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**Category Three and EB-5: Compliance with Regulation S**

**Introduction**

Projects seeking funds under the EB-5 visa program must comply not only with Section 203(b)(5) of the Immigration and Nationality Act, and related rulemakings, but also federal and state securities law. From the point of view of a securities lawyer examining the structure of and disclosure relating to EB-5 projects, it sometimes seems that short shrift has been given to compliance with securities law.

Any offer or sale of securities that uses the “jurisdictional means” (phones, mails, internet) must be registered under the Securities Act or comply with an available exemption. Registration with the SEC is a time-consuming and expensive process, and so EB-5 offerings are usually made in reliance on Regulation D or Regulation S under the Securities Act.

Regulation D is a relatively simple exemption, at least insofar as it relates to the usual structure of EB-5 offerings. The element of Regulation D most suited to such offerings is Rule 506, which permits two types of offering. Rule 506(b) provides that so long as no “general solicitation” (generally, advertising or otherwise conditioning the market for the securities, including via a non-password protected website) is used, offers and sales of securities made only to “accredited investors” (who generally self-certify as to their accredited status) are not required to be registered. Rule 506(c) provides that so long as sales (as opposed to offers and sales) are made only to accredited investors whose accredited status is verified by the issuer, no registration is required and general solicitation may be used to reach those investors. Provided that offers and sales are not made to non-accredited investors, no specific form of disclosure is mandated, although anti-fraud rules apply to any disclosure that is made.

Since the EB-5 rules require a minimum investment of $500,000 or $1 million, EB-5 offerings are frequently made in reliance on Regulation D to accredited investors only. In essence, compliance with Regulation involves verifying the accredited status of the offeree and ensuring that no misleading statements are made in the offering documentation.

Sometimes, however, the sponsor of an EB-5 project wishes to take advantage of the Regulation S exemption from registration of securities when the purchasers currently reside outside of the United States. However, relying on Regulation S poses compliance challenges that are more difficult to meet than for EB-5 offerings that rely on Regulation D.

The companies issuing securities in EB-5 deals are typically organized under the laws of a US state, and are not registered with the SEC. The offerings must be equity or equity-like in order to comply with the at-risk requirement of the EB-5 Visa. The offerings must therefore comply with the conditions that apply to equity securities issued under Category 3 of Rule 903 of Regulation S.

**The Conditions of the Federal Exemption under Regulation S**

These conditions (as they apply to the most common types of EB-5 offerings) are as follows:

* Both offers (including offers made through a website) and sales must be made in “offshore transactions.” This requires that:
  + No offer be made to “a person in the United States.” This requires that the offeree (the potential investor) be physically outside the United States when the offer is made. Certain dealers and fiduciaries acting for persons outside the United States are deemed themselves to be outside the United States for purposes of this condition, for policy reasons; AND
  + At the time the buy order is originated, the buyer must be physically outside the United States.
* No “directed selling efforts” may be made. Directed selling efforts are “any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on Regulation S.” While the directed selling efforts definition encompasses many of the same activities as “general solicitation”, there is no direct overlap.
* The securities are subject to a one-year “Distribution Compliance Period.” During the Distribution Compliance Period, the securities may not be offered, sold or resold to “US Persons.”[[1]](#footnote-1)
* “Offering Restrictions” must be adopted. Offering Restrictions require that:
  + Distributors (essentially underwriters and other intermediaries, which may include certain Regional Centers that are sponsoring the offering) must agree in writing that sales during the Distribution Compliance Period can only be made in accordance with the applicable provisions of Regulation S or in compliance with another exemption from registration. They must also agree not to engage in hedging transactions with respect to the securities.
  + All offering materials and documents must disclose that the securities are not registered under the Securities Act and cannot be sold in the United States or to US Persons. This disclosure must appear in the cover or inside front cover of any offering document and in the section where the distribution of the securities is described. The disclosure must also appear in any advertisement of the offering.
* The offer and sale of the securities may not be made to a US Person of for the account of a US Person, for the entire Distribution Compliance Period. This requirement is separate and distinct from the prohibition of offers *in the United States* discussed above, and both of these prohibitions must be complied with.
* The buyer must certify that it is not a US Person.
* The buyer must agree to resell the securities only in accordance with Regulation S or pursuant to an available exemption from registration, and not to engage in any hedging transactions with respect to the securities offered.
* The issuer’s securities must contain a legend prohibiting transfer except in accordance with Regulation S, in a registered transaction or in accordance with another available exemption and prohibiting hedging transactions.
* The issuer must be required by its charter or bylaws or by contract to refuse to register the transfer of securities not made in accordance with the requirements of Regulation S.
* Each distributor selling securities during the Distribution Compliance Period must send a confirmation or notice to the buyer with respect to the applicable restrictions.

**State Registration Requirements**

Although industry practice is not to pay a great deal of attention to the state securities laws that apply to offerings being made overseas, issuers should in fact consider whether those laws impose any additional requirements. In particular, issuers from states whose registration provisions apply to offerings made in or “from” the state (including states that have adopted certain provisions of the Uniform Securities Act) should structure their deals to comply with an available state exemption.

**Practical Application of Regulation S to EB-5 Offerings**

The following discussion sets out the practical implications of the Regulation S conditions in the context of EB-5 offerings:

* Offers and sales in “offshore transactions”: make sure the offer is made in such a way that the issuer is reasonably sure of the offerees’ location. In-person presentations should not present much doubt. Where an online intermediary is used, ensure that the intermediary requires readers to represent as to their current physical location before being permitted to view any identifying information about an EB-5 offering, and use password protections to restrict viewing. Make sure that the investor’s location is outside the United States at both the time of the offering and at the time the buyer commits to make the investment.
* The precautions outlined in the preceding bullet should also help assure compliance with the prohibition on directed selling efforts. Do not phone, text, or email persons or groups of persons who you don’t know to be outside the United States. Do not advertise in publications that are widely distributed in the United States. Do not refer to an EB-5 offering on a website that does not follow the guidelines set out above, or on social media. In the event that the issuer is making a concurrent Regulation D offering, it might be wisest for that offering to be made under Rule 506(b) as opposed to the “generally solicited” Rule 506(c). While the SEC has said concurrent offerings will not be “integrated “ (i.e., treated as being the same offering), there is still some debate in the bar as to when general solicitation might be treated as being directed selling efforts.
* The one-year Distribution Compliance Period should not present a problem for EB-5 offerings in light of the requirement that the capital remain invested and at-risk until the I-829 Petition to remove conditions on residency is approved. Even so, getting in place the documentation and agreements to ensure that it is complied with is essential.
* Offering Restrictions:
  + Regional Centers that are acting as “distributors” (playing any sort of role in promoting the offering) must agree in writing not to make sales in contravention of the Distribution Compliance Period, and not to engage in hedging transactions. This agreement should appear in any agreement between the Regional Center and the issuer, and should specifically track the language of Regulation S (as opposed to giving some general representation not to violate the securities laws, or the like).
  + Issuers should make sure that the necessary disclosure is made in the offering document and All other offering materials used, such as summaries, descriptions of the transaction in multi-issuer pitch meeting materials, advertisements and especially online, whether on a Regional Center’s site or any third party website.
* The issuer must make sure that the investor understands the definition of a US Person, and has certified either directly to the issuer or to a trusted third party that the investor is not a US Person, before the offer is made to the investor.
* The investor must certify, in writing, presumably in the subscription agreement for the offering, that it is not a US Person.
* The subscription agreement should also include a specific agreement to resell the securities only in accordance with Regulation S or pursuant to an available exemption from registration, and not to engage in any hedging transactions with respect to the securities offered. It is unlikely that there will be any opportunities to hedge securities offered in EB-5 offerings, but the representation must be made. Some entities are offering insurance for certain aspects of securities offered in crowdfunding offerings. The risk-shifting aspect of insurance may well violate the hedging prohibition, in light of the fact that the policy purpose behind the prohibition is to ensure that the buyer remains at risk, so a well-drafted representation would cover insurance as well.
* Any physical securities certificate must bear the mandated legend. In many EB-5 offerings there will be no physical certificates. LLCs and LPs present particular challenges. LLC Operating Agreements or LP Agreements should include the prescribed legend; and issuers should make sure that the subscription agreement used to document the sale of securities properly documents the investor’s accession to the Operating Agreement or LP Agreement. If any outside transfer agent is used to keep records of security-holders, that person should be instructed not to transfer the securities except in compliance with the Distribution Compliance Period.
* The issuer must be required by its charter or bylaws (this would be in the Operating Agreement of an LLC, or LP Agreement for an LP) or by contract to refuse to register the transfer of securities not made in accordance with the requirements of Regulation S. In the event the issuer does not want to make changes to its corporate governance instruments, reflecting this requirement by contract would be an alternative, but it must be a binding agreement upon the issuer. *Solely relying on representations by the investor as to transfer would not be sufficient*.
* The confirmation/notice provision was primarily designed for brokers and underwriters and so does not fit naturally into the EB-5 offering process, but it would be wise to provide some form of notice to buyers from the Regional Center, possibly within the subscription agreement.

Failing to meet these conditions results in the unavailability of any “safe harbor” under Regulation S. This does not necessary mean that the registration requirements of the Securities Act have been violated, but it does make it significantly more difficult to make concurrent Regulation S and Regulation D offerings, which often occurs in the EB-5 market.

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*The information provided here is merely a summary of the complex requirements for relying on Regulation S. It is not legal advice, and should not be relied on as such. Consult a securities attorney before making any offering of securities.*

1. The part of the definition of “US Person” relevant for the purposes of an EB-5 offering includes any natural person resident in the United States, even if that person is the citizen of another country. If the person pays taxes in the United States, he or she is a US Person. [↑](#footnote-ref-1)