December 24, 2013

SEC Proposes Rules to Update Regulation A

On December 18, 2013, the Securities and Exchange Commission ("SEC") voted to propose amendments to its public offering rules to exempt an additional category of small capital raising efforts as mandated by Title IV of the Jumpstart Our Business Startups Act (the "JOBS Act"). The SEC has proposed to amend Regulation A to exempt offerings of up to $50 million within a 12-month period, and in so doing has created two tiers of offerings under Regulation A: Tier 1, for offerings of up to $5 million in any twelve-month period, and Tier 2, for offerings of up to $50 million in any twelve-month period. Rules regarding eligibility, disclosure and other matters would apply equally to Tier 1 and Tier 2 offerings and are in many respects a modernization of the existing provisions of Regulation A. Tier 2 offerings would, however, be subject to significant additional requirements, such as the provision of audited financial statements, ongoing reporting obligations and certain limitations on sales.

One of the key questions regarding the implementation of Title IV of the JOBS Act has been how the SEC would address the state blue sky issues that have helped make Regulation A unattractive as an offering alternative. Notably, the SEC has proposed a complete preemption of state securities law registration and qualification requirements for securities offered in a Tier 2 offering.

Background

Section 401 of the JOBS Act created a new subsection (2) to section 3(b) of the Securities Act of 1933 (the "Securities Act") that directed the SEC to add a new exemption for offerings of securities up to $50 million within a 12-month period. This new exemption (often referred to as "Regulation A+") was intended to build upon Regulation A, an existing but rarely-used exemption from registration for small offerings of securities of up to $5 million in a 12-month period.

Existing Regulation A, originally adopted in 1936, provides for a simplified securities registration process tailored to smaller issuers. It requires companies offering securities under Regulation A to prepare an offering statement, the core of which is an offering circular, which is a disclosure document much like an abbreviated version of a prospectus in a registered offering, but does not mandate ongoing reporting after the offering is completed. The offering circular must be delivered to prospective purchasers. Offering statements under Regulation A are reviewed by the SEC and must comply with requirements regarding form, content, and process. Regulation A offerings are also subject to state-level registration and qualification requirements.

Regulation A is very rarely used. The commentary to the proposed rule notes that in 2012, there were eight qualified Regulation A offerings for a total offering amount of approximately $34.5 million, compared to approximately 7,700 Regulation D offerings of up to $5 million for a total offering amount of approximately $7 billion. A number of factors, including the low offering threshold and the absence of a blue sky exemption for securities offered under Regulation A, have contributed to its limited use.

The Proposed Rules

The SEC's proposed rules would update and expand the Regulation A exemption by creating two tiers of Regulation A offerings:

- Tier 1, which would include those offerings already covered by Regulation A – *i.e.*, securities offerings of up to $5 million in any 12-month period, including up to $1.5 million for the account of selling securityholders, and

- Tier 2, which would include offerings of up to $50 million in any 12-month period, including up to $15 million for the account of selling securityholders.

For offerings of up to $5 million, an issuer could elect to use either Tier 1 or Tier 2.

Eligibility. Regulation A is available to companies organized in, and with their principal place of business in, the United States or Canada. A U.S. or Canadian subsidiary of a foreign multinational company would be eligible to rely on Regulation A if its principal place of business is in the United States or Canada. The SEC requested comment on whether Regulation A should be limited to issuers organized and with a principal place of business in the United States, thereby excluding Canadian issuers, or whether the scope should be expanded to include all foreign private issuers.

The exemption would not be available to SEC reporting companies, certain investment companies, certain development stage companies, or companies that are seeking to offer and sell asset-backed securities or fractional undivided interests in oil, gas, or other mineral rights. Regulation A would be unavailable to issuers delinquent in their Regulation A filings or subject to certain SEC orders. In addition, the requirement that a securities offering be disqualified from relying on Regulation A if the issuer or other covered persons are felons or other "bad actors" would be conformed to the bad actor disqualifications in new Rule 506(d).

The proposed rule would limit the types of securities eligible for sale under both Tier 1 and Tier 2 of Regulation A to the specifically enumerated list of securities in Section 3(b)(3), *e.g.,* equity securities, debt securities, and debt securities convertible or exchangeable into equity interests (including any guarantees of such securities). Asset-backed securities would be excluded from the list of eligible securities.

Modernization of Communications and Offering Process. The proposed rules would update Regulation A to modernize the communications and offering process in Regulation A and to reflect analogous provisions of the Securities Act registration process. Among other things:

- An issuer using Regulation A could obtain indications of interest from potential investors both before and after filing the offering statement, a practice known as "testing the waters." Any solicitation materials would need to be filed with the SEC. Any solicitation materials used after the public filing of the offering statement would need to be 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 (including by providing a URL link to the offering circular or offering statement on EDGAR).

- The offering statement would be "qualified" only by SEC order (rather than, in the absence of a delaying notation, on the 20th calendar day after filing) so that the SEC has the opportunity to review and comment.

- Confidential submission of draft offering statements and amendments would be permitted, provided the documents were publicly filed no later than 21 calendar days before qualification.

- The preliminary offering circular would have to be delivered at least 48 hours in advance of a sale. A final offering circular would have to be delivered within two business days after the sale in cases where the sale was made in reliance on the delivery of a preliminary offering circular. Issuers and intermediaries would be able to satisfy the delivery requirements for the final offering circular under an "access equals delivery" approach when the final offering circular is filed and available on EDGAR.

- Regulation A issuers would be required to provide updated summary offering information after termination or completion of an offering.

- All filings would be required to be submitted to the SEC in electronic format via EDGAR.

Offering Statement. Under the proposed rule, issuers would continue to be required to prepare an offering statement, including the narrative and financial information required by Form 1-A, the current structure of which would be retained. Proposed Form 1-A would no longer permit disclosure in reliance on the Model A "question and answer" disclosure format currently permitted under existing Regulation A, and would update Model B, which requires various disclosures, including basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A type discussion; disclosures about executive officers and directors and compensation; beneficial ownership information; related party transactions; a description of the offered securities; and two years of financial statements.

Under the proposed rule, the offering statement would in some instances contain fewer disclosure items than required under existing Form 1-A (for example, proposed Form 1-A would require a description of the issuer's business for a period of three years, rather than five years). In other respects, the offering statement would contain more disclosure (for example, proposed Form 1-A would require a more detailed discussion and analysis in the MD&A of the issuer's liquidity and capital resources and results of operations).

Other Items. The proposed rule would eliminate the existing prohibition on affiliate resales, which prohibits such resales unless the issuer has had net income from operations in at least one of the last two fiscal years. It would not exempt securities sold pursuant to Regulation A from the Section 12(g) Exchange Act registration thresholds, and would add to the list of specific safe harbor provisions subsequent offers or sales made in crowdfunded offerings. The proposed rule also outlines the scope of permissible continuous or delayed offerings under Regulation A.

The proposed rule also notes that while the liability provisions of Section 11 of the Securities Act would not apply to Regulation A offerings, other anti-fraud and civil liability provisions of the securities laws, including Sections 12(a)(2) and 17 of the Securities Act and Rule 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act") would apply.

Additional Requirements for Tier 2 Issuers

In addition to the provisions described above, issuers conducting Tier 2 offerings would be subject to a number of additional requirements under the proposed rules in order to address potential investor protection concerns.

Audited Financial Statements. Unlike Tier 1 offerings, the financial statements included in the offering statement for a Tier 2 offering would be required to be audited in accordance with PCAOB standards.

Ongoing Reporting Requirements. Issuers in Tier 2 offerings would be subject to an ongoing reporting regime and would be required to file various reports, including annual reports on Form 1-K, semi-annual reports on Form 1-SA, current reports on Form 1-U and special financial reports on Form 1-SA.

Form 1-K would require disclosures relating to the issuer's business and operations for the preceding three years (or since inception, if in existence for less than three years); related party transactions; beneficial ownership; executive officers and directors; executive compensation; MD&A; and two years of audited financial statements. Form 1-SA and Form 1-U are analogous to Form 10-Q and Form 8-K, respectively, but with scaled disclosure requirements.

A Tier 2 issuer could exit the ongoing reporting regime when it becomes a reporting company under the Exchange Act or by filing a Form 1-Z exit report if there are fewer than 300 record holders of the securities of the class that were offered and the company is current in its Regulation A filing obligations.

Investor Limitation. Investors in a Tier 2 offering would be limited to purchasing no more than 10% of the greater of the investor's annual income or net worth, whichever is greater. Tier 2 issuers would be permitted to rely on an investor's representation of compliance with these limitations unless they knew at the time of sale that this representation was untrue.

Interaction with State Securities Laws

Under existing Regulation A, offerings are subject to registration and qualification requirements in the states where the offering is conducted unless a state-level exemption is available. This requirement has been identified by the Government Accountability Office and market participants as one of the main reasons for the limited use of Regulation A. As a result, the SEC has provided in the proposed rules that state securities law requirements would be preempted for Tier 2 offerings, noting that the additional requirements applicable to Tier 2 offerings should provide significant additional investor protection. The proposed rules accomplish this preemption by defining "qualified purchaser" under Section 18(b)(3) of the Securities Act to include all offerees in a Regulation A offering, and all purchasers in a Tier 2 offering.

The North American Securities Administrators Association ("NASAA"), in correspondence with the SEC, has expressed its vigorous objection to the proposed preemption of state regulation of Regulation A offerings. NASAA has proposed a coordinated review program that would streamline the state filing and review process for Regulation A offerings, whereby a single state "lead" examiner would consolidate comments from other states and serve as a single point of contact with the issuer. In the proposed rules, the SEC indicated that it would monitor the development of the coordinated review program, and solicits comment as to whether it should wait to see if such a coordinated review program can be finalized, adopted and successfully implemented and, if so, whether such a program would sufficiently address current concerns about the costs of blue sky compliance.

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The SEC will continue to solicit comments on the proposed rules discussed above until 60 days following their publication in the federal register. For a copy of the proposed rules and the SEC's accompanying release, see:

http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540518165.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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