Regulation A Plus

A New Tool to Raise Capital

by John A. Aiello and Philip D. Forlenza

In March 2015, the Securities and Exchange Commission (SEC) adopted amendments to Regulation A to implement Section 401 of the Jumpstart Our Business Startups (JOBS) Act.[1] The new rules, referred to as Regulation A Plus, are intended to facilitate capital formation, allowing companies to raise capital utilizing an exemption from registration under the Securities Act of 1933, as amended, in a more efficient, less burdensome process than is typically involved with the registration of securities for sale on Form S-1. This article will focus on the major benefits Regulation A Plus provides to companies seeking an exemption from registration, as well as the important changes the new rules offer to compensate for the historical lack of use of the Regulation A exemption.

Regulation A Background

Regulation A came into effect on March 15, 1936, and, as amended over time, provided an exemption from the registration requirements of the Securities Act for offerings of up to $5 million. The exemption was not relied upon in practice due to a few important factors, which frustrated the intended purpose of the regulation to allow smaller companies to raise capital without incurring the costs of registration. The most significant factors adversely impacting the use of the exemption were the Regulation A filing and disclosure requirements, state securities laws compliance and the cost-effectiveness of Regulation A relative to other exemptions from registration that could be utilized.[2]

Issuers seeking a Regulation A exemption expended significant resources and time in developing disclosure documents for filing with and review by the SEC. Regulation A Plus offers improvements in the process. Moreover, state securities or 'blue sky' laws posed the most significant problem to issuers. An issuer seeking to offer securities in multiple states would be required to comply with each state's individual securities laws, as well as the federal law. There was no federal preemption of state securities laws available to issuers seeking to rely upon the Regulation A exemption. For issuers looking to offer securities in multiple states, blue sky compliance significantly increased the cost of conducting a Regulation A offering and the time required to complete the offering.

In recent years, the Regulation A exemption has been utilized infrequently as a result of these cost and time issues, despite the fact that under federal law securities exempt under Regulation A are freely tradeable. The recent trend of non-use of Regulation A demonstrates the significance of these problems. According to a report prepared in 2012 by the United States Government Accountability Office, there were a total of only 18 Regulation A offerings conducted from 2008 through 2011.[3] In comparison, there were 7,517 offerings in 2010 and 8,194 offerings in 2011 conducted under Regulation D, which provides issuers another exemption from registration.[4] Regulation D statistics prove that exemption to be much more popular than the exemption under Regulation A. This is due, in part, to the federal preemption of Rule 506 of Regulation D over state securities blue sky laws, a feature Regulation A lacked prior to the recent changes.

Who May Use Regulation A?

To qualify for the Regulation A exemption, issuers must continue to maintain eligibility requirements similar to those in effect prior to the enactment of the new rules.[5] A company must be organized under the laws of the U.S. or Canada and maintain its principal place of business there. The company cannot be a blank check company (*i.e.*, a company that has no specific business plan or a company that plans to merge with an unidentified company), or be subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, registration under the Investment Company Act of 1940 or the 'bad actor' disqualifications

under Securities Act Rule 262.[6] Furthermore, the company may not issue fractional undivided interests in oil or gas rights, and cannot issue asset-backed securities. Regulation A Plus adds two new issuer eligibility requirements. The exemption will not be available to: 1) issuers that have not filed all required reports under Regulation A during the prior two years, or 2) issuers subject to orders suspending or revoking a class of securities pursuant to Section 12(j) of the Exchange Act during the prior five years.[7]

June 19, 2015, Regulatory Changes

On March 25, 2015, the SEC released the final Regulation A rules, which went into effect on June 19, 2015.[9] The new rules were intended to increase the use of the Regulation A exemption while maintaining important investor protections. The changes focused on the aggregate dollar amount allowed to be offered, the disclosure requirements of the Form 1-A offering statement used in Regulation A offerings, the ability to solicit interest prior to the filing of offering documents and the relationship of the Regulation A exemption to state securities blue sky laws. The new rules divide Regulation A offerings into two tiers: Tier 1, for offerings of up to $20 million in a 12-month period and a $6 million limit on resales by affiliated selling shareholders; and Tier 2, for offerings of up to $50 million in a 12-month period and a resale limit of $15 million. The substantial increase in the size of offerings permitted under Regulation A Plus are likely to make Regulation A offerings more attractive to companies seeking to raise capital. While certain previously existing features of Regulation A are preserved, the new rules alter the disclosure required and establish ongoing reporting obligations for certain Regulation A issuers.

Filing; Use of EDGAR

Regulation A has been revised to require issuers to file Form 1-A online using the SEC's Electronic Data Gathering, Analysis and Retrieval (EDGAR) system.[9] Previously, filing of Form 1-A via the EDGAR system was not possible, and issuers had no choice but to submit paper copies to the SEC. In proposing the new rules, the SEC noted that electronic submission has numerous benefits to issuers and investors, including easier access to offering materials by regulators, investors and financial market researchers.[10] Electronic submission also aligns the Regulation A filing process with the filing process for registered offerings and offerings exempt under Regulation D, and facilitates a more efficient review process for SEC staff.[11]

Regulation A Plus permits issuers whose securities have not been previously sold pursuant to a qualified offering statement under Regulation A or an effective registration statement under the Securities Act to submit a draft offering statement for non-public review by the SEC. The publicly filed offering statement must be on file and available on EDGAR not less than 21 calendar days before the offering statement is qualified and available for use in the sale of securities.[12]

Disclosure Requirements

Required disclosures continue to be similar to the disclosure requirements of a full Securities Act registration on Form S-1, particularly when compared to small business issuer registrations.[13] Issuers are required to file a Form 1-A offering statement with the SEC, which consists of three parts:

Part I: An eXtensible markup language (XML) based fillable online form, which contains indicator boxes or buttons, and text boxes. Part I requires disclosure of basic information about the issuer and the proposed offering;

Part II: A text file attachment containing the body of the disclosure document and financial statements; and

Part III: Text file attachments containing the signatures, exhibit index and exhibits.[14]

Part II of Form 1-A consists of an 'offering circular.' Issuers have the option of providing narrative disclosure that follows one of two prescribed formats. The offering circular format is a simplified and scaled version of the narrative disclosure requirements that are associated with a Form S-1 filing. Issuers may also choose to follow the narrative disclosure requirements set forth in Part I of Form S-1 (or Part I of Form S-11 in the case of real estate investment trusts or other real estate companies). In either case, the offering statement must include basic information with respect to the issuer and the offering, such as underwriters; risk factors; plan of distribution of the securities being offered; use of proceeds; and business operations in the prior three years, or since inception.[15] Another important disclosure an issuer is required to include in an offering statement is whether there is an anticipation that it may be necessary to raise additional funds within the 12 months following the date of the offering statement.[16] The Form 1-A financial statement requirements require issuers conducting both Tier 1 and Tier 2 offerings to file balance sheets, statements of income, statements of cash flows and statements of changes in stockholders' equity for the two most recent fiscal years. Audited financial statements must be provided in Tier 2 offerings. Tier 1 issuers need not file audited statements.

In essence, the changes to the Form 1-A offering circular format and disclosure requirements adopted pursuant to the new Regulation A rules result in disclosure that is similar to that which is required of smaller reporting companies conducting a registered offering, but scaled back or streamlined in certain areas.[17]

Compliance with Blue Sky Laws; Preemption

Perhaps the most important change prescribed by Regulation A Plus in the view of the SEC and potential issuers alike, is the federal preemption of state blue sky laws. Generally, securities that are considered covered securities, which are those sold to a 'qualified purchaser' or any security sold on a national securities exchange, are not subject to state blue sky laws.[18] The new rules provide that Tier 2 offerings are not subject to any type of state law review, and are federally preempted under Regulation A Plus because a purchaser in a Tier 2 offering is considered a qualified purchaser.[19]

Although the term 'qualified purchaser' now applies to any person to whom securities in a Tier 2 offering are offered or sold, it does not include a Tier 1 purchaser.[20] Tier 2 purchasers must be 'accredited investors' (as that term is defined in Securities Act Rule 501), or limit their investment amount to less than 10 percent of their annual income, or for a non-natural person less than 10 percent of annual revenue or net assets at year end, whichever is greater. The new regulations do not include a Tier 1 offeree in a Regulation A offering as a qualified purchaser because the SEC believed the loss of state review for Tier 1 offerings, combined with the absence of the additional investor protections required in Tier 2 offerings, could increase the likelihood of fraud in Tier 1 offerings.[21]

While the covered securities status of securities issued in Tier 2 offerings prohibits states from requiring the registration or qualification of these securities, states retain the power to require issuers to file with the state any document filed with the SEC solely for notice purposes, the assessment of fees and the power to investigate and bring enforcement actions with respect to fraudulent securities transactions.[22]

Testing the Waters

One of the most important benefits Regulation A historically provided to issuers was the ability to 'test the waters' or solicit interest in the securities proposed to be offered prior to a formal offering. In contrast, issuers conducting an S-1 registration must wait to see how the market reacts after the registration statement is filed and the offering commences. This can be a major problem for many companies, particularly smaller companies that are unsure of the interest the offering will generate. Smaller companies often lack the resources to survive an initial public offering registered on Form S-1 that does not generate investor interest because of the significant costs associated with an S-1 registration.

Under the new rules, issuers are able to test the waters with solicitation materials before and after the filing of the

offering statement,[23] which provides an extremely practical benefit to issuers that are offering the securities in one state or multiple states. Solicitation materials used before the qualification of the offering statement must bear a legend or disclaimer indicating that: 1) no money or other consideration is being solicited, and if sent, will not be accepted, 2) no sales will be made or commitments to purchase accepted until the offering statement is qualified, and 3) a prospective purchaser's indication of interest is non-binding.

There are two additional requirements for issuers that wish to gauge potential interest in an offering after an offering statement has been filed with the SEC. The solicitation materials used to test the waters after the issuer files an offering statement must be accompanied by the offering statement itself or contain a notice informing potential investors where and how the most current preliminary offering circular can be obtained.[24] In addition, the rules require issuers using testing the waters materials after the offering statement is publicly filed to update and redistribute the materials used to test the waters to the extent that they become inadequate or inaccurate in any material respect.[25] One final note relative to Tier 1 issuers: Tier 1 issuers must comply with state laws relating to a test the waters solicitation, which may present obstacles to testing the waters.

Regulation A Plus Reporting Requirements

Prior to the enactment of Regulation A Plus, Regulation A required issuers to file a Form 2-A with the SEC to report sales and termination of sales made under Regulation A every six months after qualification, and within 30 days after the termination of the offering. The new rules eliminate Form 2-A but require issuers conducting Tier 1 offerings to provide similar information through the filing of Form 1-Z no later than 30 calendar days after the termination of the offering. Issuers conducting a Tier 2 offering must provide this information in either Form 1-K or Part 1 of Form 1-Z, depending upon whether the issuer's offering is terminated or completed. In adopting the new rules, the SEC was concerned that uniform reporting requirements for all Regulation A issuers could disproportionately affect issuers in smaller offerings.[26] As a result, Regulation A Plus does not require any ongoing reporting obligations for Tier 1 issuers, other than the disclosure of the results of the offering through filing of Form 1-Z. Issuers that conduct Tier 2 offerings must file annual reports on Form 1-K, semi-annual reports on Form 1-SA and current event reports on Form 1-U. In addition, Tier 2 issuers must provide notice to the SEC of the suspension of their reporting obligations.

Exclusion from Section 12(g)

The Regulation A exemption now provides a benefit for Tier 2 issuers because the issuers are exempt from Section 12 (g) of the Exchange Act and the regulations promulgated thereunder.[27] Section 12 (g) requires any issuer with total assets of over $10 million along with a class of equity securities held by either 2,000 persons or 500 persons who are not accredited investors, to register the class of securities with the SEC and be subject to reporting requirements set forth in the Exchange Act. Under the new Regulation A Plus rules, issuers that meet certain requirements, such as being current with the Regulation A periodic reporting requirements while maintaining a public float of less than $75 million, are exempt from the rule.[28] Exemption from the application of Section 12 (g) of the Exchange Act provides a significant benefit to a Tier 2 issuer.

Conclusion

Prior to the rule changes that went into effect on June 19, 2015, Regulation A did not have the impact the SEC intended when it was adopted in 1936. The limited use of the exemption within the last decade spurred professionals in the industry and the SEC to develop proposals to change the culture of Regulation A and the benefits it confers upon companies seeking to raise capital in the competitive markets that exist today. The final rules consist of changes and compromises by the SEC, with assistance from professionals in the securities markets, that have the effect of eliminating many of the prior deficiencies of Regulation A, which led to the Regulation A exemption being underutilized in the capital formation process over several decades.

The increase in the size of the offerings permitted under Regulation A Plus will likely draw interest from small and large companies alike. The larger companies' ability to preempt state securities laws creates a significant advantage for

issuers that intend to reach out to investors in multiple states. A smaller Tier 1 company relying upon the Regulation A exemption is positioned to save time and capital when issuing securities within a single state or a limited number of states. The opportunity for companies utilizing either tier of the exemption to test the waters and solicit interest in a potential offering continues to be an important advantage for companies that are unsure of market interest or an acceptable price for the securities being offered.

Historically, the purpose of Regulation A has been to facilitate capital formulation by smaller, less financially secure companies. That purpose, which has not been achieved over the course of several decades, has been renewed with the SEC's changes to Securities Act Rules 230-251. As these new rules take hold in the investment community, it will be interesting to see the extent to which they are embraced to achieve their intended purpose. ⚖

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ENDNOTES

1. H.R. 3606, 112th Cong. (2012) (enacted).
2. Sec. Act Release No. 33-9497 [79 FR 3925] (Dec. 12, 2013) (hereinafter cited as Release No. 9497) at II.J.
3. *See Factors That May Affect Trends in Regulation A Offerings,* GAO-12-839 (July 2012), available at gao.gov/assets/600/592113.pdf.
4. *Id.*
5. Sec. Act Release No. 33-9741 [80 FR 33-9741C] (June 19, 2015) (hereinafter cited as Release No. 9741) at II.B.1.c.
6. *See* Securities Act Rule 251 and Securities Act Rule 262.
7. Release No. 9741 at II.B.1.c; *see also* Securities Act Rule 251 and Section 12(j) of the Exchange Act. Under Section 12(j) of the Exchange Act, the SEC may, among other things, institute a revocation proceeding and seek to revoke an issuer's registration under the Exchange Act as a result of delinquent filings.
8. Release No. 9741.
9. Securities Act Rule 251(f).
10. Release No. 9497 at IV.B.3.
11. *Id.* at II.C.1.
12. Securities Act Rule 252(d).
13. Release No. 9741 at II.B.1.c.3(b)(1)(c).
14. *Id.* at II.C.1.c(1).
15. *Id.* at II.C.3.c.3.a(3).
16. *Id.*
17. *Id.*
18. *See* Section 18(b)(4)(D) of the Securities Act.
19. Release No. 9741 at II.H.3.
20. *Id.*
21. Release No. 9497 at IV.B.7.
22. Release No. 9741 at II.H.3.b.
23. *Id.* at II.D.3.
24. *See* Securities Act Rule 255(b)(4).
25. *See* Securities Act Rule 255(d).
26. Release No. 9741 at II.E.1.c.
27. Release No. 9741 at II.B.6.c.
28. *Id.*