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New Life for Intrastate Offerings and
More Capital for Small Businesses

Small businesses are the "lifeblood of our economy," employing half of the workforce in the United States and creating nearly two out of every three new American jobs. Raising capital for new ventures starts out "locally" with funding by private money, initially from friends and family. Later funding comes from a wider circle of acquaintances, typically also close to home and then, perhaps, from angel investors and, only later, venture capitalists and private equity groups.

While the Internet and social media have made the universe of potential funding sources theoretically unlimited—including by geography—as a practical matter, for an entrepreneur with untested products or new services, raising capital begins with people he or she knows, usually in the same community, or at least the same state. Therefore, the securities laws of the entrepreneur's state are particularly important. Given the pervasive reach of the federal securities laws, compliance with the Securities Act of 1933, as amended (the "Securities Act"), and the rules of the U.S. Securities and Exchange Commission ("SEC") is required, and often an impediment. While the Securities Act contains an "intrastate exemption," small businesses seeking capital have had a difficult time limiting their activities to fall within the exemption.

by Gregory C. Yadley

Section 3(a)(11) of the Securities Act provides an exemption from federal registration for *"[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."* SEC Rule 147 provides a "safe harbor" with objective standards for local businesses seeking to rely on the statutory intra-state exemption.

Rule 147 has not been substantively updated since it was promulgated more than 40 years ago, notwithstanding the exponential developments in communications technologies and the increasingly interstate nature of small business activities. Given the prescriptive threshold requirements that an issuer must satisfy in order to be considered "doing business" in-state, the availability of the Rule 147 safe harbor for local companies that would otherwise conduct intrastate offerings has been extremely limited.

In October 2015, the SEC proposed a new intrastate exemption rule. It is a particularly opportune time to do so because a majority of states recently have adopted equity "crowdfunding" provisions. At least 29 states and the District of Columbia have enacted some form of crowdfunding exemption from state registration through legislation, regulation or administrative order. Additional states are expected to follow suit. Most of the states that have crowdfunding provisions require that the issuer comply with Section 3(a)(11) of the Securities Act or SEC Rule 147. However, the SEC has received feedback from state securities regulators and market participants indicating that the current statutory requirements in Section 3(a)(11) and regulatory requirements in Rule 147 make it difficult for issuers to take advantage of these new state crowdfunding provisions.

The SEC's proposals address the perceived constraints of Rule 147 and should make the intra-state offering more viable. The most significant provisions of the new intrastate exemption rule include the following:

- Each purchaser of securities is, or the issuer has a reasonable belief that the purchaser is, a resident of the same state or territory as the issuer's principal place of business.
- The issuer may engage in any form of general solicitation or general advertising, including publicly accessible Internet websites, so long as all sales occur within the same state or territory in which the issuer's principal place of business is located.
- The offering must be (i) registered in the state in which all of the purchasers are resident, or (ii) exempt from registration in that state pursuant to an exemption that (x) 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 (y) imposes an investment limitation on investors.
- The issuer's principal place of business is defined as the location in which its officers, partners, or managers primarily direct, control and coordinate the activities of the issuer.
- The issuer must satisfy at least one of four thresholds designed to demonstrate the in-state nature of the business within the state in which the offering is conducted:
  - at least 80% of its consolidated gross revenues are derived from the operation of a business or of real property located in or from the rendering of services within such state or territory;
  - 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 were located within such state or territory;
  - at least 80% of the net proceeds from sales made pursuant to the exemption are intended to be used in connection with the operation of a business or of real property in, 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.
- For a period of nine months from the date of the sale of the security by the issuer, resales may be made only to residents of such state or territory.
- An issuer's ability to rely on Rule 147 is no longer conditioned on a purchaser's compliance with the rule's resale restrictions.
- The safe harbor for "integration" of offerings has been expanded in a manner consistent with the SEC's most recently adopted integration guidance.
- The required disclosure regarding restrictions on resales are clarified and may be provided in the same manner as the offer, which might not always be in writing.

The proposals are published under the SEC's general exemptive authority under Section 28 of the Securities Exchange Act. Accordingly, if adopted as proposed, Rule 147 would no longer be a safe harbor for conducting a valid intrastate exempt offering under Section 3(a)(11). An issuer attempting to comply with the new rule that fails to do so would be entitled to rely on any other applicable exemption. However, as a practical matter, failure to satisfy the requirements of the new rule would likely also result in a failure to satisfy the Section 3(a)(11) statutory exemption since those requirements are more restrictive. Of course, any offer or sale under the proposed amendments to Rule 147 would still need to comply with the requirements of applicable state securities laws.

In the same release proposing the Rule 147 revisions, the SEC proposed amendments to Rule 504 of Regulation D under the Securities Act to facilitate issuers' capital raising efforts and provide additional investor protections. The SEC's proposals would increase the aggregate amount of securities that may be offered and sold pursuant to Rule 504 in any twelve-month period from $1 million to $5 million and disqualify certain bad actors from participation in Rule 504 offerings. The proposals would facilitate capital formation by increasing the flexibility that state securities regulators have to implement coordinated review programs to facilitate regional offerings.

The SEC's proposed amendments are salutary and a significant step forward in making the intrastate exemption more relevant. The SEC also recognizes that to make intrastate and regional crowdfunding a reality, more work is needed. States that have crowdfunding provisions based on compliance with Section 3(a)(11), or compliance with both Section 3(a)(11) and Rule 147, will need to amend these provisions in order for issuers to take full advantage of the proposed amendments.

Other issues also need to be addressed. For example, should investors acquiring securities under Rule 147 be counted in the calculation of the number of security holders that give rise to the obligation to register under Section 12(g) of the Exchange Act? How can the SEC work more closely with the states to achieve more harmonized regulation? How do the Financial Industry Regulatory Authority communications and other rules apply to offerings under revised Rule 147? Nevertheless, the SEC proposals to the intrastate offering exemption are a major step forward. The Commission has incorporated flexibility in its proposed new rule and offers a new path for cooperation among federal and state regulators.

- *The author is a member of the U.S. Securities and Exchange Commission Advisory Committee on Small and Emerging Businesses. The views expressed in this article are those of the author. They do not reflect the views of the Advisory Committee or the staff or members of the Securities and Exchange Commission.*
- *An expanded version of this article was presented at the 34th Annual Federal Securities Institute in Miami, Florida, on February 4, 2016. The author would be pleased to provide a copy of the original article upon request.*

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