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CLIENT ALERT

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SEC Approves Final Rules for Regulation A+

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On March 25, the U.S. Securities and Exchange Commission (SEC) adopted final rules amending Regulation A to implement the provisions of Section 401 of the Jumpstart Our Business Startups Act (JOBS Act).[1] The new rules confirm most of the rules that had been proposed by the SEC in December 2013.

Regulation A+, as the amendment has been called by market observers, expands the current Regulation A exemptions. All offers and sales require registration of the securities offered under the Securities Act of 1933 (Securities Act) unless an exemption applies. Regulation A is such an exemption and, consistent with the intention of the JOBS Act, is an attempt to make it easier for small businesses to raise capital. By adopting these new rules, the SEC intended to "craft a workable revision of Regulation A that would both promote small company capital formation and provide for meaningful investor protection."

Scope and Use of Regulation A Before A+

The version of Regulation A before the newly finalized rules provided for an exemption from registration requirements of the Securities Act for public offerings of securities up to $5 million in any 12-month period by U.S. and Canadian companies that are not reporting companies under Section 13 and Section 15(d) of the Securities Exchange Act of 1934 (Exchange Act). This $5 million total may include no more than $1.5 million of securities offered by current securityholders of the company, *i.e.* any secondary sale component of the offering is limited to 30 percent of the total offering. Securities sold in the Regulation A offering may be freely resold by non-affiliates of the issuer, unlike securities issued in private offerings (such as under Regulation D), which are "restricted" and subject to restrictions on resale.

The offering is subject to certain federal and state law disclosure and filing requirements, including the paper filing of an offering statement on Form 1-A and disclosure of financial statements (which may be unaudited unless audited statements are available), and including state-by-state compliance with state securities or "Blue Sky" laws. The need to comply with the individual filing, disclosure and other substantive and procedural requirements of each state where offers would be made is one of the principal reasons why legacy Regulation A has been rarely used.

Despite the seeming advantages of limited filing and disclosure requirements, offerings under Regulation A are rare compared to offerings under other Securities Act exemptions. Only seven qualified Regulation A offerings were made in 2014.

Scope of Regulation A+

The final Regulation A+ rules closely track the rules proposed by the SEC in December 2013. The final rules exclude certain issuers, consistent with current Regulation A, including, among others, non-Canadian foreign issuers, certain investment companies (including BDCs) and companies that file reports under Section 13 and Section 15(d) of the Exchange. As with legacy Regulation A, Regulation A+ also prohibits offerings in which specified "bad actors" are involved. Issuers that have been subject to a denial, suspension or revocation order by the SEC for violating the securities laws within the previous five years, and issuers that are required to, but have not filed ongoing reports with the SEC in the two years immediately preceding the filing of the offering statement cannot use Regulation A+.

In addition to the issuer exclusions, certain securities may not be offered in a Regulation A+ offering – specifically, asset-backed securities. The securities allowed for sale by the final rules include equity securities, debt securities and securities convertible into or exchangeable for equity interests, including guarantees of such securities. Finally, as initially proposed by the SEC, Regulation A+ will have an integration safe harbor such that Regulation A+ offerings will not be integrated with prior offers or sales of securities, or certain subsequent offers and sales made pursuant to Securities Act rules or employee benefit plans.

The Two Tiers of Regulation A+

The new rules increase the limit on the securities offered – from $5 million to $20 million – and add a second tier of exempted securities subject to additional requirements. These are now referred to as Tier 1 and Tier 2 offerings under Regulation A.

Tier 1 allows for securities offerings of up to $20 million in a 12-month period, including up to $6 million on behalf of selling securityholders that are affiliates of the issuer. Filings under Tier 1 are subject to all state "Blue Sky" law filing and approval requirements. Tier 1 issuers must file a balance sheet and related financial statements – which need not be audited statements unless audited statements are available – for the preceding two fiscal years, prepared in accordance with GAAP.

Tier 2 allows for securities offerings of up to $50 million in a 12-month period, including up to $15 million on behalf of selling securityholders that are affiliates of the issuer. Tier 2 issuers must file audited financial statements with their initial offering statement and must continue to file annual audited financial statements and unaudited interim financial statements with the SEC thereafter. Tier 2 issuers also are subject to additional ongoing reporting requirements. Despite these more stringent conditions, Tier 2 offers a significant benefit through preemption of state securities law requirements.[2]

Purchasers of securities in Tier 2 offerings must either be accredited investors or, if they are not accredited investors, such purchasers are not allowed to invest more than 10 percent of the greater of their annual income or net worth if a natural person, or not more than 10 percent of the greater of their revenue or net assets for the previous fiscal year if a non-natural person. Tier 2 issuers may rely on a purchaser's representation about income and net worth for the purposes of these limitations.

Filings under either Tier 1 or Tier 2 require issuers to submit an offering statement, which is reviewed and qualified by the SEC. For both Tier 1 and Tier 2, filings will be made electronically via the SEC's online filing system.

Confidential Submissions and 'Testing the Waters' Materials

Regulation A+ gives issuers the ability to file non-public submissions of offering statements for review by the SEC before filing final documents, so long as all final documents are publicly filed with the SEC no later than 21 calendar days before qualification. This does not apply to issuers whose securities have been previously sold pursuant to a qualified offering statement under Regulation A+ or an effective registration statement under the Securities Act. Regulation A+ also permits issuers to "test the waters" with the general public by soliciting interest in a potential offering before and after an offering statement is filed. Any solicitation materials must include a preliminary offering circular if the issuer's submission has not yet been qualified. The submission process for Regulation A+ updates the process under Regulation A to essentially mirror analogous filing provisions of the Securities Act.

Ongoing Reporting

Both Tier 1 and Tier 2 issuers are required under Regulation A+ to file post-offering reports with the SEC. Tier 1 issuers are required to provide information about sales in Tier 1 offerings no later than 30 days after the completion or earlier termination of the offering. Tier 2 issuers must electronically file annual, semiannual and current-event reports with the SEC. For Tier 2 issuers, the reports filed pursuant to a qualified offering under Regulation A+ would satisfy a broker-dealer's obligations under Rule 15c2-11 of the Exchange Act, permitting the broker-dealer to trade in the securities on behalf of clients. Tier 2 offerings also are exempt from the provisions of Section 12(g) of the Exchange Act, which requires companies with total 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, register such class of securities with the SEC. The exemption from Section 12(g) is conditional: an issuer is eligible for only for as long as, in addition to other requirements, (i) it remains current in its reporting obligations under Regulation A+, and (ii) either its common equity has a public float of less than $75 million or the company has annual revenues of less than $50 million. A Tier 2 issuer's ongoing reports are required to include information about sales of securities and the termination of sales in a qualified offering, as well as updates of certain information concerning the issuer.

Coordination with State Blue Sky Laws

One obstacle to the use of Regulation A has been the cost of complying with state securities laws. Regulation A+ offers Tier 2 issuers preemption from state "blue sky" compliance in the same fashion as the safe harbor under Rule 506 of Regulation D. According to the SEC, the substantial investor protections embedded in Regulation A+ (issuer eligibility conditions, limitations on investment, disclosure requirements, qualification process and ongoing reporting requirements of Tier 2) made it reasonable to preempt state securities laws registration and qualification requirements with respect to all offerees and purchasers in a Tier 2 offering. This means that issuers relying on Tier 2 of Regulation A+ can communicate their offering to potential investors using the internet, social media, and similar means, without concern that they will trigger state registration requirements.

Similar to offerings under Rule 506, state securities regulators retain the authority to (i) require filing with the state of documents filed with the SEC (and payment of fees); (ii) bring enforcement actions against fraudulent securities transactions and unlawful conduct by broker-dealers in such offerings; and (iii) suspend the offer or sale of securities for the failure to file or pay the appropriate fee.

Putting It All Together

The expansion of Regulation A's rules is intended to increase access to capital for small and growing companies. Regulation A+ attempts to do this primarily by raising the threshold for the amount of capital that can be raised under the rule and by updating and streamlining the filing and reporting requirements under the rule. Given issuers' historical reticence to use Regulation A, only time will tell whether the new rules will have more than a marginal impact.

Pepper Points

- While issuers can make sales under either Tier 1 or Tier 2, each tier has significant pros and cons. For example, while Tier 2 sales are exempt from Blue Sky requirements, they also require audited financial statements, ongoing periodic reporting and restrictions on who can purchase securities in the offering.

- While the North American Securities Administrators Association (NASAA) has a coordinated review program (available at http://www.nasaa.org/industry-resources/corporation-finance/coordinated-review/regulation-a-offerings/) to assist issuers in state securities law compliance, the program has its detractors and the preemption offered by Regulation A+ is – well - quite a plus.

- While Tier 2 issuers may rely on an investor's representation about income and net worth to see if the investor is a qualified purchaser for Tier 2, if the issuer has knowledge that the representation is wrong or disregards material facts suggesting that the investor does not meet these tests, the issuer cannot treat the investor as a qualified purchaser for a Tier 2 offering and will not be afforded the exemption from registration under Regulation A.

- In every situation, investors need a reasonable amount of time to digest offering materials before committing to an investment. What is reasonable will vary by the circumstances of the offering. The 21 days required before Tier 2 sales after "testing the waters" is consistent with requirements in registered initial public offerings of emerging growth companies and should not be extrapolated to private offering situations as to what is a reasonable period of time, or the amount of time that the SEC deems appropriate, to allow investors to digest offering disclosures.

- The SEC anticipates that it will take 750 hours to prepare the related filings for Regulation A+. Given the time and expense required to make such a filing, it is uncertain whether the expanded rules will provide enough of an incentive for companies to issue securities under the new Regulation A+.

Below is an overview comparison of Regulation A+ to public crowdfunding and Regulation D private placements.

Feature	Public Crowd-funding (Not Yet Permitted)	Prior Regulation A 3(b)	Regulation A+ (3(b)(2)) (Tier 1)	Regulation A+ 3(b)(2) (Tier 2)	Regulation D (4(a)(2)) Rule 506
Maximum Total Raised	$1 million per 12 month period	$5 million per 12 month period	$20 million per 12 month period; including up to $6 million for selling shareholders	$50 million per 12 month period; including up to $15 million for selling shareholders	Unlimited
Number of Investors	Unlimited but subject to maximum total raised	No limits other than as imposed under state laws	Unrestricted	Unrestricted	Unlimited accredited investors; up to 35 non-accredited investors unless soliciting (if soliciting non-accredited investors)

Investment Per Investor	Restricted by income/net worth	Unrestricted	Unrestricted	Restricted by income/net worth for non-accredited investors	Unrestricted
Investor Disclosure	Required, must be filed with SEC	Required, must be filed with SEC	Required, must be filed with SEC	Required, must be filed with SEC	Not required if all accredited investors; Form D filing proposed
Intermediary Required	Yes – broker/dealer or funding portal	No	No	No	No
Subject to ongoing SEC reporting following raise	Yes, at least annually, possibly more frequently	No reporting required other than use of proceeds reporting	No; as long as exit report is filed not later than 30 calendar days after termination or completion	Yes; audited financials filed annually; annual, semi-annual, current reporting required	No
Federal Disclosure Liability (State liability provisions apply in all cases)	Yes, full disclosure liability with a knowledge exception	Only anti-fraud liability	Yes, full disclosure liability with a knowledge exception	Yes, full disclosure liability with a knowledge exception	Only anti-fraud liability
Shares restricted	Yes, for one year	No, except for shares held by affiliates	No, except for shares held by affiliates	No, except for shares held by affiliates	Yes, for public companies most can sell under Rule 144 after six months
State Filing	Possibly, depends on future rules by state	Compliance with Blue Sky laws required; streamlined/coordination process may be available.	Not exempt from state securities law registration and qualification requirements	Exempt from state securities law registration and qualification requirements	Usually no if only offering to accredited investors

Endnotes

1. Section 401 of the JOBS Act amended Section 3(b) of the Securities Act by designating existing Section 3(b) as Section 3(b)(1), and creating new Sections 3(b)(2)-(5). Section 3(b)(2) directs the Commission to adopt rules adding a class of securities exempt from the registration requirements of the Securities Act for offerings of up to $50 million of securities within a 12-month period. The Regulation A+ rules are the rules implementing 3(b)(2).

2. The JOBS Act also added Section 18(b)(4)(D) to the Securities Act, which provides that Section 3(b)(2) securities are covered securities for purposes of Section 18 if they are "offered or sold on a national securities exchange" or "offered or sold to a qualified purchaser, as defined by the Commission pursuant to [Section 18(b)(3)] with respect to that purchase or sale." Under the Regulation A+ final rules, persons eligible to purchase in Tier 2 offerings are "qualified purchasers" for purposes of Regulation A.