SEC Adopts Final Rules to Amend Rule 504

If your company is raising capital by selling securities in a private offering, you'll likely need to find an appropriate securities law exemption under which to execute the offering. Regulation D of the Securities Act is where you'll find yourself looking. In the past, most companies have relied heavily on Rule 506 under Regulation D to execute their private offerings. However, restrictions imposed by Rule 506 may make it a less than perfect fit (usually due to limitations on the sale of securities to non-accredited investors and related heightened disclosure requirements). In an attempt to broaden the scope of Rule 504 and provide companies with easier access to capital, the Securities and Exchange Commission (the "SEC") recently adopted amendments to Rule 504 of Regulation D making Rule 504 offerings a more viable option to raise capital. These amendments go into effect on January 20, 2017.

Historically, issuers have avoided Rule 504 because it only permitted issuers to raise $1 million in a twelve-month period. This low fundraising threshold would typically cause transaction costs to be too high relative to the amount of capital raised, making Rule 504 an inefficient way to raise capital.

The SEC's amendments to Rule 504 are intended to reduce the "capital inefficiency" barrier and make it a more practical tool with which to raise capital. While the amendments effectuate several changes, the most notable element is the increase in the aggregate amount of capital that may be raised from $1 million to $5 million in a twelve-month period.

The remaining framework of Rule 504 stays the same. Perhaps most important, Rule 504 offerings (i) allow for an unlimited number of non-accredited investors, (ii) do not require any specific disclosures to the investors participating in the Rule 504 offering, and (iii) in limited circumstances, permit issuers to engage in general solicitation or advertising. Rule 504 offerings also remain subject to the anti-fraud provisions found in Rule 10b-5 of the Securities Exchange Act of 1934.

Collectively, the amendments coupled with the remaining Rule 504 framework, seem to increase "capital efficiency" and create a viable fundraising option. However, there are still some hurdles that should be carefully considered. In particular, unlike Rule 506, Rule 504 does not preempt state blue sky laws. This means that although the offer or sale of securities under Rule 504 may be exempt from registration under Federal securities law, the offering may still be subject to registration (unless there is an applicable state exemption) under the securities laws of each state in which securities are offered or sold.

This aspect of Rule 504 may make a Rule 504 offering prohibitively expensive for companies seeking to raise funds from investors located in multiple states. The time and cost associated with researching state blue sky laws, preparing necessary filings (or finding applicable exemptions), and paying any required filing fees, could outweigh the benefits of the amendments, particularly if the amount of securities to be offered or sold is below the $5 million threshold.

If you are considering a Rule 504 offering, it is imperative to consider the geographic scope of the proposed offering, and the estimated offering amount, before deciding that Rule 504 is the appropriate exemption to utilize. Even as amended, Rule 504 may be less favorable than other available exemptions depending on the structure of your offering. However, if you are seeking to raise up to $5 million through an offering focused on a limited number of states with issuer friendly offering registration requirements or exemptions, and you intend to sell to non-accredited investors, a Rule 504 offering might be the way to go.

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