Regulation A+: A Middle Way?

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A nonpublic company seeking access to the capital markets faces a largely binary choice between conducting a private placement, with few if any reporting obligations afterwards, and conducting an SEC-registered offering and immediately becoming subject to ongoing public-company reporting requirements and other responsibilities under the Securities Exchange Act of 1934. Depending on factors such as the type and amount of capital being raised and the company's stage of development and future financing plans, one alternative or the other usually presents itself as the logical choice. The consequences are significant. Even with the reforms ushered in by the JOBS Act of 2012, becoming a public company involves significant upfront and ongoing management attention, overhead expense and legal liability. On the other hand, going public provides significantly more liquidity for stockholders, can result in an increased equity valuation, can afford a great deal more opportunity for capital raising, and can provide the company with an improved form of currency for acquisitions and employee compensation.

When it passed the JOBS Act, Congress instructed the SEC to develop a new exemption from the registration requirements of the Securities Act of 1933 that would permit nonpublic companies to conduct securities offerings of up to $50 million in any rolling 12-month period. In response, on December 18, 2013 the SEC proposed **amendments** to Regulation A, a seldom-used Securities Act exemption, for offerings by nonpublic US and Canadian companies. The SEC is seeking comment on the proposals, colloquially called "Regulation A+," through early March 2014 (the deadline will be announced when the proposals are published in the Federal Register).

If adopted in its current form, Regulation A+ will offer some nonpublic companies a middle way between remaining private and going public. Eligible companies would include some that would not otherwise qualify as "emerging growth companies" under the JOBS Act or would not be able to take advantage of the SEC's scaled reporting requirements for smaller reporting companies.

Whether Regulation A+ proves popular remains to be seen. If companies begin to use it, for many it will be a transitional stage on the road to becoming a fully-fledged public company. Other companies, however, may find that Regulation A+ offers a longer-term solution that provides tangible public-company benefits with some but not all of the attendant costs—particularly if trading venues develop that offer secondary market liquidity and achieve market acceptance.

Eligible Companies, Securities and Transactions

As proposed, Regulation A offerings would consist of –

- **Tier 1 offerings** of up to $5 million in a rolling 12-month period, of which no more than $1.5 million may be sold by stockholders, as currently permitted under Regulation A and
- **Tier 2 offerings** of up to $50 million in a rolling 12-month period, of which no more than $15 million may be sold by stockholders.

Because Regulation A in its current form is used rarely (the SEC counted only 19 offerings from 2009 through 2012), we expect most private companies raising no more than $5 million will continue to rely on Regulation D or another Securities Act exemption that is more streamlined than Regulation A, and for this reason we do not expect companies to make much use of Tier 1 offerings. In this memo, therefore, we will focus on Tier 2 offerings by eligible companies.

The Regulation A exemption would be available to any company organized in, and with its principal place of business inside, the United States or Canada, with specified exceptions. The exemption would not be available to public companies already reporting under the Exchange Act, investment companies, special purpose acquisition companies (SPACs), business development companies (BDCs), blank check companies, companies subject to “bad boy” disqualification, or to issuers of fractional undivided interests in oil or gas rights, among others. The SEC has asked for comment on whether eligibility should also be conditioned on the company’s size, and whether to extend eligibility to foreign private issuers, SPACs and BDCs. Unless the SEC ultimately imposes a size requirement, the benefits of Regulation A would be available to some companies that cannot otherwise take advantage of the JOBS Act’s rules for emerging growth companies, or the SEC’s smaller reporting company scaled disclosure regime.

Per the JOBS Act, offerings under the new exemption may consist only of “equity securities, debt securities, and debt securities convertible or exchangeable into equity interests, including any guarantees of such securities.” As the SEC observed, on the basis of this statutory language it isn’t clear what Congress meant to exclude, although the SEC noted that “there is some evidence that suggests the exemption is meant for ordinary—and not exotic—securities.” The SEC has proposed to exclude asset-backed securities from Regulation A, and has asked for comment on whether other types of securities should also be excluded.

Transactions permitted under Regulation A would not be limited to primary capital raising in a discrete offering. Several other types of transactions may be carried out, including –

- offerings by stockholders
- offerings pursuant to a dividend or interest reinvestment plan or an employee benefit plan
- securities issuances upon the exercise of outstanding options, warrants or rights or conversion of outstanding securities
- pledging of securities as collateral and
- continuous offerings in an amount expected to be sold within two years, as long as such an offering begins within two days after the offering statement has been qualified.

The proposed rules would exclude certain transactions from Regulation A, however. For example, at-the-market offerings would not be permitted, nor would business combination transactions.

Offering Process

To offer securities under Regulation A, a company would file an “offering statement” with the SEC via EDGAR. While Regulation A currently permits automatic “qualification” of offering statements, the proposed rules would require the SEC to affirmatively qualify all Regulation A offering statements. Similar to the process for emerging growth companies under the JOBS Act, a company that has not previously sold securities under Regulation A or an effective Securities Act registration statement would be able to submit a draft offering statement for nonpublic review by the SEC.

In another echo of the rules for emerging growth companies, a company pursuing a Regulation A offering would be able to “test the waters” with potential investors prior to filing the offering statement. Testing-the-waters outreach would not be limited to qualified institutional buyers and institutional accredited investors, however, as it is for emerging growth companies. The company would be required to file any solicitation materials as an exhibit to its offering statement.

As with a registered offering, if underwriters are participating in the Regulation A offering, the offering statement and underwriting arrangements would be required to be filed with and approved by FINRA, unless an exemption is available.

We do not expect the process for filing, review and qualification of Regulation A offering statements to differ substantially from the process for filing, review and effectiveness of registration statements under the Securities Act. As a result, for any given company we do not expect the timetable for a Regulation A offering to differ significantly from that of an SEC-registered IPO. Companies with a more urgent need for capital—and companies that are not inclined to go through an SEC review process—will therefore likely continue to opt for a traditional private placement rather than take advantage of the new exemption.

Offering Statement

The Regulation A offering statement would be filed on Form 1-A and consist of three parts: Part I (Notification), Part II (Offering Circular) and Part III (Exhibits). Part I serves as a notice of certain basic information about the company and its proposed offering. Part II, the offering circular, is the analog to a prospectus in a registered offering, and Part III is similar to the exhibit requirement for a Securities Act registration statement.

As proposed, disclosure required in the offering circular would cover substantially all of the information required in a Form S-1 for the IPO of an emerging growth company, including two years of audited financial statements for Tier 2 offerings, MD&A, risk factors, a three-year description of the business, compensation information for the three most highly paid officers or directors and related-party transaction disclosure. (In fact, the SEC is soliciting comment on whether it should simply require the offering circular to comply with Form S-1 disclosure rules.) As a result, we do not expect most companies would decide between Regulation A and a registered offering on the basis of the required offering document disclosure.

Ongoing Reporting and Compliance

It is in the context of ongoing reporting and compliance that we think some nonpublic companies may see a benefit to conducting a Regulation A offering instead of a registered offering. Some of the ongoing reporting and compliance obligations that would **not** apply to Regulation A companies (and their directors, officers and stockholders) include:

- the SEC's proxy statement rules
- Section 16 reporting by directors, executive officers and 10% stockholders
- Williams Act disclosure by 5% stockholders
- audit committee independence requirements of the Sarbanes-Oxley Act
- internal controls requirements of the Sarbanes-Oxley Act
- director and officer loan prohibitions under the Sarbanes-Oxley Act
- Sarbanes-Oxley CEO/CFO certifications
- conflict minerals and resource extraction disclosures required by the Dodd-Frank Act and
- pay ratio disclosure required by the Dodd-Frank Act.

On the other hand, a company that engages in a Tier 2 offering would have certain ongoing disclosure obligations, unlike a company offering securities through a Regulation D, Rule 144A or other traditional private placement (except where ongoing obligations are required by contract). A company with a qualified Tier 2 offering statement would be required to file annual, semiannual and current reports with the SEC via EDGAR until the company becomes a reporting company or, subject to certain exceptions, until there are fewer than 300 holders of record of the securities whose issuance gave rise to the reporting obligation.

- **Annual reports on Form 1-K** would be required for the fiscal year in which the offering statement became qualified and for every fiscal year thereafter. The annual report would essentially update the information contained in the company's offering circular, including two years of annual audited financial statements. The annual report would be filed within 120 days of the company's fiscal year end, giving companies more time than the Form 10-K filing deadline of 60 to 90 days, depending on the size of the company.

- **Semiannual reports on Form 1-SA** covering the first half of each fiscal year of the company would be required beginning with the first fiscal year for which financial statements relating to the first half of that year were not included in the offering circular. The semiannual report would consist primarily of unaudited financial statements and MD&A. The semiannual report would be filed within 90 days of the end of the second quarter, compared to the Form 10-Q deadline of 40 or 45 days, depending on the size of the company, and would be filed only once a year compared to three times for Form 10-Q.
- **Current reports on Form 1-U** would be required upon the occurrence of certain specified events, and would be filed within four business days of the event, parallel to the Form 8-K filing requirement. Form 1-U reportable events are largely a subset of Form 8-K events, including bankruptcy; material modification to the rights of securityholders; changes in accountant; non-reliance on previous financial statements; changes in control; departure of the principal executive officer, principal financial officer or principal accounting officer; and unregistered sales of 5% or more of outstanding equity securities. In addition, any "fundamental change" to the nature of the company's business would trigger Form 1-U reporting. The fundamental change reporting event would be triggered by "major and substantial changes in the issuer's business or plan of operations or changes reasonably expected to result in such changes, such as significant acquisitions or dispositions, or the entry into, or termination of, a material definitive agreement that has or will result in major and substantial changes to the nature of an issuer's business or plan of operations." Several Form 8-K reporting events that are not specifically enumerated in Form 1-U could therefore nonetheless trigger Form 1-U reporting.

Secondary Market and Blue Sky Laws

Securities sold under Regulation A would have the status of publicly offered securities and therefore would not be "restricted securities" under the Securities Act, unlike securities sold in Regulation D or Rule 144A private placements. In addition, the ongoing reports required after a company's Tier 2 offering would satisfy a broker-dealer's obligations under Rule 15c2-11 to maintain records of basic information about the company and its securities—permitting broker-dealers to publish quotes for the company's stock. This should facilitate secondary market activity in Regulation A securities, and the SEC has requested comment on ways to strengthen this market, such as by encouraging the development of "venture exchanges" dedicated to trading the securities of smaller companies.

State blue sky laws would be preempted for both the offer and sale of securities in Tier 2 offerings, a significant benefit over Regulation D offerings and other private placements by nonpublic companies. Blue sky laws would continue to apply to fraudulent conduct in Regulation A transactions.

Liability Considerations

As in other offerings exempt from registration under the Securities Act, participants in Regulation A offerings would not be subject to liability under Section 11 of the Securities Act. However, other anti-fraud and civil liability provisions of the federal securities laws would apply, including Sections 12(a)(2) and 17 of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5. As a result, for liability reasons we would expect that underwriters participating in a Regulation A offering would generally require a level of diligence and disclosure comparable to that required in registered offerings.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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