Chapter 6

Replaces pp. 351-361

The next case applies the *Dirks* personal benefit test. What issues does the Supreme Court leave open in *Salman*?

Salman v. United States

-- U.S. – (2016).

■ ALITO, J.

Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b–5 prohibit undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage. Individuals under this duty may face criminal and civil liability for trading on inside information (unless they make appropriate disclosures ahead of time).

These persons also may not tip inside information to others for trading. The tippee acquires the tipper's duty to disclose or abstain from trading if the tippee knows the information was disclosed in breach of the tipper's duty, and the tippee may commit securities fraud by trading in disregard of that knowledge. In *Dirks v. SEC,* 463 U.S. 646 (1983), this Court explained that a tippee's liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information. A tipper breaches such a fiduciary duty, we held, when the tipper discloses the inside information for a personal benefit. And, we went on to say, a jury can infer a personal benefit—and thus a breach of the tipper's duty—where the tipper receives something of value in exchange for the tip or "makes a gift of confidential information to a trading relative or friend."

Petitioner Bassam Salman challenges his convictions for conspiracy and insider trading. Salman received lucrative trading tips from an extended family member, who had received the information from Salman's brother-in-law. Salman then traded on the information. He argues that he cannot be held liable as a tippee because the tipper (his brother-in-law) did not personally receive money or property in exchange for the tips and thus did not personally benefit from them. The Court of Appeals disagreed, holding that *Dirks* allowed the jury to infer that the tipper here breached a duty because he made a "gift of confidential information to a trading relative." Because the Court of Appeals properly applied *Dirks,* we affirm the judgment below.

I

Maher Kara was an investment banker in Citigroup's healthcare investment banking group. He dealt with highly confidential information about mergers and acquisitions involving Citigroup's clients. Maher enjoyed a close relationship with his older brother, Mounir Kara (known as Michael). After Maher started at Citigroup, he began discussing aspects of his job with Michael. At first he relied on Michael's chemistry background to help him grasp scientific concepts relevant to his new job. Then, while their father was battling cancer, the brothers discussed companies that dealt with innovative cancer treatment and pain management techniques. Michael began to trade on the information Maher shared with him. At first, Maher was unaware of his brother's trading activity, but eventually he began to suspect that it was taking place.

Ultimately, Maher began to assist Michael's trading by sharing inside information with his brother about pending mergers and acquisitions. Maher sometimes used code words to communicate corporate information to his brother. Other times, he shared inside information about deals he was not working on in order to avoid detection. Without his younger brother's knowledge, Michael fed the information to others—including Salman, Michael's friend and Maher's brother-in-law. By the time the authorities caught on, Salman had made over $1.5 million in profits that he split with another relative who executed trades via a brokerage account

on Salman's behalf.

Salman was indicted on one count of conspiracy to commit securities fraud, and four counts of securities fraud. Facing charges of their own, both Maher and Michael pleaded guilty and testified at Salman's trial.

The evidence at trial established that Maher and Michael enjoyed a "very close relationship." Maher "love[d] [his] brother very much," Michael was like "a second father to Maher," and Michael was the best man at Maher's wedding to Salman's sister. Maher testified that he shared inside information with his brother to benefit him and with the expectation that his brother would trade on it. While Maher explained that he disclosed the information in large part to appease Michael (who pestered him incessantly for it), he also testified that he tipped his brother to "help him" and to "fulfil[l] whatever needs he had." For instance, Michael once called Maher and told him that "he needed a favor." Maher offered his brother money but Michael asked for information instead. Maher then disclosed an upcoming acquisition. Although he instantly regretted the tip and called his brother back to implore him not to trade, Maher expected his brother to do so anyway.

For his part, Michael told the jury that his brother's tips gave him "timely information that the average person does not have access to" and "access to stocks, options, and what have you, that I can capitalize on, that the average person would never have or dream of." Michael testified that he became friends with Salman when Maher was courting Salman's sister and later began sharing Maher's tips with Salman. As he explained at trial, "any time a major deal came in, [Salman] was the first on my phone list." Michael also testified that he told Salman that the information was coming from Maher.

After a jury trial …, Salman was convicted on all counts. … Salman appealed to the Ninth Circuit. While his appeal was pending, the Second Circuit issued its opinion in *United States v. Newman,* 773 F.3d 438 (2014). There, the Second Circuit reversed the convictions of two portfolio managers who traded on inside information. The *Newman* defendants were "several steps removed from the corporate insiders" and the court found that "there was no evidence that either was aware of the source of the inside information." The court acknowledged that *Dirks* and Second Circuit case law allow a factfinder to infer a personal benefit to the tipper from a gift of confidential information to a trading relative or friend. But the court concluded that, "[t]o the extent" *Dirks* permits "such an inference," the inference "is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[1]

Pointing to *Newman,* Salman argued that his conviction should be reversed. While the evidence established that Maher made a gift of trading information to Michael and that Salman knew it, there was no evidence that Maher received anything of "a pecuniary or similarly valuable nature" in exchange—or that Salman knew of any such benefit. The Ninth Circuit disagreed and affirmed The court reasoned that the case was governed by *Dirks* 's holding that a tipper benefits personally by making a gift of confidential information to a trading relative or friend. Indeed, Maher's disclosures to Michael were "precisely the gift of confidential information to a trading relative that *Dirks* envisioned." To the extent *Newman* went further and required additional gain to the tipper in cases involving gifts of confidential information to family and friends, the Ninth Circuit "decline[d] to follow it."

We granted certiorari to resolve the tension between the Second Circuit's *Newman* decision and the Ninth Circuit's decision in this case.[2]

---

[1] The Second Circuit also reversed the *Newman* defendants' convictions because the Government introduced no evidence that the defendants knew the information they traded on came from insiders or that the insiders received a personal benefit in exchange for the tips. This case does not implicate those issues.

[2] *Dirks v. SEC,* 463 U.S. 646, (1983), established the personal-benefit framework in a case brought under the classical theory of insider-trading liability, which applies "when a corporate insider" or his tippee "trades in the securities of [the tipper's] corporation on the basis of material, nonpublic information." In such a case, the defendant

II

A

In this case, Salman contends that an insider's "gift of confidential information to a trading relative or friend," is not enough to establish securities fraud. Instead, Salman argues, a tipper does not personally benefit unless the tipper's goal in disclosing inside information is to obtain money, property, or something of tangible value. He claims that our insider-trading precedents, and the cases those precedents cite, involve situations in which the insider exploited confidential information for the insider's own "tangible monetary profit." He suggests that his position is reinforced by our criminal-fraud precedents outside of the insider-trading context, because those cases confirm that a fraudster must personally obtain money or property. More broadly, Salman urges that defining a gift as a personal benefit renders the insider-trading offense indeterminate and overbroad: indeterminate, because liability may turn on facts such as the closeness of the relationship between tipper and tippee and the tipper's purpose for disclosure; and overbroad, because the Government may avoid having to prove a concrete personal benefit by simply arguing that the tipper meant to give a gift to the tippee. He also argues that we should interpret *Dirks*'s standard narrowly so as to avoid constitutional concerns. Finally, Salman contends that gift situations create especially troubling problems for remote tippees—that is, tippees who receive inside information from another tippee, rather than the tipper—who may have no knowledge of the relationship between the original tipper and tippee and thus may not know why the tipper made the disclosure.

The Government disagrees and argues that a gift of confidential information to anyone, not just a "trading relative or friend," is enough to prove securities fraud. Under the Government's view, a tipper personally benefits whenever the tipper discloses confidential trading information for a noncorporate purpose. Accordingly, a gift to a friend, a family member, or anyone else would support the inference that the tipper exploited the trading value of inside information for personal purposes and thus personally benefited from the disclosure. …

The Government also argues that Salman's concerns about unlimited and indeterminate liability for remote tippees are significantly alleviated by other statutory elements that prosecutors must satisfy to convict a tippee for insider trading. The Government observes that, in order to establish a defendant's criminal liability as a tippee, it must prove beyond a reasonable doubt that the tipper expected that the information being disclosed would be used in securities trading. The Government also notes that, to establish a defendant's criminal liability as a tippee, it must prove that the tippee knew that the tipper breached a duty—in other words, that the tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue.

B

We adhere to *Dirks,* which easily resolves the narrow issue presented here.

In *Dirks,* we explained that a tippee is exposed to liability for trading on inside information only if the tippee participates in a breach of the tipper's fiduciary duty. Whether the tipper breached that duty depends "in large part on the purpose of the disclosure" to the tippee.. "[T]he test," we explained, "is whether the insider personally will benefit, directly or indirectly, from his disclosure." Thus, the disclosure of confidential information without personal benefit is not enough. In determining whether a tipper derived a personal benefit, we instructed courts to "focus

---

breaches a duty to, and takes advantage of, the shareholders of his corporation. By contrast, the misappropriation theory holds that a person commits securities fraud "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information" such as an employer or client. In such a case, the defendant breaches a duty to, and defrauds, the source of the information, as opposed to the shareholders of his corporation. The Court of Appeals observed that this is a misappropriation case, while the Government represents that both theories apply on the facts of this case. We need not resolve the question. The parties do not dispute that *Dirks*'s personal-benefit analysis applies in both classical and misappropriation cases, so we will proceed on the assumption that it does.

on objective criteria, *i.e.,* whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." This personal benefit can "often" be inferred "from objective facts and circumstances," we explained, such as "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient." In particular, we held that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist *when an insider makes a gift of confidential information to a trading relative or friend*." In such cases, "[t]he tip and trade resemble trading by the insider followed by a gift of the profits to the recipient." We then applied this gift-giving principle to resolve *Dirks* itself, finding it dispositive that the tippers "received no monetary or personal benefit" from their tips to Dirks, "*nor was their purpose to make a gift of valuable information to Dirks*."

Our discussion of gift giving resolves this case. Maher, the tipper, provided inside information to a close relative, his brother Michael. *Dirks* makes clear that a tipper breaches a fiduciary duty by making a gift of confidential information to "a trading relative," and that rule is sufficient to resolve the case at hand. As Salman's counsel acknowledged at oral argument, Maher would have breached his duty had he personally traded on the information here himself then given the proceeds as a gift to his brother. It is obvious that Maher would personally benefit in that situation. But Maher effectively achieved the same result by disclosing the information to Michael, and allowing him to trade on it. *Dirks* appropriately prohibits that approach, as well. *Dirks* specifies that when a tipper gives inside information to "a trading relative or friend," the jury can infer that the tipper meant to provide the equivalent of a cash gift. In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds. Here, by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, Maher breached his duty of trust and confidence to Citigroup and its clients—a duty Salman acquired, and breached himself, by trading on the information with full knowledge that it had been improperly disclosed.

To the extent the Second Circuit held that the tipper must also receive something of a "pecuniary or similarly valuable nature" in exchange for a gift to family or friends, we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*.

C

Salman points out that many insider-trading cases—including several that *Dirks* cited—involved insiders who personally profited through the misuse of trading information. But this observation does not undermine the test *Dirks* articulated and applied. Salman also cites a sampling of our criminal-fraud decisions construing other federal fraud statutes, suggesting that they stand for the proposition that fraud is not consummated unless the defendant obtains money or property. Assuming that these cases are relevant to our construction of § 10(b) (a proposition the Government forcefully disputes), nothing in them undermines the commonsense point we made in *Dirks*. Making a gift of inside information to a relative like Michael is little different from trading on the information, obtaining the profits, and doling them out to the trading relative. The tipper benefits either way. The facts of this case illustrate the point: In one of their tipper-tippee interactions, Michael asked Maher for a favor, declined Maher's offer of money, and instead requested and received lucrative trading information.

We reject Salman's argument that *Dirks* 's gift-giving standard is unconstitutionally vague as applied to this case. *Dirks* created a simple and clear "guiding principle" for determining tippee liability, and Salman has not demonstrated that either § 10(b) itself or the *Dirks* gift-giving standard "leav[e] grave uncertainty about how to estimate the risk posed by a crime" or are plagued by "hopeless indeterminacy." At most, Salman shows that in some factual circumstances assessing liability for gift-giving will be difficult. That alone cannot render "shapeless" a federal criminal prohibition, for even clear rules "produce close cases." We also reject Salman's appeal to the rule of lenity, as he has shown "no grievous ambiguity or uncertainty that would trigger the rule's application." To the contrary, Salman's conduct is in the heartland of *Dirks* 's rule concerning gifts. It remains the case that "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts." But there is no

need for us to address those difficult cases today, because this case involves "precisely the 'gift of confidential information to a trading relative' that *Dirks* envisioned.

III

Salman's jury was properly instructed that a personal benefit includes "the benefit one would obtain from simply making a gift of confidential information to a trading relative." As the Court of Appeals noted, "the Government presented direct evidence that the disclosure was intended as a gift of market-sensitive information." And, as Salman conceded below, this evidence is sufficient to sustain his conviction under our reading of *Dirks*. Accordingly, the Ninth Circuit's judgment is affirmed.

NOTES

1. *Knowledge.* The *Newman* case, discussed in Salman, required prosecutors prove the tippee's knowledge of the personal benefit received by the tipper. *Salman* does not disturb this holding from *Newman.* On this point, the *Newman* court declined to follow *SEC v. Obus*, 693 F.3d 276 (2d Cir. 2012) in a criminal context. In *Obus*, the Second Circuit held that:

> tipper liability requires that (1) the tipper had a duty to keep material non-public information confidential; (2) the tipper breached that duty by intentionally or recklessly relaying the information to a tippee who could use the information in connection with securities trading; and (3) the tipper received a personal benefit from the tip. Tippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tippee improperly obtained the information (i.e., that the information was obtained through the tipper's breach); and (3) the tippee, while in knowing possession of the material non-public information, used the information by trading or by tipping for his own benefit.

Obus does not appear to require that the tippee know that the tipper received a personal benefit in disclosing the information, i.e., knowing that the information was disclosed in breach of a duty of confidentiality is sufficient.

QUESTIONS

1. What counts as a personal benefit after *Salman*? What is excluded?

2. What state of mind must be shown to establish tipper liability in a criminal case? A civil case?

3. What hazards does tippee liability create for hedge fund managers and other active traders?

CHAPTER 9

Replaces pp. 559-588

I. REGULATION D

Although some offerings clearly fall within § 4(a)(2), substantial areas of uncertainty remain. Founders setting up a corporation and putting in cash in exchange for the corporation's initial capital stock are certainly within the scope of § 4(a)(2). When the corporation accepts first-round investments from venture capitalists, do these transactions also fall within the ambit of § 4(a)(2)? If the venture capitalists can "fend for themselves" and have access to information equivalent to that provided in the registration statement, then § 4(a)(2) exempts the transaction from § 5. Suppose, however, that the growing corporation then turns to other groups of investors including: (a) family and friends; (b) wealthy individuals; and (c) smaller institutional investors. Will the offering to these investors also fall under § 4(a)(2)?

The penalty for guessing incorrectly stings. If § 4(a)(2) does not apply, § 5 applies (absent another exemption). If the issuer is not exempt from § 5, then the issuer will face possible § 12(a)(1) liability. Recall that § 12(a)(1) does not require a showing of scienter, causation, reliance or even a material misstatement or omission. Instead, § 12(a)(1) imposes strict liability for violations of § 5. The harshness of the § 12(a)(1) remedy deters issuers from making a private placement unless they are confident of their exemption from § 5.

To provide issuers greater certainty in private placements, the SEC promulgated Regulation D of the Securities Act (Rules 500–508). Rule 506 provides a safe harbor for the § 4(a)(2) exemption. Although Regulation D does not eliminate all uncertainty, it is far more predictable than § 4(a)(2). Consider the interaction of Regulation D and § 4(a)(2). Assuming that Regulation D is somewhat narrower than § 4(a)(2), how does the safe harbor rule affect the structuring of private placements? If you were the CEO of a corporation contemplating a private placement, under what circumstances would you step outside the boundaries of Regulation D and "push the envelope" of what the law allows under § 4(a)(2)?

The starting point to understanding Regulation D is Rules 504 and 506. These rules set forth the requirements for the two exemptions under Regulation D. Although we started our discussion with § 4(a)(2), only Rule 506 is a § 4(a)(2) exemption. Offerings under Rules 504 fall under § 3(b)(1) of the Securities Act, which allows the SEC to exempt from § 5 offerings up to $5 million. Two other provisions establish the framework for Regulation D. Rule 501 provides definitions used throughout Regulation D. Rule 502 sets forth the various requirements incorporated in the two offering exemptions found in Rules 504 and 506.

The two types of Regulation D offerings differ in the eligibility of certain issuers to use the exemptions. Rule 506 is open to all issuers. Rule 504 prohibits not only investment companies and "blank check" companies, but also Exchange Act reporting issuers. Rules 504 and 506 also disqualify certain issuers involved in a past securities laws violation. The exclusion of Exchange Act reporting issuers limits Rule 504 offerings to smaller companies without a liquid secondary trading market. Excluding blank check companies prevents smaller, development stage companies without a specific business plan or purpose from using Rule 504. The following table summarizes the exclusions from Regulation D.

	Rule 504 (§ 3(b)(1))	**Rule 506 (§ 4(a)(2))**
Excluded Issuers	Not '34 Act Co. Not Investment Co. Not Blank Check Co. Disqualification per Dodd-Frank Act	Disqualification per Dodd-Frank Act

Regulation D offerings under Rules 504 and 506 also differ with respect to the following categories:

- aggregate offering price
- purchasers
- general solicitation
- disclosure
- resale restrictions

We examine each criterion in turn. As you read the materials, see if you can figure out why Rule 506 offerings dominate exempt offerings (well over 90%, both in number and dollar amount).

A. AGGREGATE OFFERING PRICE

The most conspicuous difference between the Regulation D exemptions is the offering amount allowed, i.e., "aggregate offering price." Under Rule 504, issuers may sell up to $5 million of securities; under Rule 506, issuers may sell an unlimited amount.

Constraining the aggregate offering price limits the potential scope of a Rule 504 offering. Smaller offerings are less likely to involve widespread public selling efforts. Individual retail investors are therefore also unlikely to invest in such smaller offerings.

The aggregate offering price limit raises two questions. Why might an issuer prefer a Rule 504 offering over a Rule 506 offering, which does not limit the offering amount? The answer, of course, is that the requirements for a Rule 506 private placement are more restrictive.

Second, what prevents an issuer from simply doing repeated Rule 504 offerings to evade the offering price limitation? For example, a corporation could sell $5 million on May 1, $5 million on June 1, $5 million on June 15, etc. This strategy is thwarted by aggregation rules that determine the aggregate offering price for Rule 504. Under Rule 504, issuers must reduce the offering price ceiling—$5 million for Rule 504—by the amount of securities sold in the twelve months preceding the offering pursuant to either (1) another offering under Rule 504, or (2) an offering made in violation of § 5. Thus, a corporation that sold $5 million of securities on May 1 under Rule 504 would have its aggregate offering price ceiling for a subsequent Rule 504 offering limited to $0 until May 1 of the next year.

HYPOTHETICAL TWO

Trendy decides to do a Regulation D offering to raise capital for its contemplated expansion of the marketing and distribution of Trendy's Lean Green drink.

1. Scenario One: Suppose that Trendy raises $1 million per month over a five-month period from January 2015 to May 2015. Sales are made to 25 unsophisticated purchasers. Do either of the Regulation D offering types exempt Trendy from § 5?

2. Scenario Two: After raising $5 million from January 2015 to May 2015, on February 1, 2016, Trendy decides to engage in a new round of financing. Trendy seeks to raise an additional $5 million quickly in an exempt offering to twenty unsophisticated purchasers. Can Trendy sell securities under either of the Regulation D exemptions?

3. Scenario Three: Suppose that earlier in June 2014, Trendy sold $10 million of common stock attempting to use § 4(a)(2). Trendy made the mistake of selling to 25 investors without providing either information or access. How does this 2014 offering affect Trendy's January to May, 2015 sale of securities in Scenario One?

B. PURCHASERS

The SEC's central concern with unregistered offerings is the broad-based sales of securities to the general public. Many public investors lack investment sophistication, leading them to purchase overvalued securities. In addition, public investors may feed off of each other's excessive optimism, driving the price of overvalued securities still higher. Regulation D addresses this concern by restricting purchasers.

First, Regulation D limits the number of purchasers. Rule 506 limits offerings to a maximum of 35 purchasers. Rule 504, however, does not limit the number of purchasers, instead the $5 million aggregate offering price indirectly constrains the number of purchasers.

The 35-purchaser ceiling under Rule 506 has an enormous loophole. Rule 501(e) excludes certain investors from the count of purchasers. For example, under Rule 501(e)(1)(i) any "relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser" is not counted as a separate purchaser. More importantly, Rule 501(e)(1)(iv) excludes "accredited investors" from the purchaser tally. Because of the accredited investor exclusion, Rule 506 allow sales to an unlimited number of "accredited investors" plus not more than 35 persons who are not "accredited investors." In practice, most offerings are sold exclusively to accredited investors.

Who counts as an accredited investor? Many of the categories involve large entities and institutions, including banks, broker-dealers, and insurance companies. Trusts, partnerships, and corporations also qualify if they have a minimum of $5 million in total assets, among other requirements. In addition, Rule 501(a) defines three additional categories of accredited investors:

- Rule 501(a)(4): Any director, executive officer, or general partner of the issuer of the securities.
- Rule 501(a)(5): Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000.
- Rule 501(a)(6): Any natural person whose individual income exceeded $200,000 in each of the two most recent years or whose joint income with his/her spouse exceeded $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

The concept of accredited investors is central to Regulation D. Because accredited investors are excluded from the calculation of the number of purchasers, issuers may sell to an unlimited number of accredited investors under Rule 506. Rule 506 has no limit on the aggregate offering price. As a legal matter, then, an issuer can sell an unlimited amount of securities under Rule 506 (i.e., into the billions of dollars) to an unlimited number of accredited investors.

Outside of Regulation D, Securities Act § 4(a)(5) exempts offers and sales to accredited investors from § 5. Offerings under § 4(a)(5) are limited to the $5 million limit established under § 3(b)(1). Issuers or anyone acting on behalf of the issuer may not engage in "advertising or public solicitation." Section 4(a)(5) also requires that issuers file a notice of the transaction with the SEC, which is done on Form D. Presumably because of the $5 million limit, issuers rarely rely on § 4(a)(5) exclusively as an exemption from § 5.

Issuers typically rely on placement agents to provide access to pre-screened pools of accredited investors. Placement agents maintain databases of potential accredited investors, typically determining accredited status using information found in suitability questionnaires filled out by the investors. But what if an investor lies or makes a mistake on the questionnaire? Rule 501(a) provides that the issuer need only "reasonably" believe that an investor falls in one of the specified categories of accredited investors.

Even accredited investors have a limited appetite for privately placed securities. The chief constraint on that appetite is that securities sold through Regulation D are "restricted": Resales are limited unless the securities are registered under § 5 or the selling investor finds an exemption from § 5. Rule 144, covered in Chapter 10, provides such an exemption, allowing resales of restricted securities after a specified holding period of six months (for reporting issuers) or one year (for non-reporting issuers). If the accredited investors decide to rebalance their portfolios, or need to raise cash for some other reason, the investors will be unable to sell the restricted securities immediately.

Regulation D did not originally provide for inflation adjustment for the income and net worth tests for individuals to become accredited investors. Since the income and net worth numerical thresholds were implemented in April 1982, inflation has substantially eroded those limits. One million dollars in 1982 is the equivalent of $2.43 million in 2015, so the $1 million net worth eligibility requirement is effectively less than half of what it was when Regulation D was introduced. Failing to adjust for inflation has allowed an ever-expanding group of individuals to qualify as accredited investors. The net worth test, moreover, did not take into account the mix

of assets that go into a person's net worth. Should a person whose net worth consists entirely of marketable securities be treated differently from a person whose net worth consists almost entirely of the person's house?

In 2010, Congress stepped in to compel the SEC to revise its accredited investor definition. The Dodd-Frank Act requires the SEC to adopt rules adjusting the $1 million net worth test for a natural person to become an accredited investor to exclude the "value of the primary residence of such national person." Dodd-Frank Act § 413(a). Beyond the $1 million net worth test, the Dodd-Frank Act instructs that SEC to undertake a review of the definition of an accredited investor as applied to natural persons to determine whether the definition should be adjusted "for the protection of investors, in the public interest, and in light of the economy." Dodd-Frank Act § 413(b). Starting in 2014, the Act requires the SEC to undertake a subsequent review of the accredited investor definition "in its entirety" at least once every four years thereafter.

In early 2012, the SEC adopted a rule adjusting the net worth test for a natural person accredited investor under Rule 501(a)(5). The SEC also provided parallel adjustments to the definition of accredited investor under Rule 215, which defines the term accredited investor under § 2(a)(15) of the Securities Act for purposes of the § 4(a)(5) exemption. Under the new rule, both equity and liability in the investor's primary residence are excluded, unless the liability exceeds the fair market value of the home.

HYPOTHETICAL THREE

Trendy decides to do a Regulation D offering under Rule 506 to raise capital for its contemplated expansion of the marketing and distribution of Trendy's Lean Green drink. Sales are made to 35 unsophisticated purchasers. Trendy also makes sales to the following investors. Do these additional sales create any problems under Regulation D?

1. Scenario One: Trendy sells securities in the offering to all of its executive vice presidents, including to Alan, the VP for drink research and Laura, the VP for human resources.

2. Scenario Two: Trendy sells securities in the offering to Dale. Dale is a retiree who has a stock portfolio of $1.1 million; the entire portfolio is invested in index funds and Dale has no other significant assets or debts. Dale lives off the dividends from the portfolio (along with limited sales of capital) to pay for monthly expenses. (Dale lives in San Francisco where rents can run up to $3,000 per month for his one-bedroom apartment.) Dale has no other source of income, but enjoys golfing.

3. Scenario Three: Trendy sells securities to Beth. Beth has a Ph.D. in financial economics from the University of California, Berkeley. Beth worked only one year for Morgan Stanley before being fired for insider trading. During that year, however, Beth made $2,000,000 from her trading efforts and has a net worth today of $700,000 (after paying stiff civil penalties to the SEC). Beth now froths milk for cappuccinos and makes $15.00 an hour.

4. Scenario Four: What if Beth shares an apartment with Andrei, one of the 35 unsophisticated purchasers in the offering. If Beth and Andrei are simply good friends (but nothing more), does Beth count as a purchaser, thereby increasing the total to 36 purchasers?

5. Scenario Five: Trendy sells securities to the Trendy Investment Partnership. TIP was formed a month prior to Trendy's offering and has 50 partners. None of the partners, individually, is an accredited investor. TIP's total net assets are $1 million.

In comparing the two Regulation D offerings, issuers face a tradeoff between the restrictions on the aggregate offering price and the number of purchasers. Rule 504 imposes no limit on purchasers but restricts offerings to $5 million. Rule 506, in contrast, restricts the number of non-accredited purchasers to 35 (plus an unlimited number of accredited purchasers) and allows offerings with no aggregate offering price limit. But Rule 506 offerings face an additional regulatory constraint not present for Rule 504 offerings: Rule 506 purchasers who are not accredited investors must also meet a sophistication requirement. Purchasers must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." Rule 506(b)(2)(ii)

How are issuers supposed to determine whether an investor (alone or with a purchaser representative) is able to evaluate the merits and risks of an investment? One could imagine issuers looking to factors such as:

- Wealth and income (much like for accredited investor status for individuals)
- Experience (general business or more specific to securities investment?)
- Education
- Present investment status (well-diversified????
- Performance on an investment test (like qualifying for a driver's license)

Among these factors, which ones are mostly likely to correlate with an investor's ability to assess the merits and risks of investments? How expensive would it be for an issuer to administer such a screen for sophistication? What risk would the issuer run that a court or the SEC may later question the accuracy and reasonableness of the screen? In practice, because Rule 506's sophistication requirement is somewhat vague, many Rule 506 offerings exclude non-accredited investors altogether and sell only to accredited investors.

The following table summarizes the tradeoff between aggregate offering price and purchaser restrictions for the two types of Regulation D offerings:

	Rule 504 (§ 3(b)(1))	**Rule 506 (§** 4(a) **(2))**
Aggregate Offering Price	≤ $5 million (Rules 504(b)(2), 501(c)) Prior 12 mo. and during offering aggregation with other Rule 504 offerings and § 5(a) violations	Unlimited
Number of Purchasers	No limit on purchasers	≤ 35 non-accredited Purchasers; Unlimited accredited purchasers (Rules 506(b)(2)(i), 501(a), 501(e)) Sophistication requirement (Rules 506(b)(2)(ii), 501(h))

HYPOTHETICAL FOUR

1. Scenario One: Trendy decides to raise $20 million through a common stock offering under Rule 506 of Regulation D. Among the purchasers is Howard, who is not an accredited investor. Howard spent a year and a half in business school studying the financial markets, before dropping out. Howard presently sells cool drinks from a street side vending stand in Manhattan. Do Howard's purchases jeopardize Trendy's Rule 506 exemption?

2. Scenario Two: Suppose that Howard turns to his friend Nicole, an investment banker, to help him with his investment decisions. Do Howard's purchases jeopardize the Rule 506 exemption?

3. Scenario Three: What if Nicole, Howard's potential purchaser representative, is also a director of Trendy, Inc.?

C. GENERAL SOLICITATION

Rules 506's restrictions on the number and sophistication of *purchasers* do not necessarily address § 4(a)(2)'s concern for *offerees*. Broad-based offerings to the general public may lead the public in to a "frenzy," overwhelming the valuations of sophisticated investors.

To address this concern, Regulation D addresses "offerees" separately from purchasers. Rule 502(c) bans general solicitations and advertising. This ban applies to 506(b) offerings. Rule 504 exempts issuers from Rule 502(c) if the issuer meets certain state law offering requirements. Rule 504 issuers may avoid the general solicitation ban of Rule 502(c) if the issuer sells exclusively in a state that provides for the registration of the securities under state law and also requires the public filing and delivery to investors of a "substantive disclosure document" prior to sale. Rule 504(b)(1)(i)–(iii).

In certain areas, the application of Rule 502(c) is clear. Suppose an issuer decides to run television commercials publicizing an upcoming private placement under Rule 506(b). This clearly would count as general advertising. Including a disclaimer in the advertisement restricting the solicitation to an arbitrary subset of the general public will not change this result. Suppose the placement agent for the issuer (typically an investment bank assisting with the private placement) creates a glossy offering pamphlet for the private placement and mails the pamphlet out to the following groups:

- all redheads in the United States
- all residents of Ann Arbor, Michigan
- all students taking civil procedure at NYU Law School

Although these groups are restricted, they do not create any meaningful restriction in the sense of culling out investors based on sophistication or ability to "fend for themselves."

The harder question arises with respect to investors who are selected at least somewhat based on their financial sophistication or wealth (from which sophistication perhaps can be assumed?). Consider the following groups:

- all executive officers of the *Fortune 500* companies
- all finance professors in the United States
- the 50 wealthiest people in the United States as identified in *Forbes*

Would an unsolicited mailing of an offering pamphlet to these investors run afoul of the prohibition on general solicitations?

In the Matter of Kenman Corp.

S.E.C., [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,767 (Apr. 19, 1985).

* * *

During certain times from on or about August 29, 1983 through May 15, 1984, Kenman Securities and Kenman [the parent corporation of Kenman Securities] participated in two limited partnerships offerings. Missiondale Palms Associates ("Missiondale") is a Utah limited partnership organized in August 1983 to acquire an apartment complex in Tucson, Arizona. Kenman is the general partner of Missiondale. From on or about August 29, 1983, Kenman through Kenman Securities sold limited partnership interests in Missiondale to 39 investors who invested a total of $875,000. No registration statement under the Securities Act was filed with the Commission or is in effect concerning the Missiondale limited partnership interests.

Orem Dairy Queen Associates ("Orem Associates") is a Utah limited partnership organized in January 1984 to acquire land and a franchise for a Dairy Queen restaurant and to construct and operate the restaurant in Orem, Utah. Kenman is the general partner of Orem Associates. From on or about January 13, 1984, Kenman through Kenman Securities sold limited partnership interests in Orem Associates to 25 investors who invested a total of $280,000. No registration statement was filed with the Commission or is in effect concerning the Orem Associates limited partnership interests. A Form D was filed with the Commission with respect to the Orem Associates offering, on or about March 2, 1984, which offering was made pursuant to Rule 506 of Regulation D.

In early 1983, Kenman and Kenman Securities mailed information concerning Missiondale to an unknown number of persons. This information included a one page cover letter, a four page promotional document and a reply card to request a personal sales meeting with Kenman's president. Kenman and Kenman Securities also mailed similar information concerning Orem Associates to an unknown number of persons in early 1984.

Persons to whom Kenman and Kenman Securities sent materials were chosen from six sources. First, they utilized a list of persons who had participated in prior offerings by them. Second, they reviewed the annual reports of fifty "Fortune 500" companies and obtained the names of executive officers. The third source was a list of names of persons who had previously invested $10,000 or more in real estate offerings by issuers other than Kenman. This list was purchased by Kenman from a third party. The fourth source was a list of physicians in the State

of California. The fifth source was a list of managerial engineers employed by Hughes Aircraft Company or by similar companies. Sixth, Kenman obtained a copy of the Morris County, New Jersey Industrial Directory and selected names of the presidents of certain listed companies.

Kenman and Kenman Securities did not keep sufficiently detailed records to identify the specific persons or the actual number of persons to whom information was sent concerning the Missiondale and the Orem Associates offerings. However, information concerning the offerings were sent to a number of persons on a list of names compiled from these sources. ...

* * *

Based on the foregoing, the Commission finds that Kenman and Kenman Securities willfully violated Sections 5(a) and 5(c) of the Securities Act in that they offered and sold limited partnership interests in Missiondale and Orem Associates when no registration statement was filed with the Commission or was in effect and no exemption from registration was available.

* * *

Kenman and Kenman Securities relied on the exemption from registration under Section 4[a](2) of the Securities Act with respect to the Missiondale and Orem Associates offerings. In addition, the Orem Associates offering was structured to qualify under the "safe harbor" provided by Rule 506 of Regulation D.

An offering pursuant to Rule 506 must comply with Rules 501 through 503 of Regulation D. Rule 502(c) precludes the offer and sale of securities "by any form of general solicitation or general advertisement ...." Section 4[a](2) of the Securities Act provides an exemption from registration for "transactions by an issuer not involving any public offering." The exemption from registration under Section 4[a](2) is not available to an issuer that is engaged in a general solicitation or general advertising.

The Commission concludes that Kenman and Kenman Securities engaged in general solicitations[6] and therefore the exemptions from registration under Section 4[a](2) with respect to the Missiondale and Orem Associates offerings and the safe harbor of Rule 506 of Regulation D with respect to the Orem Associates offering were not available.

* * *

QUESTIONS

1. What result if Kenman had only sold to those investors that had purchased before from Kenman?

2. The Kenman decision states: "The exemption from registration under Section 4[a](2) is not available to an issuer that is engaged in a general solicitation or general advertising." Is this consistent with Ralston Purina and Doran?

---

[6] In determining what constitutes a general solicitation, the Commission's Division of Corporation Finance has underscored the existence and substance of pre-existing relationships between the issuer and those being solicited. Kenman admits that persons who received the Orem Associates mailings had no pre-existing relationship with Kenman. These persons were selected only because their names were on lists that were purchased or created by Kenman. Although the make-up of the lists may indicate that the persons themselves have some degree of investment sophistication or financial well-being, utilization of lists of thousands of persons with no pre-existing relationship to the offeror clearly does not comply with the limitation of Rule 502(c) on the manner of solicitation. Here, Kenman mailed information concerning Orem Associates not only to previous Kenman investors, but to an unknown number of persons with whom Kenman had no prior contact or relationship.

SEC No-Action Letter Mineral Lands Research & Marketing Corporation

Publicly Available December 4, 1985.

LETTER TO SEC
March 21, 1985

Office of Chief Counsel
Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Gentlemen:

We are writing on behalf of our client Mineral Lands Research & Marketing Corporation for your advice concerning a proposed offering of the Company's securities without registration under the Securities Act of 1933 in reliance on the exemption contained in Rule 504 of Regulation D promulgated under the Act.

BACKGROUND

The Company was formed for the purpose of locating, identifying and acquiring mineral properties with a view to selling, developing or joint venturing the properties. The Company proposes to raise up to $500,000 through the sale of its equity securities in reliance upon the exemption from registration contained in Rule 504. The Company does not intend to rely on the exemption from the application of the provisions of Rule 502(c) and (d) contained in Rule 504(b)(1). Potential investors will be provided with a disclosure document containing substantially the same information as would be included in a Registration Statement on Form S–18 under the Act. All sales will be effected through the officers and directors of the Company who will not receive any commissions or any other additional remuneration in connection with the sales. It is anticipated that most of the offers and sales will be made through one officer and director of the Company to individuals with whom he has a prior existing business relationship, although a limited number of offers and sales are anticipated to be made through other officers and directors. This officer and director is a licensed insurance broker and is the owner of a sole proprietorship through which he sells a variety of insurance and financial products. He proposes to offer the Company's securities to up to 600 of his existing clientele and anticipates that each investor will purchase between $500 and $2,000 of the Company's securities. It is likely that most of the investors will neither qualify as "accredited investors" within the meaning of Rule 501(a) of Regulation D nor be sophisticated investors.

DISCUSSION

Rule 502(c) of Regulation D provides as a condition to the availability of the Rule 504 exemption that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising." Although there is no limitation on the number of offerees or purchasers involved in offerings pursuant to Rule 504 as there is with offerings pursuant to Rule 506, the Commission has indicated "that depending on the actual circumstances, offerings made to such large numbers of purchasers may involve a violation of the prohibitions against general solicitation and general advertising."

The Staff of the Commission has taken the position that the mailing of a written offer by an issuer to up to 330 persons having a pre-existing relationship with the general partner of the issuer would not exceed the terms of Rule 502(c). The Staff also noted, however, that the general partner had determined that the investment was suitable for the proposed investors and that they had the requisite sophistication. Although this latter condition will most likely not be satisfied as to a majority, if not all, of the investors in the Company's proposed offering, we nonetheless believe that the proposed manner of offering by the Company would not constitute general advertising or general solicitation because most of the offerees are a limited group with whom an officer and director of the issuer has a pre-existing business relationship and Rule 504 does not require that the investment be suitable for the purchaser or that the purchaser be sophisticated.

REQUEST

We respectfully request that the Division concur with our opinion and advise us that it would not recommend any action to the Commission if the Company proceeds with the offering of securities described above. We understand that such a position would be based upon the facts and circumstances described in this letter and that any different facts or conditions might require a different response.

* * *

[Eds.—In the typical no-action letter, the SEC staff's response follows immediately after the requesting letter as set forth below:]

SEC LETTER

* * *

You have requested that the Division take a no-action position with respect to the availability of an exemption from Regulation D. As the Commission stated in its adopting release for Regulation D, the staff will not issue no-action letters with respect to transactions under Regulation D. Your letter does, however, present an interpretive issue to which we will respond. That question concerns the application of Rule 502(c) to the Company's proposal to offer securities to persons with whom officers and directors of the Company have prior business relationships.

The class of offerees includes 600 persons who are existing clients of an officer who is an insurance broker. It is your view that the proposed manner of offering would not constitute general advertising or solicitation because most of the offerees consist of a limited group with whom an officer and director of the issuer has pre-existing business relationships.

The Division agrees with your view that the existence of relationships between an issuer and offerees is an important factor in determining whether offers violate Rule 502(c). The types of relationships with offerees that may be important in establishing that a general solicitation has not taken place are those that would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration. As your letter does not include sufficient facts to enable us to make a determination whether the type of relationship contemplated is present, the Division is unable to express a view on this matter.

* * *

How do brokerage firms acting as placement agents in a private placement obtain the requisite pre-existing relationships with investors? The SEC in a series of no-action letters has indicated that brokerage firms may actively solicit investors with a general interest in investing in private placements. *See* EF Hutton, SEC No-Action Letter (Dec. 3, 1985); Bateman Eichler, Hill Richards, SEC No-Action Letter (Dec. 3, 1985). The solicitation may not mention any particular private placement offering. Moreover, the solicitations must take place a sufficient amount of time prior to any contemplated offering to enable the brokerage firm to assess the sophistication of the investors. On-line offeree questionnaires followed by screening on the part of brokerage firms are acceptable. *See* IPOnet, SEC No-Action Letter (July 26, 1996).

The JOBS Act, enacted in 2012, directed the SEC to adopt rules removing the Rule 502(c) prohibition against general solicitation and general advertising. Congress ordered the repeal of the general solicitation ban, however, only for Rule 506 offerings sold solely to accredited investors. In 2013, the SEC implemented Congress's directive to permit general solicitation if all of the investors in a Rule 506 offering are accredited investors. Issuers relying on the new rule must take reasonable steps to verify that the purchasers are accredited investors. The changes are found in Rule 506(c).

The JOBS Act and Rule 506(c) do not eliminate the prohibition on general solicitation altogether. The prohibition still applies to Rule 506(b) offerings if not all purchasers are accredited. Issuers are therefore faced with a choice. They can structure their offerings to sell only to accredited investors, thereby avoiding general solicitation prohibition. This option under Rule 506(c) comes with a cost, however, as it requires that the issuer verify the accredited investor status of participants in the offering. The second option, under Rule 506(b), does not allow for general solicitation, but it does allow the issuer to rely on self-verification of accredited investor status by participants in the offering. To date, most issuers have chosen Rule 506(b), apparently preferring self-verification over the opportunity to engage in a general solicitation.

HYPOTHETICAL FIVE

Trendy moves forward with a Rule 506 offering to raise $10 million for its expansion campaign for the Lean Green drink. Eager to find investors for the offering, Kim, the CEO of Trendy, employs West Securities to help sell the offering. Mark, the managing partner of West Securities, is working to sell the securities. Are these sales practices permissible under Rule 502(c)?

1. Scenario One: Mark walks up and down his alma mater's health club locker room, the Yale Club in New York, telling everyone about his offering, passing out offering circulars, and collecting purchase requests. Assume that Mark, a gregarious fellow, knows everyone in the health club on a first-name basis.

2. Scenario Two: Suppose Trendy tells West Securities that it will reduce its offering down to $5 million in order to fit within Rule 504. Mark again goes to solicit interest from among his friends at the health club.

3. Scenario Three: Mark goes to the financial district in Boston and drops in unannounced at the offices of large mutual fund managers for Fidelity, Scudder, Dreyfus, and other prominent mutual funds (all very sophisticated investors). Mark again passes out offering circulars and collects purchase requests. Mark only knows of the mutual fund managers by reputation, having seen their names repeatedly in the Wall Street Journal.

4. Scenario Four: Trendy completes a Rule 506(b) offering on January 1 for $10 million in common stock, selling to ten accredited investors and twenty sophisticated purchasers (none of whom are accredited). Later in the year, Trendy makes a Rule 504 offering for $4 million of common stock from July 1 to July 30, selling to 30 unsophisticated purchasers. Trendy makes another Rule 504 offering for $1 million of common stock from December 1 to December 15 of the same year, selling to five unsophisticated purchasers. If Trendy engaged in general solicitation in all three offerings, is Trendy able to qualify for Rule 504 for the latter two offerings? (Assume no integration of the offerings.)

D. DISCLOSURE

The public offering process focuses on the registration statement and statutory prospectus. These documents are intended to reduce the informational advantage that issuers have over public investors. Of course, no one forces an investor to purchase securities in an offering. Investors can always simply walk away if an issuer does not provide information. Nonetheless, in the public offering context, mandatory disclosure may be justified if some investors lack the sophistication to recognize the importance of disclosure. Similarly, if a large number of investors invest in an offering, no one investor may expend the resources to bargain with the issuer to obtain disclosure. If the issuer is the least cost provider of information—e.g., on firm-specific information relating to the issuer itself—then forcing the issuer to make such disclosure may benefit all investors.

Do these same arguments apply for a private placement to a small number of sophisticated investors? Instead of many retail investors clamoring for the latest IPO stock, picture instead ten mutual funds, a hedge fund, and an insurance company considering whether to purchase securities in a private placement. Part of the rationale behind *Ralston Purina's* "fend for themselves" formulation is that for some types of investors, the stringent protections of the securities laws are unnecessary (i.e., not cost-justified).

Private placements under Regulation D do not entirely eliminate disclosure. Rule 502(b) divides Regulation D along two dimensions: (1) the type of investor (accredited or not) and (2) the

type of offering (Rule 504 v. Rule 506). Based on this division, the following disclosure is mandated:

	Non-Accredited Investor	**Accredited Investor**
Rule 504 Offering	No specific disclosure required	No specific disclosure required
Rule 506 Offering	Specific disclosure required by Rule 502(b)(2)	No specific disclosure required

Issuers do not need to provide any disclosure to accredited investors pursuant to Rule 502(b)(1). Issuers making a Rule 504 offering also face no mandatory disclosure requirements, at least under the federal securities laws, although they may face state securities registration requirements. Rule 502(b)(1). For Rule 506 offerings to a non-accredited investor, the type of disclosure mandated under Rule 502(b)(2) then varies based on: (1) the type of issuer and (2) the size of the offering.

	Non-Exchange Act Reporting Company	**Exchange Act Reporting Company**
Offerings up to $2 million	Non-financial info under Rule 502(b)(2)(i)(A) Financial info under Rule 502(b)(2)(i)(B)(1)	Rule 502(b)(2)(ii)
Offerings up to $7.5 million	Non-financial info under Rule 502(b)(2)(i)(A) Financial info under Rule 502(b)(2)(i)(B)(2)	Same as above
Offerings over $7.5 million	Non-financial info under Rule 502(b)(2)(i)(A) Financial info under Rule 502(b)(2)(i)(B)(3)	Same as above

The disclosure for Exchange Act reporting issuers does not vary by offering amount. Instead, Exchange Act reporting issuers have a choice. They may either provide a combination of the most recent annual report, the definitive proxy statement, and (only if requested by the purchaser in writing) the most recent Form 10–K or just the most recent Form 10–K if it contains the information found in the annual report. Rule 502(b)(2)(ii)(A) & (B). In either case, issuers must also disclose any more recent Exchange Act filings made since those filings. Also, issuers must provide "a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs that are not disclosed in the documents furnished." Rule 502(b)(2)(ii)(C).

For non-Exchange Act reporting issuers, Rule 502(b)(2)(i)(A) provides for the same non-financial disclosure regardless of offering amount. Rule 502(b)(2)(i)(A) makes reference to the "same kind" of information contained in Part I of the registration statement used in a public offering.

The offering amount becomes important only for disclosure of financial information by non-Exchange Act reporting issuers. Rules 502(b)(2)(i)(B)(1) through (3) mandate different levels of financial disclosure. Generally, as the offering amount increases, the level of financial disclosure increases (with a greater audit requirement). Students can trace the requirements through the following referenced forms:

- Up to $2 million: Article 8 of Regulation S–X (except only the issuer's balance sheet must be audited).

- Up to $7.5 million: Financial statement information contained in Form S–1 for smaller reporting companies (except only the audited balance sheet is required if obtaining audited financial statements takes "unreasonable effort or expense").
- Over $7.5 million: Financial statement information contained in the public offering registration statement (except only the audited balance sheet is required if obtaining audited financial statements takes "unreasonable effort or expense").

In addition, Rule 502(b) provides a catchall provision to ensure that non-accredited investors receive notice of information given to accredited investors. The issuer must give non-accredited investors a brief written description of "any material written information concerning the offering that has been provided by the issuer to any accredited investor" not already given to the non-accredited investors. Rule 502(b)(2)(iv). Also, if the non-accredited investor provides a written request for the information, the issuer must furnish the information to the non-accredited investor within a reasonable time prior to the purchase.

The issuer must also give each purchaser the "opportunity to ask questions and receive answers" relating to the offering. Rule 502(b)(2)(v). The issuer must also supply any additional information necessary to verify the accuracy of the specific mandatory disclosure items in Rules 502(b)(2)(i) and (ii) upon the request of any purchaser provided the "issuer possesses or can acquire without unreasonable effort or expense" the information.

HYPOTHETICAL SIX

Kim, the CEO of Trendy Inc., wants your advice regarding disclosure for Trendy's upcoming Rule 506 private placement of $10 million in common stock. She has the following questions.

1. If Trendy sells only to accredited investors, what information must Trendy disclose?

2. What information should Trendy disclose voluntarily to the accredited investors?

E. RESALE RESTRICTIONS

Securities sold through Regulation D generally cannot be freely resold with one exception. Investors that purchase securities sold through a Rule 504 offering that complies with the state law registration requirement specified by Rule 504(b)(1) may freely resell the securities. A liquid public secondary market is possible immediately after a Rule 504 offering. The small size of the Rule 504 offering (limited to $5 million) and state law restrictions may, however, limit the development of any secondary market in the Rule 504 securities.

For Rule 506 offerings, Rule 502(d) explicitly restricts resales. Regulation D securities "have the status of securities acquired in a transaction under section 4[a](2) of the Act and cannot be resold without registration under the Act or an exemption therefrom." Rule 502(d). Not only are the securities sold through Regulation D so-called "restricted securities," but Rule 502(d) imposes a requirement that the *issuer* take reasonable care to discourage investors from reselling the securities (at least under circumstances in which the purchasers would be deemed "underwriters" under § 2(a)(11)). Among other things, the issuer can disclose in writing the unregistered status of the securities and place a legend on the securities indicating that they have not been registered under the Securities Act, although this is not the exclusive means by which resale can be restricted.

One difficulty created by Regulation D's "restricted" securities is that the Securities Act does not regulate securities, but instead focuses on transactions. Consider the application of § 4(a)(1)'s exemption from § 5. As long as the *transaction* does not involve an issuer, underwriter, or dealer, investors may freely resell even a restricted security even though the security has never been registered for a public offering. As we will see in Chapter 10, the key concept for resales is whether the investor is acting as an underwriter for the issuer. If the investor has underwriter status, the § 4(a)(1) exemption is unavailable, thereby rendering any resale subject to the registration requirements of § 5.

What is the downside of owning a restricted security? Investors hope for a positive future return when they purchase a security. Common stock provides a return directly through dividends. In addition, a security holder may also benefit through capital appreciation. Many companies, however, do not pay dividends—particularly high growth companies—because

earnings are plowed back into building the business. As a company's anticipated profits grow, so does its stock price. Investors can exploit this capital appreciation by selling their securities. Restrictions on resale, therefore, severely impinge the ability of investors to realize their capital appreciation. Investors interested in diversifying their portfolio cannot do so if resale is restricted. As we will see in Chapter 10, investors can resell even restricted securities, but those avenues are limited. Consequently, private placement investors typically require an illiquidity discount to induce them to purchase.

HYPOTHETICAL SEVEN

What would be wrong with permanently prohibiting the resale of "restricted" securities without registration by the issuer? Consider the effect of an indefinite ban on resales in the following two scenarios.

1. Scenario One: Trendy, Inc. issues $10 million of common stock in a private placement. Trendy is not listed on an exchange. Few investors know much about Trendy's business or finances.

2. Scenario Two: Megasoft, Inc. issues $10 million of common stock in a private placement. Megasoft's common stock trades on the NYSE; it has a market capitalization of $200 billion. Several analysts follow Megasoft and regularly issue opinions evaluating its common stock.

F. INTEGRATION

Issuers must reduce the aggregate offering price ceiling for Rule 504 offerings to account for prior offerings under § 3(b) and in violation of § 5. The reduction in the aggregate offering price ceiling prevents issuers from easily avoiding the offering amount limitation through multiple, separate offerings closely spaced in time.

Issuers may devise other strategies to divide offerings artificially to evade other Regulation D requirements. For example, Rule 506 offerings impose a limit of 35 purchasers. An issuer may divide an offering for $10 million to 60 purchasers into two parts—selling $5 million to 30 purchasers in two "separate" offerings—to avoid the 35-purchaser limit.

Or, suppose an issuer seeks to sell $9 million of securities to 40 accredited investors with whom the issuer has a pre-existing relationship, and $1 million to twenty individual investors with whom the issuer has no pre-existing relationship. Such an offering would violate Rule 502(c)'s prohibition on general solicitation due to the presence of the individual investors. Nonetheless, the issuer could seek to characterize the offering as two separate offerings: one offering of $9 million to the 40 accredited investors with the preexisting relationship under Rule 506; and a second offering of $1 million to the twenty individual investors under Rule 504, to which the general solicitation ban does not apply (assuming state law registration requirements are met). Left unconstrained, issuers would be free to break apart transactions, evading many of Regulation D's limitations.

The integration doctrine restrains the ability of issuers to recharacterize offerings strategically. Several factors are relevant in determining whether seemingly separate offers and sales should be treated as one transaction (integrated). These factors are:

- whether the sales are part of a single plan of financing
- whether the sales involve issuance of the same class of securities
- whether the sales have been made at or about the same time
- whether the same type of consideration is received
- whether the sales are made for the same general purpose

Securities Act Release No. 4552 (November 6, 1962)

To provide greater certainty for issuers, the SEC in Regulation D provides a safe harbor from integration under Rule 502(a). Rule 502(a) applies six months prior to the start of the offering and six months after the *end* of the offering. To illustrate, imagine that a Regulation D private placement occurs from 7/1/15 to 8/1/15 as depicted below:

Minus	Start	End	Plus
6 months	Offering	Offering	6 months
1/1/15	7/1/15	8/1/15	2/1/16

Two time periods are important for the Rule 502(a) safe harbor: (a) the *safe harbor window* stretching from the beginning of the pre-offering six-month period to the end of the post-offering six-month period (1/1/15 to 2/1/16 in the diagram above) and (b) the *six-month periods window* consisting of the pre-offering and post-offering six month periods but not the time period of the offering itself (1/1/15 to 7/1/15 and 8/1/15 to 2/1/16 in the diagram above).

Sales outside the *safe harbor window* are deemed separate from the Regulation D offering, with one exception. During the *six-month periods window*, if the issuer offers or sells securities that "are of the same or similar class as those offered or sold under Regulation D," then the issuer loses the safe harbor entirely.

HYPOTHETICAL EIGHT

1. Scenario One: Trendy is contemplating a private placement to raise $10 million to fund its Lean Green drink expansion campaign. Trendy wants to raise this money through sales using a broker-dealer that has contacts with 35 individual investors (non-accredited but sophisticated) who want in the aggregate to purchase $5 million of common stock. Trendy also plans on making cold calls to 35 individual investors (assume accredited) to sell the remaining $5 million of common stock. If there were no integration doctrine, how could Trendy structure its transactions within Regulation D, allowing it to raise all this money in the next month?

2. Scenario Two: Suppose Trendy instead decides to do the following two offerings:

> On January 1, Trendy conducts a Rule 504 offering of preferred stock sold through its brokers to investors with whom the company has a pre-existing relationship. The offering raises $5 million and the proceeds are used to expand its Lean Green production facilities. Thirty purchasers (non-accredited) participate in the offering.
>
> Exactly two years later, Trendy decides to hire a new marketing consultant and engage in a new marketing campaign for Lean Green. To fund the campaign, Trendy conducts a private placement under Rule 506 for $10 million of bonds to ten purchasers (non-accredited) in return for the purchasers' marketing efforts.

3. Scenario Three: Suppose Kim reads Rule 502(a) and decides to structure the following series of transactions:

> On 1/1 Trendy makes a Rule 504 offering for $1 million of common stock selling to ten individual purchasers (non-accredited and unsophisticated) through broker-dealers who have pre-existing relationships with the purchasers. The offer closes on 1/1 and is all cash. The proceeds are used to expand the Lean Green production facilities.
>
> On 3/1 Trendy makes a Rule 506 offering for $10 million of common stock, selling to 35 individual purchasers (non-accredited) through broker-dealers with pre-existing relationships with the purchasers. The offer closes on 3/1 and is all cash. The proceeds are also used to expand the Lean Green production facilities.
>
> Trendy on 11/1 decides to conduct a Rule 504 offering, selling $4 million of common stock to 25 former law students with whom the CEO has pre-existing relationships (all took the CEO's securities regulation class a few years ago but alas remain unsophisticated). The offering is all in cash and the proceeds are used to fund a new office building for Trendy's executive officers.

Are there any problems with these offerings?

G. INNOCENT AND INSIGNIFICANT MISTAKES

To err is human; fortunately, Regulation D forgives (some) mistakes. Under Rule 508, failure to comply with a requirement for a Rule 504 or 506 offering will not necessarily result in a loss of exemptions for an offer or sale to a particular individual or entity.

Recall that in our study of the gun-jumping rules for registered public offerings, we did not see an explicit "insignificant and innocent" defense for issuers. Issuers that inadvertently condition the market in the Pre-Filing Period or innocently include additional free writing with the preliminary prospectus in the Waiting Period violate § 5 unless they comply with one of the various safe harbors. Moreover, a defect in the offer or sale of securities to *one* investor would taint the offering for all investors, with the consequence that the entire transaction would violate § 5. Section 12(a)(1) then provides a strict liability private cause of action for all those who purchased securities sold in the offering. Even if the mistake is innocent or trivial, investors can rescind their purchases, recovering their full purchase price under § 12(a)(1).

Given the SEC's hard stance with regard to registered offerings, why does Regulation D excuse insignificant and innocent mistakes? Indeed, in some ways, mistakes are harder to justify in a Regulation D offering. Because Regulation D is relatively bright-line, issuers have an easier time complying. Does Rule 508 result in issuers taking a lax approach to complying with Regulation D requirements?

One possible justification for Rule 508 is that the average investor in a Regulation D offering is more sophisticated compared with investors in a public offering. Presumably such sophisticated investors are able to "fend for themselves" and thus do not necessarily need the full gamut of securities law protections.

Although more generous than the gun-jumping rules, Rule 508's forgiveness is limited in several respects. First, Rule 508 does not shield the issuer from SEC enforcement actions. The SEC may bring an enforcement action against the issuer for violation of § 5 under § 20 of the Securities Act. Rule 508 only shields the issuer from private actions under § 12(a)(1).

Second, Rule 508 limits excuse to those situations where "failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity." Thus, if the issuer failed to deliver the required disclosure under Rule 502(b) to a particular investor and that investor sues for violation of § 5, the issuer cannot rely on Rule 508 to cure the defect in its use of Regulation D. If *other* investors (who did receive the information under Rule 502(b)) complain about the lack of information given to a particular investor, however, the issuer may then invoke Rule 508 to bar the claim of these other investors.

Third, even if the failure to comply was not related to a requirement directly intended to protect the particular investor suing, Rule 508 will also be unavailable to the issuer unless the failure to comply was "insignificant with respect to the offering as a whole." This exclusion has real teeth; certain types of failures to comply are defined by the SEC as significant, thereby making Rule 508 inapplicable. The failures relate to the following (as listed in Rule 508(a)(2)):

- the general solicitation prohibition (Rule 502(c))
- the aggregate offering price limit (Rule 504(b)(2))
- the limit on the number of purchasers (Rule 506(b)(2)(i))

Finally, Rule 508(a)(3) requires that "[a] good faith and reasonable attempt was made to comply with all applicable terms, conditions, and requirements of Rule 504 or 506."

HYPOTHETICAL NINE

Trendy conducts a private placement for $10 million of common stock under Rule 506, selling to five large hedge funds (all accredited investors with pre-existing relationships with Trendy and the placement agent for the offering) and 36 sophisticated, non-accredited purchasers (all lower-level Trendy employees). Two of the non-accredited purchasers tell Trendy that they are cousins and live in the same house. Consider how Rule 508 may apply to the following circumstances.

1. Scenario One: It turns out that the cousins are not in fact cousins, but just friends (and they lied on their offeree questionnaire about their status). The hedge funds sue under § 12(a)(1) to rescind their purchases.

2. Scenario Two: Suppose instead that Trendy simply forgot to mail the required disclosures under Rule 502(b) to the cousins. The cousins eventually get the information after they make their purchases. The hedge funds sue under § 12(a)(1) to rescind their purchases.

3. Scenario Three: Suppose that one of the non-accredited investors was not an employee and had no pre-existing relationship with Trendy. The hedge funds sue under § 12(a)(1) to rescind their purchases.

H. DISQUALIFICATION

In 2013 the SEC promulgated rules to implement disqualification for Rule 506 pursuant to Dodd-Frank under Rule 506(d). In 2015, the SEC applied the Rule 506(d) disqualification provisions to Rule 504. Rule 504(b)(3). Rule 506(d)'s disqualification is based on the presence of specified bad acts on the part of two groups of potential participants in the private placement.

- The issuer, including any predecessors or any affiliated issuer (termed the "issuer" here)
- Key individuals and entities connected with the issuer or the offering (termed the "related participants" here). These include any director or officer of the issuer, beneficial owner of 20 percent or more of any class of its equity securities, and any promoter of the issuer presently connected with it in any capacity. Also included is any person that is paid for the solicitation of purchasers in connection with the Rule 506 offering (including typically the private placement agent assisting the issuer in the offering) as well partner, director, or officer of the soliciting agent.

The presence of a bad act on the part of the issuer or a related participant results in the issuer losing the exemption under Rule 506. Rule 506(d)(1) thus punishes the issuer for associating with related participants that have engaged in prior bad acts.

For the issuer and related participants in a Rule 506 private placement, an important subset of bad acts includes past securities-related wrongdoings. The past securities-related wrongdoing must be in connection with the purchase or sale of any security, relate to a false filing with the SEC, or involve the "conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities." Rule 506(d) disqualification follows if the bad act has led to (among other consequences):

- A conviction for any felony or misdemeanor related to the purchase or sale of securities in the ten years prior to the sale of securities under Rule 506 involving the past securities-related wrongdoing. For issuers, including predecessors or any affiliated issuers, the time period is shortened to five years prior to the sale of securities under Rule 506. *See* Rule 506(d)(1)(i).
- A court order, judgment, or decree entered within five years of the sale of securities under Rule 506 restraining or enjoining the individual or entity from engaging or continuing to engage in any conduct or practice related to the past securities-related wrongdoing. *See* Rule 506(d)(1)(ii).

Outside of these specific past securities-related wrongdoings, issuers are also disqualified from Rule 506 if either the issuer or related participant, is subject to one of the following restrictions:

- A final order from state securities commissions, a state authority that supervises or examines financial institutions, a state insurance commission, an "appropriate" federal banking agency, the U.S. Commodity Futures Trading Commission, or the National Credit Union Administration that, among others, bars the specific party from association with the other regulator, bars the specific party from engaging in the business of securities, insurance or banking, or "[c]onstitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale." Rule 506(d)(1)(iii).
- Certain SEC orders that, among others, at the time of the sale of securities under Rule 506, suspends of revokes the specific party's registration as a broker, dealer, municipal securities dealer, or investment advisor or otherwise limits their activities. Rule 506(d)(1)(iv).
- An SEC order entered into within five years of the sale of securities under Rule 506 that orders the specific party to "cease and desist from committing or causing a

violation or future violation of" any scienter-based antifraud provision of the federal securities laws (including Rule 10b–5) or § 5 of the Securities Act. Rule 506(d)(1)(v).

- A suspension or expulsion from membership in FINRA or a national securities exchange "for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade." Rule 506(d)(1)(vi). This restriction also covers individuals who are barred from associating with a member for such conduct.
- "[A] stop or refusal order under § 8 [entered within five years of the Rule 506 sale] or is at the time of the Rule 506 sale of securities the subject of an SEC investigation or proceeding to determine whether a stop order should be issued. Rule 506(d)(1)(vii).

Rule 506 gives discretion to the SEC to waive the disqualification if "the Commission determines that it is not necessary under the circumstances that an exemption be denied." Rule 506(d)(2)(ii). In addition, the issuer may avoid disqualification if: "the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed under [Rule 506(d)(1)]." Rule 506(d)(2)(iv). The instructions to Rule 506(d)(2)(iv) then state: "An issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualifications exist. The nature and scope of the factual inquiry will vary based on the facts and circumstances concerning, among other things, the issuer and the other offering participants."

In addition to the specific disqualification provisions under Rule 506(d), Rule 507 applies a general disqualification from the use of Regulation D. The disqualification provision under Rule 507 is narrow, focusing solely on issuers that in the past have failed to comply with the notice filing requirement of Rule 503.

The SEC used its authority to waive disqualification upon a showing of "good cause" in the following SEC administrative order.

Order Under Rule 506(d) of the Securities Act of 1933 Granting a Waiver of the Rule 506(d)(1)(ii) Disqualification Provision In the Matter of Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith, Inc.

S.E.C. Rel. No. 9421 (Nov. 25, 2014).

* * *

Bank of America, N.A. and Merrill Lynch, Pierce, Fenner & Smith Inc. (the "Respondents"), submitted a letter dated November 18, 2014, requesting that the Securities and Exchange Commission (the "Commission") grant a waiver of disqualification under Rule 506(d)(1)(ii) of Regulation D... upon entry of the final judgment (the "Judgment") by the United States District Court for the Western District of North Carolina Charlotte Division. The Judgment enjoins the Respondents from committing violations of Sections 17(a)(2) and (3), and Section 5(b)(1) of the Securities Act of 1933.

Rule 506(d)(2)(ii) of Regulation D provides that disqualification "shall not apply. upon a showing of good cause and without prejudice to any other action by the Commission, if the Commission determines that it is not necessary under the circumstances that an exemption be denied." The Commission has determined that as part of the Rule 506(d)(2)(ii) showing of good cause, the Respondents will comply with the following:

A. Retain, at Respondents' expense and within sixty (60) days of the issuance of this Order, a qualified independent consultant (the "Consultant") not unacceptable to the Staff. Respondents shall require the Consultant to conduct a comprehensive review of the policies and procedures relating to compliance with Rule 506 of Regulation D by Respondents and the subsidiaries of Respondents conducting any activities that would otherwise be disqualified pursuant to the Judgment (together with Respondents, the "Rule 506 Entities").

B. Cooperate fully with the Consultant, including providing the Consultant with access to the Rule 506 Entities' files, books, records, and personnel as reasonably requested for the review, obtaining the cooperation of employees or other persons under Respondents' control, and permitting the Consultant to engage such assistance (whether clerical, legal, technological, or of any other expert nature) as necessary to achieve the purposes of the retention.

C. Require the Consultant to complete its review and submit a written preliminary report ("Preliminary Report") to the Respondents and Commission staff within three hundred and sixty (360) days of the issuance of this Order. …

D. Within one hundred and eighty (180) days of receipt of the Preliminary Report, adopt and implement all recommendations contained in the Preliminary Report. …

E. Within one hundred and eighty (180) days from the date of the Respondents' implementation of the recommendations contained in the Preliminary Report, require the Consultant to submit a final written report ("Final Report") to the Respondents, including their principal executive officers and principal legal officers, and Commission staff. The Consultant shall certify in the Final Report that the Respondents have implemented the recommendations contained in the Preliminary Report and that the Respondent's policies and procedures designed to ensure compliance by the Rule 506 Entities with their obligations under Rule 506 of Regulation D are reasonably designed to achieve their stated purpose.

F. On or after the date that the Respondents have adopted and implemented all recommendations referenced in paragraph D of this Order, and in no event earlier than the date when the Final Report is delivered pursuant to paragraph E of this Order, the Respondents may apply to the Commission for a waiver covering the remaining 30 months in the disqualification period that are not covered by this Order.

G. Require the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Rule 506 Entities, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. . . .

H. To ensure the independence of the Consultant, Respondents shall not have the authority to terminate the Consultant without prior written approval of Commission staff and shall compensate the Consultant and persons engaged to assist the Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

Based on the foregoing, Commission has determined that pursuant to Rule 506(d)(2)(ii) of Regulation D under the Securities Act a showing of good cause has been made that it is not necessary under the circumstances that the exemptions be denied.

* * *

QUESTIONS

1. Why did Bank of America and Merrill Lynch need to cooperate with the SEC's "good cause" conditions to obtain a waiver from disqualification?

2. Is the SEC getting "two bites at the apple" through the "good cause" provision? Presumably the SEC got the sanctions the court deemed appropriate in the underlying case against Bank of America and Merrill Lynch. Why should the SEC then get to impose further remedial requirements on the bad actor as a condition for the waiver under Rule 506(d)(2)(ii)?

I. OTHER ASPECTS OF REGULATION D

1. STATE SECURITIES REGULATION

Long before the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, states imposed "Blue Sky" regulations, starting with Kansas in 1911. Today states vary

widely in their methods of regulation. Some states, such as New York, do not require registration of securities (except for securities sold in real estate or intrastate offerings) and instead impose only antifraud liability. Other states, including California, Texas, and Wisconsin, require issuers to meet a merit test, prohibiting issuers from offering or selling securities that failed to meet certain substantive criteria (and thus are deemed "unfair" for investors). Most states combine disclosure with limited merit review. Although the predominant number of states model their Blue Sky laws after the Uniform Securities Act of 1956 and the Revised Uniform Securities Act of 1985, with variations across different states, the model codes do not specify a single method of securities regulation. Instead, the "uniform" acts allow states to pick and choose from among antifraud liability, disclosure, and merit regulation options.

The diversity of regulatory approaches among the states forced issuers selling securities in multiple states to spend time and resources to comply with each states' securities registration requirements. In 1996, Congress narrowed the scope of state securities regulation with the National Securities Markets Improvement Act of 1996 (NSMIA). Certain "covered securities," including securities listed or approved for listing on the NYSE, AMEX and Nasdaq are exempted from state securities registration requirements. Covered securities also include securities issued in an exempt offering under Rule 506. Consequently, states may not require the registration of securities offered and sold under Rule 506. States may nonetheless require that Rule 506 issuers notify the states of the offering and to impose a notification fee. Although NSMIA bars state registration of certain securities, states can continue to investigate and enforce their antifraud laws.

Under NSMIA, covered securities do not include securities exempt from registration pursuant to Rules 504 of Regulation D. State Blue Sky regulation may potentially apply to Rule 504 offerings as a result. Covered securities also do not include securities offered and sold under § 3(a)(11) of the intrastate offering exemption. We discuss the intrastate offering exemption later in the chapter.

Despite the potential application of Blue Sky registration requirements to Rule 504 offerings, most states have adopted exemptions from registration. The states vary in their requirements for an exemption. Several states have moved over the past decade to adopt the Uniform Securities Act of 2002. Under the 2002 Act, states provide for an exemption from state registration for all sales and offers to institutional investors. The 2002 Act also provides an exemption for sales to 25 or fewer investors in a 12-month period so long as the issuer restricts advertisement of the offering, pays commissions only to registered broker-dealers or agents, and makes sales only to those whom the issuer reasonably believes has investment intent. The 25 or fewer investor exemption does not impose any sophistication, net worth, income, or other requirement on the investors.

2. Rule 504

Rule 504 excuses issuers from the requirements imposed under Rule 506, including the general solicitation ban (Rule 502(c)), disclosure (Rule 502(b)), and resale restriction (Rule 502(d)). An issuer complying with Rule 504 may solicit offers broadly without disclosing any information. Investors purchasing through a Rule 504 offering, moreover, may immediately resell the securities into the public secondary markets. Issuers complying with Rule 504 can essentially engage in a mini-public offering.

There are two caveats, however, to this observation. First, Rule 504 is limited in its aggregate offering price to $5 million and it excludes Exchange Act reporting issuers. The mini-public offering allowable under Rule 504 therefore is primarily of use for small, less well-followed issuers that need to raise small amounts of capital. The ability to engage in general solicitation and avoid disclosure may not matter if only more sophisticated investors participate in the market for such offerings. Sophisticated investors will presumably demand disclosure and will have the wherewithal to fend for themselves despite receiving a general solicitation, but are such investors interested in such small-scale offerings?

Second, issuers using Rule 504 to avoid the general solicitation and resale restrictions of Regulation D must meet certain requirements related to state law registration requirements. First, the issuer may sell securities in states, such as California, that provide for state registration of the securities and the "public filing and delivery to investors of a substantive disclosure

document before sale." Issuers that sell securities in "accordance with those state provisions" may avoid the application of Rule 502(c) (general solicitation) and Rule 502(d) (resale restrictions). Rule 504(b)(1)(i). Second, issuers may also sell in states that have no state registration requirement, such as New York, so long as they comply with the registration and public filing and delivery requirements of another state, such as California. Issuers must ensure that "the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure)." Rule 504(b)(1)(ii). Third, issuers may make sales "[e]xclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to 'accredited investors' as defined in Rule 501(a)." Rule 504(b)(1)(iii).

3. FORM D

Rule 503 requires that issuers making a Rule 504 or 506 offering file a Form D with the SEC. The issuer has until the fifteenth day after the start of the offering to file Form D. No immediate penalty results if an issuer fails to file Form D. Rule 507, however, provides that an issuer may not use Regulation D if it is subject to an order, judgment, or decree by any court enjoining it from violating Rule 503.

Form D contains basic information on the issuer and the offering, including the promoters of the offering, 10% beneficial owners, and the executive officers and directors of the issuer, broker-dealers assisting with the offering and their commission, the minimum investment required of an investor, and the offering price, the number of investors, expenses, and use of proceeds.

4. EXCHANGE ACT FILING

Exchange Act reporting issuers of equity securities in an unregistered offering must also file a Form 8–K with the SEC. Item 3.02(a) of Form 8–K provides that the issuer must report the information specified in Item 701 of Regulation S–K, including information on the securities sold, the underwriters and other purchasers, the consideration received for the securities, the use of proceeds, and the exemption claimed from § 5. If the equity securities sold in the unregistered offering account for less than 1% of the outstanding equity securities of the same class, Item 3.02(b) exempts the issuer from the Form 8–K filing requirement (an even more generous exemption applies for small business issuers). All Exchange Act reporting issuers, including those exempt under Form 8–K, must provide similar information on unregistered sales of securities in their periodic Form 10–K and 10–Q filings unless already reported in a prior filing. Because the Form 8–K filing requirement applies to all unregistered sales, issuers must file a Form 8–K not only for Regulation D offerings, but also for § 4(a)(2), intrastate, Regulation S, and other offerings exempt from § 5.

J. THE PRIVATE PLACEMENT PROCESS

Although the legal requirements for a private placement are complicated, many issuers successfully sell securities through a private placement under § 4(a)(2) or Regulation D. How does the typical private placement work? This depends on the size of the offering. If a company sells securities to its top officers, the offering will typically take place under § 4(a)(2) without much formality.

If the company is offering securities to outside investors, the issuer will hire a placement agent to assist in the offering. Most private placements are done as best efforts offerings under which the placement agent is compensated through a commission for each security sold in the offering and reimbursed for expenses.

The placement agent, much like an underwriter in a registered public offering, will first review the business and finances of the issuer. One goal of this initial review is to give the placement agent the opportunity to develop a "due diligence" package to give to investors who are considering the offering. The review will also result in a plan of financing. This recommendation may include timing, types of securities, and amounts to be raised through a private placement. In some cases, a third party rating agency may then rate the issuer and the offered securities (particularly debt).

Once a plan of financing is agreed upon and the issuer moves forward with a private placement, the placement agent will also help write up a private placement memorandum. No specific SEC form dictates the exact contents of the private placement memorandum, although Rule 502(b) specifies what information must be included. The memorandum typically contains similar information to a public offering statutory prospectus, detailing the issuer's business, properties, management, and financials. The requirements of the securities laws aside, most sophisticated investors in the private placement market will not buy offerings that lack a private placement memorandum containing this standardized information.

Once the private placement memorandum is ready, the placement agent will begin marketing the offering. This involves contacting investors with whom the agent has a pre-existing relationship (complying with the general solicitation prohibition in Regulation D). For issuers unfamiliar with the private placement market, the placement agent will guide the issuer toward investors most likely to participate in the offering and provide advice on selling the offering. The placement agent may also set up roadshow meetings between the issuers and investors. Investors, for their part, may look to the placement agent to screen issuers, recommending only viable, worthwhile investments. The due diligence package created by the placement agent will also assist investors in valuing the private placement.

Investors wishing to participate in the offering may then negotiate terms with the issuer. In a bond offering, for example, investors will focus particular attention on the covenants in the bond indenture. Such terms may include maximum debt-equity ratios, restrictions on dividends, and so on. Once investors make the decision to purchase, the private placement agent will assist with the execution of the subscription agreements and the transfer of money and securities.

Section 4(a)(2) and Regulation D provide the most important set of exemptions from § 5's registration requirement. We finish our coverage of offering exemptions with four additional exemptions from registration: Regulation A, Crowdfunding, the intrastate offering exemption under § 3(a)(11) and Rules 147 and 147A of the Securities Act, and Regulation S.

Given the availability of § 4(a)(2) and Regulation D, why have Congress and the SEC provided these additional exemptions? Section 4(a)(2) and Regulation D focus primarily on the needs of the investors (i.e., are the investors able to fend for themselves), the relatively small scope of the offering, and the selling efforts. What other reasons push Congress and the SEC to exempt offerings from § 5? Paramount are: (1) the needs of small business issuers; (2) the presence of an alternative regulatory regime (state-based securities regulation); and (3) the importance of national boundaries and the need to respect the authority of other countries.

Replaces pp. 605-627

V. CROWDFUNDING

Crowdfunding has its roots outside of the formal capital markets, drive by the rise of the Internet. The Internet allowed groups of people to pool their money through websites, such as kickstarter.com, to fund various artistic and other creative endeavors. People typically contributed money without regard to investment return, for projects such as the development of a video game, the filming of documentaries, or the writing of a first novel. In return for their funding, project sponsors typically promised contributors copies of the completed video game, a digital download of the finished documentary film, or first edition copies of their book.

When crowdfunding fundraisers offer the people contributing money the prospect of financial returns from business activities then the fundraisers run the risk of having this "equity model" of crowdfunding deemed an offer or sale of a security under the federal securities laws. One consequence for equity crowdfunding is the application of § 5 of the Securities Act and the gun-jumping rules. The securities law antifraud provisions would also apply.

To regulate equity crowdfunding, Congress enacted the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (the CROWDFUND Act) as part of the JOBS Act of 2012. Pursuant to Congress's instructions, the SEC promulgated Regulation Crowdfunding. The JOBS Act exempts equity crowdfunding from § 5 Securities Act § 4(a)(6). Unlike the § 4(a)(2) or Rule 506 exemptions from § 5, the JOBS Act does not restrict the types of investors who may participate in crowdfunding, so retail investors are included. The JOBS Act, however, does exclude certain issuers from crowdfunding including foreign issuers, Exchange Act reporting issuers, and investment companies. Securities Act § 4A(f). These exclusions are in keeping with purpose of crowdfunding to facilitate capital formation by early stage companies.

A. AGGREGATE OFFERING LIMITS

The JOBS Act limits both the quantity that issuers can sell and investors can buy. An issuer can sell no more than an aggregate $1 million to all investors in a 12-month period in reliance on § 4(a)(6). Rule 100(a)(1) Regulation Crowdfunding. An issuer will often raise capital through different types of offerings that occur close in time. If an issuer raises capital through § 4(a)(6) crowdfunding, the amount sold will reduce the amount the issuer may raise for the next 12 months through another crowdfunding offering. Rule 100(a)(1). If an issuer raises capital through another type of exempt transaction, however, such as a Regulation D private placement, this separately raised capital will not aggregate for purposes of the $1 million issuer sales limit. Rule 100(a)(1).

Section 4A(h) provides that the SEC must adjust the $1 million issuer aggregate sales limit at least every five years to account for inflation. The $1 million limit parallels the $1 million aggregate offering price limitation in Rule 504 and severely limits the appeal of crowdfunding for most issuers, especially if they have an established business. Only smaller lesser-known companies—for example new Internet startups—are likely to take advantage of crowdfunding.

Given the high compliance costs that follow a crowdfunding offering, including ongoing reporting requirements, it is unclear why an issuer would want to incur such costs to raise only $1 million. Moreover, other types of exempt offerings, including Regulation D, do not carry those ongoing costs. It is possible that companies may value the "buzz" that the company will receive from a well-publicized crowdfunding offering. This "buzz" may help pave the way for an eventual initial public offering. It is also possible, however, that only those issuers unable to sell through a more traditional private placement will turn to crowdfunding. This selection effect could leave unsuspecting retail investors with higher risk and lower quality issuers utilizing crowdfunding. Moreover, the truly fly-by-night crowdfunding issuers may not care about the costs of ongoing reporting requirements if they do not expect to survive very long, which would give such issuers a cost advantage in choosing crowdfunding.

The SEC requires that the crowdfunding issuer must commit to a target offering amount and an offering deadline. Rule 201(g). Investors may worry that an issuer will not raise enough capital to follow through on its business plans. If a company needs $1 million to launch its product and the company raises only $700,000, investors may worry that the product will not launch and the company will use the $700,000 for other purposes. Addressing this fear, § 4A(a)(7) requires that an intermediary transmit offering proceeds from a crowdfunding offering only when the aggregate capital raised is equal to or exceeds the target offering amount. Investors can also cancel their commitment to invest up until 48 hours prior to the offering deadline identified in the issuer's offering materials. Rule 304(a). If the issuer does not complete the offering, the intermediary must send each investor notice of the cancellation and refund the offering amount to each investor. Rule 304(d). An issuer that determines that it is unlikely to reach the target offering amount by the offering deadline can change the target amount, but the intermediary must notify investors who have made a commitment and inform the investors that the investor's commitment will be cancelled unless the investor affirmatively re-commits to the offering. Rule 304(c).

B. Investors

The JOBS Act also limits the aggregate amount that may be sold to any particular investor across all issuers in reliance on Section 4(a)(6) during a 12-month period. In Regulation Crowdfunding, the SEC specified the limit for any particular investor as: "(1) The greater of: $2,000 or 5 percent of the lesser of the investor's annual income or net worth if either the investor's annual income or net worth is less than $100,000; or (2) 10 percent of the lesser of the investor's annual income or net worth, not to exceed an amount sold of $100,000, if both the investor's annual income and net worth are equal to or more than $100,000." Rule 100(a)(2). For example, if an investor has an annual income of $125,000 and a net worth of $50,000 then the limit would equal $2,500 (5% of $50,000, the lesser of the two thresholds). Notably, the individual investor's limit is aggregated during any 12-month period for all issuers using the § 4(a)(6) crowdfunding exemption. In establishing the limits for any particular investor, the SEC recognized that the "startups and small business that we expect will rely on the crowdfunding exemption are likely to experience a higher failure rate than more seasoned companies" and that the limits will "potentially limit investment losses in crowdfunding offerings for investors who may be less able to bear the risk of loss." Sec. Act Rel. 33-9974, at p. 26.

The computation of the annual income and net worth of an investor is the same as accredited investor status under Rule 501 of Regulation D. Rule 100(a)(2), Instruction 1. For example, in determining the net worth of a natural person, the person's primary residence is not included as an asset. Spouses are also allowed to calculate their net worth or annual income jointly. When computed jointly, the aggregate investment of the spouses may not exceed the limit that would apply to an individual investor with the same income and net worth level. For example, if two spouses utilize joint calculation and have a joint income of $1.2 million and joint net worth of $2 million then they would be limited to investing $100,000 (the same investment cap as for individuals) in any 12-month period across all § 4(a)(6) crowdfunding offerings. Issuers may rely on crowdfunding intermediaries to determine that the aggregate amount of securities purchased by any particular investor through crowdfunding does not exceed the investment limit unless the issuer knows that the investor has exceeded the investor limits or would exceed the investor limits by purchasing securities in the issuer's offering. Rule 100(a)(2), Instruction 3. To account for inflation, § 4A(h) of the Securities Act provides that the SEC must adjust the individual investment dollar limits periodically along with the limits for accredited investor status.

C. Intermediaries

Given the low investment limits, retail investors are likely to dominate the crowdfunding market. Retail investors purchasing securities from relatively unknown startup companies face risky investment choices without the information or sophistication to make informed decisions. Worst case scenario, retail investors will face a sea of fraudsters. Congress's solution to this dilemma was to employ third party intermediaries to act as gatekeepers to

ensure compliance with the crowdfunding regulations. The starting point for a crowdfunding offering is for an issuer and a crowdfunding intermediary to connect.

The SEC imposes a number of requirements on intermediaries. First, an intermediary must either register with the Commission as a broker under § 15(b) of the Exchange Act or as a "funding portal" under Rule 400 of Regulation Crowdfunding. Rule 300(a)(1) Regulation Crowdfunding. In addition, the intermediary must be a member of a national securities association registered under § 15A of the Exchange Act (FINRA). Rule 300(a)(2).

Brokers that register with the Commission under § 15(b) of the Exchange Act are subject to extensive regulation. These include requirements governing the conduct of the brokers, such as the duty of fair dealing, duty of best execution, suitability, and various restrictions on trading. Registered brokers also must meet certain financial requirements, including minimum net capital requirements, requirements dealing with the use of customer funds, and the keeping of books and records. Registered brokers are also subject to examinations and inspections by the SEC and FINRA.

Crowdfunding intermediaries wanting to register as a "funding portal" face a number of requirements specific to them. Funding portals are not allowed to: (i) Offer investment advice or recommendations; (ii) Solicit purchases, sales or offers to buy the securities displayed on its platform; (iii) Compensate employees, agents, or other persons for such solicitations or based on the sale of securities displayed or referenced on its platform; or (iv) Hold, manage, possess, or otherwise handle investor funds or securities." Rule 300(c)(2).[3] Funding portals must register with the Commission using Form Funding Portal and become a member of FINRA. Rule 400. Note that while the SEC uses the word "broker" in its definition of a funding portal, funding portals that are registered pursuant to Rule 400 of Regulation Crowdfunding are exempt from the broker registration requirements of § 15(a)(1) of the Exchange Act and therefore do not need to register under § 15(b) of the Exchange Act as a broker with the Commission. Rule 401.

The SEC provides a list of permitted activities for funding portals in Rule 402(b), including the ability to provide search functions and communication channels to investors, to compensate third parties for referrals of persons to the funding portal in certain circumstances, and to advertise the funding portal. Rule 402(b). A registered funding portal must also implement written policies and procedures "reasonably designed to achieve compliance with the federal securities laws and the rules and regulations thereunder relating to its business as a funding portal." Rule 403(a). Funding portals have record-keeping requirements and are subject to examinations and inspections by the SEC and FINRA. Rules 403(c) and 404.

Whether an intermediary is a broker or funding portal, a crowdfunding offering must be conducted only through a single intermediary. Rule 100(a)(3). According to the SEC, "in order for a crowd to effectively share information, we believe it would be most beneficial to have one meeting place for the crowd to obtain and share information, thus avoiding dilution or dispersement of the 'crowd.'" Sec. Act Rel. 33-9974, at p. 31. The SEC also imposed an "online-only" requirement, requiring that crowdfunding transaction take place over the Internet or another similar electronic medium that is accessible to the public. The SEC believed that the online-only requirement "enables the public to access offering information and share information publicly in a way that will allow members of the crowd to share their views on whether to participate in the offering and fund the business or idea." Sec. Act Rel. 33-9974, at pp. 31-32.

Intermediaries in a crowdfunding offering face limits on their financial interests. First, affiliates of an issuer, "may not have a financial interest in an issuer that is offering or selling securities" in a crowdfunding offering through the intermediary's platform. Rule 300(b). Second, the intermediary itself is prohibited from having a financial interest in an issuer except for

[3] The SEC also defines an "associated person of a funding portal or person associated with a funding portal" as "any person directly or indirectly controlling or controlled by such funding portal, or any employee of a funding portal." Rule 300(c)(1). The SEC then includes, where relevant, persons associated with a registered broker or registered funding portal in its definition of an "intermediary." Rule 300(c)(3).

interests received as compensation for services in a crowdfunding. Those interests must have the same terms as those being offered. Rule 300(b)(1), (2).

The SEC relies on the intermediary in a crowdfunding transaction to screen issuers. The intermediary must, among other things, have a reasonable basis for believing that the issuer complies with the crowdfunding disclosure requirements. Rule 301(a). The intermediary must also have a reasonable basis for believing that the issuer has established means to keep accurate records of the holders of its securities offered and sold through the intermediary's platform. Rule 301(b). The intermediary must deny access to its platform to an issuer if the intermediary has a reasonable basis for believing that the issuer or any of its officers, directors, or beneficial owners of 20 percent or more of the issuer's outstanding voting equity securities, is subject to disqualification under Rule 503 of Regulation Crowdfunding. The intermediary must conduct a background check as well as check the securities enforcement regulatory history of those individuals. Rule 301(c)(1). The intermediary must deny access to its platform if the intermediary has a reasonable basis for believing that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection. Rule 301(c)(2).

Intermediaries must provide investors with certain disclosures, including among other things, the issuer's required crowdfunding disclosures (discussed below) and the intermediary's compensation in crowdfunding offerings. Rule 302(d). The intermediary must provide investors with certain educational materials. Rule 302(a)(2), (b). In a provision unique to crowdfunding, the intermediary must also engage in investor screening. Before accepting a commitment from an investor, the intermediary must have a reasonable basis for believing that the investor satisfies the investment limitations established by § 4(a)(6)(B). Rule 303(b). In satisfying that obligation, the intermediary may rely upon the investor's representations concerning those requirements unless the intermediary has reason to question the reliability of the representation. Rule 303(b)(2). The intermediary must also obtain from the investor a representation that the investor has reviewed the educational materials and understanding that "his or her investment may be lost, and is in a financial condition to bear the loss of the investment" and a completed questionnaire by the investor demonstrating the investor's understanding that the investor may face restrictions on the investor's ability to cancel an investment commitment, that the investor may have difficulty reselling the securities, and that crowdfunding transactions have risk. Rule 303(b)(2).

A key part of the SEC's vision for crowdfunding is the sharing of information by investors through an intermediary's crowdfunding platform. Accordingly, the SEC requires an intermediary to provide on its platform "communication channels" for investors to communicate with one another and with issuer representatives about offerings on the intermediary's platform. Rule 303(c). The SEC also requires intermediaries to provide notices of investment commitments to investors (Rule 303(d)), maintain and transmit investor funds in a particular manner (Rule 303(e)), and send confirmation of transactions to investors (Rule 303(f)). Intermediaries are prohibited from compensating any person for identifying investors or potential investors in a crowdfunding transaction. Rule 305.

Crowdfunding poses a dilemma for securities regulators. The goal is to increase capital market access for small and unknown startups that otherwise would have difficulty raising capital. The downside of facilitating capital raising for these companies is that crowdfunding also invites fraudsters and con artists eager to bilk unsophisticated investors of their money. Issuers self-select themselves into the crowdfunding market because they are unable to raise capital from institutional investors through more traditional means. Will harnessing securities market intermediaries as gatekeepers to provide disclosures, conduct investor tests, and background checks adequately offset the increased risk of fraud posed by those issuers?

D. Disclosure

Section 4A(a)(6) requires the issuer to file the information specified in § 4A(b) no later than 21 days prior to the first day that securities are sold to investors through crowdfunding. Through rulemaking, the SEC has delineated the information items required in § 4A(b) in Rule 201 of Regulation Crowdfunding. In particular, the issuer must file a mandatory disclosure document, the Offering Statement (filed on Form C), with the SEC and with the issuer's

selected intermediary. Regulation Crowdfunding provides for both updating disclosures on the progress of an offering (Form C-U) as well as ongoing reporting in an annual report after sales take place (Form C-AR).

1. Offering Statement and Progress Updates

Form C requires identification of the issuer (including its physical and website addresses), Rule 201(a), as well as the location of the issuer's annual report on the issuer's website. Rule 201(w). The Offering Statement provides information on the control and capital structure of the issuer. Issuers must disclose, among other things, the names of directors and officers, and their positions, each person's principal occupation and employment, and their business experience during the past three years. Rule 201(b). Issuers must disclose the names of shareholders with more than 20 percent beneficial ownership of the outstanding voting equity, Rule 201(c), describe the material terms of the issuer's indebtedness, Rule 201(p), and describe the ownership and capital structure of the issuer, Rule 201(m).

Offering Statement disclosures also cover the issuer's business and plans. The issuer must describe its business and anticipated business plan, Rule 201(d), disclose the current number of employees, Rule 201(e), and discuss the material factors that make an investment in the issuer speculative or risky, Rule 201(f). The issuer must also provide a discussion of its financial condition, including "to the extent material, liquidity, capital resources and historical results of operations." Rule 201(s). The issuer must provide certain financial statements depending on the size of the target offering. For a target offering amount of more than $1 million, for example, the issuer must provide financial statements audited by an independent public accountant. Rule 201(t).

The SEC excludes issuers that lack a specific business plan or plan to engage in mergers or acquisitions with unidentified companies. Rule 100(b)(6). In excluding such issuers, the SEC focused on the information sharing among investors that it hoped would occur in crowdfunding and that this information sharing may not occur if investors are not provided with "sufficient information about a particular proposed project or business to allow investors to make an informed investment decision." Sec. Act Rel. 33-9974, at p. 40.

The Offering Statement includes transaction-specific information including the target offering amount and the offering deadline to reach that target, Rule 201(g), whether the issuer will accept investments in excess of the target amount, Rule 201(h). the purpose of the offering and intended use of proceeds, Rule 201(i), a description of the process for an investor to complete the transaction or cancel an investment commitment (including the investor's right to cancel an investment commitment until 48 hours prior to the deadline for the offering), Rule 201(j), the price of the securities (or method to determine the price – investors must be provided the final price in writing prior to sale), Rule 201(l). Issuers must disclose the terms of the securities being offered, including voting rights, how the exercise of rights by the principal shareholders could harm the crowdfunding investors, how the offered securities are being valued, and the risks to investors from minority ownership in the issuer and the risks associated with corporate actions such as additional issuances of securities of transactions between the issuer and related parties. Issuers must also disclose restrictions on the transferability of the securities. Rule 201(m).

Issuers must provide updates on their progress in meeting the target offering amount. Rule 201(v). The issuer must also notify investors that if they do not reconfirm their investment commitment after a material change is made to the offering, they will have their investment commitment cancelled and their funds returned. Rule 201(k). The Offering Statement also provides for disclosure regarding the issuer's selected intermediary, including the intermediary's financial interest in the transaction and in the issuer. Rules 201(n), (o).

The Offering Statement provides disclosure of certain past transactions of the issuer. This includes a description of exempt offerings within the past three years. Rule 201(q). Issuers must also describe certain transactions in which a related party had a direct or indirect material interest including: any director or officer of the issuer, any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, and any promoter of the

issuer if the issuer was organized within the past three years, and certain family members of the foregoing persons. Rule 201(r). The Offering Statement also requires the disclosure of certain bad acts by the issuer, including any matters that would have triggered disqualification under Rule 503(a) prior to the adoption of the crowdfunding rules, Rule 201(u), and whether the issuer failed in the past to comply with the Regulation Crowdfunding ongoing reporting requirements described below, Rule 201(x). Finally, the Offering Statement includes a catch-all provision that requires the issuer to disclose any "material information necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." Rule 201(y).

Crowdfunding offerings may take more time to complete than traditional public offerings. Regulation Crowdfunding provides no time limit for offerings other than requiring the issuer to include a deadline in the Offering Statement. Issuers must also file with the SEC and provide to investors and the relevant intermediary a Form C: Progress Update (Form C-U) to disclose the issuer's progress in meeting its target within five business days of the issuer reaching the 50 percent and 100 percent amount. Rule 203(a)(3)(i). If the issuer decides to accept proceeds in excess of the target offering amount, the issuer must also file with the SEC and provide to investors and the relevant intermediary, no later than five business days after the offering deadline, a final Form C-U to disclose the total amount of securities sold. Rule 203(a)(3)(ii). Other than the filing of a Form C-U indicating the total amount sold, the issuer does not need to file a Form C-U if the relevant intermediary provides frequent updates on the issuer's progress to its target or its platform. Rule 203(a)(3)(iii).

2. Ongoing Reporting

An issuer that has offered and sold securities through crowdfunding under § 4(a)(6) must file with the SEC and post on the issuer's website "an annual report along with the financial statements of the issuer certified by the principal executive officer." Rule 202(a), 203(b). The issuer must file the annual report on Form C: Annual Report (Form C-AR). If the issuer has available "financial statements that have either been reviewed or audited by a public accountant that is independent of the issuer" then the certification by the principal executive officer is not required and those financial statements must be provided. The annual report must update many of the items in the Offering Statement described above. To ensure compliance with ongoing reporting, the SEC excludes issuers from a new crowdfunding offering if the issuer has failed to provide required ongoing annual reports during the prior two years.

The issuer must report on an ongoing basis until one of several events occur: 1) the issuer is required to file reports under § 13(a) or § 15(d) of the Exchange Act (i.e., the issuer becomes a public reporting company, Rule 202(b)(1)); 2) the issuer has filed at least one annual report pursuant to Rule 202 and has fewer than 300 holders of record, Rule 202(b)(2); 3) the issuer has filed the required annual reports under Rule 202 for at least the three most recent years and has total assets that do not exceed $10 million, Rule 202(b)(3); 4) the issuer or another party repurchases all of the crowdfunding securities, Rule 202(b)(4); or 5) the issuer liquidates or dissolves it business in accordance with state law, Rule 202(b)(5).

Will the ongoing disclosure obligation discourage use of crowdfunding? A private company that raises capital through a private placement faces no ongoing disclosure obligations after the offering. If private companies that can find sufficient interest to sell securities in a private placement avoid crowdfunding, what type of issuers will be left in the crowdfunding pool?

E. Limits on Issuer Communication

Crowdfunding issuers, although subject to mandatory disclosure requirements, also face limits on their ability to communicate directly with investors. Issuers are prohibited from advertising a crowdfunding offering except for notices that direct investors to an intermediary's platform. Rule 204. Such notices may include the terms of the offering, the amount of securities offered, the nature of the securities, the price of the securities, the closing date of the offering period, and factual information about the legal identity and business location of the issuer. The issuer and those acting on its behalf, who must identify their affiliation with the issuer, may

also communicate with investors and potential investors about the terms of the offering through the intermediary on the intermediary's platform, as long as an issuer identifies itself in those communications. Rule 204(c). Issuers can also compensate others to promote crowdfunding through channels in an intermediary's platform as long as the compensation is disclosed. Rule 205.

F. ANTIFRAUD LIABILITY

Rule 10b–5 applies to crowdfunding, as it does to all transactions in connection with the purchase or sale of securities that use an instrumentality of interstate commerce. Congress also enacted a heightened private antifraud liability provisions specifically for crowdfunding to address concerns about the types of investors (retail) and issuers (smaller, lesser-known) that will participate in crowdfunding.

Crowdfunding antifraud liability closely follows § 12(a)(2) liability. Like § 12(a)(2), only those who purchase securities have standing to bring a private suit under § 4A(c). Section 4A(c) provides that a person who purchases securities in a § 4(a)(6) transaction may bring a private action against an "issuer," but § 4A(c)(3) defines an issuer to include directors, CEOs, CFOs, and "any person who offers or sells the security in such offering." Securities Act § 4A(c)(3). Thus, the list of defendants under § 4A(c) is a hybrid of the potential defendants under §§ 11 and 12(a)(2).

Like § 12(a)(2), § 4A(c) provides liability if an issuer makes "an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading" as part of an offering or sale of securities under § 4(a)(6). Also like § 12(a)(2), plaintiffs do not need to show scienter, reliance, or loss causation as part of their cause of action under § 4A(c).

Several defenses are available to issuers. Purchasers that knew of the untruth or omission at the time of the offer or sale are barred. Section 4A(c)(2)(A). Section 4A(c)(1)(B) also provides that § 12(b)'s loss causation defense applies to the § 4A(c) private actions. Issuers also have a reasonable care defense. Section 4A(c)(2)(B). The statute of limitations provision of § 13 applies. Securities Act § 4A(c)(1)(B). Finally, § 4A(c) provides similar remedies to § 12(a)(2). Purchasers receive rescission as their remedy, adjusted for any income received, or damages if they no longer own the securities.

G. INTEGRATION

An issuer that offers or sells securities through crowdfunding and another type of exempt transaction during the same or similar timeframe runs the risk of having the two offerings integrated absent an integration safe harbor, such as Rule 502(a) under Regulation D. Nonetheless, the SEC anticipated the possibility of concurrent crowdfunding offerings and other types of exempt offerings under certain circumstances: "For example, an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers in that offering were not solicited by means of the offering made in reliance on Section 4(a)(6)." Sec. Act Rel. 33-9974, at p. 19.

H. RESALES

As we saw in our discussion of § 4(a)(2) and Regulation D, investors who purchase securities through an exemption from § 5 are subject to resale limits. These privately-placed securities are referred to as "restricted" securities. On the one hand, the resale restrictions reduce the value of the securities to the investors. If they cannot resell, investors cannot convert these securities into cash and will demand an illiquidity discount. On the other hand, the resale restrictions help protect the public offering process. If investors can immediately resell freely after an exempt offering, issuers will have little reason to use public offerings.

Congress followed the path taken for other forms of exempt offerings by imposing resale restrictions on crowdfunding securities. Securities sold pursuant to § 4(a)(6) cannot be resold by

the purchaser for one year. Section 4A(e). The SEC provides several exceptions from the restriction on resales, including sales back to the issuer, to accredited investors, sales through a registered public offering, sales to family members. Rule 501(b).

The one-year limitation on resale may not be the most important resales constraint. Only smaller, little-known issuers are likely to take advantage of crowdfunding. Moreover, issuers can raise only up to $1 million in a 12-month period using crowdfunding. The volume of securities sold by a typical crowdfunding issuer generally will be insufficient to support a liquid trading market, even after the 1-year holding period expires. Without such a market, retail investors will have difficulty reselling their securities; they will have to hope that the issuer eventually does a registered public offering, thereby creating a liquid market.

I. "Bad Actor" Disqualification

Rule 503 addresses disqualification of issuers, brokers, and funding portals. The disqualification sweeps broadly: "the issuer; any predecessor of the issuer; any affiliated issuer; any director, officer, general partner or managing member of the issuer; any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; any promoter connected with the issuer in any capacity at the time of such sale, any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; or any general partner, director, officer, managing member of any such solicitor." Rule 503(a). If disqualification under Rule 503 applies then the § 4(a)(6) exemption is no longer available. In other words, if any of the delineated entities or persons eligible for disqualification in fact is disqualified under Rule 503 then the entire crowdfunding offering loses its exemption from § 5.

Rule 503 then proceeds to provide a laundry list of events that lead to disqualification. One path to disqualification focuses on activities (a) in connection with the purchase or sale of any security, (b) involving the making of any false filing with the Commission, or (c) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, funding portal or paid solicitor of investors (collectively termed "securities related activities"). Disqualification occurs if the person was convicted of any securities related activities, or is subject to any court order, judgment or decree that restrains or enjoins such person from engaging or continuing to engage in any conduct or practice involving securities related activities.

Disqualification also occurs if a person is subject to a certain final orders of various regulators including state securities commissions, banking regulators, the Commodity Futures Trading Commission, and the National Credit Union Administration. The final order must bar the person from, among other things, associating with an entity regulated by the particular institution or engaging in the business of securities, insurance, or banking. The final order must also be based on a violation of any law or regulation that "prohibits fraudulent, manipulative or deceptive conduct entered within ten years before such filing of the offering statement."

Disqualification also results from SEC administrative proceedings. A person is disqualified if he or she is subject to an administrative order that suspends or revokes such person's registration as a broker, dealer, municipal securities dealer, investment adviser or funding portal, places limitation on the activities, functions or operations of such person, or bars the person from being associated with any entity or from participating in the offering of any penny stock. Persons are also disqualified if they are subject to any administrative order to cease and desist from committing or causing a violation or future violation of § 5 of the Securities Act or any scienter-based anti-fraud provision of the federal securities laws. Disqualification can also result from disciplinary actions from a self-regulatory organization if a person is suspended or expelled from membership in, or suspended or barred from association with a member, of an SRO for conduct inconsistent with "just and equitable principles of trade." Disqualification can also occur if a person has filed as a registrant or issuer or was an underwriter in any registration statement or Regulation A offering statement that was the subject of an SEC refusal order, stop order, or order suspending the Regulation A exemption or is the subject of an investigation or proceeding to determine whether such an order should be issued; or is subject to certain U.S. Postal Service false representation orders. The SEC can

waive disqualification upon "a showing of good cause." Rule 503(b)(2). Time will tell how often the SEC uses this ability to waive disqualification.

J. Insignificant Deviations

As with Rule 508 of Regulation D, the SEC provides forgiveness for minor deviations from terms, conditions, or requirements of Regulation Crowdfunding. Rule 502 of Regulation Crowdfunding provides that: "A failure to comply with a term, condition, or requirement of this part will not result in the loss of the exemption" if the issuer can demonstrate several conditions: 1) the failure to comply was "insignificant with respect to the offering as a whole," 2) the issuer made a "good faith and reasonable attempt to comply with all applicable terms, conditions and requirements" of Regulation Crowdfunding, and 3) the issuer "did not know of such failure where the failure … was the result of the failure of the intermediary to comply with the requirements of section 4A(a) of the Securities Act and the related rules, or such failure by the intermediary occurred solely in offerings other than in the issuer's offering." Note that § 4A(a) deals with requirements imposed on intermediaries in a crowdfunding offering. As with Rule 508 of Regulation D, the forgiveness under Rule 502 of Regulation Crowdfunding does not preclude the SEC from bringing an enforcement action for an issuer's failure to comply. Forgiveness under Rule 502 of Regulation Crowdfunding is only against private liability for violations of § 5 that might occur due to the loss of the crowdfunding exemption.

K. Public Company Status

We saw in Chapter 4 that private companies seeking to raise capital through exempt offerings must worry about becoming a public company even without an initial public offering. The JOBS Act of 2012 greatly alleviated the risk of becoming a creeping public company by: 1) increasing the threshold number of shareholders of record of a class of equity to become a public company from 500 to 2,000 (or 500 non-accredited investors); and 2) excluding employees from the shareholders of record tally if they receive equity securities through exempt transactions pursuant to an employee compensation plan.

Crowdfunding poses a heightened risk to startups of becoming a public company. If the total assets of a startup company are above $10 million, the startup must worry that crowdfunding will attract a relative large number of retail investors, each purchasing a relatively small number of shares. For purposes of avoiding public company status, it is much better to have one institutional investor purchase 200,000 shares than to have 2,000 retail investors each purchase 100 shares. The fear of inadvertently triggering public company status could chill the use of crowdfunding by startups. Addressing this concern, Rule 12g-6 of the Exchange Act provides that holders of securities purchased in a crowdfunding transaction are not counted toward the number of shareholders of record threshold of § 12(g) of the Exchange Act for public company status if: 1) the issuer is current in its annual crowdfunding reporting obligation; 2) the issuer retains the services of a registered transfer agent pursuant to § 17A of the Exchange Act; and 3) the issuer has less than $25 million in assets as of the end of its last fiscal year.

Hypothetical Eighteen

Redeye, Inc. is a startup company based in New York City that manufactures highly caffeinated energy drinks. Jeff, the CEO, founder, and sole shareholder of Redeye, hopes to break out of the Northeast region and market Redeye's energy drinks out on the West Coast in direct competition with Trendy, Inc. Redeye is a low budget operation and Jeff calculates that Redeye needs only $500,000 to start an Internet-based word-of-mouth campaign to raise awareness of Redeye on the West Coast. What are the pros and cons of crowdfunding for Redeye? What alternatives methods of raising capital would you suggest to Jeff?

II. Intrastate Offerings

Section 5 of the Securities Act reaches broadly to regulate all offers and sales of securities involving interstate commerce. Even for a securities offering that takes place exclusively in one state, issuers and those working on the issuers' behalf can run afoul of § 5 if they use a telephone, the mail, or other instruments of interstate commerce.

Despite the reach of § 5 to offerings essentially intrastate in character, there are reasons to exempt such offerings from the registration requirements. Intrastate offerings are often smaller in scope and are sold to investors that have a general knowledge of the local companies offering the securities, reducing the need for the heavy regulatory intervention of § 5. Offerings that take place solely within one state may have less effect on the confidence of investors in the national securities marketplace. Finally, state "Blue Sky" securities regulation, discussed earlier in the chapter, provides a substitute for federal securities regulation. Particularly if the offering is sold in only one state, state regulators have both a greater incentive to police the offering (all the investors are within their jurisdiction) and a greater ability to do so. The National Securities Markets Improvement Act of 1996 preempts state securities registration requirements for "covered securities." The definition of covered securities, however, does not include securities offered and sold under § 3(a)(11), allowing for state "Blue Sky" regulation of securities sold pursuant to the intrastate offering exemption.

We start with a discussion of the intrastate offering exemption under § 3(a)(11). We then discuss the safe harbor for intrastate offerings in Rules 147 and 147A.

A. Section 3(a)(11) Offerings

Section 3(a)(11) of the Securities Act exempts from § 5 securities sold as "part of an issue offered and sold only to person's 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." Consider the SEC's view of the scope of § 3(a)(11) in the following release. Despite the presence of possible state securities regulation, the SEC has generally construed § 3(a)(11) narrowly. Why do you think the SEC has taken this attitude toward the intrastate exemption?

Securities Act Release No. 4434

Securities and Exchange Commission (Dec. 6, 1961).

* * *

The legislative history of the Securities Act clearly shows that [the § 3(a)(11)] exemption was designed to apply only to local financing that may practicably be consummated in its entirety within the State or Territory in which the issuer is both incorporated and doing business. . . .

"Issue" Concept

A basic condition of the exemption is that the entire issue of securities be offered and sold exclusively to residents of the state in question. Consequently, an offer to a non-resident which is considered a part of the intrastate issue will render the exemption unavailable to the entire offering.

Whether an offering is "a part of an issue", that is, whether it is an integrated part of an offering previously made or proposed to be made, is a question of fact and depends essentially upon whether the offerings are a related part of a plan or program. Thus, the exemption should not be relied upon in combination with another exemption for the different parts of a single issue where a part is offered or sold to non-residents. . . .

[S]ince the exemption is designed to cover only those security distributions, which, as a whole, are essentially local in character, it is clear that the phrase "sold only to persons resident" as used in Section 3(a)(11) cannot refer merely to the initial sales by the issuing corporation to its underwriters, or even the subsequent resales by the underwriters to distributing dealers. To give effect to the fundamental purpose of the exemption, it is necessary that the entire issue of securities shall be offered and sold to, and come to rest only in the hands of residents within the

state. If any part of the issue is offered or sold to a non-resident, the exemption is unavailable not only for the securities so sold, but for all securities forming a part of the issue, including those sold to residents. It is incumbent upon the issuer, underwriter, dealers and other persons connected with the offering to make sure that it does not become an interstate distribution through resales. It is understood to be customary for such persons to obtain assurances that purchases are not made with a view to resale to non-residents.

Doing Business Within the State

In view of the local character of the Section 3(a)(11) exemption, the requirement that the issuer be doing business in the state can only be satisfied by the performance of substantial operational activities in the state of incorporation. The doing business requirement is not met by functions in the particular state such as bookkeeping, stock record and similar activities or by offering securities in the state. Thus, the exemption would be unavailable to an offering by a company made in the state of its incorporation of undivided fractional oil and gas interests located in other states even though the company conducted other business in the state of its incorporation. While the person creating the fractional interests is technically the "issuer" as defined in Section 2[a](4) of the Act, the purchaser of such security obtains no interest in the issuer's separate business within the state. Similarly, an intrastate exemption would not be available to a "local" mortgage company offering interests in out-of-state mortgages which are sold under circumstances to constitute them investment contracts. . . .

If the proceeds of the offering are to be used primarily for the purpose of a new business conducted outside of the state of incorporation and unrelated to some incidental business locally conducted, the exemption should not be relied upon. So also, a Section 3(a)(11) exemption should not be relied upon for each of a series of corporations organized in different states where there is in fact and purpose a single business enterprise or financial venture whether or not it is planned to merge or consolidate the various corporations at a later date.

Residence Within the State

Section 3(a)(11) requires that the entire issue be confined to a single state in which the issuer, the offerees and the purchasers are residents. Mere presence in the state is not sufficient to constitute residence as in the case of military personnel at a military post. The mere obtaining of formal representations of residence and agreements not to resell to non-residents or agreements that sales are void if the purchaser is a non-resident should not be relied upon without more as establishing the availability of the exemption.

An offering may be so large that its success as a local offering appears doubtful from the outset. . . .

A secondary offering by a controlling person in the issuer's state of incorporation may be made in reliance on a Section 3(a)(11) exemption provided the exemption would be available to the issuer for a primary offering in that state. It is not essential that the controlling person be a resident of the issuer's state of incorporation.

Resales

From these general principles it follows that if during the course of distribution any underwriter, any distributing dealer (whether or not a member of the formal selling or distributing group), or any dealer or other person purchasing securities from a distributing dealer for resale were to offer or sell such securities to a non-resident, the exemption would be defeated. In other words, Section 3(a)(11) contemplates that the exemption is applicable only if the entire issue is distributed pursuant to the statutory conditions. Consequently, any offers or sales to a non-resident in connection with the distribution of the issue would destroy the exemption as to all securities which are a part of that issue, including those sold to residents regardless of whether such sales are made directly to non-residents or indirectly through residents who as part of the distribution thereafter sell to non-residents. . . .

This is not to suggest, however, that securities which have actually come to rest in the hands of resident investors, such as persons purchasing without a view to further distribution or resale to non-residents, may not in due course be resold by such persons, whether directly or through dealers or brokers, to non-residents without in any way affecting the exemption. The relevance of any such resales consists only of the evidentiary light which they might cast upon the factual question whether the securities had in fact come to rest in the hands of resident investors. If the

securities are resold but a short time after their acquisition to a non-resident this fact, although not conclusive, might support an inference that the original offering had not come to rest in the state, and that the resale therefore constituted a part of the process of primary distribution; a stronger inference would arise if the purchaser involved were a security dealer. It may be noted that the non-residence of the underwriter or dealer is not pertinent as long as the ultimate distribution is solely to residents of the state. . . .

Conclusion

In conclusion, the fact should be stressed that Section 3(a)(11) is designed to apply only to distributions genuinely local in character. From a practical point of view, the provisions of that section can exempt only issues which in reality represent local financing by local industries, carried out through local investment. Any distribution not of this type raises a serious question as to the availability of Section 3(a)(11). Consequently, any dealer proposing to participate in the distribution of an issue claimed to be exempt under Section 3(a)(11) should examine the character of the transaction and the proposed or actual manner of its execution by all persons concerned with it with the greatest care to satisfy himself that the distribution will not, or did not, exceed the limitations of the exemption. Otherwise the dealer, even though his own sales may be carefully confined to resident purchasers, may subject himself to serious risk of civil liability under Section 12[a](1) of the Act for selling without prior registration a security not in fact entitled to exemption from registration. In Release No. 4386, we noted that the quick commencement of trading and prompt resale of portions of the issue to non-residents raises a serious question whether the entire issue has, in fact, come to rest in the hands of investors resident in the state of the initial offering.

Busch v. Carpenter

827 F.2d 653 (10th Cir. 1987).

■ SEYMOUR, S., CIRCUIT JUDGE.

Paul and Linda Busch brought this action under [§ 12 of the Securities Act] against Craig Carpenter, George Jensen, and Ronald Burnett to recover the purchase price of shares of stock in Sonic Petroleum, Inc. Plaintiffs alleged that the stock had not been registered as required by [§ 5(a)], and that the stock did not qualify for the intrastate offering exemption set out in [§ 3(a)(11)].[1] . . . The parties filed cross motions for summary judgment, and the district court granted judgment for defendants. We affirm in part, reverse in part, and remand for further proceedings.

I.

BACKGROUND

The undisputed facts are briefly as follows. Sonic was incorporated in Utah on October 2, 1980. The three defendants were officers and directors of Sonic at its inception. Carpenter was president until May 1981, and a director and officer through June 26, 1981, the date on which plaintiffs bought their shares. Jensen was vice president and a director through June 26. Burnett was secretary and a director until May 1981. During October and November of 1980, Sonic publicly offered and sold shares of Sonic stock to Utah residents through Olsen & Company, Inc. Although Sonic complied with Utah state registration requirements, it did not file a registration statement under federal securities law, relying on the exemption from registration provided for intrastate offerings. Sonic, which had no prior operating history at the time of this offering, was incorporated in Utah and purportedly organized to acquire, extract, and market natural resources such as oil, gas, and coal. Although the company had not undertaken this activity in Utah or anywhere else, it maintained its corporate office, books, and records in Utah at the time of the initial offering. It is not disputed that the offering of 25,000,000 shares of Sonic was sold for $500,000 entirely to Utah residents.

[1] Plaintiffs also alleged that defendants had violated Rule 147, which is a "safe harbor" provision establishing the circumstances in which the SEC will not challenge the applicability of the intrastate offering exemption. The district court held that defendants' failure to comply with Rule 147 did not preclude them from establishing that they were nonetheless entitled to the exemption. Plaintiffs do not raise this ruling as error on appeal.

In late March or early April of 1981, Carpenter was contacted by William Mason, an Illinois oil and gas promoter, about a merger of Sonic with Mason's operations in Illinois. Sonic and Mason reached an agreement, effective May 25, 1981, under which Sonic issued Mason a controlling block of stock and acquired an Illinois drilling corporation privately owned by Mason. Carpenter, Jensen, Mason, Mason's wife, and their son were officers and directors of the new company, which was renamed Mason Oil Co., Inc. Burnett had resigned his positions with Sonic at the shareholders meeting on the proposed merger, and he took no part in the operation of Mason Oil. Shortly after Mason Oil was formed, William Mason drew $351,126 from the remainder of the $435,000 net proceeds of the original Sonic offering and deposited it in Illinois. This money was not used in Utah.

In May 1981, Mason and Carpenter set up Norbil Investments, a brokerage account in Utah, so that Mason and his friends could buy shares of the company's stock. Plaintiffs, who are California residents, bought their stock through Norbil. Plaintiffs also presented evidence of purchases through Norbil of stock by other non-residents between May and August 1981.

II.

THE INTRASTATE OFFERING EXEMPTION

* * *

Congress . . . recognized that the protections of the 1933 Act were not essential for those securities that could be supervised effectively by the states. . . .

* * *

A. Coming to Rest

The district court ruled that the resale of stock to non-residents occurred after the issued securities had come to rest in Utah and concluded that the public offering was therefore consummated in Utah within the meaning of section 3(a)(11). On appeal, plaintiffs contend that the court's ruling was erroneous and that the circumstances of the resale defeated the intrastate exemption.

In order to fall within the intrastate exemption, initial sales to state residents must be bona fide. The intrastate exemption becomes unavailable whenever sales or purchases by an issuer, an intermediary, or a subsequent purchaser circumvent the federal securities laws. The SEC has consistently maintained that a distribution of securities must have "actually come to rest in the hands of resident investors—persons purchasing for investment and not with a view to further distribution or for purposes of resale." We agree.

During the proceedings below, plaintiffs contended that the resale to non-residents within seven months of the initial offering in and of itself precluded the application of the intrastate offering exemption. The Amicus [the SEC] raises a new argument on appeal, contending that because defendants had the burden to show their right to the exemption, they had the burden below to present evidence that the original buyers bought with investment intent. The [SEC] argues that without such a showing, summary judgment for defendants was improper. . . .

We reject the [SEC's] argument. The intrastate offering exemption requires that the issue be "offered and sold only to persons resident within a single State." In our view, a seller seeking summary judgment makes a prima facie showing that the offering was consummated within a state by showing that the stock was sold only to residents of that state. We disagree with [the SEC] that, in order to be entitled to summary judgment, the issuer should be required to disprove all the possible circumstances that might establish the stock has not come to rest. It seems more logical to us to impose on the other party the burden of producing some contrary evidence on this issue when the seller claiming the exemption has satisfied the facial requirement of the statute. In the face of defendants' undisputed showing that all of the original buyers were Utah residents, plaintiffs were therefore required to produce evidence that the stock had not come to rest but had been sold to people who intended to resell it out of state.

The evidence fails to suggest that any of Sonic's publicly offered shares were issued under questionable circumstances. Carpenter and Mason did not know each other until their initial conversation in the spring of 1981. . . . Moreover, the interstate purchases by Mason and others of freely trading shares several months after the completion of the intrastate offering do not,

without more, impugn the investment intent of the original buyers or otherwise imply an effort to evade the federal securities laws. Norbil served as a conduit for over-the-counter purchases made by Olsen & Company on behalf of Mason and various acquaintances. Although Carpenter did collect from buyers, pay Olsen, and transfer the stock certificates to their new owners, there is simply no indication that those who sold through Norbil had not originally purchased their stock for investment purposes. . . . Accordingly, the trial court did not err in concluding that no genuine question of fact was raised on whether the issue had come to rest in the hands of Utah residents.

B. Doing Business

Plaintiffs alternatively contend that defendants were not entitled to the intrastate offering exemption because the corporate issuer was not doing business in Utah as required by section 3(a)(11). There is no dispute that the newly formed company, not yet operational, maintained its offices, books, and records in Salt Lake City. The decisive issue concerns whether, under the circumstances of this case, Sonic's failure to invest a portion of the proceeds from its initial public offering in Utah could defeat the intrastate exemption.

Although neither the statute nor its legislative history defines the doing business requirement, courts have uniformly held that it refers to activity that actually generates revenue within an issuer's home state. The leading case is *Chapman v. Dunn*, 414 F.2d 153 (6th Cir.1969), which involved a company that maintained its offices and issued stock in Michigan while operating its sole productive venture, an oil and gas business, in Ohio. The *Chapman* court reasoned that "doing business" in the context of securities regulation connotes substantially more activity than that which would warrant exercising personal jurisdiction in ordinary civil suits. Effective supervision of stock offerings, the court added, can entail on-site inspections, familiarity with local economic conditions, and sometimes reliance upon judicial process. State oversight of business operations located elsewhere could often prove cumbersome, costly, and ineffective. The *Chapman* court therefore approved the SEC's view that the intrastate exemption applies only in cases of local financing for local industries. The court held that "doing business" refers to income-producing activity, and that an issuer must conduct a "predominant amount" of that activity within its home state.

* * *

[A]n issuer cannot claim the exemption simply by opening an office in a particular state. Conducting substantially all income-producing operations elsewhere defeats the exemption, as do the plans of recently organized companies to invest the net proceeds of initial public offerings only in other states. Doing business under the 1933 Act means more than maintaining an office, books, and records in one state.

Viewing the evidence and drawing reasonable inferences most favorably to plaintiffs, a fact issue exists regarding . . . Sonic's plans for the use of proceeds. . . . Here the corporation never did more than maintain its office, books, and records in Utah. This was not sufficient to make a prima facie showing of compliance with the intrastate offering exemption. While its prospectus stated that no more than twenty percent of all proceeds would be used outside of Utah, Sonic nonetheless transferred essentially all of its assets to Mason in Illinois. The record contains no evidence, moreover, of any prior efforts whatever at locating investment opportunities within Utah. These considerations support a reasonable inference that Sonic may have been intending all along to invest its assets outside the state. Although Carpenter and Mason may have been strangers to one another, this fact alone fails to dispel the possibility that Sonic had been seeking and perhaps investigating other business operations out of state. If so, and we intimate no view on this unresolved fact question, the intrastate exemption would be unavailable.

We are not persuaded by defendants' argument that Sonic did business in Utah when its public offering was consummated, that its stated purpose was to do business within that state, and that the company should not be penalized for reorganizing its operations at a later date. We have already noted that under the Act, doing business means more than opening an office at the time of a public offering. The issue is not whether a newly formed company performs such minimal corporate functions within a state, but whether subsequent proceeds are to be employed in that same state. A newly formed company may not claim the exemption while planning covertly to

invest the proceeds of a local offering in other states. . . . Accordingly, we conclude that a genuine issue of material fact exists precluding summary judgment in favor of all defendants.

* * *

IV.

CONCLUSION

In view of our conclusion that fact questions exist on whether the company was doing business in Utah within the ambit of the intrastate exemption and as to Carpenter's liability for any violation of the Act, we reverse in part and remand for further proceedings. . . .

QUESTIONS

1. Who bears the burden of demonstrating that all the purchasers of securities under § 3(a)(11) are residents of the same state?

2. Sonic was initially incorporated in Utah and had its office, corporate books, etc. there. Why didn't this establish that Sonic was resident and doing business in Utah?

3. What if Sonic had substantial income producing activities in Utah but intended to use the proceeds from the offering to drill for gas in Nevada?

Although the intent behind § 3(a)(11) is straightforward (exempting local financing for local businesses from federal securities registration requirements), the application of § 3(a)(11) is more ambiguous. Consider the following concepts important in determining the application of § 3(a)(11):

- Issuer Resident and Doing Business in a State
- Investors Resident in a State
  - — When are sales to investors outside the states integrated?
  - — When do securities sold to investors within the state "come to rest"?

Section 3(a)(11) defines none of these items with precision. Instead, we are left with somewhat vague standards. The SEC in Securities Act Release 4552, for example, put forth a multi-prong test for integration. We are told that two offerings may be integrated and treated as one to the extent the two offerings have the same general purpose, plan of financing, consideration, and are close in time to one another. Release 4552 does not tell us, however, how to balance these factors if they do not all point in the same direction.

Similarly, if investors within the state resell their securities to out-of-state investors, does this result in a loss of the exemption? The answer depends on whether the in-state investors had "investment intent." Although the passage of time (in particular over two years) before a resale suggests initial investment intent, the SEC does not favor reliance upon the mere passage of time as evidence of investment intent. Consider how you would resolve these ambiguities in the following hypothetical.

HYPOTHETICAL NINETEEN

Assume that Trendy is based in San Francisco, CA. On January 1 it sold $50 million worth of common stock through a private placement to 30 sophisticated purchasers and accredited investors across the United States pursuant to Rule 506 of Regulation D. Trendy used the $50 million to construct a soft drink manufacturing plant in Los Angeles, CA. On August 1, Trendy then sold an additional $20 million of common stock solely to California investors. Trendy used the proceeds from the offering to finish construction of the manufacturing plant.

1. If Trendy's January 1 and August 1 offerings are integrated, what effect does that have on the § 3(a)(11) offering?

2. Will the two offerings be integrated? Do any safe harbors protect against integration?

3. Assume that on July 31, Trendy had $20 million in cash that it could use either to finish construction of the factory or invest in a new research and development facility located in Arizona. Rather than make this choice, Trendy conducts an intrastate offering of common stock to California residents, raising an additional $20 million in cash. Trendy directs the proceeds from the intrastate offering to finance the construction of the factory. Trendy simultaneously directs the $20 million in cash it had on hand prior to the intrastate offering to build the R & D facility in Arizona. Does this jeopardize the § 3(a)(11) exemption?

B. RULES 147 AND 147A

To bring certainty to issuers wanting to raise capital through an intrastate offering, the SEC provides issuers with two safe harbors under Rules 147 and 147A. The SEC originally promulgated Rule 147 in 1974. Consider the following SEC Release announcing the adoption of Rule 147.

Exchange Act Release No. 5450

Securities and Exchange Commission (Jan. 7, 1974).

The Securities and Exchange Commission today adopted Rule 147 which defines certain terms in, and clarified certain conditions of, Section 3(a)(11) of the Securities Act of 1933. . . .

Background and Purpose

* * *

Section 3(a)(11) was intended to allow issuers with localized operations to sell securities as part of a plan of local financing. Congress apparently believed that a company whose operations are restricted to one area should be able to raise money from investors in the immediate vicinity without having to register the securities with a federal agency. In theory, the investors would be protected both by their proximity to the issuer and by state regulation. Rule 147 reflects this Congressional intent and is limited in its application to transactions where state regulation will be most effective. The Commission has consistently taken the position that the exemption applies only to local financing provided by local investors for local companies. To satisfy the exemption, the entire issue must be offered and sold exclusively to residents of the state in which the issuer is resident and doing business. An offer or sale of part of the issue to a single non-resident will destroy the exemption for the entire issue.

In late 2016, the SEC amended Rule 147 and promulgated a new Rule 147A. Sec. Act Rel. 33-10238,. Rule 147A allows smaller companies greater freedom to utilize broad-based electronic communication, such as through the Internet, to solicit investors while at the same time maintaining the local character of an intrastate offering. Recognizing that the SEC lacked authority to expand solicitation out-of-state under § 3(a)(11), the SEC promulgated Rule 147A instead using the SEC's general exemptive authority under § 28 of the Securities Act.

Both Rules 147 and 147A, exempt offers and sales from § 5 of the Securities Act. Unlike Rule 147, Rule 147A is not available to issuers that are investment companies or required to register under the Investment Company Act of 1940. Rule 147A(a).

The requirements of Rules 147 and 147A focus on the intrastate character of the offering. Although the SEC touted the benefit of such offerings to smaller companies, any size company may utilize Rule 147 or 147A to conduct an intrastate offering exempt from the registration requirements of § 5. Issuers selling in a Rule 147 or 147A intrastate offering also face no limits on the amount of the offering or the number of purchasers. To maintain the intrastate character of the Rule 147 or 147A offering exemption, the SEC imposes requirements on: (1) the manner of offering, (2) residency, and (3) resales. In addition, the SEC requires that the issuer (4) undertake certain precautionary measures and (5) provide certain prominent disclosure on the intrastate nature of the offering. Finally, the SEC provides a (6) integration safe harbor and (7) makes clear that issuers must comply with the applicable state regulatory regime. We discuss each of these components of Rules 147 and 147A below.

1. Manner of Offering

In keeping with the purpose of § 3(a) (11) and the original intent behind Rule 147 as indicated in the SEC's 1974 Release, the SEC requires issuers to limit all offers and sales under Rule 147 to residents of the same state in which the issuer is resident. Rule 147(b). The SEC stated in its 2016 Promulgating Release: "We believe offers made over the Internet that can be viewed by a significant number of out-of-state residents are not consistent with § 3(a)(11) and Rule 147, even if such offers include prominent disclosure stating that sales will be made only to residents of the same state or territory as the issuer." Sec. Act Rel. 33-10238, at p. 16. The SEC stated that the Internet made it "difficult for issuers to keep the distribution of such offers local in nature." Id. at p. 16.

Despite the concerns with widespread solicitations, the SEC in 2016 promulgated Rule 147A to allow an issuer in an intrastate offering to engage in general solicitation and advertising out of the state in which the issuer is resident, using any form of mass media, including over the Internet. Rule 147A(b). Although offers may occur out-of-state, the SEC requires that all sales under Rule 147A must take place to persons resident in the same state as the issuer. Rule 147A(d).

2. Residence Requirement

In keeping with the goal of intrastate offerings, Rules 147 and 147A impose a residence requirement on issuers for the state in which the offering takes place. Both Rules 147 and 147A require that purchasers in the offering are resident in the same state as the issuer. Rule 147 is more restrictive; it requires that offerees are resident in the same state as the issuer.

Issuer. Rules 147 and 147A require that the issuer is both (a) resident and (b) doing business in the state or territory in which offers and sales take place. First, consider the residence requirement. Rule 147 takes a more restrictive approach to determining the issuer's residence compared with Rule 147A. For corporations, limited partnerships, trusts, and other forms of business organizations that are organized under state or territorial law, Rule 147 deems the issuer as a resident of the state or territory in which the issuer is incorporated or organized *and* has its "principal place of business." Rule 147(c)(1)(i). Rule 147A, in contrast, deems the issuer as a resident of the state or territory in which the issuer simply has its "principal place of business." Rule 147A(c)(1). Rules 147 and 147A define the "principal place of business" of an issuer as the state or territory "in which the officers, partners or managers of the issuer primarily direct, control and coordinate the activities of the issuer." Rules 147(c)(1)(i), 147A(c)(1). For general partnerships and other entities not organized under any state or territorial law, Rule 147, similar with Rule 147A, provides that the entity is resident in the state or territory where the entity has its "principal place of business." Rule 147(c)(1)(ii). In omitting the in-state incorporation or organization requirement for issuers under Rule 147A, the SEC stated that focusing solely on the location of an issuer's principal place of business "is more consistent with modern business practices in which issuers are permitted to incorporate or organize in states other than the state or territory of their principal place of business," Sec. Act Rel. 33-10238, at p. 24.

Issuers may sometimes change their principal place of business to another state. If an issuer conducts a Rule 147 or 147A offering in one state and then moves its principal place of business to a new state, Rules 147 and 147A prohibit the issuer from offer and selling in a subsequent Rule 147 or 147A offering "until such time as securities sold in reliance on the exemption in the prior state have come to rest in that state." Sec. Act Rel. 33-10238, at p. 25. When do securities come to rest in a state? The SEC utilizes the six-month period from the date of the last sale in a Rule 147 or 147A offering during which resales are limited pursuant, Rules 147(e) and 147A(e), as the time period after which the securities are deemed as coming to rest in the state. Thereafter, an issuer that switches its principal place of business may commence a subsequent Rule 147 or 147A offering in a new state.

Second, consider the doing business requirement. Rules 147 and 147A impose identical requirements. Rule 147 deems an issuer as doing business within a particular state or territory if the issuer satisfies at least one of four requirements (note that satisfying more than one requirement is not necessary to be deemed as doing business in a state or territory):

> (i) 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;
>
> (ii) The issuer had at the end of its most recent semi-annual fiscal period prior to an initial offer of securities in any offering or subsequent offering pursuant to this section, at least 80% of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;
>
> (iii) The issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to [Rule 147] 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
>
> (iv) A majority of the issuer's employees are based in such state or territory.

Rule 147(c)(2). Rule 147A provides the identical four requirements (substituting Rule 147A instead of Rule 147 for part (iii)). Rule 147A(c)(2). With respect to part (iv), the SEC stated that: "An employee would be based in the same state or territory of the issuer for purposes of this test if such employee is based out of offices located within such state or territory. For example, if an employee provides services in the Maryland, Virginia and Washington, DC metro area out of the offices of the company in Maryland, the employee would be based in Maryland for purposes of this test." Sec. Act Rel. 33-10238, at p. 33.

Offerees and Purchasers. Rule 147 requires that offerees and purchasers are resident, or that the issuer reasonably believes are resident, in the same state as the issuer at the time of the offers and sales. Rule 147(d). In contrast, Rule 147A only requires that purchasers and not offerees are resident, or that the issuer reasonably believes are resident, in the same state as the issuer at the time of the offers and sales. Rule 147A(d).

Corporations, partnerships, limited companies, trusts, and other forms of business organizations are deemed resident in a particular state or territory as offerees or purchasers if at the time of the offers or sales the business organization has its principal place business within the state or territory. Rules 147(d)(1), 147A(d)(1). Individuals are deemed resident of a particular state or territory as offerees or purchasers if the individuals, at the time of the offers or sales, have their principal residence in the state or territory. Rules 147(d)(2), 147A(d)(2).

One of the key amendments in 2016 to Rule 147 and included in Rule 147A was the ability of an issuer to meet the offeree and purchaser (or just purchaser in the case of Rule 147A) residence requirement by demonstrating that the issuer "reasonably believes" that offerees and purchasers had the requisite residency at the time of the offers and sales. The SEC warned, however, that: "[o]btaining a written representation from purchasers of in-state residency status will not, without more, be sufficient to establish a reasonable belief that such purchasers are in-state residents." Rule 147(d) Instruction to paragraph (d); Rule 147A(d) Instruction to paragraph (d). The SEC provided the following further guidance: "In addition to written representation, other facts and circumstances could include, but will not be limited to, for example, 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 principal place of business so as to enable the issuer to have a reasonable basis to believe that the prospective purchaser is an in-state resident." Sec. Act Rel. 33-10238, at p. 37. Other evidence could include evidence of the home address of a prospective purchaser from a "utility bill, pay-stub, information contained in state or federal tax returns, a documentation issued by a federal, state, or local government authority, such as a driver's license or identification card, or a public or private database that the issuer has determine is reasonably reliable, including credit bureau databases, directory listings, and public records." Sec. Act Rel. 33-10238, at p. 38.

With respect to residence, Rules 147 and 147A provide a special anti-sham provision. Imagine investors in Alaska, Hawaii, and California wish to participate in an intrastate offering under Rule 147 or 147A taking place solely in the state of New York. The investors could band together and form a special purpose investment vehicle organized and doing business solely in New York. The investment vehicle could then invest in the offering, providing a backdoor way for

out-of-state investors to participate in the intrastate offering. Rule 147(d)(3) addresses this possibility by deeming any corporation, partnership, trust, or other form of business organization that is "organized for the specific purpose of acquiring securities offered pursuant to [Rule 147]" in a particular state or territory as not resident of the state or territory unless all the beneficial owners of the entity are also residents of the state or territory. Rule 147(d)(3). Rule 147A(d)(3) provides an identical anti-sham provision for entities organized with the specific purpose of acquiring securities offered pursuant to Rule 147A. Rule 147A(d)(3).

3. Limitation on Resales

Rule 147 and 147A impose resale limitations on those purchasing under either exemption. Without a resale limitation, the initial purchasers in an intrastate offering, say, taking place in Michigan, could turn around and resell in Ohio and Indiana, undermining the intrastate nature of the offering. To combat this possibility, the SEC requires that for a six-month period, measured from the date of the issuer's sale by a particular resident investor under Rule 147 or 147A, any resale of such security by the resident investor must be made only to "persons resident within the state or territory in which the issuer was resident … at the time of the sale of the security by the issuer." Rule 147(e); 147A(e).

In employing a six-month holding period, the SEC was persuaded by the argument that, "a period of six months is adequate to establish that securities sold in an intrastate offering have 'come to rest' in a state by analogizing to provisions of Rule 144, in which a six-month holding period is deemed sufficient to establish investment intent." As discussed earlier in this Chapter, the six-month holding period under Rule 144(d)(1)(i) applies only for restricted securities of an Exchange Act reporting issuer. For non-Exchange Act reporting issuers, the likely status of many Rule 147 and 147A issuers, the holding period under Rule 144(d)(1)(ii) is one year, Rules 147 and 147A provide more resale flexibility.

What happens after the expiration of the six-month period from the date of purchase from the issuer under Rules 147 and 147A? If the securities have come to rest, then the investors in the Rule 147 or 147A offering are not underwriters for the issuer and thus the investors resale transaction is separate from the issuer's Rule 147 or 147A offering. As a separate transaction, as we will discuss in Chapter 10, the reselling investor will likely be able to use § 4(a)(1)'s exemption from § 5for resale.

What happens if a resident investor who purchases from a Rule 147 or Rule 147A offering decides to resell to out-of-state investors before the expiration of the six-month period? Rules 147(b) and 147A(b) make clear that compliance with the six-month resale limitation period is not a condition for the issuer to obtain an exemption from § 5 under Rules 147 and 147A. Rules 147(b), 147A(b). A resident investor that resells securities to out-of-state investors before the expiration of the six-month period must nonetheless consider whether the resident investor is an underwriter if they purchased from the issuer with a view to the distribution of the securities (see discussion in Chapter 10). If the resident investor is an underwriter, resale of securities purchased in a Rule 147 or 147A offering will violate § 5 unless the reseller finds an alternative exemption.

4. Precautions Against Interstate Sales

The SEC imposes several precautions to curtail interstate sales during the Rule 147 or 147A offering itself and in the secondary resale market after the offering (during the six-month resale limitation period). These precautions include a "prominent legend" on the certificate or other document evidencing the security that indicates that that the securities were sold through an exemption from § 5 registration and that the securities are subject to a six-month resale limitation period during which securities may only be sold intrastate. Rules 147(f)(1)(i), 147A(f)(i). The issuer must issue stop transfer instructions to the issuer's transfer agent with respect to the securities sold through Rule 147 or 147A. If no transfer agent exists and the issuer transfers its own securities, then the issuer must make "notation in the appropriate records of the issuer." Rules 147(f)(1)(ii), 147A(f)(1)(ii). The issuer must also obtain a written representation from each purchaser as to the purchaser's residence. Rules 147(f)(1)(iii), 147A(f)(1)(iii).

5. Disclosures

Both Rules 147 and 147A require the issuer to disclose to each offeree in the manner in which any offer is communicated and to each purchaser a reasonable amount of time before the sale date the following statement:

> Sales will be made only to residents of [identify the name of the state or territory in which the issuer was resident at the time of the sale of the securities by the issuer]. Offers and sales of these securities are made under an exemption from registration and have not been registered under the Securities Act of 1933. For a period of six months from the date of the sale by the issuer of the securities, any resale of the securities (or the underlying securities in the case of convertible securities) shall be made only to persons resident within the state or territory of [identify the name of the state or territory in which the issuer was resident at the time of the sale of the securities by the issuer].

Rules 147(f)(3), 147A(f)(3). According to the SEC, "disclosure will help alert potential investors that only residents of the state in which the issuer is located are eligible to participate in the offering." Sec. Act Rel. 33-10238, at p. 18.

6. Integration Safe Harbor

Rule 147 and 147A provide integration safe harbors similar to the integration safe harbor for Regulation A. If the terms of Rule 147(g) are met, then the Rule 147 offering will not be integrated with another offering. Symmetrically, the other offering will also not have the Rule 147 offering integrated into it. Thus, Rule 147(g) provides a "two-sided" integration safe harbor, protecting both offerings from integration. Rule 147A(g) provides a similar two-sided integration safe harbor. The Rule 147(g) and 147A(g) two-sided integration safe harbors are broader than the one-sided integration safe harbor we saw in Rule 502(a) of Regulation D.

The Rule 147 and 147A integration safe harbors have two components. First, there is a backward integration safe harbor. Offers or sales of securities under Rule 147 or Rule 147A will not be integrated with offers or sales of securities made in any offer or sales prior to the commencement of the Rule 147 or Rule 147A offering. Rules 147(g)(1), 147A(g)(1).

Second, there is a more limited forward integration safe harbor. Offers or sales of securities under Rule 147 or Rule 147A will not be integrated with certain specified offers or sales made after the completion of the Rule 147 or 147A offering. Rules 147(g)(2), 147(g)(2). These specified post-completion offers or sales include offers or sales registered under § 5 (i.e., a registered public offering). Rules 147(h) and 147A(h) provide an important limit to the integration safe harbors under Rules 147A(g)(2) and 147A(g)(2) respectively for subsequent registered offerings. Suppose an issuer starts with an intrastate offering and makes offers under Rule 147 to numerous investors in the same state as the issuer. After the completion of the offering, the issuer immediately commences a registered public offering and is in the Pre-Filing Period of the public offering. Recall that the Pre-Filing Period prohibits offers under § 5(c) (with some exceptions). To prevent an issuer from conditioning the market with a Rule 147 or 147A offering prior to a registered public offering, the SEC requires that the issuer must wait at least 30 calendar days between the last date of offers under Rule 147 or 147A and the filing of the registration statement with the SEC (mirroring the 30 day "cool down" time period under Rule 163A) with one exception. If the offers under Rule 147 or 147A are limited to only qualified institutional buyers and institutional accredited investors referenced in § 5(d), then the Rule 147 or 147A offers will not be integrated with a subsequent registered offering without the need to wait 30 calendar days. Rules 147(h), 147A(h).

Other specific post-completion offers and sales that qualify for the Rule 147 or 147A safe harbors include offers and sales under Regulations A, and S, Rule 701, pursuant to an employee benefit plan, and § 4(a)(6). For each of these specified offerings, the integration safe harbor allows the issuer to commence the specified offering immediately after the completion of the Rule 147 or 147A offering. Rule 147(g)(2)(ii)-(vi), 147A(g)(2)(ii)-(vi). Outside of these specified offerings, the forward integration safe harbor applies to any offering that is made more than six months after the completion of the Rule 147 or 147A offering. Rule 147(g)(2)(vii), 147A(g)(2)(vii).

What happens to offerings that are not covered by the Rule 147(g) or 147A(g) integration safe harbors? "There is no presumption that offerings outside the integration safe harbors should be integrated. Rather, whether concurrent or subsequent offers and sales of securities will be integrated with any securities offered or sold pursuant to amended Rule 147 or new Rule 147A will depend on the particular facts and circumstances, including whether each offering complies with the requirements of the exemption that is being relied upon for that particular offering. For example, an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers in that offering were not solicited by means of the offering made in reliance on Rule 147 or new Rule 147A." Sec. Act Rel. 33-10238, at p. 51-52.

7. State Securities Law

Both Rules 147 and 147A provide that issuers must comply with the relevant state securities regulatory regime. The SEC noted: "[S]tates will retain flexibility to adopt requirements that are consistent with their respective interests in facilitating capital formation and protecting their resident investors in intrastate securities offerings, including the authority to impose additional disclosure requirements regarding offers and sales made to persons within their state or territory, or the authority to limit the ability of certain bad actors from relying on applicable state exemptions." Sec. Act Rel. 33-10238, at p. 9. In addition, both federal and state antifraud provisions apply. Sec. Act Rel. 33-10238, at p. 9.

HYPOTHETICAL TWENTY

1. Trendy sells $20 million of common stock in an intrastate offering solely to California residents. Incorporated and headquartered in California, Trendy plans to use the proceeds to finance additional drink-related research and development at its lab located in Berkeley, CA. Research expenditures typically include purchasing a large amount of raw materials from around the globe (e.g., exotic plant roots, etc. to use in formulating new drinks). Assume that at least 50% of the proceeds will be used to purchase these raw materials for use in the Berkeley lab. Does the offering comply with Rule 147 or 147A?

2. What if Trendy, in conducting the $20 million intrastate offering, circulates an offering memorandum rife with inaccuracies relating to the background of Trendy's officers and directors?

3. Kim, the CEO of Trendy, is also its largest shareholder. Kim decides to cash out some of her holdings. If Kim were simply to sell her securities through a broker into the national securities markets, she would run afoul of § 5. Instead, Kim seeks to sell her securities in a broad-based offering solely to residents of California using ads placed in the Los Angeles Times. Would this offering be covered by Rule 147 or 147A?

4. Mitu, a purchaser of the securities in Trendy's California Rule 147A intrastate offering, suddenly finds out that he needs a new car three months after making his investment. Mitu liquidates his Trendy holdings (his only liquid asset) to purchase the car, selling the securities to his brother-in-law in New York.

5. In conducting its intrastate offering, Trendy makes a mistake. It fails to check for the residency of one out of 500 investors in its offerings. As it turns out, the one investor recently moved to Arizona. Does Trendy's offering still qualify under Rule 147 or 147A?

6. Trendy, a Delaware corporation with its principal place of business in Michigan, sells $50 million of common stock in a Rule 147A intrastate offering solely to Michigan residents. During the Rule 147A offering, Trendy engaged in general solicitation and advertising, using the Internet to solicit investors for the offering. One month after the completion of the Rule 147A offering, Trendy sells $50 million of debentures in a Rule 506 offering to 10 accredited investors and 10 sophisticated, non-accredited investors. The Rule 506 investors are located in Wisconsin, Michigan, and Pennsylvania. Assume that Trendy has a pre-existing relationship with each offeree in the Rule 506 offering that enables Trendy to determine the financial sophistication of the offerees. Does Trendy's $50 million intrastate offering qualify for Rule 147A?