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REGULATION A+ IS ON THE HORIZON: IS IT A GAME-CHANGER FOR PRIVATE COMPANY CAPITAL FORMATION?

March 24, 2014 marked the end of the Securities and Exchange Commission's (SEC) public comment period for its proposed rules to implement Title IV of the Jumpstart Our Business Startups Act of 2012 (the JOBS Act). The overarching goal of the JOBS Act is to promote job growth by easing regulatory requirements for capital formation.

BACKGROUND

All issuers of securities must either (1) conduct a public offering by registering the securities with the SEC, which is expensive, time-consuming, and increases potential legal liability, or (2) issue the securities in accordance with an exemption from registration. Regulation A currently provides one such exemption, but it is little used. Title IV of the JOBS Act, officially titled "Small Company Capital Formation," mandates changes to current Regulation A of the Securities Act of 1933 (the Securities Act) and has been widely labeled by commentators as Regulation A+.

Regulation A+ may be the game-changer of the JOBS Act. Yet, since the enactment of the JOBS Act, the majority of press attention has focused on two other provisions: (1) general solicitation and advertising; and (2) crowdfunding. In September 2013, the SEC adopted rules to amend Regulation D, Rule 506 of the Securities Act to lift the ban on general solicitation and advertising. Private companies may now publicly advertise investment offers through mass communication (such as the Internet, email, and social media) without complying with the registration requirements of the Securities Act, as long as all purchasers are "accredited investors" and certain other requirements are met.[1] In addition, the SEC is currently finalizing rules to implement the crowdfunding provisions of the JOBS Act. These provisions will allow companies to conduct Kickstarter-style campaigns of greater consequence by offering stock to accredited and non-accredited investors, provided certain requirements are met and the total amount raised is limited to $1 million in a 12-month period. While these provisions have received a great deal

[1] *See* Rule 501 of Regulation D, 17 C.F.R. §230.215.

of press attention, many believe they may not significantly alter the fundraising landscape due to the uncertainty of the rules, the high costs of legal compliance, and the degree of disclosure obligations.[2]

In its current form, Regulation A permits non-reporting companies (companies not required to file periodic reports with the SEC in accordance with the Securities and Exchange Act of 1934 (the 1934 Act)) to conduct unregistered public offerings to accredited and non-accredited investors of up to $5 million in any 12-month period. In general, the intended attractions of Regulation A include:

- reduced disclosures to investors relative to full SEC registration;
- the ability to use reviewed financial statements instead of audited financial statements;
- the ability to test the waters with investors for potential interest in the offering before incurring the significant costs and burdens of filing an offering memorandum with the SEC;
- the issuance of freely-tradable securities to accredited and non-accredited investors (*i.e.*, not subject to the limitations on resale applicable to securities sold in private offerings); and
- continued freedom from the 1934 Act's reporting requirements.

Despite these theoretical advantages, however, Regulation A has been nearly irrelevant as a fundraising mechanism. The number of qualified Regulation A offerings decreased from 57 in 1998 to one in 2011.[3] By contrast, there were 8,194 Regulation D offerings under $5 million in 2011.[4] Two factors have primarily contributed to the irrelevance of Regulation A: (1) the high cost of disclosure requirements relative to the $5 million investment limitation; and (2) the need to comply with burdensome state blue sky laws in each state where the offering is conducted.

WHAT IS THE + SIDE?

On December 18, 2013, the SEC released proposed rules for Regulation A+[5], which create two tiers of securities offerings: Tier 1 for offerings of up to $5 million in any 12-month period; and Tier 2 for offerings of up to $50 million in any 12-month period. Tier 1 offerings are practically unchanged from the current Regulation A, so it is anticipated that issuers seeking less than $5 million will continue to rely on Regulation D as the preferred exemption from registration. Tier 2 offerings will likely have a greater impact on capital formation.

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[2] For excellent and more detailed discussions of general solicitation and advertising, the proposed crowdfunding rules, and their respective downsides, see generally Neil P. Casey, Merritt A. Cole & Lori S. Smith, *General Solicitation and (Public) Private Placements: Navigating the Minefield Planted by New and Proposed SEC Rules* (Sept. 11, 2013), and Neil P. Casey, Brittany Edwards, and Lori S. Smith, *Jumpstart or False Start? SEC Proposes New Rules to Implement Crowdfunding Provisions of the JOBS Act* (Dec. 3, 2013).

[3] U.S. Gov't Accountability Office, *Securities Regulation: Factors That May Affect Trends in Regulation A Offerings*, GAO-12-839 at 9 (July 2012). This number increased to eight in 2012, compared to 7,700 Regulation D offerings of under $5 million.

[4] *Id*. at 11.

[5] The SEC's 387-page release can be found at here.

Tier 2 highlights include:

1. *Available Issuers*. Regulation A+ would be available only to companies with a principal place of business in the U.S. or Canada. Among other limitations, Regulation A+ would not be available to companies that are already subject to the public company reporting requirements of the Exchange Act and certain investment companies.
2. *Limitation on Investment*. Regulation A+ contains a limitation on the amount of securities an investor can purchase. Investment is capped at no more than ten percent of the greater of the investor's annual income or net worth.
3. *The Offering Statement*. To offer securities under Regulation A+, the issuer would need to file an offering statement with the SEC, which must then be affirmatively qualified by the SEC. Companies that have not previously used Regulation A or an effective Securities Act registration statement could submit a draft offering statement for non-public review by the SEC. The offering statement would consist of two years of audited financial statements,[6] management discussion and analysis, a three-year description of the business, compensation information for the three most highly paid officers or directors, and related-party transaction disclosures. While the proposed disclosure obligations are significant and comparable to those required in connection with an IPO, they are not unreasonable for private companies seeking up to $50 million from investors.
4. *Types of Securities*. The types of securities issuers can sell under Regulation A+ would be limited to equity securities, debt securities, and debt securities convertible or exchangeable into equity interests. The SEC has noted that Regulation A+ is not intended to cover exotic securities, and it has specifically carved out asset-backed securities from Regulation A+'s scope.
5. *Testing the Waters Permitted*. Companies would be able to test the waters with potential investors in order to gauge interest prior to filing the offering statement. Testing the waters under Regulation A+ would not be limited to qualified institutional buyers and institutional accredited investors, as it is under the JOBS Act's IPO on-ramp process for emerging growth companies.
6. *Ongoing Reporting and Compliance*. Companies using Regulation A+ would have fewer ongoing reporting and compliance obligations than public companies. Regulation A+ companies would, nonetheless, be required to file annual, semiannual, and current event reports with the SEC. These reporting obligations would continue until the company becomes a reporting company or until there are fewer than 300 holders of record of the securities whose issuance gave rise to the reporting obligation. In any event, an issuer must complete its reporting for the fiscal year in which the offering statement was qualified and offers or sales made in reliance on a qualified offering statement are not ongoing.[7]

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[6] The use of non-audited financial statements is currently permitted under Regulation A.

[7] Regulation A+ periodic reporting would include (1) annual reports on Form 1-K (within 120 days of the fiscal year end); (2) semiannual reports on Form 1-SA (within 90 days of the end of the second quarter); and (3) current reports on Form 1-U upon the occurrence of certain specified, material events or changes. The proposal relating to the termination of the issuer's reporting obligations under Regulation A+ is similar to the provisions of the 1934 Act.

However, the following would not apply to Regulation A+ issuers:

- SEC proxy statement rules;
- required ownership reporting by directors, executive officers, and ten percent shareholders under the 1934 Act;
- Williams Act disclosures by five percent shareholders;
- Sarbanes-Oxley Act audit committee independence and internal controls requirements;
- Sarbanes-Oxley prohibition against director and officer loans;
- Sarbanes-Oxley CEO and CFO certifications; and
- pay ratio disclosure required by the Dodd-Frank Act.

7. *Unrestricted Securities*. Regulation A+ securities would be unrestricted and freely tradable securities under the Securities Act, unlike securities sold in Regulation D or Rule 144A private placements. This could create liquidity for shareholders through a potentially robust secondary market in Regulation A+ securities, presumably making investment more attractive.

8. *Preemption of State Blue Sky Laws*. As proposed, Regulation A+ will preempt state blue sky laws for the offer and sale of securities. Compliance with blue sky laws can be an administrative headache at best and an outright roadblock at worst for private issuers.[8] But the SEC's preemption proposal has drawn the ire of many state securities regulators.[9] SEC Commissioner Luis Aguilar recently spoke at a conference of the North American Securities Administrators Association (NASAA), an organization devoted to investor protection that typically advocates in favor of increased state securities regulatory authority.[10] Commissioner Aguilar discussed the NASAA's proposed coordinated state review protocol for Regulation A+ offerings, which the NASAA has advocated for in lieu of Regulation A+ securities being deemed by the SEC as exempt from state-level registration. While Commissioner Aguilar acknowledged the perceived benefits of the NASAA's proposal, he also maintained the review program could, nonetheless, give rise to undue burden and expense. The comment letters received by the SEC were largely dominated by this preemption topic, and where the SEC lands on this issue will likely be critical to the utility of Regulation A+.

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[8] For example, state securities regulators tend to conduct merit-based review of issuers and their securities, whereas the SEC's review is focused on the degree of disclosure. This may preclude viable and potentially lucrative companies from raising money because their near-term financial strength is not ideal in the mind of a state securities regulator.

[9] For example, the Massachusetts Secretary of the Commonwealth, William F. Galvin, wrote to the SEC that he was "dismayed and shocked" over preemption proposal. "Shame on the SEC for this anti-investor proposal," Secretary Galvin wrote. Letter from William F. Galvin, Secretary of the Commonwealth, Commonwealth of Massachusetts, to the SEC, dated December 18, 2013. The SEC also sought public comment on whether Tier 1 issuances should be exempt from state blue sky laws. If the SEC ends up going down this road, Tier 1 securities offerings may become more relevant.

[10] A transcript of Commissioner Aguilar's speech is available here.

STAY TUNED

As noted, the public comment period for Regulation A+ has ended. The SEC must now review and consider roughly 80 comment letters it received during that time. The extent to which the SEC adopts its proposed rules remains to be seen. Considering the JOBS Act did not create a deadline for the SEC to implement Regulation A+, the SEC acted relatively swiftly in proposing these rules.[11] It may be the SEC's initiative in this regard reflects the perceived importance of Regulation A+. Regulation A+ has the potential to serve as a transition for companies on their way to going public or a longer-term solution for private companies that provide increased access to capital markets, without all of the costs and burdens that go along with being a public company. Stay tuned for more details.

If you have any questions about this alert, please contact one of the authors, Andrew D. Myers or Michael V. Serra, in our Business Law Practice.

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[11] In contrast, the SEC was significantly late in enacting rules for general solicitation and advertising under Rule 506 of Regulation D and is currently late in implementing crowdfunding provisions under the JOBS Act.

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