took effect on January 20, 2017, and the repeal of Rule 505 will take effect on May 20, 2017.

Rule 504

- An exemption pursuant to Section 3(b) of the Securities Act; Section 3(b) authorizes the SEC to exempt from the registration requirements of the Securities Act offerings of securities not exceeding $5 million
- The amendments to Rule 504 were intended to "facilitate state efforts to increase the efficiencies associated with the registration of securities offerings in multiple jurisdictions through regional coordinated review programs"
- **Amount of offering**: The offering threshold was $1 million of securities sold under Rule 504 within a 12-month period, less selling price of other securities sold under another section 3(b) exemption within prior 12 months; *the SEC amendments raise the threshold to $5 million*
- **By?** Issuer cannot be a reporting company, an investment company or a SPAC
- **Who can invest?** Depends on form of offering
- **Is there an investor cap?** No

- **Manner of offering**: a private placement or an offering registered under applicable state laws
  - If it is structured as a private placement, then the issuer cannot use general solicitation or general advertising and must obtain investment representations, impose transfer restrictions, use restrictive legends on the securities, etc.
  - If it is structured as a state-registered offering, the issuer must comply with state registration requirements ("qualification") in each state where securities are sold, including preparing and delivering a required "substantive disclosure document before sale" to purchasers in all states (whether or not each state requires registration and delivery of a disclosure document), **or** sell only to "accredited investors" in accordance with available state law exemptions that permit general solicitation and general advertising
- **Is an intermediary required?** No, although it would be challenging for an issuer to complete a Rule 504 offering as a private placement on its own

Rule 504, cont'd.

- **Offering disclosure requirements:** as discussed above, these depend on the manner of offering
- **Reporting following the offering:** none
- **Form D**: issuer must file a Form D
- **New Bad Actor Disqualification Provision**: the SEC amendments include a provision that disqualifies certain bad actors from participation in Rule 504

- The final rules repeal Rule 505 of Regulation D, which had provided a safe harbor from registration for securities offered and sold in any twelve-month period from $1 million to $5 million sold solely to accredited investors or no more than 35 non-accredited investors

Rule 504, cont'd.

Rule 147

- Section 3(a) of the Securities Act provides an exemption from the registration requirements for "any 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."
- Section 3(a)(11) provides an exemption provided that:
  - The issuer be incorporated (and resident) and doing business in the state; and
  - The securities are offered and sold to persons resident in the state.
- **Amount of offering**: no limitations on the dollar amount being raised
- **Who can invest**: no limitations on the number or the sophistication of offerees or purchasers
- **Advertising**: no publicity or general solicitation restrictions, except offers and sales may be made only to residents of one state
- **Disclosure requirements**: no specific disclosure requirements apart from the resale restrictions

Rule 147, cont'd.

- Rule 147 is a safe harbor under Section 3(a)(11); if the conditions of the safe harbor have not been satisfied, the 3(a)(11) exemption may still be available.
- Prior to its recent amendment, the conditions of the Rule 147 safe harbor were as follows:
  - To be "doing business" in the state, the issuer must derive 80% of its consolidated gross revenues from the state, and have 80% of its consolidated assets located in the state, and use 80% of the net offering proceeds in the state, and have its principal office in the state;
  - The entire offering must be made under the exemption, i.e., no additional offers and sales of securities that would be integrated may be made under any other exemption from registration—integration is determined under the five factor test subject to the rule of thumb that offers and sales made more than 6 months before or after an intrastate offering will not be integrated; and
  - Resales of the securities within nine months of an intrastate offering may only be made to residents of the same state—and the securities must be legended, and transfer restrictions imposed, to reflect this resale restriction.

Amendments to Rule 147

- The SEC proposed to amend Rule 147 because quite a number of the conditions of Rule 147 were viewed as preventing its use in connection with intrastate crowdfunding (relying on a website), such as the prohibition on general solicitation, the requirement that the issuer be incorporated in the state in which the offering was made, etc.

Amendments to Rule 147 and New 147A

- Rule 147A is substantially identical to Rule 147 except that it allows offers to be accessible to out-of-state residents and for companies to be incorporated or organized out-of-state.
- Both new Rule 147A and amended Rule 147 include the following provisions:
  - Requirement that the issuer has its "principal place of business" in-state and satisfies at least one "doing business" requirement that would demonstrate the in-state nature of the issuer's business;
  - 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;
  - Requirement that issuers obtain a written representation from each purchaser as to residency;
  - Limit on resales to persons residing within the state or territory of the offering for a period of six months from the date of the sale by the issuer to the purchaser;
  - An integration safe harbor; and
  - Legend requirements to offerees and purchasers about the limits on resales.

Principal Place of Business

- Amended Rule 147 and new Rule 147A define an issuer's "principal place of business" (as opposed to its "principal office" as defined in old Rule 147) as the location from which the officers, partners, or managers of the issuer primarily direct, control, and coordinate the activities of the issuer
- Under amended Rule 147, issuers that are incorporated or organized under state or territorial law will be deemed a "resident" of a particular state or territory in which they are both incorporated or organized and have their "principal place of business"
- New Rule 147A(c)(1), however, relies solely on the principal place of business requirement to determine the state or territory in which the issuer shall be deemed a "resident," not only for corporate issuers, but for all issuers
- Under amended Rule 147 and new Rule 147A, issuers that have changed their principal place of business after making sales in an intrastate offering pursuant to amended Rule 147 or new Rule 147A, as applicable, will not be able to conduct another intrastate offering pursuant to either rule in another state for a period of six months from the date of the last sale in the prior state

Doing Business Requirement

Under amended Rule 147 and new Rule 147A, an issuer is required to meet at least one of the following requirements in order to be considered "doing business" in-state:

- The issuer derived 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 or territory;
- 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% of its consolidated assets located within such state or territory;
- The issuer intends to use and uses at least 80% 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; or
- A majority of the issuer's employees are based in such state or territory (this requirement was not included in old Rule 147).

Reasonable Belief Standard

- Amended Rule 147(d) and new Rule 147A(d) includes a reasonable belief standard for the issuer's determination as to the residence of the purchaser at the time of the sale of the securities
- This requirement can be satisfied by
  - The existence of the fact that the purchaser is a resident of the applicable state or territory, or
  - Establishing that the issuer had a reasonable belief that the purchaser of the securities in the offering was a resident of such state or territory
- Under amended Rule 147 and new Rule 147A, the residence of a purchaser that is a legal entity (i.e., a corporation, partnership, trust, or other form of business organization) is defined as the location where, at the time of the sale, the entity has its principal place of business.
- Amended Rule 147 and new Rule 147A also define a purchaser's "principal place of business," consistent with the final definition for issuer eligibility purposes.

Limitation on Resales

- The final rules amend the limitation on resales in old Rule 147(e) to provide that for a period of six months from the date of the sale by the issuer of a security sold pursuant to the rule, any resale of such security by a purchaser will be made only to persons resident within such state or territory, as determined pursuant to amended Rule 147(d) or new Rule 147A(d), as applicable.
- Compliance with the amended limitation on resales is not required for an issuer relying on amended Rule 147 or new Rule 147A.

Integration

- The final rules also align the integration safe harbor in Rule 147 with the integration safe harbor in Rule 251(c) of Regulation A
- Under the final rules, offers and sales made pursuant to amended Rule 147 or new Rule 147A will not be integrated with:
  - Prior offers or sales of securities; or
  - Subsequent offers or sales of securities that are:
    - Registered under the Securities Act, except as provided in amended Rule 147(h) or new Rule 147A(h);
    - Exempt from registration under Regulation A;
    - 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;
    - Exempt from registration under Section 4(a)(6) of the Securities Act; or
    - Made more than six months after the completion of an offering conducted pursuant to amended Rule 147 or new Rule 147A.

Practical Concerns

- The amendments to Rule 504 are helpful, but there are still limitations on the use of general solicitation in Rule 504 offerings
- Rule 504 only allows companies to solicit or advertise their securities to the public and to sell securities that are not restricted, if one of the following circumstances is met:
  - The company registers the offering exclusively in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors
  - A company registers and sells the offering in a state that requires registration and disclosure delivery and also sells in a state without those requirements, so long as the company delivers the disclosure documents required by the state where the company registered the offering to all purchasers (including those in the state that has no such requirements)
  - The company sells exclusively according to state law exemptions that permit general solicitation and advertising, so long as the company sells only to accredited investors
- However, many states do not permit the use of general solicitation for non-accredited investors or under their smaller offering exemptions

Integration guidance

Integration Guidance

- The Staff issued guidance in the form of a C&DI in November 2016, which is Question 256.34
- **Question**: An issuer has been conducting a private offering in which it has made offers and sales in reliance on Rule 506(b). Less than six months after the most recent sale in that offering, the issuer decides to generally solicit investors in reliance on Rule 506(c). Are the factors listed in the Note to Rule 502(a) the sole means by which the issuer determines whether all of the offers and sales constitute a single offering?
- **Answer**: No. Under Securities Act Rule 152, a securities transaction that at the time involves a private offering will not lose that status even if the issuer subsequently decides to make a public offering. Therefore, we believe under these circumstances that offers and sales of securities made in reliance on Rule 506(b) prior to the general solicitation would not be integrated with subsequent offers and sales of securities pursuant to Rule 506(c). So long as all of the applicable requirements of Rule 506(b) were met for offers and sales that occurred prior to the general solicitation, they would be exempt from registration and the issuer would be able to make offers and sales pursuant to Rule 506(c). Of course, the issuer would have to then satisfy all of the applicable requirements of Rule 506(c) for the subsequent offers and sales, including that it take reasonable steps to verify the accredited investor status of all subsequent purchasers.

- Prior to issuance of this C&DI, Rule 152 had been relied upon principally in the context of PIPE transactions, wherein the issuer enters into a definitive purchase agreement and subsequently files a resale registration statement.
- Although the SEC has addressed integration safe harbors in the context of adopting the amendments to Regulation A and adopting Regulation CF, additional integration questions remain. It would be helpful for the SEC to revisit the area.

Integration Guidance, cont'd

Rule 701

Rule 701

- Rule 701 provides an exemption for compensatory issuances by private companies to directors, employees, consultants and advisors
- In any 12-month period, an issuer may offer securities representing not more than greatest of:
  - $1 million,
  - 15% of the issuer's total assets, and
  - 15% of the outstanding amount of the class of securities being offered and sold
- Disclosure is required:
  - A written plan or contract
  - Additional disclosure is required if the issuer has sold securities having a value of greater than $5 million in any 12-month period
- Perhaps in light of the trend that more companies are choosing to remain private longer and defer their initial public offerings, there has been renewed focus on Rule 701

Rule 701, cont'd.

- **Exchange Act 12(g) threshold**
  - The JOBS Act modified the 12(g) threshold and also required that the SEC provide guidance regarding the meaning of "held of record"
  - In May 2016, the SEC issued final rules.
  - For purposes of determining whether an issuer is required to register a class of equity securities pursuant to section 12(g)(1) of the Exchange Act, the issuer may now exclude (from the definition of "held of record") securities that are:
    - Held by persons who received the securities pursuant to an employee compensation plan in transactions exempt from, or not subject to, the registration requirements of section 5 (now Rule 12g5-1(a)(8)(i)(A)); or
    - Held by persons who received the securities in a transaction exempt from, or not subject to, the registration requirements of section 5 from the issuer, a predecessor of the issuer or an acquired company in substitution or exchange for excludable securities under Rule 12g5-1(a)(8)(i)(A), as long as the persons were eligible to receive securities pursuant to Rule 701(c) under the Securities Act at the time the excludable securities were originally issued to them (now Rule 12g5-1(a)(8)(i)(B)).

- **Rule 701 C&DIs**
  - The Staff has issued two sets of C&DIs relating to Rule 701
  - In June 2016, the Staff issued a series of C&DIs that addressed the application of Rule 701 in the context of a merger transaction
  - Specifically, the C&DIs provided that:
    - An acquirer in a merger that assumed the target's derivative securities does not need an exemption for the assumption if, at the time of the grant by the target, the plan under which the securities were issued permitted the assumption without the consent of holders of the derivative securities
    - Securities underlying the derivative securities are considered to have been sold on the grant date of the derivative securities. Therefore, provided the target company complied with Rule 701 at the time the derivative securities assumed were originally granted, the exercise or conversion of the derivative securities would be exempt
    - Post-merger, in order to determine the amount of securities that the acquirer may sell pursuant to Rule 701, the acquirer must include the aggregate sales price and amount of securities for which the target company claimed the exemption during the same 12-month period

Rule 701, cont'd.

- Post-merger, to calculate the amount that can be issued pursuant to Rule 701 (based on total assets or percentage of the class), an acquirer may use either a pro forma balance sheet as of its most recent balance sheet date that reflects the merger as if it occurred on that date, or a balance sheet date after the merger that will reflect the total assets and outstanding securities of the combined entity
- When aggregate sales in any 12-month period exceed $5 million, an issuer may elect to provide financial statements that follow the requirements of either Tier 1 or Tier 2 Regulation A offerings, without regard to whether the amount of sales that occurred pursuant to Rule 701 during the time period contemplated in Rule 701 would have required the issuer to follow the Tier 2 financial statement requirements in a Regulation A offering of the same amount
- For assumed derivative securities where the target company was required to provide disclosures under Rule 701 post-merger, the acquirer would assume the disclosure obligation and would satisfy it by providing information required under Rule 701
- Post-merger, in determining whether the amount of securities the acquirer sold during any consecutive 12-month period exceeds $5 million, the acquirer must include any securities that the target company sold during the same period

- In October 2016, the Staff issued additional guidance in the form of C&DIs
  - The Staff clarified that when a private company not subject to Exchange Act reporting requirements issued options in reliance on Rule 701 and is acquired by a company that both is subject to the Exchange Act reporting requirements and assumes the outstanding options, the acquiring company need not register the offer and sale of the shares issuable upon the exercise of the options. The acquirer may rely on Rule 701 for the exercise of the assumed options and the acquirer's public filings would satisfy the disclosure obligations
  - Where an issuer relies on Rule 701 to issue an RSU to an employee, which settles upon satisfaction of certain conditions, and the employee does not pay additional consideration on settlement, the issuer would have to satisfy the enhanced disclosure requirement under Rule 701 if it has sold securities in excess of the $5 million threshold (counting the RSUs) before the sale date, which is the RSU grant date. Rule 701(e)(6) relating to the exercise or conversion of derivative securities does not apply to RSUs.

Rule 701, cont'd

Rule 701, cont'd

- The Financial CHOICE Act
  - Section 1006 of the CHOICE Act would require that within 60 days of enactment the SEC revise Rule 701 to increase from $5 million to $10 million the aggregate sales price or amount of securities sold during any consecutive 12-month period in excess of which the issuer is required to deliver an additional disclosure to investors

Rule 144 Guidance

Rule 144 Guidance

- The Staff has issued additional guidance regarding Rule 144 in the form of two no-action letters and one C&DI
- The up-REIT letter
  - In March 2016, the Staff issued interpretative guidance that clarifies that, in the context of an upREIT, a holder of partnership interests in an umbrella operating partnership (OP units) that proposes to exchange its OP units for shares of its parent REIT can be deemed to have commenced it Rule 144(d)(1) holding period when it acquired the OP units
  - The guidance notes that in order to "tack" the holding periods, the following conditions must be satisfied:
    - the OP unit holder paid the full purchase price for the OP units at the time they were acquired from the umbrella operating partnership
    - an OP unit is the economic equivalent of a REIT share, representing the same right to the same proportional interest in the same underlying pool of assets

- the exchange of REIT shares for OP units is entirely at the discretion of the parent REIT; and
- no additional consideration is paid by the OP unit holders for the REIT shares.

- The up-C letter
  - In November 2016, the Staff issued similar guidance, consistent with the upREIT letter, which addressed the required Rule 144 holding period after the exchange of partnership interests in an umbrella operating partnership (OP units) into shares of its parent corporation in an up-C structure
  - The guidance clarifies that for purposes of Rule 144(d)(1), the holding period for Corporation shares issued in up-C transaction commences upon the earlier acquisition of the OP units
  - The following conditions must be satisfied:
    - the OP unit holders paid the full purchase price for the OP units at the time they were acquired from the umbrella operating partnership;

Rule 144 Guidance, cont'd

- the up-C governing documents contemplate and provide the terms for the exchange of OP units for Corporation shares such that the OP unit holder has the same economic risk as if it were a holder of the Corporation shares during the entire period it holds the OP units; and
- no additional consideration is paid by the OP unit holders for the Corporation shares

- In October 2016, the Staff issued a revised C&DI (Question 532.06), which addresses the commencement of the Rule 144(d) holding period for restricted securities issued under a written agreement and provides that the period commences when the recipient is deemed to have paid for them and assumed risk of economic loss. In the context of securities received pursuant to an employment agreement begins when risk passes to the employee. For securities subject solely to vesting based on continued employment or performance related conditions, the holding period starts when granted. For awards requirement payment on exercise, conversion or settlement, the holding period begins when payment is made

Client Alert

October 27, 2016

SEC Adopts Final Rules Regarding Intrastate and Regional Offerings

On October 26, 2016, the Securities and Exchange Commission (the "SEC") adopted final rules regarding intrastate and regional offerings, which largely follow the SEC's proposed rules issued on October 30, 2015.[1] The final rules amend Rule 147 ("Rule 147") under the Securities Act of 1933, as amended (the "Securities Act"), to facilitate offerings relying upon recently adopted intrastate crowdfunding exemptions under state securities laws. Rule 147 provides a safe harbor for intrastate offerings exempt from registration pursuant to Section 3(a)(11) of the Securities Act ("Section 3(a)(11)"), which exempts any security offered and sold only to persons resident within a single state or territory by an issuer residing or incorporated in and doing business within such state or territory. As amended, Rule 147 will continue to function as a safe harbor under Section 3(a)(11), though Section 3(a)(11) will still be available as a potential statutory exemption in and of itself. The final rules also establish a new Securities Act exemption, designated Rule 147A, that further accommodates offers accessible to out-of-state residents and companies that are incorporated or organized out-of-state. The final rules also amend Rule 504 ("Rule 504") of Regulation D under the Securities Act ("Regulation D") to (1) increase the aggregate amount of securities that may be offered and sold in any twelve-month period from $1 million to $5 million and (2) disqualify certain bad actors from participating in Rule 504 offerings. In addition, the final rules repeal Rule 505 of Regulation D, which had provided a safe harbor from registration for securities offered and sold in any twelve-month period from $1 million to $5 million.

Amendments to Rule 147

The final rules largely follow the proposed rules, by continuing to require that sales be made only to residents of an issuer's state or territory, redefining "intrastate offering," and easing issuer eligibility requirements. The final rules, however, do not adopt the proposed federal limits on state exemptions.[2] As amended, Rule 147 will continue to function as a safe harbor under Section 3(a)(11), though Section 3(a)(11) will still be available as a potential statutory exemption in and of itself. The final rules also establish a new Securities Act exemption, designated Rule 147A, which is substantially identical to Rule 147 except that it allows (1) offers to be accessible to out-of-state residents and (2) for companies to be incorporated or organized out-of-state. Amended Rule 147 and new Rule 147A will become effective 150 days after publication in the Federal Register.

[1] *See* SEC Release Nos. 33-9973; 34-76319 (Oct. 30, 2015) (hereinafter, the "proposing release") and SEC Release Nos. 33-10238; 34-79161 (Oct. 26, 2016) (hereinafter, the "final release").

[2] The proposed rules included amendments to Rule 147 to limit the availability of the Section 3(a)(11) 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 (1) limits the amount of securities an issuer may sell pursuant to such exemption to no more than $5 million in a twelve-month period and (2) imposes an investment limitation on investors.

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Both new Rule 147A and amended Rule 147 include the following provisions, which we discuss in more detail below:

- A requirement that the issuer has its "principal place of business" in-state and satisfies at least one "doing business" requirement that would demonstrate the in-state nature of the issuer's business;
- 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;
- A requirement that issuers obtain a written representation from each purchaser as to residency;
- A limit on resales to persons residing within the state or territory of the offering for a period of six months from the date of the sale by the issuer to the purchaser;
- An integration safe harbor that would include any prior offers or sales of securities by the issuer made under another provision, as well as certain subsequent offers or sales of securities by the issuer occurring after the completion of the offering; and
- Legend requirements to offerees and purchasers about the limits on resales.

Principal Place of Business and Doing Business Requirement

Amended Rule 147 and new Rule 147A define an issuer's "principal place of business" (as opposed to its "principal office" as defined in old Rule 147) as the location from which the officers, partners, or managers of the issuer primarily direct, control, and coordinate the activities of the issuer. Under amended Rule 147, issuers that are incorporated or organized under state or territorial law will be deemed a "resident" of a particular state or territory in which they are both incorporated or organized and have their "principal place of business." New Rule 147A(c)(1), however, will rely solely on the principal place of business requirement to determine the state or territory in which the issuer shall be deemed a "resident," not only for corporate issuers, but for all issuers, including issuers that are not organized under any state or territorial law, such as general partnerships.

Under amended Rule 147 and new Rule 147A, issuers that have changed their principal place of business after making sales in an intrastate offering pursuant to amended Rule 147 or new Rule 147A, as applicable, will not be able to conduct another intrastate offering pursuant to either rule in another state for a period of six months from the date of the last sale in the prior state. This is consistent with the duration of the resale limitation period specified in amended Rule 147(e) and new Rule 147A(e), which we discuss in more detail below.

Under amended Rule 147 and new Rule 147A, an issuer is required to meet at least one of the following requirements in order to be considered "doing business" in-state:

- The issuer derived 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 or territory;
- 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% of its consolidated assets located within such state or territory;
- The issuer intends to use and uses at least 80% 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; or
- A majority of the issuer's employees are based in such state or territory (this fourth prong was not included in old Rule 147).

Reasonable Belief Standard

Amended Rule 147(d) and new Rule 147A(d) include a reasonable belief standard for the issuer's determination as to the residence of the purchaser at the time of the sale of the securities. This requirement can be satisfied by (1) the existence of the fact that the purchaser is a resident of the applicable state or territory or (2) establishing that the issuer had a reasonable belief that the purchaser of the securities in the offering was a resident of such state or territory. Under amended Rule 147 and new Rule 147A, the residence of a purchaser that is a legal entity (i.e., a corporation, partnership, trust, or other form of business organization) is defined as the location where, at the time of the sale, the entity has its principal place of business. Amended Rule 147 and new Rule 147A also define a purchaser's "principal place of business," consistent with the final definition for issuer eligibility purposes.

Limitation on Resales

The final rules amend the limitation on resales in old Rule 147(e) to provide that for a period of six months from the date of the sale by the issuer of a security sold pursuant to the rule, any resale of such security by a purchaser will be made only to persons resident within such state or territory, as determined pursuant to amended Rule 147(d) or new Rule 147A(d), as applicable. The SEC had originally proposed a nine-month period in the proposing release. In addition, compliance with the amended limitation on resales is not required for an issuer relying on amended Rule 147 or new Rule 147A.

Integration

The final rules also align the integration safe harbor in Rule 147 with the integration safe harbor in Rule 251(c) of Regulation A under the Securities Act ("Regulation A"). Under the final rules, offers and sales made pursuant to amended Rule 147 or new Rule 147A will not be integrated with:

- Prior offers or sales of securities; or
- Subsequent offers or sales of securities that are:
  - Registered under the Securities Act, except as provided in amended Rule 147(h) or new Rule 147A(h);
  - Exempt from registration under Regulation A;
  - 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;
  - Exempt from registration under Section 4(a)(6) of the Securities Act; or
  - Made more than six months after the completion of an offering conducted pursuant to amended Rule 147 or new Rule 147A.

Amendments to Rule 504

The final rules adopted by the SEC amend Rule 504 to (1) increase the aggregate amount of securities that may be offered and sold in any twelve-month period from $1 million to $5 million and (2) disqualify certain bad actors from participation in Rule 504 offerings by referencing the disqualification provisions of Rule 506 of Regulation D. In addition, the final rules repeal Rule 505 of Regulation D ("Rule 505"), which had provided a safe harbor from registration for offerings of up to $5 million annually that must be sold solely to accredited investors or no more than 35 non-accredited investors. Amended Rule 504 will become effective 60 days after publication in the Federal Register, and the repeal of Rule 505 will become effective 180 days after publication in the Federal Register.

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