Client Alert

January 2014

SEC Releases "Regulation A+" Proposal

On December 18, 2013, the SEC proposed rules under Title IV of the JOBS Act to amend Regulation A (Rules 251-263 under the Securities Act of 1933 (the "Securities Act")).[1] The proposed rules, which have been referred to informally as Regulation A+, are intended to promote small company capital formation and provide for meaningful investor protection. Proposed Regulation A+ would increase the amount an issuer could raise in an unregistered, public offering in a 12-month period from $5 million to $50 million and are intended to provide smaller companies with improved access to the public capital markets at a lower cost than a traditional registered offering.

Overview

Regulation A+ preserves and expands the current Regulation A framework by creating two tiers of Regulation A offerings. Tier 1 would preserve the current Regulation A offering limitation set forth in existing Rule 251(b) and would permit eligible issuers to conduct unregistered, public offerings, provided that the total amount of securities sold does not exceed $5 million in any 12-month period. Tier 2 would increase the dollar amount of the offering limitation and permit eligible issuers to conduct unregistered, public offerings, provided that the total amount of securities sold does not exceed $50 million in any 12-month period. Securities sold in Tier 1 and Tier 2 offerings would not be "restricted securities" under the Securities Act and would be freely tradable by non-affiliates. Tier 1 offerings would continue to be subject to the registration and qualification requirements in each state in which there are purchasers of the securities. Regulation A+ would preempt state securities laws for Tier 2 offerings, thereby removing one of the most significant obstacles for use of Regulation A as a viable capital-raising mechanism for smaller companies.

Regulation A+ builds on the current Regulation A framework and preserves, with some modifications, existing provisions regarding issuer eligibility, offering circular contents, testing-the-waters and "bad actor" disqualifications. The proposed rules also modernize the Regulation A filing process for Tier 1 and Tier 2 offerings and align practice in certain areas with prevailing practice for registered offerings. Issuers in Tier 2 offerings would be required to include audited financial statements in their offering documents and to file annual, semiannual and current reports with the SEC. In addition, purchasers in Tier 2 offerings would

[1] The full text of the proposing release is available on the SEC's website at http://www.sec.gov/rules/proposed/2013/33-9497.pdf. Title IV of the JOBS Act did not amend Regulation A. Rather, Section 401 of the JOBS Act amended Section 3(b) of the Securities Act, which provides the SEC with exemptive authority for offerings of up to $5 million, by designating the current Section 3(b) as new Section 3(b)(1) and adding a new Section 3(b)(2) to the Securities Act. New Section 3(b)(2) directs the SEC to adopt rules exempting offerings of up to $50 million of securities annually from the registration requirements of the Securities Act.

be subject to certain limitations on their investment. The changes to Regulation A are discussed in more detail below.

Eligible Issuers

As proposed, Regulation A+ would preserve the existing issuer eligibility requirements set forth in Rule 251(a). Under existing Rule 251(a), the exemption is available to non-reporting companies (i.e., companies that are not subject to Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act")) organized in, and with their principal place of business inside, the United States or Canada. The exemption would continue to be unavailable to development stage companies, investment companies, issuers of fractional undivided interests in oil or gas rights (or similar interests in other mineral rights) and "bad actors" under Rule 262, as proposed to be amended.

The proposed rules make Regulation A unavailable to two new classes of issuers:

- issuers that have not filed with the SEC the ongoing reports required by the proposed amendments during the two years immediately preceding the filing of a new offering statement (or for such shorter period that the issuer was required to file such reports); and

- issuers that are or have been subject to an SEC order denying, suspending or revoking the registration of a class of securities under the Exchange Act.

Rule 262 contains certain bad actor provisions that will disqualify an issuer from relying on Rule 262. The proposed rules would amend Rule 262 to include bad actor disqualification provisions in substantially the same form as recently adopted under Rule 506(d) of the Securities Act, but without the categories of covered persons specific to fund issuers, which would not be eligible to use Regulation A under the proposed rules.

Eligible Securities

The proposed rules would limit the type of securities that can be offered and sold in both Tier 1 and Tier 2 offerings to equity securities, debt securities and debt securities convertible or exchangeable into equity interests, including any guarantees of such securities. The proposed rules would exclude asset-backed securities from the list of eligible securities under Regulation A.

Sales by Selling Security Holders

Consistent with the existing provisions of Regulation A, the proposed rules would permit sales by selling security holders of up to 30% of the maximum amount permitted under the applicable offering limitation ($1.5 million in any 12-month period for Tier 1 offerings and $15 million in any 12-month period for Tier 2 offerings). Sales by selling security holders under either Tier 1 or Tier 2 would be aggregated with sales of Regulation A securities by the issuer and other selling security holders for purposes of calculating the maximum permissible amount of securities that may be sold during any 12-month period. In addition, the proposed rules would eliminate the last sentence of Rule 251(b) of Regulation A, which currently prohibits affiliate resales unless the issuer has had net income from continuing operations in at least one of its last two fiscal years.

Investment Limitation

The proposed rules would limit the amount of securities an investor can purchase in a Tier 2 offering to no more than 10% of the greater of its annual income and net worth, with annual income and net worth being calculated for individual purchasers in the same manner as the "accredited investor" definition in Rule 501(a) under the Securities Act.

Integration of Offerings

The proposed rules would preserve the existing integration safe harbors in Rule 251(c) and would add to the list of safe harbor provisions subsequent offers or sales of securities made pursuant to the rules for securities-based crowdfunding transactions pursuant to Title III of the JOBS Act. In addition, the proposed rules would amend Rule 254(d) to provide an integration safe harbor for abandoned Regulation A offerings. Under the new safe harbor for abandoned offerings, if an issuer decides to register an offering after soliciting interest in a contemplated, but abandoned, Regulation A offering, any offers made pursuant to Regulation A would not be subject to integration with the registered offering, unless the issuer engaged in solicitations of interest in reliance on Regulation A to persons other than qualified institutional buyers and institutional accredited investors permitted by Section 5(d) of the Securities Act.

Treatment Under Section 12(g) of the Exchange Act

The proposed rules would not exempt Regulation A securities from the registration requirements of Section 12(g) of the Exchange Act or provide an exemption from Section 12(g) of the Exchange Act for Tier 2 issuers that are current in their Regulation A ongoing reporting obligations. As a result, issuers will need to monitor the number of security holders in order to comply with Section 12(g) of the Exchange Act.

Securities Act Liability

A Regulation A offering is a public offering that is exempt from Securities Act registration requirements. Because Regulation A offerings are exempt from the registration requirements of the Securities Act, issuers and other offering participants are not subject to the liability provisions of Section 11 of the Securities Act. Consistent with current Regulation A, other anti-fraud and civil liability provisions of the securities laws, including Section 12(a)(2) and Section 17 of the Securities Act and Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5, apply to the offer and sale of securities in reliance on Regulation A.

Offering Statements; Offering Process

Regulation A requires the filing and qualification of an offering statement on Form 1-A. Currently, Form 1-A is filed in paper form, rather than electronically via EDGAR, and consists of three parts: Part I (Notification); Part II (Offering Circular); and Part III (Exhibits). Part I of Form 1-A calls for certain basic information about the issuer and proposed offering that is necessary to determine the availability of the exemption. Part II of the offering statement consists of an offering circular — similar to the prospectus in a registration statement — that serves as the primary disclosure document to investors of the material facts about the issuer, its securities and the offering. Corporate issuers are given the option of following any one of three disclosure formats in Part II: Model A (Question-and-Answer Format); Model B (a scaled version of Form S-1 that largely follows the SEC's disclosure standards in effect for registration statements when Model B was adopted in 1981); and Part I of Form S-1. All other issuers have the option of using either Model B or Part I of Form S-1.

The proposed rules would:

- require issuers to file offering statements with the SEC electronically (i.e., via EDGAR);
- similar to recently adopted rules for "emerging growth companies," permit the non-public submission of offering statements and amendments for review by the SEC staff before filing such documents with the SEC, so long as all such documents are publicly filed not later than 21 calendar days before qualification (the timing of the public filing would not be tied to the commencement of a "road show");
- eliminate the Model A (Question-and-Answer) disclosure format under Part II (Offering Circular) of Form 1-A;

- update and clarify the Model B (Narrative) disclosure format under Part II of Form 1-A, while continuing to permit the use of Part I of Form S-1 narrative disclosure as an alternative;

- permit an offering statement to be qualified only by order of the SEC rather than, in the absence of a delaying notation on the offering statement, without SEC action on the 20th calendar day after filing, as is currently the case;

- require issuers in a Tier 2 offering to include audited financial statements in their offering circulars (issuers in a Tier 1 offering would not be required to include audited financial statements unless such financial statements have been prepared for another purpose);

- require all issuers to file balance sheets for the two most recent fiscal year-ends (or for such shorter time that an issuer has been in existence); and

- permit issuers to provide financial statements in Form 1-A that are dated not more than nine months before the date of non-public submission or filing, and require issuers to include financial statements in Form 1-A that are dated not more than nine months before qualification, with the most recent annual or interim balance sheet not older than nine months.

Under the proposed rules, the financial statements included in a Regulation A offering statement would be required to be prepared in accordance with US GAAP, except that Canadian issuers could follow either US generally accepted accounting principles or International Financial Reporting Standards issued by the International Accounting Standards Board. Furthermore, issuers would be required to include interim financial statements for at least six months if the latest year-end balance sheet is dated more than nine months before the date of qualification. Interim financial statements would not be required to be audited or reviewed. In connection with a Tier 2 offering, the financial statements to be included in the offering statement would have to be audited in accordance with Public Company Accounting Oversight Board ("PCAOB") standards. However, the firm auditing those financial statements would not have to be PCAOB registered. Issuers would follow the financial statement requirements for smaller reporting companies under Article 8 of Regulation S-X, in most cases.

The proposed rules would require issuers and intermediaries in the prequalification period to deliver a preliminary offering circular to prospective purchasers at least 48 hours in advance of sale. In addition, the proposed rules would modernize the qualification, communications and offering process in Regulation A offerings to reflect analogous provisions of the Securities Act registration process and would:

- permit issuers and intermediaries to satisfy their delivery requirements as to the final offering circular under an "access equals delivery" model when the final offering circular is filed and available on EDGAR;

- require issuers that sell to prospective purchasers in reliance on the delivery of a preliminary offering circular to provide purchasers, not later than two business days after completion of the sale, with a copy of the final offering circular or a notice that the sale occurred pursuant to a qualified offering statement that includes the URL where the final offering circular, or the offering statement of which such final offering circular is part, may be obtained and contact information sufficient to notify a purchaser where a request for a final offering circular can be sent and a final offering circular will be received in response; and

- permit issuers to file offering circular supplements after qualification of the offering statement in certain circumstances in lieu of post-qualification amendments, including to provide the types of information that may be excluded from a prospectus under Rule 430A.

Offering Communications; Testing-the-Waters

Testing-the-waters is currently permitted under Rule 254, which requires, among other things, that issuers submit all solicitation materials to the SEC no later than the time of first use. Under existing Rule 254(b)(3), issuers must stop using test-the-waters solicitation materials after the initial filing of the offering statement for a Regulation A offering. Testing-the-waters under Rule 254 is different from testing-the-waters for a registered offering by an emerging growth company under Section 5(d) of the Securities Act. Under Section 5(d), testing-the-waters is limited to communications with qualified institutional buyers and institutional accredited investors. Under current Rule 254, there is no limitation on the type of investor that may be solicited.

Under the proposed rules, similar to existing Rule 254, issuers would be permitted to test-the-waters or solicit interest in a potential offering from the general public either before or after the filing of the offering statement, so long as any solicitation materials used after publicly filing the offering statement are preceded or accompanied by a preliminary offering circular or contain a notice informing potential investors where and how the most current preliminary offering circular can be obtained. This requirement could be satisfied by providing the URL to the preliminary offering circular or the offering statement on EDGAR.

Ongoing Reporting Obligations

The proposal would require Tier 2 issuers to file ongoing periodic reports via EDGAR. The ongoing reporting obligations would not constitute Exchange Act reporting and would not require a Tier 2 issuer to register under the Exchange Act unless registration is otherwise required under Section 12 of the Exchange Act. Annual reports on new Form 1-K would have to include audited financial statements and meet disclosure requirements similar to those of the offering statement. Form 1-K would be due within 120 days after the issuer's fiscal year-end. The proposal also would require semiannual reports to be filed on new Form 1-SA within 90 days after the end of an issuer's second fiscal quarter that would include interim financial statements and certain MD&A disclosures. An audit or review of the interim financial statements would not be required. Tier 2 issuers would also be required to report certain current events on new Form 1-U, similar to those that registrants are required to report on Form 8-K. These events would include fundamental changes in the business, changes in the issuer's certifying accountant, non-reliance on previous financial statements or related audit reports, and departures of key executives.

Issuers would exit the Regulation A ongoing reporting regime when they become subject to the ongoing reporting requirements of Section 13 of the Exchange Act, and may exit the Regulation A reporting regime at any time by filing an exit report after completing reporting for the fiscal year in which the offering statement was qualified, so long as the securities of each class to which the offering statement relates are held of record by fewer than 300 persons and offers or sales made in reliance on a qualified Regulation A offering statement are not ongoing.

What's Next; REIT Specific Issues

The SEC is seeking comments on the Regulation A+ proposal. Comments should be submitted by the date that is 60 days after publication of the proposing release in the Federal Register. In the proposing release, the SEC requested comments on certain issues that could impact the use of the exemption by REITs.

In order to address concerns regarding the use of Regulation A by REITs, absent additional REIT-specific disclosure, the SEC is requesting comments on whether it should require additional disclosure by REITs. As noted above, the proposed rules would eliminate Model A as a disclosure option for offering circulars and would allow issuers to follow Model B or Part I of Form S-1. In order to make Regulation A+ a viable, capital-raising mechanism for REITs, we think the SEC should allow REITs to prepare offering circulars for Regulation A offerings based on the disclosure requirements specified in Part I of Form S-11.

While it is not currently proposed, the SEC is requesting comments on whether it should limit the availability of the exemption to companies satisfying a new definition of "operating company." In March 1992, the SEC proposed revisions to Regulation A, including a proposal to limit Regulation A to operating companies.[2] The March 1992 proposal would have made the exemption available only "to raise funds to put into the operations of an actual business and not simply for investment," and would have specifically excluded "those enterprises with the principal business of investing or reinvesting funds in securities, properties, commodities, business opportunities or similar media of speculative opportunity."[3] The SEC did not adopt the proposed operating company requirement, and it specifically noted in the adopting release that "partnerships or certain other entities organized primarily for the purpose of investing in properties, commodities or other investment vehicles have long been eligible to use Regulation A," and that after consideration of public comment it was appropriate to continue to make Regulation A available to such companies.[4] Along the same lines as the March 1992 proposal, the SEC is now requesting comments on whether it should exclude certain non-operating companies from Regulation A. In the Regulation A+ proposing release, the SEC notes that it could limit availability of Regulation A to issuers that have generated total revenue in excess of a certain amount (e.g., $1,000,000) over a certain period of time (e.g., its prior two fiscal years) through the provision of goods or services, or based on similar or different criteria intended to facilitate access to the proposed rules by small companies. If the SEC were to adopt an operating company limitation, Regulation A would be unavailable to blind pool REITs. In light of the SEC's direct oversight over offering statements filed by Regulation A issuers and the meaningful investor protections provided by the proposed rules, including the ongoing reporting obligations applicable to Tier 2 issuers, we believe the SEC should continue to make the exemption available to non-operating companies, including blind pool REITs.

Conclusion

At this early juncture, it is unclear if Regulation A+ will become a viable capital-raising vehicle for smaller issuers. As compared with a traditional IPO, proposed Regulation A+ would reduce disclosure requirements but may not provide secondary market liquidity due to the inability to have the securities listed on platforms reserved for registered securities. As compared with a traditional Regulation D private placement, proposed Regulation A+ would allow issuers access to a broader investor base, including non-accredited retail investors, potentially allowing issuers access to capital at a lower cost but would impose additional reporting requirements and accompanying costs. Ultimately, issuers will need to weigh these and other considerations to determine which offering method is best suited to their needs.

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2 *See,* Securities Act Release No. 33-6924 (March 1992) [57 Fed. Reg. 9768, at 9771].

3 *Id.*

4 *See,* Securities Act Release No. 33-6949 (August 1992) [57 Fed. Reg. 36442, at 36443].