Raising EB-5 Capital: Key Securities Laws Considerations and a Compliance Roadmap

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A Practice Note describing key securities laws including the Securities Act, the Securities Exchange Act, the Investment Company Act and the Investment Advisers Act in raising capital under the EB-5 immigrant investor visa program. This Note discusses legal requirements for raising capital to satisfy both immigration and securities laws and provides a compliance roadmap.

Congress established the EB-5 Program in 1990 to create jobs and to attract investment capital. Under the EB-5 Program, which is administered by the US Citizenship and Immigration Services (USCIS), immigrant investors who make the required minimum investment in a new commercial enterprise may receive conditional permanent residence in the US for themselves, their spouses and their children under age 21. After two years, if the immigrant investor satisfies the statutory and regulatory requirements of the EB-5 Program, which include creating ten new jobs per investment, the conditions are removed and the immigrant investor and her family may become unconditional lawful permanent residents of the United States.

This Note discusses the US securities laws that are implicated in conducting securities offerings to raise capital under the EB-5 immigrant investor program. It provides a roadmap to assist counsel in addressing the principal challenges when representing issuers in EB-5 securities offerings.

EB-5 PROGRAM FINANCING

The EB-5 Program has raised billions of dollars since its inception, and the program is being used now more than ever (see *USCIS: EB-5 Statistics (2005-2012)*). In fiscal year 2012 (October 1, 2011 to September 30, 2012), the last year for which data is available, mainland-born Chinese investors were issued 6,124 EB-5 visas, far more than investors of any other country (see *Department of State: Immigrant Visas Issued and Adjustments of Status Subject to Numerical Limitations (by Foreign State Chargeability): Fiscal Year 2012, Part 3 (Employment Fifth and Totals, Grand Totals*) (at page 16)). The annual allocation of 10,000 EB-5 visas has not yet been reached. Full issuance of all available EB-5 visas each year could reflect billions of dollars of financings annually.

Since the collapse of the traditional financing markets in 2008, many commercial real estate developers cannot find financing to fill their capital stacks, particularly mezzanine financing. Even for developers with access to construction loans, high loan-to-cost ratio requirements and the returns expected by equity players leave many developers unable to finance their projects.

Some developers now seek alternative sources, such as EB-5 financing, for their projects. This financing may be provided by a new commercial enterprise that conducts an offering of its equity securities to EB-5 investors who invest $500,000 in exchange for an equity interest in the new commercial enterprise if the project is in a targeted employment area. The new commercial enterprise may then pool these investments and offer a loan to or an investment in the project developer at a below-market rate. The new commercial enterprise may be a USCIS-designated regional center or may be sponsored by a USCIS-designated regional center to allow for the use of an indirect job creation economic methodology. Indirect jobs are created as a result of a new commercial enterprise, as opposed to jobs created in a new commercial enterprise (see *Practice Note, Hiring and Employing Foreign Nationals in the US: Overview (http://us.practicallaw.com/0-500-9967)* and *Key Immigrant Visa Classifications Chart (http://us.practicallaw.com/3-505-9885)*).

Even though the EB-5 program is designed to provide a path for immigrant investors to obtain a visa, EB-5 financing involves the offer and sale of securities and must be analyzed like any other securities

offering. Issuers and their counsel should consider the various securities laws that impact an EB-5 securities offering. In addition to state "blue sky" laws if the offering is also made in the US, these laws include:

- The Securities Act of 1933 (see *The Securities Act*).
- The Securities Exchange Act of 1934 (see *The Securities Exchange Act*).
- The Investment Company Act of 1940 (see *The Investment Company Act*).

Because these offerings are only made to individual investors seeking conditional permanent resident status, this Note focuses only on individuals.

THE SECURITIES ACT

EB-5 offerings involve the sale of securities, and issuers must either register these securities with the Securities and Exchange Commission (SEC) under the Securities Act or else find an exemption from registration. The more appropriate exemptions to consider include:

- The exemption provided by Regulation S for offers and sales to non-US persons as defined in Regulation S under the Securities Act (see *Regulation S*).
- The private placement exemption under Section 4(a)(2) of the Securities Act and the safe harbor provided by Regulation D (see *Regulation D*).

REGULATION S

Because EB-5 offerings are directed at non-US persons, Regulation S under the Securities Act is often relevant. Regulation S is meant to assist US and foreign companies with raising capital overseas quickly and inexpensively without complying with the registration requirements under Section 5 of the Securities Act. Because equity securities must be issued in an EB-5 offering, if the issuer is a newly formed entity (and they usually are), Category 3 of Rule 903 applies to the offering.

Rule 903(b)(3) of Regulation S has restrictions and conditions for compliance (*17 C.F.R. § 230.903(b)(3)*). Because Category 3 securities are most at risk of flowing back into the US, in addition to the two basic requirements of Regulation S concerning offshore sales and no directed selling efforts, they have an extended distribution compliance period and are subject to additional transactional and offering restrictions. Under Rule 903 of Regulation S, securities sold should not be transferred to a US person or for the account or benefit of a US person for a period of one year in the case of equity securities (which is required for an EB-5 investment). To ensure compliance:

- Non-US investors should certify that they are not:
  - US persons; and
  - acquiring the securities for the account or benefit of any US person.
- Non-US investors should agree to resell the securities only in accordance with the provisions of Regulation S.
- The issuer's securities should contain a legend stating that transfer is prohibited except in accordance with the provisions of Regulation S.
- The issuer should not register any transfer of the securities not made in accordance with the provisions of Regulation S.
- The issuer should implement other reasonable procedures to prevent any transfer of the securities not made in accordance with the provisions of Regulation S when:
  - the securities are in bearer form; or
  - foreign law prevents the issuer of the securities from refusing to register securities transfers.

To comply with Rule 903, the issuer should request that non-US persons acknowledge and represent that they:

- Are domiciled and have their principal place of business outside the US.
- Are not:
  - a US person as defined under Rule 902 of Regulation S;
  - acquiring the securities for the account or benefit of any US person; and
  - acquiring the securities for their distribution.
- Are located outside the US during:
  - the offering to and communication of their order to subscribe for the securities;
  - the execution of the subscription documents to the offering; and
  - the closing.
- Have both:
  - received or had access to all information they deem relevant to evaluate the merits and risks of the prospective investment; and
  - reviewed and understood the information.
- Can bear the economic risk of an investment in the offering for an indefinite period of time.
- Have the knowledge and experience of financial and business matters to evaluate the merits of an investment in the offering.

Rule 904 and Rule 905 deal with offshore resales of securities (*17 C.F.R. §§ 230.904-230.905*). Resales of securities by non-US investors must be made either:

- In accordance with Regulation S.
- In accordance with the registration requirements of the Securities Act.
- Under an exemption from Regulation S or the Securities Act.

Rule 904 describes the conditions under which securities may resold by offshore purchasers, while Rule 905 specifies that equity securities of domestic issuers are deemed restricted securities as defined in Rule 144 of the Securities Act (*17 C.F.R. § 230.144*).

REGULATION D

Regulation D is a safe harbor exemption from securities registration requirements under the Securities Act that allows issuers to conduct an exempt private placement. Under Rule 501(a) (*17 C.F.R. § 230.501(a)*), an accredited investor includes any individual who comes

within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, during the sale of the securities to that individual:

- Any director, executive officer or general partner of the issuer of the securities being offered or sold, or any director, executive officer or general partner of a general partner of that issuer.
- Any natural person whose individual net worth (or joint net worth with that person's spouse) at the time of his purchase exceeds $1 million. In calculating a person's net worth (the amount of assets in excess of liabilities):
  - the value of the person's primary residence is not included as an asset;
  - the amount of debt secured by the primary residence, up to its estimated fair market value, is not included as a liability, unless the person incurred debt within 60 days before buying securities in an unregistered offering for buying those securities and not buying the residence. In that situation, the amount of debt borrowed during the 60-day period must be included as a liability;
  - any debt secured by the primary residence in excess of the estimated fair market value of the home is included as a liability; and
  - these additions and subtractions to the definition of net worth do not apply to a person exercising a right to buy securities if the person held that right to buy those securities, as well as other securities of the same issuer, on July 20, 2010, and met the net worth test in effect when the person acquired the right.
- Any natural person who:
  - had an individual income greater than $200,000 or joint income with that person's spouse greater than $300,000 in each of the two most recent years; and
  - has a reasonable expectation of reaching the same income level in the current year.
- Any trust:
  - with total assets in excess of $5 million;
  - that was not formed for the specific purpose of acquiring the securities offered; and
  - whose purchase of the securities is directed by a sophisticated person as described in Rule 506(b)(2)(ii) under Regulation D (*17 C.F.R. § 230.506(b)(2)(ii)*).

THE SOLICITATION AND ADVERTISING PROHIBITION

Regulation D has additional criteria for complying with the exemption depending on the size of the offering under Rule 504, Rule 505 or Rule 506 (*17 C.F.R. §§ 230.504, 230.505* and *230.506*). However, since EB-5 offerings often exceed $5 million, the issuer often relies on the Rule 506 safe harbor. To have a valid private placement under Rule 506(b), all non-US investors must be accredited investors and neither the issuer of the securities nor any person acting on behalf of the issuer may offer or sell securities in the offering through general soliciting or general advertising. General solicitation and general advertising may include advertisements, articles, notices or other communications, such as:

- Publications in any newspapers, magazines or similar media.
- Broadcasts over the television, radio or internet.
- Any seminars or meetings whose attendees were invited by general solicitation or general advertising.

For further information on general solicitation and advertising, see *Practice Note, Section 4(a)(2) and Regulation D Private Placements: No General Solicitation or Advertising of the Offering under Rule 504, Rule 505 and Rule 506(b) (http://us.practicallaw.com/8-382-6259#a426143)*.

Since September 23, 2013, issuers can rely on Rule 506(c) of Regulation D (see *Final General Solicitation Rules*). Rule 506(c) creates a safe harbor from registration for Rule 506 offerings that use general solicitation, subject to certain conditions. Issuers conducting a Rule 506 offering on or after that date can rely on Rule 506(c) or conduct an offering without general solicitation under Rule 506(b). In addition, effective September 23, 2013, Rule 506(d) bars reliance on the Rule 506 safe harbor if offerings under both Rules 506(b) and 506(c) include bad actors, participants who have experienced disqualifying events. For sample representation language, see *Standard Clause, Bad Actor (Rule 506(d)) Disqualification Representations and Warranties (http://us.practicallaw.com/2-536-5786)*.

The Regulation D exemption is unavailable for the resale of securities. It is only available to the original issuer. A valid Regulation D exemption does not also establish an exemption from the antifraud, civil liability or other similar provisions under the US federal securities laws.

INTEGRATION OF REGULATION S AND REGULATION D OFFERINGS

Since a Regulation S offering can involve a public offering of securities, issues arise about what extent a Regulation D private offering can be made concurrently with a Regulation S offering and not lose its exemption. The SEC has issued guidance providing for the conditions when these concurrent public and private offerings may be made (see *Practice Note, Multiple Offerings: Dealing with Integration (http://us.practicallaw.com/1-381-9554)*).

Moreover, in the release for Final General Solicitation Rules, the SEC addressed the issue of concurrent private offerings, one in reliance on Rule 506(c) (*17 C.F.R. § 230.506(c)*) and another in reliance on the safe harbor set out in Regulation S for offers and sales in offshore transactions. One of the conditions of Regulation S's safe harbor is that there be no directed selling efforts, which includes activities that may be seen as conditioning the market in the US for the securities being sold in reliance on Regulation S. The SEC made it clear that an offshore offering conducted in reliance on Regulation S cannot be integrated with a domestic private offering that uses general solicitation or advertising and that is otherwise conducted in compliance with Rule 506(c).

THE SECURITIES EXCHANGE ACT

If an offering is made through a registered broker-dealer, Rule 15c2-4 under the Securities Exchange Act may apply, but Rule 10b-9 under the Securities Exchange Act always applies if the offering is structured to include offering contingencies (*17 C.F.R. §§ 240.15c2-4* and *240.10b-9*).

RULE 10B-9: PROHIBITED REPRESENTATIONS IN CONNECTION WITH OFFERINGS

Rule 10b-9 applies to offerings made on an "all or none" or on a "part or none" basis whether or not:

- The offering is registered under the Securities Act.
- Broker-dealers participate in the offering.

(*17 C.F.R. § 240.10b-9.*)

For example, if an offering is being made for a maximum of $100 million, but no securities will be sold unless a minimum of $50 million is raised (a "mini-max" offering), then Rule 10b-9 requires that:

- The specified minimum number of securities be sold at the specified price within the specified time period.
- The total minimum amount is received by the issuer by the specified date.

If the minimum amount of the offering is not received by the specified date, all funds received must be promptly refunded by the issuer to investors.

RULE 15C2-4: PAYMENTS RECEIVED IN CONNECTION WITH UNDERWRITINGS

Rule 15c2-4 is a companion to Rule 10b-9 (*17 C.F.R. § 240.15c2-4*). It requires that the funds received by broker-dealers from investors be promptly deposited and segregated in a separate trust or agency account or transmitted to a bank and held for the non-US investors' benefit until there has been compliance with the "all-or-none" or "part or none" terms. In addition, once funds are deposited into the trust or agency account, they may only be invested in qualified investments.

After the terms of an offering are met, the funds can be transmitted to the issuer. If the terms of the offering are not met, then the funds must be promptly returned to the investors by the bank or account holder. Rule 15c2-4 is designed to prevent an offering from being a fraudulent, deceptive or manipulative act or practice under Section 15(c)(2) of the Securities Exchange Act.

FINDERS VERSUS BROKER-DEALERS

Issuers often choose to use a broker-dealer or finder to assist in the offer or sale of their securities. Under the Securities Exchange Act, a broker is defined as "any person engaged in the business of effecting transactions in securities for the account of others," and a dealer is defined as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." Each of these definitions also requires the use of a US jurisdictional means while engaging in these activities.

A finder is an individual or entity that is not a registered broker-dealer, but is otherwise retained by an issuer to assist in raising funds through the offer and sale of its securities. A finder may need to register as a broker-dealer if any of the following are present:

- The finder participates in important parts of the offering, including soliciting, negotiating or executing the sale of securities.
- Compensation depends on the results or amount of securities sold.
- The finder has a history of executing these offerings.
- The finder is involved in offerings for others.

A domestically organized entity, even if only soliciting non-US investors off-shore, generally must register as a broker-dealer if it participates in broker-dealer activities abroad. That is because US jurisdictional means is established by the receipt of funds domestically and the project being financed is in the US. However, entities organized off-shore can conduct activities in foreign countries that would otherwise be US broker-dealer activities if their activities comply with the laws of the countries in which they conduct their activities.

An agreement between the issuer and a finder should be established before its participation in an offering to avoid potential non-compliance issues. Issuers may be civilly and criminally liable for using the services of an unregistered broker-dealer and should carefully monitor the activities of any non-registered broker-dealer in an offering.

THE INVESTMENT COMPANY ACT

EB-5 offerings generally are made by newly formed issuing entities. The entities use the proceeds of the offerings to make loans to or investments in other entities that actually own the project being financed or constructed. Either of these scenarios raises questions of whether the issuing entities are investment companies within the meaning of the Investment Company Act because the majority of the assets they end up holding, such as mortgage notes and debt or equity securities, constitute securities under the securities laws. In these cases, the exemptions under the Investment Company Act generally relied on include the exemptions provided by:

- Section 3(c)(1) (see *Section 3(c)(1)*).
- Section 3(c)(5)(C) (see *Section 3(c)(5)(C)*).
- Section 3(c)(7) (see *Section 3(c)(7)*).
- Certain other exemptions, including the exemption provided by Rule 3a-5 of the Investment Company Act (see *Rule 3a-5 Finance Subsidiaries*).

Companies rely on Sections 3(c)(1) and 3(c)(7), the private investment company exemptions, when there is no easier way to avoid becoming an inadvertent investment company and therefore subject to the onerous requirements of the Investment Company Act (*15 U.S.C. § 80a-3(c)(1), (c)(7)*). The exemptions provided by Sections 3(c)(1) and 3(c)(7) impose investor restrictions that apply both in the initial placement of the securities of an issuer that seeks to rely on one of those Sections and to any secondary market transfers of those securities.

Transactions that violate the Investment Company Act are void and unenforceable under Section 47 of the Act. If an issuer must register as an investment company, it has to comply with a variety of substantive requirements under the Investment Company Act that impose, among other things:

- Limits on capital structure.
- Restrictions on specified investments.
- Prohibitions on transactions with affiliates.

- Compliance with reporting, recordkeeping, voting and other rules and regulations that may significantly increase operating expenses and be difficult to comply with.

SECTION 3(C)(1)

Section 3(c)(1) under the Investment Company Act provides an exemption for any issuer:

- Whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons.
- That is not making and does not presently propose to make a public offering of its securities.

(*15 U.S.C. § 80a-3(c)(1)*).

Certain attribution rules apply in determining the 100-person limit. The 100-person limit applies to all classes of securities of the issuer, not just the class of securities being offered. To comply with Section 3(c)(1), resale restrictions on the securities should be imposed to ensure continuing compliance with the 100-person limit. In addition, the issuer should consider integrating offerings to comply with the private placement requirement and the 100-person limit.

Since offerings are made to individuals who need only make a $500,000 investment for a qualifying project, total offering amounts of less than $50 million should only be considered for a Section 3(c)(1) exemption to comply with the 100-person limit.

SECTION 3(C)(5)(C)

If the issuer in an offering receives a qualifying mortgage or other interests in a real estate project being financed, an exemption under Section 3(c)(5)(C) of the Investment Company Act may be available (*15 U.S.C. § 80a-3(c)(5)(C)*). Experienced counsel should carefully analyze the complex requirements to comply with this exemption.

SECTION 3(C)(7)

An exemption under Section 3(c)(7) of the Investment Company Act (*15 U.S.C. § 80a-3(c)(7)*) requires that domestic issuers have outstanding securities that are offered only in a non-public offering only to "qualified purchasers" as defined in Section 2(a)(51) of the Investment Company Act (*15 U.S.C. § 80a-2(a)(51)*). Because of the investment amount required for a person to be a qualified purchaser and the fact that only qualified purchasers can be investors at any time, the Section 3(c)(7) exemption has limited usefulness in an EB-5 offering.

RULE 3A-5 FINANCE SUBSIDIARIES

If structured properly, Rule 3a-5 of the Investment Company Act may provide a Investment Company Act exception if:

- A finance subsidiary is established by the project ownership entity that issues non-voting preferred stock to EB-5 investors.
- At least 85% of the funds raised are invested in or loaned to the ownership entity or a company controlled by it no later than six months after the funds are received.

(*17 C.F.R. § 270.3a-5.*)

In addition, a two-tiered-partnership exemption may be available if the financing entity owns or controls the project ownership entity.

THE INVESTMENT ADVISERS ACT

Entities involved in the EB-5 program occasionally are involved in rendering advice to investors and others for investing in, purchasing or selling securities. These activities can subject an entity to the requirements of the Investment Advisers Act of 1940.

An investment adviser is one who provides advice or analysis to others about securities for compensation and during the normal course of the adviser's business. Investment advisers are subject to SEC registration requirements and are regulated (see *Article, US Investment Adviser Registration: Overview (http://us.practicallaw.com/7-386-4497)* and *Practice Note, US Securities Laws: Overview (http://us.practicallaw.com/3-383-6798)*).

HEIGHTENED REGULATORY CONCERNS

The SEC and state securities regulators through the North American Securities Administrators Association, as well as the USCIS, are focusing on EB-5 offerings and whether they are being made in compliance with the securities laws discussed. Issuers and developers should ensure that they receive knowledgeable securities advice early on in structuring and carrying out EB-5 offerings.

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