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Crowdfunding news: SEC fixes significant potholes for intrastate offerings



By BENJI JONES, special to WRAL TechWire

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Editor's note: Benji Jones is a partner with the Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P. firm in Raleigh. She supported the N.C. crowdfunding legislation known as the NC PACES Act which was signed into law in August.

RALEIGH, N.C. - On October 26, the Securities and Exchange Commission (the "SEC") took steps to "update and modernize how companies can raise money from investors through intrastate and small offerings." These changes should make it easier for more companies to use NC PACES to raise capital.

In addition to various technical updates, here is the gist of what the SEC did:

There will now be two different paths for "local" exempt offerings.

The SEC created a new exemption for local offerings by adopting Rule 147A. The SEC also revised rules applicable to the historical intrastate offering exemption to incorporate some (but not all) of the changes implemented by Rule 147A. The SEC states that new Rule 147A would be "substantially identical" to revised Rule 147 (the existing safe harbor under Section 3(a)(11) of the Securities Act, which issuers have historically relied upon to conduct intrastate offerings), except that Rule 147A "would allow offers to be accessible to out-of-state residents and for companies to be incorporated or organized out-of-state".



The changes expand the types of companies that can use the exemptions.

Section 3(a)(11) of the Securities Act and Rule 147 permit an issuer to make offers and sales to residents of the state in which it is incorporated (or organized) and doing business. Under the old rules, a company had to be organized under the laws of North Carolina and had to satisfy all three prongs of Rule 147's "80-80-80 test" to be considered to be "doing business" in the state, requiring (a) 80% of its revenue comes from within the state, (b) 80% of its assets to be located in the state, and (c) 80% of the funds raised to be used to fund operations in the state. Any company that fails to satisfy all of these conditions was prohibited from using the intrastate offering exemption.

The SEC has significantly liberalized these restrictions under the new and revised rules. Now, under Rule 147A, any company (no matter where it is organized or incorporated) can conduct an exempt "local offering" in the state in which it has its "principal place of business" (where the officers, partners,

or managers of the company primarily direct, control, and coordinate the business's activities). To do so, it must establish that it has a meaningful presence within the state by satisfying at least ONE of the following FOUR "doing business" requirements:

- 80% of its revenues come from within the state,
- 80% of its assets are located in the state,
- 80% of the funds raised are to be used to fund operations in the state, or
- a majority of the company's employees are based in the state.

Companies conducting exempt offerings under the historical exemption (Section 3(a)(11) and Rule 147) would still need to be organized under the laws of the state in which it is making the offering, but otherwise would need to satisfy only one of the same four "doing business" requirements outlined above (rather than satisfying all three prongs of the historical 80-80-80 test).

Rule 147A offerings may be conducted across state lines (i.e., over the internet and without geographical restriction).

A company can use general solicitation/advertisement under an exempt intrastate offering, but historically the rules required that the offering be narrowly targeted to in-state residents only. Such a restriction can make the use of the internet (including social media) more challenging for traditional intrastate offerings.

Under new Rule 147A, companies will be permitted to make offers (but no sales) outside of the state where it is located as long as it limits sales to investors who are residents of the state. As a result, under Rule 147A,

Companies that continue to rely on Section 3(a)(11) and Rule 147 would still need to limit offers (as well as sales) within the state.

What does this mean for NC PACES?

Ideally, companies in North Carolina will be able to pursue either exemption under NC PACES. At this time, we are still in a holding pattern waiting for two sets of rules to become effective. First, these changes in federal law do not become effective until 150 days after publication in the Federal Register (which should be at the end of the first quarter of 2017). In addition, we will need to wait on the rules being implemented by the Secretary of State of North Carolina before companies can take advantage of NC PACES.

These rules, which are expected to be finalized in time for offerings to commence in early 2017, should explain the interplay with the new SEC rules and clarify what companies need to do to be eligible to use NC PACES and the manner by which they can reach potential investors.

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