akerman

Practice Update

Amendments to "Regulation A" - A Step Toward Middle Ground in Smaller Company Capital Formation

May 6, 2015

By: Philip B. Schwartz, Kenneth G. Alberstadt, and Andrew E. Schwartz

On March 25, 2015, the Securities and Exchange Commission (Commission) adopted final rules amending Regulation A. These new rules, which are often referred to as Regulation A+, were mandated by Title IV of the Jumpstart our Business Startups Act (JOBS Act). The amendments enable an exemption from federal registration for companies to sell up to $50 million of securities pursuant to Regulation A over a rolling 12-month period. (Click here to view the Commission's final release on Regulation A+.) The new rules will become effective on June 19, 2015.

Background

Under current Regulation A, issuers may raise up to $5 million in any rolling 12-month period, including up to $1.5 million offered by security holders of the company. The issuer is obligated to file an offering statement with the SEC, which is reviewed by both the Staff of the Commission, as well as by state securities regulators in the states where the securities are to be offered and sold. Securities sold under Regulation A are not "restricted securities" under the Securities Act of 1933 (Securities Act), unlike securities sold under Regulation D.

Related People

Kenneth G. Alberstadt
Andrew Schwartz
Philip Schwartz

Related Work

Capital Markets
Corporate

The adoption of Title IV of the JOBS Act is an attempt by Congress to open new and better avenues for capital formation to smaller issuers. The Commission's Regulation A+ final rules appear to represent a rational middle ground for capital formation by smaller issuers between fully registered offerings and offerings under Regulation D. While it is by no means clear whether issuers will use Regulation A+ following the adoption of these final rules, if trading venues open for securities issued under Regulation A+, offering capital to issuers and secondary market liquidity to investors, the new rules could be a next step in the rationalization of the capital formation options available to smaller issuers.

Overview of Regulation A+

In the final rules, the Commission expanded Regulation A into two tiers:

- Tier 1 for offerings of up to $20 million, including no more than $6 million to be offered on behalf of selling security holders
- Tier 2 for offerings of up to $50 million, including no more than $15 million to be offered on behalf of selling security holders

Both of these proposed offering tiers build on existing Regulation A, and include provisions regarding issuer eligibility, offering circular contents, "testing the waters," and bad actor disqualification. With some modifications, these provisions are similar to those contained in existing Regulation A. Tier 2 offerings will be subject to additional requirements, including a requirement for audited annual financial statements and required annual, semiannual, and current reports to the Commission (on new forms proscribed in the final rules). Purchasers in Tier 2 offerings will also be subject to certain limitations on the amount of their investment. Further, in an important change, Tier 2 offerings under Regulation A will be preempted from state "blue sky" regulation.

Eligible Issuers

Under the final rules, the use of Regulation A is limited to companies organized and with their principal place of business in the United States and Canada. Similar to existing Regulation A, Regulation A+ will continue to be unavailable to certain types of issuers, including (i) reporting companies whose securities are registered under Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (Exchange Act), (ii) companies registered under the Investment Company Act of 1940, (iii) blank-check companies and special purpose acquisition companies (SPACs), (iv) business development companies (BDCs), and (v) issuers of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights. Further, the final rules add two new categories of ineligible issuers: (i) companies that have not filed with the Commission the ongoing reports required to be filed under Regulation A and (ii) companies that are or have been subject to an SEC order in the past five years revoking or suspending the registration of their securities pursuant to Section 12(j) of the Exchange Act.

Further, the final rules exclude certain "bad actors" from participating in Regulation A offerings, and the Commission's proposal amends the existing "bad actor" disqualifications in existing Regulation A to include to the "bad actor" disqualification provisions that were added to Rule 506(d) as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act). (Click here to view a summary of the "bad actor" provisions adopted under the Dodd Frank Act.)

Under the final rules, an issuer that would have been disqualified from reliance on existing Regulation A based on the "bad actor" rules contained in existing Regulation A remains disqualified. However, similar to the "bad actor rules" adopted under Rule 506, "bad actors" as that term is defined under the more expansive new rules would only be disqualified for acts taking place after the effective date of the changes to Regulation A, although the issuer would be required to disclose the "bad acts" on a basis consistent with Rule 506(e).

Eligible Securities and Eligible Transactions

Section 3(b)(3) of the Securities Act and Regulation A thereunder currently limit the use of Regulation A to sales of "equity securities," which are defined to include warrants, "debt securities," and "debt securities convertible or exchangeable into equity securities," and the final rules continue this limitation. The final release expressly makes clear that the new rules are not available for asset backed securities offerings.

Consistent with existing Regulation A, the final rules include provisions for primary offerings by an issuer, secondary offerings by selling stockholders, securities issuances on the exercise of options, warrants or rights or conversions of outstanding securities, or offerings pursuant to a dividend investment plan or an employee benefit plan. The rules also include provisions for continuous or delayed offerings, but adopt new procedures modeled after current Rules 415 and 424(b) of the Securities Act. Further, the final rules, as with existing Regulation A, expressly exclude certain enumerated transactions from Regulation A, including business combinations and "at the market" offerings.

Integration with Other Offerings

The final rules preserve the safe harbors from integration contained in existing Regulation A for prior offerings or sales of securities, or subsequent offers or sales of securities, that are (i) registered under the Securities Act, (ii) made in reliance on Rule 701, (iii) made pursuant to an employee benefit plan, (iv) made in reliance on Regulation S, or (v) made more than six months after completion of a Regulation A offering. The final rules also add an exception for prior offerings or sales of securities, or subsequent offers or sales of securities that are made pursuant to crowdfunding rules under Rule 4(a)(6) under the Securities Act.

Further, the final rules clarify the scope of the safe harbor from integration where an issuer abandons a contemplated Regulation A offering before qualification, but after soliciting interest in the offering from persons other than QIBs and institutional accredited investors. The final rules state that waiting, where an abandoned offering under Regulation A was made only to QIBs and institutional accredited investors and where the issuer waits at least 30 calendar days between the last solicitation of interest in the Regulation A offering and the filing of the registration statement, the abandoned offering will not be integrated with a subsequent offering. The final rules also state that, in situations where a company waits less than 30 calendar days before a subsequent registered offering, the subsequent offering will not necessarily be integrated with the prior abandoned offering; instead, the potential integration of the two offerings will depend on particular facts and circumstances.

Offering Limitations and Secondary Sales

The final release creates two tiers of offerings under Regulation A. In new Tier 1, issuers will be limited to offerings of $20 million of securities in any rolling 12-month period, and in new Tier 2, issuers will be limited to offerings of not more than $50 million of securities in any rolling 12-month period. The proposed rules continue to allow the use of Regulation A offerings for selling securities holders. However, sales by selling stockholders that are affiliates of the issuer are limited to $6 million in a Tier 1 offering and up to $15 million in a Tier 2 offering. Furthermore, sales by all selling stockholders in the first Regulation A+ offering by an issuer and any Regulation A offering within the 12-month period following the qualification of the initial Regulation A offering are limited to 30 percent of the aggregate offering price of the particular offering, based on the theory that Regulation A+ is primarily designed as a capital raising vehicle for smaller issues.

The Tier 1 offering size increased from $5 million in the proposing release to $20 million in the final release. In deciding to raise the Tier 1 limit in the final rules, the Commission stated that the existing $5 million offering limitation has been cited as “one of the main factors limiting the utility of [Regulation A]”, and that in some circumstances, the fixed costs of any offering, including legal and accounting fees, serves as a disincentive to its use. In raising the limit of the exemption from $5 million to $20 million, the amount that can be sold by selling security holders was proportionally raised from $1.5 million to $6 million.

The Commission noted in its final release that it had received comments suggesting that the Tier 2 offering limit should be raised to more than $50 million. The Commission noted in the adopting release that, while it was keeping the Tier 2 limit at $50 million, it is required to review the offering limitation every two years. The Commission stated that by April 2016 it will “revisit the offering limitation”, as required by the statute, with a view towards determining whether or not the $50 million Tier 2 limitation should be raised.

The final rules also eliminate the prohibition currently in Regulation A on affiliate resales unless the issuer has had income from continuing operations in at least one of the prior two years. The Commission stated in the adopting release for the final rules that the revised “bad actor” disqualification provisions (described above) and issuer eligibility requirements serve the prior rule’s purpose of limiting access to companies with track records of non-compliance or abuse.

Investment Limitations

In the final adopting release, the Commission, consistent with the proposing release, has limited the amount of securities that a natural person who is not an accredited investor may purchase in a Tier 2 offering to no more than 10 percent of the greater of their annual income and their net worth. Both amounts are calculated as they would in the "accredited investor" definition under Rule 501 of Regulation D. Investments by non-accredited, non-natural persons are subject to the same limitation, and are based on an investment of no more than 10 percent of the greater of the purchaser's revenue or net assets (as of the purchaser's most recently completed fiscal year end). The investment limitations do not apply to those who meet the "accredited investor" definition under Rule 501 of Regulation D, nor do they apply to securities that will be listed on a national securities exchange upon qualification.

Issuers are required to make investors aware of the limitations, but will be able to rely on the investor's representation of their income or net worth, including the investor's representation that they are an "accredited investor", unless, at the time of the investment, the issuer knew the investor's representation to be untrue.

Because of required state blue sky merit regulation of Tier 1 offerings, the Regulation A+ adopting release does not include any investment limitations for Tier 1 offerings.

Section 12(g) Compliance

Under Section 12(g) of the Exchange Act, an issuer with assets exceeding $10 million and a class of equity securities held of record by either 2,000 persons, or 500 persons who are not accredited investors, must register that class of securities with the Commission. In its proposing release, the Commission considered, but ultimately rejected in the final release, exempting companies relying on a

Regulation A exemption from compliance with Section 12(g).

In the final rule, the Commission exempts securities issued in a Tier 2 offering from the provisions of Section 12(g) so long as the issuer remains subject to, and is current in (as of its last fiscal year end), its Regulation A+ periodic reporting obligations. In addition, for the exemption to apply, issuers must engage the services of a transfer agent registered with the Commission pursuant to Section 17A of the Exchange Act. Finally, the exemption from Section 12(g) is only available to companies who meet the "smaller reporting company" definition under the Securities Act and the Exchange Act; that is, the conditional exemption is only available to issuers who have a public float of less than $75 million, as determined as of the last business date of its most recently completed semiannual period, or, in the absence of a public float, annual revenues of less than $50 million, as of its most recently completed fiscal year. If a company initially meets these qualifications but exceeds the "smaller reporting company" thresholds as of some later date, the company would be granted a two-year transition period before it is required to register its class of securities pursuant to Section 12(g) (provided it meets the other Section 12(g) exemption requirements set forth above).

State "Blue Sky" Regulation

In its proposing release, the Commission had sought comments as to whether Regulation A+ offerings should be preempted from state "blue sky" regulation. The Government Accountability Office, as required by Section 402 of the JOBS Act, had previously conducted a study on the impact of state securities laws registration and qualification requirements conducted under Regulation A and found that state securities laws were among several central factors contributing to the lack of use of Regulation A.

In the final rules, the Commission provided for preemption of Tier 2 offerings from state blue sky regulations. The Commission noted that they were taking this step because of the "substantial investor protections" embedded in Tier 2 offerings.

Tier 1 offerings will remain subject to state securities law qualification. While the North American Securities Administrator Association's (NASAA) coordinated review program may prove to be a workable solution over time, it is too soon to determine whether it will be a workable solution for qualification of Tier 1 offerings, and not all states are yet signed up. Additionally, after the Commission's proposed Regulation A was announced in December 2013, NASAA expressed unhappiness with the proposed concept of preemption of Regulation A+ offerings, including making a statement questioning "the legal sufficiency of the proposal." It is unknown at this time whether NASAA or one or more state securities agencies will attempt to take action to stop the preemption for Tier 2 offerings from state "blue sky" regulations.

Filing of the Offering Statement

In an effort to conform Regulation A with modern filing requirements under federal securities laws, the final rules require the electronic filing of Regulation A offering statements on the EDGAR system, consistent with registered offerings and the required filing of Form Ds. In addition, the Commission proposed an "access equals delivery model" for Regulation A final offering statements.

Non-Public Filings

Under the final rules, first time Regulation A issuers who have not previously completed a registered offering of securities under the Securities Act will be permitted to make a non-public submission of draft offering statements. Any such draft offering statement must be substantially complete upon draft filing with the Commission. The offering statement must be publicly filed 24 hours prior to qualification.

The Regulation A+ Offering Statement

The rules provide for a three-part offering statement for use by issuers intending to conduct an offering under Regulation A+:

- Part I, which includes basic information about the issuer and the offering. This information would be submitted via an online, XML-based form with indicator boxes and buttons, along with text boxes, that would be submitted to the Commission via EDGAR.
- Part II, which is an offering circular that includes information about the issuer and the offering. The Model A question and answer format that is contained in existing Regulation A has been eliminated, and issuers will continue to have the option to follow the disclosure regimen in Form S-1 required of "smaller reporting companies" in lieu of using the offering circular format contained in Regulation A. Further, Form B under existing Regulation A, while retaining a scaled disclosure concept, has been revised to update the required disclosure to make it more consistent with the disclosure requirements of smaller reporting companies.

With the exception of certain clarifying changes, scaled disclosure items applicable to Tier 1 offerings, and additional guidance to issuers designed to streamline disclosure, Part II of the Offering Statement was adopted substantially as proposed. Tier 2 companies that otherwise meet the smaller reporting company definition under the Securities Act may follow scaled disclosure rules contained in Part II of the Offering Statement.

The Offering Statement under Part II of Form 1-A must include:

- Item 1: Basic information about the issuer and the offering, including the identification of any underwriters and disclosure of any underwriting discounts or commissions
- Item 2: Table of Contents
- Item 3: Summary and Risk Factors, including a disclosure of the "most significant factors that make the offering speculative or substantially risky;" These risk factors should be similar to the risk factors that would be included in a registration statement filed pursuant to a registered offering
- Item 4: Dilution, a discussion of the disparities between the public offering price and the effective cash costs for shares acquired by insiders in the prior year
- Item 5: Plan of Distribution and Selling Security holders
- Item 6: Use of Proceeds to Issuer
- Item 7: Disclosure of the issuer's business operations for the prior three years (or since inception if the company has been in existence for less than three years)
- Item 8: Description of the company's material physical properties
- Item 9: Similar to the MD&A section of registered SEC filings, this section requires a discussion and analysis of the issuer's liquidity and capital resources and results of operations for the prior two most recently completed fiscal years and interim periods (and, for issuers with no revenue for the prior three fiscal years, the plan of operations for the 12 months following qualification of the offering), including a statement of whether the issuer anticipates it will have to raise additional funds within the following six months
- Item 10: Identification of officers, directors, and significant employees, a discussion of any family relationship within that group, business

experience during the prior five year period, and involvement in certain legal proceedings during the prior five year period

  - Item 11: Disclosure of the three highest paid officers or directors and group-level disclosure of director compensation (Tier 2 offerors) or group-level executive compensation disclosure for the three highest paid officers or directors (Tier 1 offerors)
  - Item 12: Disclosure of beneficial ownership of officers, directors and 10 percent owners
  - Item 13: Transactions with related persons, promoters and certain control persons
  - Item 14: Material terms of the securities being offered
  - Disclosure of any events that would have triggered disqualification of the offering under Rule 262 if the issuer could not rely on the provisions in Rule 262(b)(1)

- Part III, which requires the filing of certain exhibits. The Commission did not propose any changes in the exhibit requirements from existing Regulation A. However, issuers are now allowed to incorporate by reference any other Regulation A filings on EDGAR, so long as the issuer agrees to be subject to the Tier 2 requirements for ongoing reporting obligations, regardless of whether the offering was made under Tier 1 or Tier 2. The Part III standards are unchanged from the proposing release.

Tier 1 and Tier 2 issuers are required to file balance sheets and other required financial statements as of the issuer's two most recently completed fiscal years (or for such shorter time as the company has been in existence) as part of Part F/S of the Offering Statement. Tier 2 issuers are required to file audited financial statements as well. Financial statements for U.S.-based issuers must follow U.S. GAAP; Canada-based issuers may use GAAP or IFRS. These audited financial statements must meet the requirements of

Article 8 of Regulation S-X (except for Rule 8-04 and 8-05, which deal with financial information with respect to acquired businesses), as if the issuer was a smaller reporting company. Tier 1 issuers do not have to submit audited financial statements; however, if a Tier 1 issuer has obtained an audit for other purposes, and the audit is performed in accordance with GAAP or the standards of the PCAOB, and the auditor followed the independence standards of Rule 201 of Regulation S-X or the AICPA, those audited financial statements must be included. Offerors are not required to submit financial statements in an XBRL format.

At the mid-April 2015 meeting of the Federal Regulation of Securities Law Committee of the ABA Business Law Section, in a speech given by Keith F. Higgins, the Director of the Commission's Division of Corporation Finance, it was reported that Regulation A+ offering statements will be reviewed by the same groups within the Division of Corporation Finance that review registration statements generally, based on the industry of the issuer.

Ongoing Reporting Requirements

Under the final rules, Tier 2 offerings will be subject to ongoing reporting requirements under which issuers will be required to file:

(i) Annual Reports on Form 1-K (updating the information included in the offering statement). These will consist of two parts: Part I (Notification), which will consist of an of an XML-based fillable form, prepopulated on the basis of the information in the Form 1-A Offering Statement, which can be changed or updated by the offeror, and Part II (Information to be included in the report), which consists of a text file attachment containing the body of the report and financial statements, formatted to be EDGAR-compatible. Part II of the Form 1-K will be required to cover:

- Business operations of the issuer for the prior three fiscal years (or since inception, if the issuer has existed for less than three years)
- Transactions with related persons, promoters and certain control persons
- Beneficial ownership of voting securities by executive officers, directors, and 10 percent owners
- Identities of directors, executive officers, and significant employees, with a description of their business experience and involvement in certain legal proceedings
- Executive compensation for the most recent fiscal year for the three highest

paid executive officers or directors

- MD&A of the issuer's liquidity, capital resources, and results of operations covering the two most recently completed fiscal years
- Two years of audited financial statements

The Annual Report on Form 1-K will be due no later than 120 days after the end of the issuer's fiscal year.

(ii) Semiannual updates on a new Form 1-SA (covering the first half of the fiscal year and consisting primarily of unaudited financial statements and MD&A), which would be due 90-days after the end of the first half of the issuer's fiscal year,

(iii) Current reports on Form 1-U reporting on the occurrence of certain specified events (a list similar to but less expansive than the list of events required to be disclosed under Form 8-K). Similar to Form 8-K, Form 1-U will be required to be filed no more than four business days after the triggering event.

Tier 2 offerors must give notice to the Commission of the suspension of ongoing reporting obligations on a new Form 1-Z. Many of the rules that apply to public companies that are obligated to file reports under Section 12 of the Exchange Act would not apply to issuers who use Regulation A for their offerings, including the proxy statement rules, Williams Act disclosure by five percent stockholders, Section 16 reporting by directors, executive officers and 10 percent stockholders, and corporate governance rules under the Sarbanes-Oxley Act. Tier 1 offerors must also use Form 1-Z to provide information about sales in offerings and update issuer information by electronically filing the Form 1-Z no more than 30 calendar days after termination or completion of an offering.

The final rules also permit a Tier 2 issuer to exit the ongoing reporting requirements at any time after filing a Form 1-Z exit report after completing reporting for the fiscal year in which the offering statement was qualified, so long as the offering is not ongoing and the securities are held of record by fewer than 300 persons. An issuer's obligations to file ongoing reports under Regulation A would also be automatically suspended if the issuer becomes subject to the periodic and current reporting requirements under Section 12 of the Exchange Act.

Issuers who are selling less than $20 million in securities may conduct their offering under either Tier 1 or Tier 2.

"Testing the Waters"

Regulation A currently permits issuers to "test the waters" for investor interest in an offering before the filing of an offering statement. The new rules continue to include these provisions, and will provide additional flexibility. As adopted by the Commission, solicitation materials will have to be submitted or filed as an exhibit when the offering statement is either submitted for non-public review or filed, but will no longer have to be filed at or before the time of first use.

Liability under Section 12(a)(2)

Since an offering under Regulation A is exempt from the registration requirements of the Securities Act, there is no Section 11 liability for a Regulation A offering. However, consistent with existing Regulation A, sellers of securities under new Regulation A+ will have liability to investors under Section 12(a)(2) of the Securities Act, which provides for liability in respect of any offer or sale of securities by means of an offering circular or an oral communication that includes a materially misleading statement or omission. Further, other antifraud and civil liability provisions of federal securities laws, including Rule 10b-5, and similar provisions in state "blue sky" laws, will apply to Regulation A offerings under the new rules, even where compliance with such laws is otherwise preempted.

Reading the "Tea Leaves"

The final Regulation A+ rules appear to be a compromise position made among the Commissioners to move these rules forward, something that everyone could support even though each Commissioner appeared to have some reservations about some parts of the final rules. The final rules also appear to represent a significant step forward in the Commission's thinking on smaller issuer capital formation. Regulation A, substantially ignored in the past in favor of Regulation D offerings and fully registered offerings, could attract issuers due to its modified reporting requirements, higher limits on offering size, and lack of substantial reliance on whether or not an investor is an "accredited investor" and the ability to offer securities that are not "restricted securities." Further, the Regulation A+ ongoing reporting scheme may appeal to smaller issuers.
