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Regulation A: Easier Access to the U.S. Capital Markets is Coming

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Client Advisory
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In December 2013, the U.S. Securities and Exchange Commission ("SEC") proposed new rules that would permit U.S. and Canadian companies that are not SEC reporting issuers ("Reg A Issuers") to sell up to $50 million of their securities in any rolling 12 month period with reduced regulation and related expense, and immediate subsequent public trading of the purchased securities. This proposed Regulation A offers access to capital and the U.S. capital markets with reduced initial and ongoing expenses, reduced legal liability, potentially higher valuations, increased capital raising possibilities and improved currency for acquisitions and employee compensation, and with limited subsequent SEC reporting and without ongoing SOX compliance. In contrast to a private placement, Regulation A offers "free trading" securities and could be used as either a transitional stage on the road to becoming a full-fledged public company or simply as a means to accessing the U.S. capital markets with reduced fees and concomitant expense.

The proposed Regulation A consists of:

Tier I Offerings: Up to $5 million in a rolling 12 month period, $1.5 million of which may be sold by stockholders.

Tier II Offerings: Up to $50 million in a rolling 12 month period, $15 million of which may be sold by stockholders.[1]

For offerings up to $5 million, issuers may use Regulation A Tier 1 or Tier II, Regulation D or another Securities Act exemption under the U.S. Securities Act of 1933 (the "Securities Act").

Regulation A offers significantly reduced ongoing reporting and compliance obligations compared to a registered offering. The following reporting and compliance obligations would NOT apply to Regulation A companies (and their directors, officers and stockholders):

- the SEC's proxy statement rules;
- the SEC's tender offer rules and going private rules;
- Section 16 shareholder reporting by directors, executive officers and 10% stockholders, related short swing profit recapture and prohibition on "short" transactions;
- Section 13 D/G market alert disclosure by 5% stockholders;
- audit committee independence requirements of SOX;
- SOX Sec. 404 internal controls;

- director and officer loan prohibitions under SOX;
- CEO/CFO SOX certifications;
- conflict minerals and resource extraction disclosures under the Dodd-Frank Act; and
- pay ratio disclosure under the Dodd-Frank Act.

Eligible Issuers

The Regulation A exemption would be available to any company that is both organized in and has its principal place of business in the United States or Canada, but is NOT:

- subject to reporting under the Securities Exchange Act of 1934 (the "Exchange Act");
- an investment company;
- a development stage company with no specific business plan or purpose or whose business plan is to engage in a merger or acquisition with an unidentified company (e.g., SPACs, BDCs, blank check and shell companies);
- disqualified under the "bad actor" provisions of the proposed rules (similar to Reg. D Rule 506(d)); or
- an issuer of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights.

Additionally, issuers conducting Regulation A offerings under the proposed rules must also:

- have filed the ongoing reports required by the proposed rules (described below) during the preceding two years of filing a new Regulation A offering statement; and
- not be subject to an SEC order revoking its registration under the Exchange Act under Section 12(j) of that Act during the preceding five years.

Eligible Securities

Offerings under proposed Regulation A must consist only of equity securities, debt securities and debt securities convertible into or exchangeable for equity securities, including any guarantees of those securities. Asset-backed securities will not be eligible to be offered under the proposed rules.

Eligible Transactions

Transactions permitted under Regulation A would include:

- primary capital raising offerings;
- offerings by stockholders;
- offerings under 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 the offering begins within two days after the offering statement has been qualified.

The proposed rules would not be available for at-the-market offerings or business combination transactions.

Investment Limitation on Purchasers

The proposed rules would limit the amount of securities that a potential investor may invest in a Tier 2 offering to 10% of the greater of the investor's annual income or net worth, calculated in accordance with Regulation D guidelines. There is no similar limit for a Tier 1 offering. Tier 2 issuers would be able to rely on an investor's representation of compliance with these limitations unless the issuer knew at the time of sale that the representation was false. However, there is no limit on how much an investor may purchase in the open market after the offering.

Integration of Safe Harbors

Regulation A offerings will not be integrated with:

- prior offers or sales of securities (outside Regulation A); or
- subsequent offers and sales of securities that are:
- o registered under the Securities Act, except as provided in Rule 254(d);
- o made under Rule 701;
- o made under an employee benefit plan;
- o made under Regulation S;
- o made more than six months after completion of the Regulation A offering; or
- o crowdfunding offers (once rules are adopted).

Offering Process

To offer securities under Regulation A, a company must file an "offering statement" with the SEC via EDGAR for both Tier 1 and Tier 2 offerings, and the SEC must affirmatively "qualify" the Offering Statement. For a company that has not previously sold securities under either Regulation A or an effective registration statement under the Securities Act, confidential, non-public review of draft offering statements would be permitted before filing. However, the non-public documents would have to be publicly filed no later than 21 days before qualification. This enables Regulation A issuers to maintain confidentiality through road shows. In contrast, emerging growth companies must come out of confidential treatment before road shows.

A company pursuing a Regulation A offering would be able to "test the waters", i.e., seek indications of interest, from any potential investors before filing the offering statement. The company would be required to file any solicitation materials as an exhibit to its offering statement. See "Solicitation Communications" below.

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.

Although the process for filing, review and qualification of Regulation A offering statements would be similar to that for full blown registration statements, given the reduced disclosures, the Regulation A offering process should be somewhat faster and less costly than a full blown registration statement. However, that remains to be seen.

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 provides notice of certain basic information about the company and its proposed offering, including disclosure of issuer eligibility, "bad actor" disqualification, unregistered securities sold within the past year, and a summary of key issuer financial information and offering details. Part II, the offering circular, is similar to a prospectus in a registered offering, and Part III is similar to the exhibit requirement in a registration statement.

As proposed, disclosure required in the offering circular would cover substantially similar information to that required on 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. The information required is intended to be similar to that required of smaller companies in a prospectus, but more limited in certain respects.

Pricing can be done by supplement rather than an amendment, which is easier.

Financial Statements

Under the proposed rules, issuers conducting Tier 1 and Tier 2 offerings will be required to comply with the financial statement and auditing requirements as set forth in the table below.

Canadian issuers can use IFRS instead of U.S. GAAP.

Financial Statement and Audit Requirements

Type of Offering	Tier 1	Tier 2
Financial Statements	Two years financial statements (or since inception if less than 2 years)	Two years financial statements
Audit Required	No, only required to the extent that they were prepared for other purposes	Yes, required
Audit Standard	U.S. GAAS or PCAOB standards	PCAOB standards
Auditor Independence	Must meet Rule 2-01 of Regulation S-XNeed not be PCAOB-registered	Must meet Rule 2-01 of Regulation S-XNeed not be PCAOB-registered

Continuous or Delayed Offerings

The proposed rules permit continuous or delayed offerings for, among other types of offerings, secondary offerings, securities offered and sold under dividend reinvestment plans or employee benefit plans, securities issued upon the exercise of options, warrants or rights, and certain other continuous offerings. The proposed rules also require amendments to the offering statement to be filed and requalified annually to include updated financial statements and fundamental changes to the information in the offering statement.

Solicitation Communications – Test the Waters Expanded to Pre-and Post-Filing of Offering Statement

An issuer using Regulation A could "test the waters," i.e., seek indications of interest, from all types of potential investors both before and after filing and offering statement, unlike EGCs, which are limited to qualified institutional buyers and institutional accredited investors. Any solicitation material would need to be filed with the SEC and must also contain certain disclaimers and legends indicating that sales under Regulation A would be contingent on qualification of the offering statement by the SEC, and the delivery of a final offering statement. Any solicitation materials used after filing of the offering statement with the SEC would have 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 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.

The proposed rules would amend Rule 254(d) to provide that where an issuer decides to register an offering after soliciting interest in a contemplated, but abandoned, Regulation A offering, any Tier 1 or Tier 2 offers made pursuant to Regulation A would not be subject to integration with the subsequent registered offering, unless the issuer engaged in solicitations of interest in reliance on Regulation A to persons other than qualified institutional buyers (QIBs) and institutional accredited investors. An issuer soliciting interest in either a Tier 1 or Tier 2 offering to persons other than QIBs and institutional accredited investors must wait at least 30 calendar days between the last solicitation of interest and the filing of the registration statement with the SEC.

Ongoing Reporting and Compliance

Tier 1 issuers would be required to file electronically with the SEC certain information about their offerings within 30 days after completion or termination of the offering on a new form Form 1-Z, which is an exit report. Tier 2 issuers 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 of the class sold per Regulation A securities.

For Tier 2 issuers:

- 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 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 (compared to 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 (similar to the Form 8-K filing requirement). Form 1-U reportable events are a reduced number 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. Additionally, any "fundamental change" to the nature of the company's business would trigger a Form 1-U filing. The fundamental change required to be reported would be 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.

- Exit Report on Form 1-Z could be filed by a Tier 2 issuer to exit the ongoing reporting regime at if any time after completing reporting for the fiscal year in which the offering statement was qualified if the securities of the relevant class are held of record by less than 300 persons and offers and sales under a qualified offering statement are not ongoing and it is current in its Regulation A filing obligations.

Secondary Markets

Securities sold under Regulation A would have the status of "free trading" securities and would not be "restricted securities" under Rule 144 under the Securities Act (unlike securities sold in Regulation D or Rule 144A private placements). Additionally, 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. This would permit broker-dealers to publish quotes for the company's stock, which should facilitate secondary market activity in Regulation A securities.

State "Blue-Sky" Laws Pre-Empted

State "blue sky" laws would be preempted for both the offer and sale of securities in Tier 2 offerings, which is a significant benefit. For Tier I offerings, state "blue sky" laws would not be pre-empted. Blue sky laws would also continue to cover fraudulent conduct in both Tier I and Tier II transactions. 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.

Securities that are "Widely-Held" Trigger Exchange Act Registration under Section 12(g)

Under the proposed rules, when the securities of a Regulation A issuer become "widely-held", the issuer may become subject to registration and periodic reporting under Section 12(g) of the Exchange Act. The Section 12(g) threshold is: an issuer having total assets exceeding $10 million and a class of securities held of record by either 2,000 persons, or 500 persons who are not accredited investors. For purposes of determining holders of record, beneficial owners who hold their shares through a broker are not counted. Such shares are instead counted at the broker level, so that each broker who is a record holder for one or more beneficial owners holding their shares in "street name" would constitute one shareholder of record (i.e., no "look through" to beneficial owners).

Canadian issuers using Regulation A could rely on the Rule 12g3-2(b) information supplying exemption from Exchange Act registration.

Liability

Under the proposed rules, sellers of securities would not be subject to Section 11 liability of the Securities Act. However, they will be subject to liability to investors under Section 12(a)(2) for any offer or sale by means of an offering circular or an oral communication that includes a false or misleading statement of fact. Additionally, other anti-fraud and civil liability provisions of the securities laws would apply, including Section 17 of the Securities Act, Section 10(b) of the Exchange Act and related Rule 10b-5. As a result, underwriters in a Regulation A offering would probably require due diligence renew comparable to a registered offering.

Conclusion

The proposed Regulation A offers a real opportunity for U.S. and Canadian issuers to access the U.S. capital markets and obtain the benefits of "registered" securities with less regulation and ongoing expense.

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Endnotes

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[1] All sales by selling securityholders under either Tier 1 or Tier 2 will be aggregated with all other sales of Regulation A securities by the issuer and other securityholders for purposes of calculating the maximum permissible amount of securities that may be sold during any 12-month period. Additionally, affiliates can use these rules.

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