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CLIENT ALERT

SEC Proposed Regulation 'A+': Does It Make The Grade?

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On December 18, 2013, the U.S. Securities and Exchange Commission (SEC) announced proposed rules designed to transform Regulation A from a seldom-used, high-effort exemption from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act") to a much more useful capital-raising tool for offerings up to $50 million. The proposed rules seek to modernize the current regulatory framework by creating two tiers of offerings, including what is being referred to as "Regulation A+," and in so doing, hopefully increase access to capital for smaller companies. However, the reporting and disclosure requirements are very similar under the proposed rule and the public offering process. It remains to be seen whether companies will view the benefits of Regulation A as outweighing these burdensome disclosure processes, or whether the industry will continue to rely on other exemptions from the registration process.

Notably, the proposed rules would:

- **Increase the dollar limits of exempt offerings**. The proposed rules would exempt two tiers of offerings:
    - Tier 1 would mirror the current Regulation A exemption allowing offerings up to $5 million in any 12-month period, including up to $1.5 million sold by selling shareholders.
    - The new "A+" Tier 2 would cover offerings of up to $50 million in any 12-month period, including up to $15 million sold by selling shareholders.
    - For offerings up to $5 million, issuers could choose to proceed under Tier 1 or Tier 2.
- **Preempt state regulation**. States would continue to regulate Tier 1 offerings, but Tier 2 offerings would not be subject to state blue sky laws due to preemption by federal law. However, state securities regulators would still have jurisdiction to investigate and bring enforcement actions in the event of fraud or deceit under either tier.
- **Enable issuers to submit electronic filings**. Issuers in both Tier 1 and Tier 2 offerings would be required to electronically file offering statements and other documents on EDGAR instead of filing in paper form with the SEC. Such electronic filings would also satisfy issuers' delivery requirements related to the final offering circular.
- **Continue to allow sales to non-accredited investors**. As is currently the case under Regulation A, issuers in both Tier 1 and Tier 2 offerings would be able to sell to non-accredited investors without restriction.

Current Regulation A

As it currently exists, Regulation A only exempts offerings up to $5 million. To utilize the exemption, issuers must file – in paper form – an offering statement including risk factors, a description of the offeror's business, and information on control persons. The SEC then has a period of 20 days to review the offering statement, after which it is automatically qualified absent a delaying order by the SEC. Further, all current Regulation A offerings are still subject to state regulation.

As a result of the costs and effort associated with use of the current exemption, for the last few decades, almost no issuer has made an offering under Regulation A. In 2012, there were 8 offerings under Regulation A, almost 1,000 times fewer than under another regulatory exemption – Regulation D.

Other Features of the Proposed Rules

Tier 1 and Tier 2 Eligibility Requirements

Ineligible Issuers: Currently, the following issuers are not allowed to take advantage of the Regulation A exemption:

- Companies subject to ongoing reporting requirements under the Securities Exchange Act of 1934, as amended (the "Exchange Act").
- Companies registered or required to be registered under the Investment Company Act of 1940.
- Development stage companies (i) with no specific business plan or purpose or (ii) that indicate their business plan is to participate in a merger or acquisition with an unidentified company or companies.
- Issuers of asset-backed securities or fractional undivided interests in oil, gas, or other mineral rights.

The proposed rules would add two new categories to the list of ineligible issuers:

- Companies that have previously made a Regulation A offering and have not filed the required ongoing reports under Regulation A for the preceding two years.
- Companies that are or have been subject to an SEC order denying, suspending or revoking the registration of a class of securities pursuant to Section 12(j) of the Exchange Act within the preceding five years.

Issuers are also ineligible if they are, or are affiliated with, a "bad actor," including persons who have been convicted of felonies or misdemeanors involving securities laws or are otherwise barred from engaging in securities-related activities. Proposed new Rule 262 expands the list of disqualifying events, as well as the persons whose actions are considered when determining eligibility.

- **Permitted Security Types**: The proposed changes would limit the availability of the exemption to offerings of equity securities, debt securities and debt securities convertible or exchangeable into equity interests (including any guarantees of such securities). Offerings of asset-backed securities, and other securities that are not "eligible" in accordance with the proposed rule, would be excluded from coverage under proposed Rule 261.
- **Limitations on Individual Investors**: The proposed rules limit the amount of securities that any individual may invest in a Tier 2 offering to 10 percent of the investor's annual income or net worth. Issuers would be able to rely upon an individual's representation of compliance unless otherwise known to be untrue. As in the current rules, there would be no such limitation on Tier 1 offerings.
- **Jurisdiction**: Only companies organized in and having a principal place of business in the U.S. or Canada would be able to take advantage of the Regulation A exemption, as is the case under the existing rules.

Communications with Investors

The proposed changes to Regulation A would allow issuers more flexibility in their communications with potential investors, although the proposed changes also would call for issuers to file more information with the SEC than is currently required under Regulation A (or more than that currently required under Regulation D).

- **Testing the Waters:** Both prior to and following the filing of an offering statement with the SEC, issuers would be permitted to communicate orally or in writing with potential investors to determine whether there is interest in the proposed offering. These communications would be deemed offers for the antifraud provisions of securities laws, but until an offering statement is qualified – i.e., affirmatively approved by the SEC – issuers would not be able to solicit money or any commitment to purchase securities.
- **Filing the Offering Statement:** No offers could be made until filing of a Form 1-A offering statement with the SEC, along with balance sheets for the two most recently completed fiscal years and, for Tier 2 offerings, audited financial statements. In a change from existing practice (which allows sales after the mere passage of time), sales could not be made until the SEC affirmatively qualified the offering statement.
- **Making Offers:** Issuers would be able to make offers after filing an offering statement, whether or not it has yet been qualified, as long as such offers are accompanied by the latest preliminary or final offering circular. If used, preliminary offering circulars would have to be delivered at least 48 hours before a sale, and final offering circulars within two business days of a sale if there had been a preliminary offering circular.

<u>Integration with Other Offerings</u>

The proposed updates to Regulation A would provide that Regulation A offerings would not be integrated with offerings made pursuant to Regulation Crowdfunding, thus allowing issuers to pursue both types of nonpublic offerings simultaneously. However, Regulation A offerings would be integrated with offerings made under Regulation D, unless the Regulation D offering begins more than 6 months after the Regulation A offering is completed.

<u>Additional Filing and Reporting Requirements</u>

Under the proposed rules, companies conducting Tier 2 offerings would be required to include audited financial statements as part of their offering circulars. In another new provision, Tier 2 issuers would have to make ongoing reports via EDGAR as long as securities are held of record by at least 300 investors. Ongoing filings would include annual and semiannual reports as well as current event updates similar to those reports typically required of public reporting companies by the Exchange Act.

The new provisions are intended to address investor protection concerns in light of the fact that states would not regulate Tier 2 offerings. However, when added to the disclosures already required under Regulation A, these new reporting requirements make the Regulation A exemption process (for both Tiers 1 and 2) and the public offering process extremely similar:

- **Expert Opinions:** Formal legal opinions would still be required under both tiers of Regulation A, and audited financial statements would be required under Tier 2, the same as for public offerings.
- **Disclosure of Material Contracts:** Both public offering documents and Form 1-A require the disclosure of material contracts, including all non-ordinary course agreements, agreements with related parties, contracts on which the issuer's business is substantially dependent, and any contract calling for the acquisition or sale of any property, plant or equipment for consideration exceeding 15 percent of the offeror's fixed assets.

- **Description of Business and Offering:** Both Regulation A issuers and public issuers must include substantially the same information regarding their business in their offering document, including risk factors, descriptions of business and property, management's discussion and analysis, and ownership interests of management and significant shareholders.

Generally, Regulation A would continue to use simpler terms to describe its filing requirements, and would not refer to external regulations such as Regulation S-K. This may make preparation of a Regulation A offering statement somewhat easier than a public offering statement. It remains to be seen whether in practice the SEC will interpret the new Regulation A as demanding less extensive information than public offerings, or whether the requirements are scaled back after the commenting period. However, even if the disclosure documents for Regulation A and public offerings turn out to be substantially similar, nonpublic companies will still avoid having to comply with a host of other regulations applicable to public companies, such as proxy solicitation and shareholder vote provisions and Sarbanes-Oxley requirements.

Please note that notwithstanding the reduced reporting requirements of Regulation A, issuers with total assets greater than $10 million must register any class of equity securities held of record by either 2,000 people or 500 unaccredited investors pursuant to Section 12(g) of the Exchange Act. As a result, private issuers could become subject to Exchange Act reporting requirements in spite of their reliance on the Regulation A exemptions from Securities Act registration.

Next Steps for Proposed Regulation A

The full text of the SEC's release regarding the new rule can be found here. The SEC will seek public comment on the proposed rules for a 60-day period once the rules are published in the Federal Register.

The SEC has already suggested that it would consider an intermediate tier, for offerings between $10 and $15 million, which would have less extensive continuing disclosure obligations, but would also preempt state regulation. Furthermore, in light of the fact that Regulation A offerings can be used with investors that are not accredited investors, the North American Administrators Association (NASAA), an organization of state regulators, has already voiced resistance to the preemption of state blue sky laws for Tier 2 offerings, cautioning that the proposed rules disregard the importance of state oversight in discouraging fraud.

Practice Points

After the finalization of the proposed revisions to Regulation A and other regulations mandated by the JOBS Act, issuers will have a number of exemptions to choose from when considering an unregistered offering of securities.

- **Crowdfunding:** Although the limited disclosure requirements under Regulation Crowdfunding could make capital raising under this exemption attractive, this regulation does impose significant restrictions. Regulation Crowdfunding limits the amount of money an issuer can raise ($1 million over a 12-month period), provides that the securities sold in the crowdfunding are restricted, and does not preempt state securities laws. Also, issuers relying on Regulation Crowdfunding are not permitted to solicit interest in the offering prior to actually making offers, which could lead to unnecessary expenses if an offering does not go as planned.
- **Regulation D:** Notwithstanding Congress' political motivations in adopting the JOBS Act to spur the use of alternative mechanisms for capital raising, the reality is that this likely will remain the most used regulation for exempting

offerings. There are no dollar limitations on certain types of Regulation D issuances, making this exemption useful for extremely large capital raises. And odds are that most investors will remain accredited investors, meaning that issuers can avoid making significant disclosures required when non-accredited investors participate in a Regulation D offering.

- **Regulation A Tier 1 Offerings:** Under the proposed rules, it remains questionable whether issuers will undertake Tier 1 offerings as opposed to offerings under the various rules of Regulation D which provide greater flexibility to raise capital and do not involve SEC review of an offering statement.
- **Regulation A Tier 2 Offerings:** Although the initial and ongoing disclosure requirements under Tier 2 offerings are somewhat extensive, state law preemption, along with the ability to offer to purchasers that are not accredited investors, may make this exemption attractive to issuers who are otherwise unable to raise capital from institutional and high net worth investors which have traditionally provided capital to private companies.

As it finalizes the proposed rules on Crowdfunding and Regulation A, the SEC may expand their availability and ease of use. In any event, issuers should carefully consider all factors when considering which exemption to rely on. Crowell & Moring's Corporate Group is available to assist issuers in determining which exemption is the most appropriate, in preparing all required offering materials, and in ensuring that any offering complies with applicable securities laws.

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