

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

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Client Advisory

April 30, 2015 by Guy P. Lander and Bruce A. Rich

In March 2015, the U.S. Securities and Exchange Commission ("SEC") adopted new rules effective June 19, 2015 that permit U.S. and Canadian companies that are not SEC reporting issuers to sell up to U.S. \$50 million of their securities and their shareholders to sell up to U.S. \$15 million, in any rolling 12 month period with immediate public trading in the United States of the purchased securities. New Regulation A offers access to capital and the U.S. trading 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, with limited SEC reporting and without ongoing Sarbanes-Oxley ("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 expense.

Regulation A consists of two exemptions for public offerings:

Tier I Offerings:	Up to U.S. \$20 million of securities in a rolling 12 month period, U.S. \$6 million of which may be sold by stockholders that are affiliates of the issuer.
Tier II Offerings:	Up to \$50 million of securities in a rolling 12 month period, U.S. \$15 million of which may be sold by stockholders that are affiliates of the issuer. ^[1]

Sales by all selling stockholders are limited to 30% of the particular offering and of other offerings during the subsequent year.^[2]

For offerings of up to U.S. \$20 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 issuers have significantly reduced ongoing reporting and compliance obligations compared to those required after a registered offering; see "Ongoing Reports and Compliance" below. The following reporting and compliance obligations will 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;
 - Schedule 13 D/G market alert disclosure by 5% stockholders;
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- 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 Wall Street Reform and Consumer Protection ("Dodd-Frank Act"); and
- pay ratio disclosure under the Dodd-Frank Act.

Eligible Issuers

The Regulation A exemption will 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:

- reporting under the Securities Exchange Act of 1934 (the "Exchange Act");
- a company required to be registered under the Investment Company Act;
- a blank check company;^[3]
- an issuer of fractional undivided interests in oil or gas rights, or similar interests in other mineral rights;
- disqualified under the "bad actor" provisions of the rules (which are similar to Reg. D Rule 506(d));
- an issuer that has not filed with the SEC ongoing reports required by Regulation A during the two years before the filing of a new offering statement; and
- an issuer that has had its registration revoked under an Exchange Act Section 12(j) order entered within the five years before the filing of an offering statement.

Eligible Securities

Offerings under Regulation A must consist only of equity securities, debt securities and securities convertible into or exchangeable for equity securities (such as warrants), including any guarantees of those securities. Asset-backed securities are not eligible to be offered under Regulation A.

Eligible Transactions

Transactions permitted under Regulation A 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.

Regulation A is not available for at-the-market offerings. Regulation A offerings must be conducted at a fixed price.

Investment Limitation on Purchasers

The rules limit the amount of securities that a potential investor may invest in a Tier 2 offering where: (a) the investor is not “accredited” under Regulation D, and (b) the securities will not be listed on a national securities exchange. So, non-accredited investors and non-exchange traded securities are limited in Tier 2 offerings: (i) for natural persons, to 10% of the greater of the investor’s annual income or net worth, calculated in accordance with Regulation D guidelines; or (ii) for non-natural persons, to the greater of the investor’s revenues or net assets for the most recently completed fiscal year end.^[4] There is no similar limit on investor purchases for a Tier 1 offering. Tier 2 issuers must notify investors of these limitations. However, issuers may 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. There is no limit on the dollar amount of Regulation A securities an investor may purchase in the open market after the offering.

Non-Integration 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 255(e) regarding abandoned offerings;
 - o made under Rule 701 relating to compensatory plans and contracts;
 - o made under an employee benefit plan;
 - o made under Regulation S;
 - o crowdfunding offers (once rules are adopted); or
 - o made more than six months after completion of the Regulation A offering.

Offering Process

To offer securities for both Tier 1 and Tier 2 offerings under Regulation A, a company must file an “offering statement” with the SEC via EDGAR, and the SEC must affirmatively “qualify” the Offering Statement. No filing fee is required, and Canadian issuers must provide a consent to service of process.

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 is permitted before filing. ^[5] However, the non-public documents must 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. This 21 day public filing period also provides state securities regulators with an opportunity to assure filing of offering materials with the states in advance of the offerings.

A company pursuing a Regulation A offering is able to “test the waters”, i.e., seek indications of interest, from any potential investors before filing the offering statement. However, the company is required to file any solicitation materials as an exhibit to its offering statement. See “Solicitation Communications-Testing the Waters and Other Communications” below.

As with a registered offering, if underwriters are participating in the Regulation A offering, the offering statement and underwriting arrangements must be filed with and approved by the Financial Industry Regulatory Authority (“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 faster and less costly than a full blown registration statement. SEC Staff members have expressed their view that this review will be appropriately scaled. However, that remains to be seen.

Offering Statement

The Regulation A offering statement is filed on EDGAR on Form 1-A and consists of three parts: Part I (Notification), Part II (Offering Circular) and Part III (Exhibits). Part I is an XML based fill-in form which 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, jurisdiction where securities will be offered, 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. Part III contains the required exhibits. Issuers may incorporate by reference certain information and exhibits that were previously filed in EDGAR.

The disclosure in Part II of the offering circular covers substantially similar information to that required of smaller companies on Form S-1 for the IPO of an emerging growth company, but more limited in certain respects.

The Offering Circular disclosure includes the following (which may vary depending on whether the issuer is conducting a Tier 1 or Tier 2 offering):

- Basic information about the issuer, the offering and any underwriters;
- Underwriting discounts and commissions;
- Summary and risk factors;
- Dilution, i.e., material disparities between offering price and cost of shares acquired by insiders during the past year;
- Plan of distribution;
- Selling security-holders;
- Use of proceeds;
- Description of business operations for the prior three fiscal years;
- Physical property;

- Discussion and analysis of the issuer's financial condition (i.e., liquidity and capital resources) and results of operations;
- Directors, executive officers and significant employees;
- Executive compensation disclosure for the three most highly paid officers or directors;
- Ownership of voting securities by officers, directors and 10% owners;
- Transactions with the related persons, promoters and certain control persons; and
- Securities being offered.

Alternatively, an issuer can choose to comply with Part 1 of Form S-1 for its disclosure.

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

Financial Statements

Issuers conducting Tier 1 and Tier 2 offerings must comply with the financial statement and auditing requirements as set forth in the table below.

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) Interim financials if the annual statements are more than 9 months old.	Two years financial statements (or since inception if less than 2 years) Interim financials if the annual statements are more than 9 months old.
Accounting Standards	U.S. GAAP Canadian issuers may use U.S. GAAP or IFRS	U.S. GAAP Canadian Issuers may use U.S. GAAP or IFRS
Audit Required	No, only required if they were prepared for other purposes and comply with the auditing standards and independence standards below. But, states may require.	Yes, required
Audit Standard	U.S. GAAS or PCAOB standards For both U.S. and Canadian issuers	U.S. GAAS or PCAOB standards For both U.S. and Canadian issuers
Auditor Independence	Must meet the independence standard of Rule 2-01 of Regulation S-X Need not be PCAOB-registered	Must meet the independence standard of Rule 2-01 of Regulation S-X Need not be PCAOB-registered

As with emerging growth companies ("EGCs"), an issuer may elect to delay implementation of new accounting standards to the extent the standard permits delayed implementation for non-public companies, which it must disclose. However, this is a one-time election, i.e., once an issuer forgoes this accommodation, it must forgo it for all financial accounting standards and for all future filings.

An issuer conducting a Regulation A offering that seeks to concurrently register its securities under the Exchange Act must file audited financial statements prepared in accordance with PCAOB standards by an auditor that is PCAOB registered.

Shelf Offerings

Regulation A permits continuous or delayed offerings for the following types of securities offerings: securities offerings for selling security holders; securities offerings under dividend reinvestment plans or employee benefit plans; securities issued upon the exercise of options, warrants, rights, or the conversion of other outstanding securities; securities pledged as collateral; and securities that are part of an offering that commences within two calendar days after the qualification date, to be offered on a continuous basis, may continue to be offered for over 30 days from the date of initial qualification, and will be offered in an amount that, when the offering statement is qualified, as reasonably expected to be offered and sold within two years from the initial qualification date.

At the market offerings are not permitted under Regulation A. Issuers in continuous or delayed offerings under Tier 2 must be current in their annual and semi-annual reporting. Issuers may qualify additional securities under Regulation A by filing a post-qualified amendment to a qualified offering statement, subject to the Regulation A dollar limitations. The 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.

Issuers may refile to continue the offering before the third anniversary of the initial qualification.

Solicitation Communications – Testing the Waters and Other Communications

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 in “testing the waters” to qualified institutional buyers (“QIBs”) and institutional accredited investors. Any solicitation material must 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 must 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 with a URL link to the offering circular or offering statement on EDGAR.

Solicitation materials must be filed as exhibits to the offering statement once they are submitted for non-public review or filed, but issuers need not submit solicitation materials to the SEC at or before first use.

Regularly released factual business communications will not constitute solicitation materials pursuant to the guidance of Rule 169.

When a preliminary offering circular is used to offer securities to a potential investor and the issuer is not already subject to Tier 2 reporting, the preliminary offering circular must be delivered at least 48 hours in advance of a sale. A final offering circular must be delivered within two business days after the sale where the sale was made in reliance on the delivery of a preliminary offering circular. Issuers and intermediaries may 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.

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, if the issuer engaged in solicitations of interest in reliance on Regulation A only to QIBs and institutional accredited investors. If an issuer solicited interest in either a Tier 1 or Tier 2 offering to persons other than QIBs and institutional accredited investors the abandoned Regulation A offering would not be subject to integration if the issuer waits at least 30 calendar days between the last solicitation of interest in the Regulation A offering and the filing of the registration statement with the SEC.

Ongoing Reporting and Compliance

Tier 1 issuers are required to file electronically in EDGAR 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. No ongoing reporting is required for Tier 1 issuers. 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 pursuant to the Regulation A offering and certain other conditions described below are met.

For Tier 2 issuers:

- **Annual reports on Form 1-K** are required for the fiscal year in which the offering statement became qualified and for every fiscal year thereafter. The annual report updates the information contained in the company's offering circular, and require disclosure concerning the issuer's business and operations for the preceding three years (or since inception if less), related party transactions, beneficial ownership of voting securities, executive officers and directors, executive compensation, MD&A and two years of annual audited financial statements. Form 1-K requires that financial statements be prepared on the same basis, and subject to the same audit standards and auditor independence standards, as the financial statements required in the Regulation A offering circular for Tier 2 offerings. The annual report must 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 is similar to Form 10-Q and consists primarily of unaudited financial statements and MD&A. The semiannual report must be filed within 90 days of the end of the first six months of the issuer's fiscal year end (compared to the Form 10-Q deadline of 40 or 45 days, depending on the size of the company) and must be filed only once a year (compared to three times for Form 10-Q).
- **Current reports on Form 1-U** will 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 security holders; 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 (i.e., terminate or suspend) the ongoing reporting regime at 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, i.e., it has filed all required ongoing reports for its most recent three fiscal years and the portion of the current year preceding the filing of the Form 1-Z (or the period since the issuer became subject to reporting if shorter, but at least one annual report on Form 1-K must be filed). Regulation A ongoing reporting is automatically suspended if an issuer registers a class of securities under the Exchange Act.

Free Trading Securities and Secondary Markets

Securities sold under Regulation A have the status of “free trading” securities and are not “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 will satisfy a broker-dealer’s obligations under Rule 15c2-11 under the Exchange Act to maintain records of basic information about the company and its securities. This will permit broker-dealers to publish quotes for the company’s stock, which should facilitate secondary market activity in Regulation A securities.

However, if an issuer wants to enable resales under Rules 144 and 144A, then to comply with the information requirements of Rules 144 and 144A, a Tier 2 issuer must voluntarily file quarterly financial statements in addition to the Form 1-SA semi-annual financial statements. A Tier 2 issuer that is current in its semi-annual reporting and voluntarily provides quarterly financial statements on Form 1-U during a given year will have provided reasonably current and adequate current public information for the entirety of that year for purposes of Rule 144 and Rule 144A.

An issuer seeking to list on a U.S. national exchanges must register under the Exchange Act to do so. Registering under the Exchange Act can be done easily by the filing of a short Form 8-A if it is done contemporaneously with the qualification of the offering. An issuer that becomes Exchange Act reporting may qualify as an EGC. Issuers that list in the OTCQX will not have to register under the Exchange Act although the OTCQX highest Tier is expected to require Regulation A issuers to provide quarterly information on Form 1-U.

Bad Actor Disqualification

The bad actor disqualification provisions of Regulation A are substantially the same as those of Rule 506 of Regulation D.

State “Blue-Sky” Laws Pre-Empted For Tier 2 Offerings

State “blue sky” laws are 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 will not be pre-empted, and Tier 1 offerings can use NASAA’s new coordinated review program, which provides relief from some merit review standards. States retain their authority to require filing of offering materials in Tier 2 offerings and to enforce their laws prohibiting fraudulent conduct in both Tier I and Tier II transactions.

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

Generally, when the securities of an issuer become “widely-held”, the issuer is required to register and comply with the public company reporting obligations under the Exchange Act. The Section 12(g) threshold triggering Exchange Act registration and reporting 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 excluding recipients of securities under a compensation plan.

The rules provide an exemption from the “holder of record” threshold for securities in a Tier 2 offering that would otherwise trigger the registration requirement of Section 12(g) of the Exchange Act. To qualify, the issuer must retain a SEC registered transfer agent, remain subject to and current in its Tier 2 periodic reporting obligations, and have a public float of less than \$75 million as of its most recently completed semiannual period (or for an issuer without a public float, annual revenues of less than U.S. \$50 million as of its most recently completed fiscal year). An issuer that exceeds both the exemption’s public float or revenue threshold and Section 12(g)’s 2,000 holders or 500 non-accredited holders threshold will be granted a two-year transition period before being required to register its securities under Section 12(g). An issuer that becomes Exchange Act reporting would be an EGC to the extent the issuer otherwise qualifies as such.

For purposes of determining holders of record under the Section 12(g) holder of record threshold, 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 Regulation A, sellers of securities and their officers and directors 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 review comparable to a registered offering.

Conclusion

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 reduced regulation and ongoing expense.

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Endnotes

[1] All sales by selling security holders under either Tier 1 or Tier 2 will be aggregated with all other sales of Regulation A securities by the issuer and other security holders for purposes of calculating the maximum permissible amount of securities that may be sold during any 12-month period. Additionally, if convertible securities or warrants are being offered and those securities are convertible or exercisable within one year or at the issuer's discretion, the underlying securities must be qualified and the maximum estimated conversion or exercise price of those securities must be included in the aggregate offering price.

[2] After one year from the initial Regulation A offering, non-affiliates are not subject to this percentage limitation on resale, but the dollar limitations above remain thereafter for affiliates.

[3] A "blank check company" is 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., a SPAC). However, this does not include a "shell company" or a penny stock issuer, i.e., those companies are eligible to use Regulation A.

[4] If an investor is purchasing convertible securities that are exercisable within a year or otherwise being qualified, the investment limitation includes the aggregate conversion price in addition to the purchase price.

[5] Documents, including those in non-public submissions, are not exempt from public disclosure under the Freedom of Information Act ("FOIA") unless an exemption applies and is obtained.

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