NIESAR & VESTAL LLP
ATTORNEYS AT LAW

90 NEW MONTGOMERY STREET 9TH FLOOR
SAN FRANCISCO, CALIFORNIA 94105
TELEPHONE (415) 882-5300
FACSIMILE (415) 882-5400
www.nvlawllp.com

Law Alert

To: Firm Clients and Contacts

From: Niesar & Vestal LLP

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Re: **New SEC Rules Will Make It Easier for Companies to Raise Money Through Small Offerings and Offerings Within One State**

In October 2016 the Securities and Exchange Commission (the "SEC") adopted final rules making it easier for companies to offer and sell securities in small offerings and in offerings within one state without registering the transaction with the SEC. The new rules relating to offerings within one state will take effect April 20, 2017. Some of the new rules relating to small offerings took effect January 20, 2017; others will take effect March 22, 2017.

We believe these new rules are the SEC's attempt to formulate practical avenues for small and emerging companies to raise capital. Most securities counsel consider the crowdfunding rules the SEC was required to promulgate under the JOBS act to be unwieldy and of little use for serious capital formation. In those rules the SEC was required by the JOBS act to include provisions (such as the requirement for a licensed intermediary, audited financial statements if more than $500,000 is to be raised, and on-going reporting requirements) that are so onerous that almost no one would consider using them. The rules now coming into effect are much better designed to afford reasonable investor protection while eliminating requirements that would add significant expense to the offering, but not really provide much by way of investor protection.

New SEC Rules Relating to Offerings Within One State: Amendments to Rule 147 and New Rule 147A (effective April 20, 2017)

Background

Section 3(a)(11) of the Securities Act of 1933 (the "Securities Act") provides an exemption from federal securities registration for an offering of any "security which is 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." The purpose of Section 3(a)(11) is to facilitate the local financing of companies by investors within the company's own state by removing federal regulation from such offerings and relying on state regulation to protect such investors. In 1974 the SEC adopted Rule 147 as a non-exclusive safe harbor under Section 3(a)(11) to provide objective standards for companies who want to rely on Section 3(a)(11)'s exemption.

New Rules

The SEC is amending Rule 147 to modernize and update this existing safe harbor under Section 3(a)(11), so that issuers may continue to use state law securities registration exemptions that require compliance with Section 3(a)(11) and Rule 147. Almost all state crowdfunding exemptions require the offering to qualify under Section 3(a)(11) and its Rule 147 safe harbor.

The SEC has also adopted a new, additional intrastate offering exemption, Rule 147A under the Securities Act, which is not subject to certain limitations of Section 3(a)(11). Rule 147A is substantially identical to Rule 147, except that Rule 147A will offer two additional benefits over Rule 147. First, Rule 147A will allow an issuer to make offers accessible to out-of-state residents, provided that sales are made only to in-state residents. This means that, under Rule 147A, issuers will be able to advertise their offering using any form of mass media (including unrestricted, publicly-available Internet websites) that may be viewed by out-of-state residents, as long as all sales of securities are made only to residents of the same state as the issuer. Second, Rule 147A will not require issuers to be incorporated or organized in the same state where the offering occurs as long as issuers can demonstrate that they are "doing business" in the state where the offering occurs. In adopting Rule 147A, the SEC recognized that the jurisdiction of entity formation should not affect the ability of an issuer to be considered resident for purposes of an intrastate offering, as there are valid business reasons for incorporating or organizing in a different state, such as Delaware, from the state where the issuer has its principal place of business.

Both amended Rule 147 and new Rule 147A will include the following requirements:

1) The issuer must have its "principal place of business" in the state of the offering. "Principal place of business" is defined as the "location from which the officers, partners, or managers of the issuer primarily direct, control and coordinate activities of the issuer." Issuers that change their principal place of business to another state after conducting an intrastate offering in reliance on amended Rule 147 or Rule 147A may not conduct another subsequent

intrastate offering pursuant to either rule in a different state for a period of six months from the date of the last sale in the prior state.

2) The issuer must satisfy at least one of the following conditions to show that they are "doing business" in the state of the offering:

- The issuer must derive at least 80% of its consolidated gross revenues from the operation of a business or real property in the state or from the performing of services in the state; OR
- The issuer had at least 80% of its consolidated assets located in the state at the end of its most recent semi-annual fiscal period prior to the first offer of securities pursuant to amended Rule 147 or Rule 147A; OR
- The issuer intends to use and actually uses at least 80% of the net proceeds it receives from an amended Rule 147 or Rule 147A offering in connection with the operation of a business or real property in the state, the purchase of real property in the state, or the performing of services in the state; OR
- A majority of the issuer's employees are based in the state

3) The issuer must obtain a written representation from each purchaser as to such purchaser's in-state residency. The residence of a purchaser that is a non-natural person, such as a corporation, partnership or other business organization, will be defined as the location where, at the time of the sale, the entity has its "principal place of business" (as defined above).

4) The issuer must have a "reasonable belief" that the purchaser is a resident of the state of the offering at the time of the sale of securities. Under old Rule 147, regardless of the efforts an issuer took to determine that potential investors were residents of the issuer's state, the exemption was lost for the entire offering if securities were offered or sold to just one investor that was not in fact a resident of such state. The SEC has created this new "reasonable belief" standard that issuers may rely on in determining the residence of the purchaser to increase the utility of amended Rule 147 and Rule 147A by providing issuers with additional certainty about the availability of the exemptions. Whether an issuer has formed a "reasonable belief" that the prospective purchaser is an in-state resident will be determined on the basis of all facts and circumstances. The written representation required above will not, without more, be sufficient to establish a "reasonable belief" that such purchasers are in-state residents. In addition to the written representation, other facts and circumstances could include a pre-existing relationship between the issuer and the prospective purchaser that provides the issuer with sufficient knowledge about the prospective purchaser's principal residence, or evidence of the home address of the prospective purchaser in the form of a recently dated utility bill, pay-stub, state or federal tax return, government issued driver's license or identification card, or public or private database.

5) For a period of 6 months from the date of purchase of securities in a Rule 147 or Rule 147A offering, the purchaser may only resell the securities it purchases in such offering to residents of the issuer's state at the time of the offering. This 6-month limitation on resales applies to all holders of securities, including holders subsequent to the original purchaser,

whether they receive the shares as a gift, donation, or by purchase. If an issuer were to change its state of residence during the 6-month resale limitation period, all resales would continue to be limited to the state in which the issuer resided at the time of the original sale of securities. As long as the issuer takes reasonable steps to comply with this limitation on resales, e.g. by having legends, stop transfer instructions for transfer agents, and offeree and purchaser disclosures, the issuer will not lose the availability of the amended Rule 147 or Rule 147A exemption simply because a purchaser did not comply with the resale limitation.

6) Offers and sales of securities made pursuant to amended Rule 147 or Rule 147A will not be integrated with:

- Any prior offers or sales of securities made by the issuer under a different provision
- Any subsequent offers or sales of securities made by the issuer after completion of the Rule 147 or Rule 147A offering that are either (i) registered under the Securities Act, (ii) exempt from registration under Section 4(a)(6) of the Securities Act or under Regulation A, Regulation S, or Rule 701 under the Securities Act, (iii) made pursuant to an employee benefit plan, or (iv) made more than six months after completion of the Rule 147 or Rule 147A offering.

7) The issuer must include legends on all offering materials stating that sales and resales for a period of six months will be made only to residents of the issuer's state. Although this disclosure should be made to each offeree and purchaser at the time any offer or sale is made by the issuer, such disclosure to an offeree does not need to be made in writing; the issuer simply needs to provide the disclosure to offerees in the same manner in which an offer is communicated. Thus, the issuer may disclose this information orally to offerees if the offer is communicated orally. However, the issuer must provide written disclosure to all purchasers within a reasonable period of time before the date of sale of securities.

Of course, issuers relying on amended Rule 147 or new Rule 147A must comply with any additional requirements that may be imposed by state securities laws.

New SEC Rules Relating to Small Offerings: Amendments to Rule 504 (effective January 20, 2017) and Repeal of Rule 505 (effective May 22, 2017)

Background

Prior to the new SEC rules, Rule 504 of Regulation D under the Securities Act provided an exemption from Securities Act registration for securities offerings of up to $1 million in a 12-month period. Rule 505 of Regulation D under the Securities Act provided an exemption from Securities Act registration for securities offerings of up to $5 million in a 12-month period, provided that (i) the issuer limited offers and sales to 35 unaccredited investors (versus an unlimited number of unaccredited investors in a Rule 504 transaction) and gave certain financial information about the issuer to such unaccredited investors, and (ii) the issuer did not use any general advertising or general solicitation in the offering.

New Rules

The new SEC rules amend Rule 504 to (i) increase the aggregate amount of securities that may be offered and sold in any 12-month period from $1 million to $5 million and (ii) disqualify certain "bad actors" from participating in Rule 504 offerings (making Rule 504 consistent with the rest of Regulation D). As these amendments make Rule 505 less useful, the new rules also repeal Rule 505 (which has historically been used much less than Rule 506). The new rules will allow issuers to raise funds pursuant to Rule 504 in amounts equal to the current Rule 505 threshold of $5 million, without the additional limitations placed on Rule 505 offerings.

Conclusion

The SEC's changes to Rule 147 and adoption of new Rule 147A should give issuers greater flexibility in conducting intrastate offerings and expand the availability of these two intrastate offering exemptions by making it easier for issuers to comply with them. For example, Rule 147A now allows a Delaware corporation with its principal place of business in California to do a public offering in California under Section 25102(n) and be exempt from the federal securities law (previously, an issuer had to be incorporated in California as well as have its principal place of business in California in order to conduct a Section 25102(n) offering in California and be exempt from federal registration). Likewise, the SEC's changes to Rule 504 should also expand the capital raising avenues for smaller companies.

This article is intended to provide a general summary and should not be construed as a legal opinion nor a complete legal analysis of the subject matter. To learn more about how these new developments may facilitate your capital raising objectives, please contact June Lin (jlin@nvlawllp.com), Gerald Niesar (gniesar@nvlawllp.com) or Oscar Escobar (oescobar@nvlawllp.com).

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