May 26, 2015

Law Alert

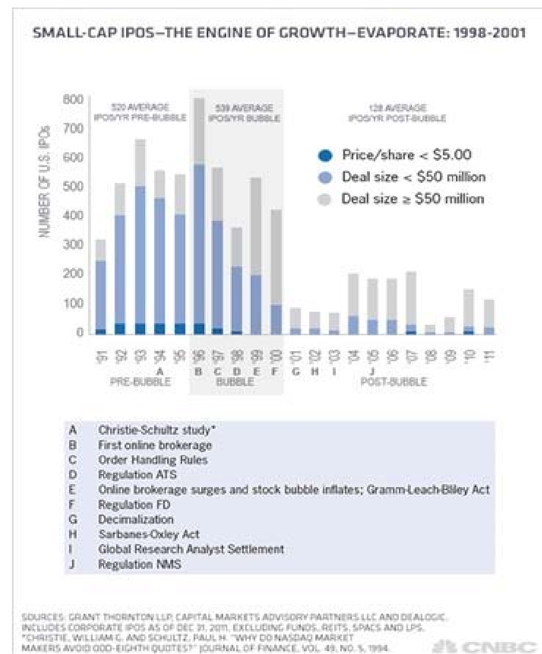
SEC Adopts Changes to Regulation A

On March 25, 2015, the Securities and Exchange Commission (SEC) adopted final amendments to Regulation A, one of the key exemptions from the general requirement that securities be registered before sale.[1] The amendments were adopted in response to changes in the Securities Act passed by Congress as part of the JOBS Act of 2012.[2] How those amendments work, and how they create a pathway for growing companies to access capital markets, will have a significant impact on how high-growth companies get access to capital.

Introduction

The 2012 JOBS Act had several purposes, the chief of which was to invigorate U.S. capital markets in a way that would make growth capital available for small and medium-sized businesses (SMBs). This intention was based on the view that the financial disruptions in 2007–2008 and subsequent behavior of banks and other lenders had made it difficult for SMBs to obtain growth capital.

A related view was that growth capital had become scarce for SMBs because a series of financial market changes over the past decade or so had nearly eliminated the possibility for initial public offerings (or "IPOs") for firms with a small market capitalization (generally considered to be a market cap of less than $100 million). As depicted in the attached graphic[3], in each year from 1991–2000, there were more than 100 IPOs with a deal size of $50 million or less. In contrast, from 2001–2011, there was not a single year in which there were more than 100 IPOs of this size. In fact, in nearly every year from 2001–2011, there were fewer than 50 deals of this size.



Analysts attributed the decline in small-cap IPOs to a variety of causes, including the decimalization of trading, the rise of discount online brokerage services, and the increased cost of going public, including the cost of Sarbanes-Oxley compliance. Regardless of the cause, however, Congress was concerned that the lack of an opportunity for a strategic exit via a small cap IPO was acting as a damper on growth capital investment, as investors were concerned that they would not be able to get liquidity for their capital growth investments.

Consequently, in the 2012 JOBS Act, Congress modified the law to make it easier for smaller companies to seek an initial public offering (by removing certain compliance thresholds for smaller companies) and Congress also modified Regulation A, increasing the offering limits cap from $5 million to $50 million, to provide an alternative means for SMBs to generate growth capital.

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[1] See Release Nos. 33-9741; 34-74578; 39-2501, "Amendments to Regulation A" (March 25, 2015), available at: http://www.sec.gov/rules/final/2015/33-9741.pdf.

[2] H.R. 3606 (April 5, 2012).

[3] Graphic courtesy of CNBC, available at http://www.cnbc.com/id/100432179.

History of Regulation A and the Securities Act

Prior to the Great Depression, which began in 1929 with the Wall Street Crash, neither the individual states nor the federal government did much to regulate the sale of securities. The abuses related to the Wall Street Crash, however, led to the adoption of the Securities Act of 1933 (or "Securities Act"), which created the Securities and Exchange Commission (or "SEC"). The Securities Act also prescribed rules for the sale of securities in interstate commerce, including registration of such offers with the SEC.

The following year, Congress adopted the Securities and Exchange Act of 1934 (or "Exchange Act"), which regulated the secondary market for securities, stock exchanges and companies listed on stock exchanges. Stock exchange listed companies were required to file periodic reports with the SEC and, if they solicited their shareholders' approval of certain actions, they were required to do so using proxy materials that complied with the SEC's proxy rules.

One of the first "exemptions" to the registration requirements of the Securities Act, however, was an exemption for sales of securities that were made pursuant to a prospectus that was approved by the SEC for an issuer that was not required to have its shares traded on a stock exchange. This exemption, referred to as Regulation A (as it existed in 1992, when it was last amended), was easier for issuers to utilize than a registration statement under the Securities Act because:

1) The issuer's financial statements could be simplified and did not need to be audited unless audited financial statements already existed and were available;
2) issuers under Regulation A did not have to file periodic reports under the Exchange Act;
3) the prospectus, or offering circular, could fit one of three formats, one of which was a simplified question-and-answer format; and
4) issuers under Regulation A could take reasonable "testing the waters" steps to determine potential market interest in their offering before filing with the SEC (and incurring the expense of doing so).

Eligible issuers under Regulation A could not raise more than $5 million in one year (including up to $1.5 million in sales from existing security holders). Affiliate resales were permitted only if the issuer had net income from continuing operations in at least one of the last two fiscal years.

New Regulation A+

The new Regulation A+ rules create an exemption for companies in the U.S. and Canada that are not required to file reports under the Exchange Act. The new rules create two tiers: (1) a Tier 1 exemption for offerings of up to $20 million in any 12-month period, and (2) a Tier 2 exemption for offerings of up to $50 million. The new rules also bring Regulation A offerings in-line with other recently-modified exemptions, by requiring disclosures through the EDGAR system, allowing an issuer to make a confidential submission to the SEC, permitting certain test-the-waters communications and disqualifying bad actors.

<u>Eligible Issuers and Securities</u>

Although the SEC received numerous comments advocating the expansion or restriction of eligibility, it ultimately decided to take a cautious approach, allowing additional time to observe developments in the Regulation A+ market before eligibility rules are amended further. Other than two conforming changes intended to harmonize Regulation A with other securities laws and regulations, the eligibility rules have remained largely intact. Thus, to be eligible to issue securities exempt under the new version of Regulation A+, the issuer must be organized under the laws of Canada or the U.S., or any of their territories or possessions, and the issuer must have its principal place of business in the U.S. or Canada. The remainder of the eligibility rules consist of a long list of exclusions. Regulation A+ is not available to issuers that are required to file periodic reports under the Exchange Act. In addition, Regulation A+ is not available to:

- blank check companies (companies with no specific business plan, or a plan to merger or acquire one or more unidentified companies);
- investment companies registered (or required to be registered) under the Investment Company Act of 1940, and business development companies (companies that focus on investment in SMBs);
- entities issuing fractional undivided interests in oil rights, gas rights or other mineral rights; and
- entities subject to the “bad actor” disqualification under Securities Act Rule 262.

The two changes on eligibility serve to exclude (1) any issuer that is required to, but has not, filed with the SEC reports required by Regulation A+ during the two years preceding the filing of a new offering statement, or (2) any issuer that has had its registration revoked pursuant to an Exchange Action Section 12(j) order that was entered within five year before the filing of the offering statement.

The new rules include a clarifying definition of “eligible securities” for Regulation A+, that parallels the specifically enumerated list of exempt securities under Section 3(b)(3) of the Securities Act. The list includes both equity and debt securities, securities convertible or exchangeable to equity interests, and guarantees of such securities. The definition was adopted to make it clear that asset-backed securities are not eligible under the new rules. Asset-based securities are the subject of Regulation AB, which was adopted since the last update to Regulation A.

Offering Limitations

Under the new rules, a Tier 1 issuer may offer and sell up to $20 million of securities in a 12-month period, of which up to $6 million (up to 30 percent of the aggregate offering amount in the 12-month period) may constitute secondary sales. A Tier 2 issuer may offer and sell up to $50 million of securities in a 12-month period of which up to $15 million (but not more than 30 percent of the aggregate offering amount in the 12-month period) may constitute secondary sales. The new rules provide a formula for calculating limits for offerings that include convertible or exchangeable securities. Generally, issuers who wish to use Regulation A+ must aggregate the price of all securities for which qualification is currently being sought, including the securities underlying any rights to acquire that are convertible, exercisable or exchangeable within the first year after qualification.

The SEC also considered the important role secondary sales should play in Regulation A+ offerings, and acknowledged that allowing selling security holders access to avenues for liquidity would encourage investment in SMBs. The SEC therefore made a number of changes to Regulation A+ to accommodate secondary sales. Under the new rules, the 30 percent limitation on secondary sales by non-affiliates of the issuer expires after the first anniversary of the initial qualification of the issuer’s first registration statement under Regulation A+. Also, the SEC deleted the requirement that the issuer have net income in at least one of the preceding two years for secondary sales by affiliates.

Limitations on Investments

While traditional Regulation A placed no limitations on the amount any individual investor could purchase from an issuer, the new rules under Regulation A+ limit individual investor purchases of Tier 2 offerings. (Tier 1 offerings will continue to have no investment limitations.) Under the new provisions of Regulation A+, individual natural persons must be accredited investors (using Regulation D’s Rule 501 definition of accredited investor) or must stay within the new limitation of investments not to exceed either:

(a) 10 percent of the investor’s annual income; or
(b) 10 percent of the investor’s net worth, whichever is the greater number.

For non-natural persons investing in Tier 2 offerings, investments must not exceed the new Regulation A+ limitation of either:

(a) 10 percent of the investor’s annual revenue at the last fiscal year-end; or
(b) 10 percent of the investor’s net worth at fiscal year-end, whichever is the greater amount.

These limitations do not apply, however, to securities that will be listed on national securities exchange when they qualify for listing. Issuers are required to notify investors of the investment limitations, but may rely on the eligibility representations of investors unless the issuer had actual knowledge at the time of sale that an investor is ineligible under the applicable limitation test.

Integration of Offerings

Regulation A+ adds a new safe harbor from integration of offerings that may have caused issuers to exceed limitations under prior Regulation A. The integration safe harbor provides that offerings pursuant to Regulation A+ will not be integrated with:

- prior offers or sales of securities;
- subsequent offers and sales of securities that are:
  - registered under the Securities Act, except as provided in Securities Act Rule 255(c);
  - made pursuant to Securities Act Rule 701;
  - made pursuant to an employee benefit plan;
  - made pursuant to Regulation S;
  - made pursuant to Section 4(a)(6) of the Securities Act; or
  - made more than six months after completion of the Regulation A+ offering.

Exchange Act Threshold

Regulation A+ contains a new conditional exemption for securities issued in a Tier 2 offering, applicable to issuers who would otherwise trigger the registration requirement under Section 12(g) of the Exchange Act. The offering would be exempt if the issuer:

- engages a registered transfer agent to conduct the offering;
- remains subject to Tier 2 reporting obligations;
- is and remains current in its Tier 2 reporting obligations; and
- has a public float of less than $75 million as of the end of the most recent semi-annual reporting period; or, in the absence of a public float, has annual revenues under $50 million as of the most recent fiscal year end.

If an issuer later exceeds either the $75 million float threshold or the $50 million annual revenue threshold, the issuer is eligible for a two-year transition period before being required to register pursuant to Section 12(g), so long as the issuer timely files all ongoing reports due during that period. An issuer will be considered an “emerging growth company” if it otherwise qualifies for that status.

Filing and Delivery; Form 1-A

The issuer must file each separate Regulation A+ offering, regardless of tier, on EDGAR using the newly approved Form 1-A. No further delivery of the offering material is required as the rules equate EDGAR access to delivery, but, where a preliminary offering circular is used by an issuer not already subject to Tier 2 reporting requirements, the preliminary offering circular must be delivered to prospective purchasers at least 48 hours before any sale is made.

The new Form 1-A consists of three parts:

- Part I: basic issuer information;
- Part II: the disclosure document and financial statements; and
- Part III: exhibits and related materials.

Both Tier 1 and Tier 2 issuers must file balance sheets and certain other required financial information for the two most recently completed fiscal years and the financial statements must be GAAP-compliant, unless the issuer is a

foreign entity. Other than the balance sheet and specifically required information, the issuer in a Tier 1 offering is not required to disclose its financial statements unless the issuer has previously obtained an audit performed in accordance with U.S. GAAS or the PCAOB standards and the auditors meet the independence standards. Tier 2 offerors must have audited financial statements, which must be disclosed. The auditor firm must satisfy the independence standard but does not have to be PCAOB-registered.

Non-Public Review

Under Regulation A+, the SEC will, upon request by the issuer, conduct a non-public review of a proposed offering (for either Tier 1 or Tier 2). To obtain a confidential review, the issuer must publicly file the offering statement not less than 21 calendar days before qualification of the offering statement. The SEC's rationale is that the 21-day period will give state securities regulators an opportunity to assure filing of offering materials at the state level in advance of an offering under Regulation A.

Continuous Offering

The new rules permit continuous offerings and delayed offerings in certain instances, including offerings on behalf of selling security holders; securities offered under employee benefit plans; securities pledged as collateral; securities issued upon conversion of other outstanding securities or upon the exercise of other derivative securities; or securities to be offered as part of an offering that starts within two calendar days after the qualification date, that will be offered on a continuous basis, will be offered for more than 30 days and will be offered in an amount that, at the time the offering statement is qualified, is reasonably expected to be offered and sold within a period of two years from the initial qualification date. Such offerings under Regulation A+ will be limited in the same manner as under Rule 415.

Offering Communications

Issuers under Regulation A+ have significant flexibility in their offering communications. An issuer must file its solicitation materials with the SEC. Any solicitation materials used after an offering circular is filed must be accompanied by the offering circular or include a link to the offering circular. All solicitation materials must include legends provided in the rules.

The SEC indicated in its release of the new rules that regularly-released factual business communications will not be deemed to constitute solicitation materials, consistent with the provisions of Rule 169.

Ongoing Reporting Requirements

The old version of Regulation A did not require issuers to file ongoing reports with the SEC, except for Form 2-A, which reported sales and terminations of sales.

The new Regulation A+ imposes two levels of ongoing reporting. Tier 1 issuers will be required to report certain information about their offerings on newly-created Form 1-Z. Tier 2 issuers will have ongoing reporting duties that are analogous to those required of registered issuers, including:

- annual reports on Form 1-K;
- semi-annual reports on Form 1-SA;
- current reports on Form 1-U;
- special financial reports on Form 1-K and Form 1-SA; and
- exit reports on Form 1-Z.

Form 1-K requires the issuer to make disclosures regarding its business and operations for the three preceding fiscal years; related party transactions; beneficial ownership; executive officers and directors; executive compensation; MD&A; and two years of audited financial statements. The issuer must file Form 1-K within 120 days after the end of the issuer's fiscal year.

The semi-annual report on Form 1-SA requires the issue to make disclosures in a manner similar to Form 10-Q. The semi-annual report must be filed within 90 days after the end of the first six months of the end of the fiscal year.

A Tier-1 issuer must file a current report on Form 1-U within four days after an applicable triggering event. Triggering events are defined to include fundamental changes to the issuer's business; entry into bankruptcy or receivership proceedings; material modifications to the rights of security holders; changes in accountants; non-reliance on audited financial statements; changes in control; changes in key executive officers; and sales of 10 percent or more of outstanding equity securities in exempt offerings.

An issuer must also file an exit report on Form 1-Z within 30 days after the termination or completion of an exempt offering under Regulation A+.

Rule 15c2-11, Rule 144 and Rule 144A

Rule 15c2-11.

Amended Regulation A+ permits the ongoing reports filed by a Tier 2 issuer to satisfy a broker-dealer's obligations under Rule 15c2-11 of the Exchange Act of 1934 (the "Exchange Act"). (Rule 15c2-11 makes it unlawful for a broker or dealer to publish any quotation for a security or to submit any such quotation for publication, unless such broker or dealer has in its records the documents and information about the issuer and its securities required by Rule 15c2-11.)

Rule 144.

Rule 144 provides a safe harbor for resell to the public of restricted and control securities. Restricted securities are securities acquired in unregistered private sales from the issuer or its affiliate. Control securities are securities held by an affiliate of the issuer. Neither Restricted nor Control securities can be resold to the public without registration on an exemption from registration. Rule 144 is the primary method for affiliates of issuers to resell securities of the issuer.

One of the requirements for resale under the Rule 144 safe harbor is that there be current public information about the issuer. For Exchange Act issuers, this means that all reports have been filed that are required under the Exchange Act, including quarterly reports. The semi-annual reports under Tier 2 of Regulation A+ do not satisfy the requirement for adequate current public information for certain portions of the year. Rather, Regulation A+ as amended says that if an issuer voluntarily submits quarterly financial statements on Form 1-U, is current on its Tier 2 reports and its financial statements otherwise meet the financial statement requirements of Form 1-SA, the issuer would satisfy Rule 144 current information requirements for the entire year.

Rule 144A.

Rule 144A provides a safe harbor from registration for resales of unregistered securities that meet certain requirements to buyers that meet certain requirements. Rule 144A is important to issuers because it permits a financial intermediary to buy unregistered securities from an issuer and resell such securities to an unlimited number of qualified institutional buyers (QIBs) in transactions that comply with Rule 144A. In order to comply with the Rule 144A safe harbor, all holders and prospective buyers must be able to obtain from the issuer certain "reasonably current" information upon request.

Similarly to Rule 144, the semi-annual reports under Tier 2 of Regulation A+ do not satisfy the Rule 144A requirement for adequate current information. Rather, Regulation A+ as amended says that if an issuer voluntarily submits quarterly financial statements on Form 1-U, is current on its Tier 2 reports and its financial statements otherwise meet the financial statement requirements of Form 1-SA, the issuer would satisfy current information requirements.

Tier 2 Offering with Concurrent Exchange Act Registration

Amended Regulation A+ permits Tier 2 issuers to use a Form 8-A short form registration statement concurrently with the qualification of a Regulation A+ offering statement that includes Part I of Form S-1 (or Form S-11 in the case of real estate investment trusts or certain other entities that primarily invest in real estate) narrative disclosure in Form 1-A in order to register a class of securities under Sections 12(g) or 12(b) of the Exchange Act. An issuer may choose to register on Form 8-A if it desires to list the securities offered under Tier 2 on a national exchange at the time of the Tier 2 offering. Such issuers will be considered "Emerging Growth Companies" to the extent such issuers otherwise qualify for such status.

Termination or Suspension of Tier 2 Disclosure Obligations

If a Tier 2 issuer becomes subject to reporting requirements under Section 13 or 15(d) of the Exchange Act, such issuer's obligation to file Tier 2 ongoing reports is suspended.

A Tier 2 issuer that is not subject to reporting requirements under the Exchange Act may terminate its obligation to provide ongoing Tier 2 reporting by filing a Form 1-Z notifying the SEC of the suspension of its ongoing reporting obligations if:

a) there is no ongoing Regulation A+ offering;
b) the issuer has filed all ongoing reports required by Regulation A+ for the shorter of the period since the issuer became subject to the reporting requirements and its most recent three fiscal years plus the portion of the year preceding the date of filing the Form 1-Z; and
c) there are fewer than 300 record holders of the class of securities that were offered under Tier 2 (or in the case of a bank or hank holding company, fewer than 1,200 record holders).

Bad Actor Disqualification Provisions

Rule 262 of Regulation A+ closely follows the more stringent "Bad Actor Disqualification" rules the SEC adopted for Rule 506 of Regulation D. The disqualification provisions broadens the group of "covered persons" who are disqualified from Regulation A+ exemptions to issue securities due to criminal conviction, an administrative order or an injunction or bar involving certain securities laws. Disqualified persons include: the issuer and its directors, officers, general partners, 10 percent owners or promoters; an affiliate; and the underwriter or its partners, directors or officers. The SEC has the authority to waive the disqualification in certain instances. The Chief of the SEC's Office of Small Business Policy Division of Corporate Finance, through a delegation from the Commission, may grant waivers on a case by case basis, upon the showing of good cause, to issuers who have gone through the waiver process, as detailed on the SEC's website.

Blue Sky Exemption

Tier 1 and Tier 2 Offerings are treated differently for state registration purposes. Like former Regulation A, Tier 1 Offerings must be registered and qualified by the state where the securities are being offered.

Due to the language describing purchasers and offerees of Tier 2 securities under the new rules, Tier 2 offerings are exempt from state registration and qualification. Tier 2 issuers, however, must still make state notice filings, observe state anti-fraud rules and follow applicable state broker-dealer registration requirements.

The new rules also permit states to impose filing fees on both Tier 1 and Tier 2 offerings.

Securities Act Liability

Regulation A+ subjects issuers to liability under Section 12(a)(2) of the Securities Act for any material misstatements or omissions made by the issuer in any offering circular or oral communication. An issuer may be liable under Section 12(a)(2) if the purchaser can show that the misleading misstatement or omission occurred. There is no requirement to show that the issuer intended to manipulate, deceive or defraud anyone.

Character of the Securities Sold in a Regulation A+ Offering

Because the securities sold in a Regulation A+ offering are registered with the SEC, they are freely tradable under federal securities laws, except in the case of affiliates of the issuer, who will be subject to the applicable limitations of Rule 144 under the Securities Act. At the state level, the securities issued in a Tier 2 offering will be freely tradable, while those issued in a Tier 1 offering will be freely tradable in the states in which they are registered or exempt from registration.

Effective Date

The final rules will be effective on June 19, 2015.

FINRA Review

Financial Industry Regulatory Authority (FINRA) rules will apply to a Regulation A+ offering to the same extent as they apply to any public offering in which a FINRA member firm or "associated person" (as defined in the FINRA By-laws) participates[4]. For example, FINRA Rule 5110, the Corporate Financing Rule, requires that copies of the registration statement (which for a Regulation A offering would be the Form 1-A), any amendments and the underwriting agreement be submitted to FINRA for review no later than one business day after they are filed with the SEC or with any state securities regulatory authority. No sales may commence until FINRA has completed its review and issued a "no objection" letter relating to the underwriting terms and arrangements of the offering.

About Taylor English Duma LLP

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[4] "Participation" in an offering is defined in FINRA Rule 5110(a)(5) as participation in the preparation of offering or other documents, participation in the distribution of the offered securities, furnishing of customer and/or broker lists for solicitation, or participation in a consulting or advisory capacity to the issuer in relation to the offering (except in the case of an independent financial advisor that is neither engaged in, nor affiliated with, any entity engaged in the solicitation or distribution of the offering).

Authors

Al B. Hill
ahill@taylorenglish.com
678.336.7154

Emily Stuart Horn
ehorn@taylorenglish.com
678.336.7220

Katherine M. Koops
kkoops@taylorenglish.com
678.426.4611

Morris O. Little, Jr.
mlittle@taylorenglish.com
678.336.7297

Melissa E. McMorries
mmcmorries@taylorenglish.com
678.336.7155

Brian T. Nash
bnash@taylorenglish.com
678.336.7188

Timothy C. Reis
tcreis@taylorenglish.com
678.336.7277

Michael H. Trotter
mtrotter@taylorenglish.com
678.336.7147

Jonathan B. Wilson
jwilson@taylorenglish.com
678.336.7185

Appendix

Key differences between Traditional Regulation A and the New Rules.

	Traditional Regulation A Exemption	**Tier 1 of New Regulation A+**	**Tier 2 of New Regulation A+**
Offering Limit	Up to $5 million during any 12-month period.	Up to $20 million in any 12-month period.	Up to $50 million in any 12-month period.
SEC Filing Required	Must file Form 1-A to be reviewed and qualified by SEC.	Same	Same
State Blue Sky Requirements	Issuer must comply with state blue sky requirements.	Issuer must comply with state blue sky requirements. NASAA has new coordinated review process.	Exempt from state blue sky requirements (other than anti-fraud and filing requirements).
Limitations on Investors	No limitations except as provided in state law.	No limitations.	No limitations except for limitations on non-accredited investors.
Restrictions on Resales	No restrictions except for securities held by an affiliate of the issuer.	Same	Same
Offering Communications	Issue may "test the waters" to determine if there is interest in a potential offering before filing Form 1-A. Promotional materials may be used before, during and after filing.	Same	Same
Mandatory Financial Statements	Current balance sheet and past two years' income statements required. Must comply with GAAP but not Regulation S-X. In many causes audit is not required.	• Current balance sheet and income statement for past two years (as well as any interim period). • Must provide audited statements if they are available. If they are audited, they must be audited by an independent accountant (but PCAOB registration not required).	• Current balance sheet and income statement for past two years (as well as any interim period). • Must be audited by PCAOB-registered accountant.
Disqualification	Felons and listed bad actors are disqualified per Rule 262.	Same, with updated Rule 262.	Same, with updated Rule 262.
Ongoing Reporting	No reporting other than to disclose use of proceeds.	Terminate report required.	Ongoing reporting required; current reports, semi-annual reports and annual reports until obligations are terminated or suspended.