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Amendments To "Regulation A" - A Step Towards a Middle Ground in Smaller Company Capital Formation

January 31, 2014

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The Securities and Exchange Commission (Commission) recently proposed rules amending Regulation A. Regulation A currently allows an exemption from federal registration under the Securities Act of 1933 (the Securities Act) for small offerings of up to $5 million over a rolling 12-month period. The Commission has proposed amendments to Regulation A, commonly referred to as Regulation A+, as mandated by Title IV of the Jumpstart our Business Startups Act (JOBS Act). The amendments would 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. The Commission's proposing release on Regulation A+ is available here.

Background

Regulation A offerings are small, unregistered "public" offerings. 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

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and sold. Securities sold under Regulation A are not "restricted securities" under the Securities Act, unlike securities sold under Regulation D.

Regulation A in its present form is rarely used. In the Regulation A+ proposing release, the Commission reported that there were only 19 offerings under Regulation A between 2009 and 2012, raising a total of approximately $73 million. In contrast, during the same period, the Commission estimated that there were approximately 27,500 offerings of up to $5 million under Regulation D, for a total offering amount of approximately $25 billion, and 373 offerings of up to $5 million conducted on a registered basis, for a total offering amount of approximately $810 million. Further, a 2012 report by the Government Accountability Office (GAO) determined that numerous factors appear to have influenced the use of Regulation A compared to other types of offerings, including the type of investors that businesses seek to attract, the process of filing the offering statement with the Commission, the costs of state securities law compliance and the cost-effectiveness (or ineffectiveness) of Regulation A offerings.

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+ proposal appears to represent a middle ground between fully registered offerings and offerings under Regulation D. While it is not clear whether issuers will use Regulation A (even if the proposed rules are adopted) if trading venues open for securities issued under Regulation A, offering capital to issuers and secondary market liquidity to investors, the Commission's proposal could be a next step in the rationalization of the capital formation options available to smaller issuers.

Overview of Regulation A+

The Commission has proposed expanding Regulation A into two tiers:

- Tier 1, for offerings of up to $5 million, including no more than $1.5 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 would 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 proposed rules). Purchasers in Tier 2 offerings would also be subject to certain limitations on the amount of their investment. Further, in an important proposed change, Tier 2 offerings under Regulation A would be preempted from state "blue sky" regulations. Finally, if the proposed changes to Regulation A are adopted, the paper filing requirements of current Regulation A would be eliminated and issuers would be required to make all required filings under Regulation A through the EDGAR system.

Eligible Issuers

Use of Regulation A is currently limited to companies organized and with their principal place of business in the United States and Canada. Regulation A is currently 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. As proposed, Regulation A would continue to make these types of issuers ineligible, and would also add two new categories of ineligible issuers: (i) companies that have not filed with the Commission the ongoing reports required under proposed 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 Commission has asked for comments on whether eligibility should be conditioned on company size and/or whether to extend eligibility to use Regulation A to foreign private issuers, SPACs and BDCs.

Further, the proposed rules would 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 confirm them to the "bad actor" disqualification provisions that were added last year to Rule 506(d) as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd Frank Act). A summary of the "bad actor provisions adopted under the Dodd Frank Act can be found in the client alert that we published last year, which can be found here.

Under the proposal, an issuer that would have been disqualified from reliance on Regulation A based on the "bad actor" rules in existing Regulation A would remain disqualified. However, similar to Rule 506, "bad actors" as it is defined under the more expansive proposed rules, would only be disqualified for prior acts going forward, although the issuer would be required to disclose the "bad acts" on a basis consistent with new Rule 506(e).

Eligible Securities and Eligible Transactions

Section 3(b)(3) of the Securities Act and Regulation A thereunder currently limits the use of Regulation A to sales of "equity securities," "debt securities," and "debt securities convertible or exchangeable into equity securities." The Commission's proposing release continues to limit the availability of Regulation A to offerings of these types of securities. The proposing release expressly makes clear that the new rules are not available for asset backed securities offerings, although the Commission has asked for comments as to whether asset backed securities offerings should be allowed under Regulation A while still maintaining investor protection.

Consistent with existing Regulation A, the proposed 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 proposed 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 proposed rules exclude certain transaction from Regulation A, including business combinations and "at the market" offerings.

Offering Limitations and Secondary Sales

The proposing release creates two tiers of offerings under Regulation A. In Tier 1, consistent with existing Regulation A, issuers would be limited to offerings of $5 million of securities in any rolling 12-month period, and in new Tier 2, issuers would 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 (up to $1.5 million in a Tier 1 offering and up to $15 million in a Tier 2 offering, which is based on 30% of the total offering amount allowed under proposed

Regulation A in Tier 1 and Tier 2, respectively). The Commission has also proposed eliminating 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.

Investment Limitations

Regulation A does not currently restrict the amount of securities that a single purchaser may purchase in an offering. However, with the greatly expanded limitations on offering size, the Commission added certain investor protections to proposed Regulation A to limit the risk of increased investor losses. In the proposal, the Commission has limited the amount of securities that any one investor may purchase in a Tier 2 offering to no more than 10% of the greater of their annual income and their net worth. Both amounts would be calculated as they would in the "accredited investor" definition under Rule 501 of Regulation D. Issuers would be required to make investors aware of the limitations, but would be able to rely on the investor's representation of their income or net worth unless, at the time of the investment, the issuer knew that representation to be untrue.

Integration with Other Offerings

The proposed 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 proposed rules also add sales made under the recently proposed crowdfunding rules to the list of safe harbors. Finally, the proposing release includes guidance on how offerings that are concurrently with, or close in

time to, a Regulation A offering might or might not be integrated with an offering under Regulation A.

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. The Commission considered, but ultimately rejected, exempting companies relying on a Regulation A exemption from compliance with Section 12(g). However, in the proposing release the Commission asks for comments on whether an exemption from the requirements of Section 12(g) can be added to Regulation A while still protecting investors.

Filing of the Offering Statement

Regulation A was last amended in 1992, and it required paper filings of offering statements with the Commission. In an effort to conform Regulation A with modern filing requirements under federal securities laws, the Commission has proposed requiring 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 has proposed an "access equals delivery model" for Regulation A final offering circulars.

While non-public submission of Regulation A offering statements was not included in the Title IV of the JOBS Act, the Commission has proposed allowing the non-public submission of Regulation A offering statements consistent with the rules that allow such confidential filings by "emerging growth companies."

The Regulation A Offering Statement

The proposed 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 would be eliminated, and issuers would 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, would be revised to update the required disclosure to make it more consistent with the disclosure requirements of smaller reporting companies.
- Part III, which requires the filing of certain exhibits. The Commission has not proposed any changes in the exhibit requirements from existing Regulation A. However, issuers would be allowed to incorporate by reference any other Regulation A filings on EDGAR, so long as the issuer agreed 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.

Tier 2 offerings would now require audited financial statements of the issuer, but audited financial statements would not be required for Tier 1 offerings unless they were already prepared for other purposes.

Ongoing Reporting Requirements

As proposed in Regulation A+, Tier 2 offerings would be subject to ongoing reporting requirements under which issuers would be required to file: (i) annual reports on Form 1-K (updating the information included in the offering circular), which would be due 120 days after the end of the fiscal year, (ii) semiannual updates on a new proposed 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), and (iv) notice to the Commission of the suspension of ongoing reporting obligations on a new proposed 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 5% stockholders, Section 16 reporting by directors, executive officers and 10% stockholders, and the corporate governance rules under the Sarbanes-Oxley Act.

The proposed rules would 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 was 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.

"Testing the Waters"

Regulation A currently permits issuers to "test the waters" for investor interest in an offering before the

filing of a registration statement. The proposed rules would continue to include these provisions, and would provide additional flexibility. As proposed, solicitation materials would have to be submitted or filed as an exhibit when the offering statement is either submitted for non-public review or filed, but would no longer have to be filed at or before the time of first use.

Application of State "Blue Sky" Laws

Historically, Regulation A offerings required compliance with state "blue sky" laws in those states where the offering is to be offered. Under proposed Regulation A, state blue sky laws would be preempted for all offers of securities and for sales of securities in Tier 2 offerings (but not Tier 1 offerings). This change has been made based on the view that a primary factor that has led to the underuse of current Regulation A is the burden of compliance with multi-state "blue sky" laws.

The preemption of Tier 2 offerings from state "blue sky" law requirements is likely to be opposed by securities regulators in many states, and the Commission has already received a comment letter to this effect from the state securities regulator in a significant business state. However, the North American Securities Administrators Association (NASAA) has recently proposed a coordinated review program, that would permit issuers to file Regulation A offering materials with states participating in NASAA's electronic filing system and have those filings subject to a coordinated state review effort. If such a system were to be instituted, and if states were to agree to participate, it is possible that the Commission would conclude that such preemption is not required.

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 proposed Regulation A would 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, would apply to Regulation A offerings under the new rules.

Reading the "Tea Leaves"

The proposed changes to Regulation A appear to represent a significant step in the Commission's thoughts 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, unlike Regulation D offerings, lack of substantial reliance on whether or not an investor is an "accredited investor." Further, the proposed Regulation A ongoing reporting scheme may appeal to smaller companies. Finally, the proposed Regulation A offering scheme could be instructive about how the Commission might view the disclosure requirements for smaller reporting issuers generally, which over time could be grafted into the disclosure requirements for those size entities.

We will continue to monitor and report on the progress of the Regulation A+ proposal. If you have any questions or want more detailed information about the proposal, please feel free to contact the authors or your Akerman attorney.

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