Dechert LLP

SEC Boosts Smaller Company Capital Raising with Regulation A+

A legal update from Dechert's Corporate Finance and Capital Markets Group

April 2015

SEC Boosts Smaller Company Capital Raising with Regulation A+

Spurred by the Jumpstart Our Business Startups (JOBS) Act,[1] the SEC has adopted final rules easing the way for smaller U.S. and Canadian companies to raise capital.[2] These rules build on current Regulation A and are sometimes referred to colloquially as Regulation A+.

Regulation A, as revised by the SEC, includes significant limitations on its use by, among others, existing reporting companies under the U.S. Securities Exchange Act of 1934 (Exchange Act), blank check companies such as SPACs, and investment companies, including BDCs. In addition, while Regulation A provides simplified Exchange Act registration for Tier 2 offerings, it does not facilitate registration under the Exchange Act for Tier 1 offerings, so companies qualifying under Tier 1 of Regulation A must subsequently undertake a full Exchange Act registration in order to list on a national securities exchange. As a result, while Regulation A helpfully increases the size limitation on companies that elect to use it and provides an exemption from state-by-state registration under some circumstances, other limitations embedded in Regulation A are likely to limit its utility for many early-stage companies.

Highlights

- Certain offerings eligible for SEC qualification process rather than SEC registration process
- Non-public SEC review permitted
- Issuers permitted to “test the waters”
- Tier 1 offerings:
  - up to $20 million in a 12-month period
  - 30% sublimit on secondary sales by all selling security-holders in the first year; $6 million sublimit on secondary sales by *affiliates* in any 12 month period thereafter
  - no ongoing reporting obligations
- Tier 2 offerings:
  - up to $50 million in a 12-month period
  - 30% sublimit on secondary sales by all selling security-holders in the first year; $15 million sublimit on secondary sales by *affiliates* in any 12 month period thereafter
  - exempt from state securities law registration and qualification
  - subject to limits on the amounts non-accredited investors may invest
  - limited ongoing reporting obligations

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1 Jumpstart Our Business Startups Act, Available from GPO Access, http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf

2 The SEC adopted the final rules on March 25, 2015 and they will become effective 60 days after publication in the Federal Register. http://www.sec.gov/rules/final/2015/33-9741.pdf

Key Provisions

The rules provide for two tiers of offerings: Tier 1, for offerings of securities of up to $20 million in a 12-month period; and Tier 2, for offerings of securities of up to $50 million in a 12-month period. Companies may make these offerings without complying with the more onerous requirements of registration under the U.S. Securities Act of 1933 (Securities Act) or of ongoing reporting under the Exchange Act. Perhaps of even more benefit, the rules provide for preemption of state law so that companies can make Tier 2 offerings without complying with the more onerous requirements of state law registration and qualification, if the offers are to "qualified purchasers"[3] or of securities to be listed on a national exchange.[4] The rules revitalize the existing Regulation A, which is now rarely used because of a $5 million offering size cap and other limitations, including required compliance with state securities laws. The chart below summarizes key provisions of revitalized Regulation A.

	Tier 1	Tier 2
Offering Size Cap	Up to $20 million in a 12-month period (for all primary and secondary sales).	Up to $50 million in a 12-month period (for all primary and secondary sales).
	If securities are convertible into, or exercisable or exchangeable for, other securities within the first year after qualification or at the discretion of the issuer, the offer and sale of the underlying securities also requires qualification. Thus, the aggregate conversion, exercise or exchange price of the underlying securities would count against the offering size cap.	Same.
Secondary Sales Cap	Sales by all selling security-holders in an issuer's first Regulation A offering and within the following 12 months are limited to no more than 30% of the aggregate offering price (offering size) of the particular offering.	Same.
	Following the expiration of the first year after an issuer's initial qualification of an offering statement, sales by affiliates are limited to $6 million in any 12-month period.	Following the expiration of the first year after an issuer's initial qualification of an offering statement, sales by affiliates are limited to $15 million in any 12-month period.
	After the first year, no limit for non-affiliates (subject to the overall Tier 1 offering size cap).	After the first year, no limit for non-affiliates (subject to the overall Tier 2 offering size cap).
Investment Limitation	None.	Non-accredited investor may not invest more than 10% of the greater of the investors' net worth or annual income (for natural persons) or net assets or annual revenue (for other persons), unless the securities will be listed on a national exchange.[5]

[3] The definition of "qualified purchasers" includes any person to whom securities are offered or sold in a Tier 2 offering.

[4] Regulation A originally required the simultaneous review of both the SEC and state securities law regulators, which in many offerings would require review from multiple states' securities regulators. Subjecting the offerings to multiple regulators and the general lack of coordination between the federal and state regulators added to the already burdensome requirements. The North American Securities Administrators Association (NASAA) recently implemented a new procedure in an attempt to consolidate and streamline the filings and review process at the state level; however the benefits of the NASAA program are still to be determined.

[5] It is important to note that the aggregate conversion, exercise or exchange price of any underlying securities is included in the calculation.

	Tier 1	Tier 2
State Securities Law Preemption	No, offerings must comply with state securities law.	Yes, offerings are exempt from state securities law registration and qualification.[6] Simultaneous state filings and fees may still be required.[7]
Initial SEC Filing and Review	Yes, Form 1-A must be filed on EDGAR. Non-public submissions are permitted. However, it is important to note that, unlike confidential submissions of registration statements by emerging growth companies, confidential submissions of offering statements under Regulation A are not protected from compelled disclosure under FOIA.[8]	Same.
Initial SEC Filing and Review; Offering Circular Delivery	Notice and electronic access is sufficient.[9]	Same.
Financial Statement Required in Initial SEC Filing	Current balance sheet and income statement for two years and any interim period (or such shorter period as the issuer has been in existence), prepared under U.S. GAAP (or IFRS for Canadian issuers).	Same.
	Compliance with Regulation S-X generally not required.	Compliance with Regulation S-X for smaller reporting companies generally required.
	Dated not more than 9 months before the date of non-public submission, filing or qualification.	Same.
	Not required to be audited unless already prepared for a separate purpose.	Must be audited to GAAS or PCAOB standards. Auditor must be independent but need not be PCAOB-registered.
Other Disclosure Required in Initial SEC Filing	Description of the issuer's business, MD&A and exhibits.	Same.
"Testing the Waters"	Issuers may "test the waters" to determine interest in the proposed offering. Solicitation materials may be used before and after filing and qualification of the offering statement, subject to compliance with rules on filing and disclaimers.	Same.

[6] Preemption applies to all Tier 2 offerings because it applies to securities offered to "qualified purchasers" and such term is defined to include all purchasers in a Tier 2 offering.

[7] Under Section 18(c) of the Securities Act, states retain the jurisdiction to investigate and bring enforcement actions with respect to fraudulent securities transactions and unlawful conduct by broker dealers, the ability to require issuers to file with the state any documents filed with the SEC, and the power to enforce the filing and fee requirements by suspending the offer or sale of securities within a given state for the failure to file or pay the appropriate fee.

[8] The issuer must not have had securities previously sold pursuant to a qualified offering statement under Regulation A or an effective registration statement under the Securities Act. Non-publicly submitted drafts should be substantially complete upon submission and must be submitted at least 21 calendar days before qualification of the offering statement.

[9] Issuers and participating broker dealers must deliver a preliminary offering circular to prospective purchasers at least 48 hours in advance of a sale, in the case where a preliminary offering circular is used during the prequalification period to offer such securities to potential investors. This requirement does not apply to an issuer that is already subject to the Tier 2 reporting obligations.

	Tier 1	Tier 2
Continuous and Delayed Offerings	Allowed. Certain changes to the offering statement no longer trigger an obligation to amend. Issuers will now be able to use offering circular supplements to update information in some cases, and to qualify additional securities by post-qualification amendment.	Same.
Securities Act Liability	Issuer subject to Section 12(a)(2) liability (but not Section 11 liability) for offers and sales made by means of material misleading statements or omissions. Issuer also subject to antifraud rules under federal securities laws.	Same.
Reporting Obligations Subsequent to Initial Filing	No, issuer need only file an exit report after termination of the offering.	Yes, including annual reports[10], semi-annual reports, current event reports, special financial reports, and exit reports.[11] The issuer may suspend its reporting obligations after completing reporting for the fiscal year in which the offering statement was qualified, if there are fewer than 300 record holders.
Exchange Act Reporting Risk	Yes, if an issuer exceeds $10 million in assets and its holders of record exceed 2,000 (or 500 non-accredited investors), it must register under Section 12(g) of the Exchange Act, which triggers ongoing reporting obligations.	An issuer can have an unlimited number of holders without triggering Exchange Act registration and reporting so long as the issuer: ■ is current in its Tier 2 reporting obligations ■ uses the services of a registered transfer agent ■ has a public float less than $75 million, or in the absence of a public float, revenues less than $50 million. If the issuer does not meet these requirements, and exceeds the Section 12(g) thresholds, it must register after a two-year transition period.[12]

10 The annual reports generally require disclosure of the business operations for the prior three fiscal years, transactions with related person, beneficial ownership of voting securities by executives, officers, directors and 10% owners, identities of directors, executive officers, and significant employees, executive compensation, MD&A, and two years of audited financial statements.

11 The SEC attempted to balance the costs and benefits associated with reporting requirements in Regulation A+, and as such have created less burdensome ongoing reporting requirements than exist for reporting companies. For example, the SEC only requires semi-annual reports via Form 1-SA under Regulation A+ whereas reporting companies are required to submit quarterly reports via Form 10-K. Unlike the Form 10-K, the Form 1-SA does not require disclosure about quantitative and qualitative market risk, controls and procedures, updates to risk factors, or defaults on senior securities.

12 Regulation A will now provide for a simplified means of registering Tier 2 offerings under the Exchange Act. The issuer can register by filing a Form 8-A in conjunction with Form 1-A, rather than the more expansive Form 10; however only issuers that provide more disclosure (follow Part I of Form S-1 or the Form S-11) in the offering circular will be permitted to use Form 8-A. After the effectiveness of the Form 8-A, the issuer will be subject to the Exchange Act reporting requirements and will be considered an “emerging growth company” to the extent the issuer otherwise qualifies for such status.

	Tier 1	Tier 2
Resale Restrictions[13]	Not for non-affiliates. Affiliates are subject to Rule 144 resale limitations.[14]	Same.[15]
Ineligible Companies	■ Exchange Act reporting companies ■ Blank check companies ■ Investment company registered under the Investment Company Act of 1940 (and business development companies) ■ Offering undivided interests in oil, gas or other mineral rights ■ Delinquent filers and bad actors	Same.
Ineligible Securities	Asset-backed securities.	Same.
Integration	Safe harbor provides that Regulation A offerings will not be integrated with (1) prior offers or sales of securities, or (2) subsequent offers and sales of securities: ■ registered under the Securities Act, except as provided in Rule 255(c) of the Securities Act ■ under Rule 701 of the Securities Act ■ under an employee benefit plan ■ under Regulation S ■ under Section 4(a)(6) of the Securities Act (crowdfunding) ■ made more than six months later ■ exempt from registration.	Same.

[13] Issuers must register securities under Section 12 of the Exchange Act before they can be listed or quoted on a securities exchange; therefore the market for such securities may not provide liquidity.

[14] The new rules eliminate the rule that prohibited affiliate resales unless the issuer had net income from continuing operations in at least one of its last two fiscal years.

[15] Note that the SEC did not implement the request that Tier 2's ongoing reporting requirements satisfy the "reasonably current information" and "adequate publication information" requirements of the Rule 144 and Rule 144A safe harbors. The SEC noted that quarterly reporting is an integral part of the resale safe harbors, and that if a Tier 2 issuer voluntarily submits Form 1-U on a quarterly basis with financial statements and other necessary information, it will satisfy the respective rule requirements.

Potential Impact

Regulation A, with its new higher offering size limits and state securities law preemption, should be an attractive option for smaller companies seeking to raise capital, though remaining eligibility and national exchange listing requirements may dampen the utility of the final rules.

Additionally, only time will tell if the state preemption provisions withstand the scrutiny and potential legal challenges of state regulators and other opponents. These provisions attracted more controversy than other parts of the rules. The SEC received multiple comment letters advocating for no state preemption and arguing that state securities laws are the first line of defense in investor protection. Additionally, some letters and commentary implied that state regulators may seek to prevent the implementation of the preemption rules by filing a lawsuit against the SEC. The SEC forged ahead despite these objections, but it noted in its press release regarding the final rules that it is exploring ways to further collaborate with state regulators in implementing the new Regulation A rules.

The SEC is required to review the Tier 2 offering limitation every two years and has stated it will review Tier 1 at the same time. In the adopting release indicates that this review would be with a view to considering whether to increase the offering size limits and whether additional investor protections would be necessary. The SEC has also committed to study the impact of the rules within the next five years. Thus, the final chapter may not have been written yet on Regulation A. In the meantime, smaller companies have an opportunity to access capital with much less friction.

For more information regarding any of these issues, please contact one of the authors below or the Dechert attorney with whom you work.

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