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white paper

SEC Proposes Rules to Facilitate Small Business Financing

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Introduction

On December 18, 2013, the Securities and Exchange Commission (SEC) proposed rules to enhance access to capital by smaller companies pursuant to its rulemaking mandate under Title IV of the Jumpstart Our Business Startups Act (JOBS Act). Title IV of the JOBS Act created a new exemption under section 3(b)(2) of the Securities Act of 1933, as amended (Securities Act), for smaller offerings. As directed by section 3(b)(2), the proposed rules would amend and update the existing Regulation A, an exemption for unregistered public offerings of securities up to $5 million.

The long-awaited proposed rules represent the last significant SEC rulemaking under the JOBS Act. The amended Regulation A, commonly referred to as “Regulation A+,” is intended to facilitate capital formation for small companies by addressing certain impediments in the current Regulation A that have deterred companies from using Regulation A to raise funds, including the low maximum offering amount and the high costs of state blue-sky compliance requirements.

The proposed rules would create two tiers of Regulation A offerings: Tier 1 for offerings of up to $5 million in a 12-month period and Tier 2 for offerings up to $50 million in a 12-month period. As discussed in more detail below, both tiers would be subject to certain basic eligibility, disclosure, and procedural requirements that are derived from the existing Regulation A framework, with certain updates to conform to current practices for registered offerings. Tier 2 offerings would be subject to additional requirements, including the provision of audited financial statements, ongoing reporting obligations, and certain investment limitations. As proposed, Tier 2 offerings would provide federal law preemption and thus be exempt from state blue-sky requirements.

The proposed rules will undergo a 60-day public comment period after publication in the *Federal Register*. If adopted, Regulation A+ has the potential to provide start-ups and private companies with a viable alternative for raising capital quickly and inexpensively, while improving the liquidity of their securities in secondary markets.

Background and Current Regulation A

The current Regulation A provides an exemption that allows eligible nonreporting companies to conduct small public offerings of securities up to $5 million in a 12-month period, including up to $1.5 million of securities sold by selling stockholders, without having to comply with the more expensive and time-consuming registration requirements under section 5 of the Securities Act. Companies relying on Regulation A must prepare and file an offering statement on Form 1-A with the SEC, the core of which is the offering circular akin to an abbreviated version of a prospectus in registered offerings. The offering statement is filed in paper form with the SEC for review and qualification prior to any sales. The content of the offering statement includes, among other things, information on the company, management and director biographies, risk factors, use of proceeds, and financial statements. Companies are required to provide two years of financial statements, which need not be audited unless the company has audited financial statements available. The offering statement must be delivered to prospective investors.

Regulation A offerings may be marketed like registered public offerings in that general solicitation is permitted. Regulation A also allows companies to engage in “test the water” (TTW) communications with potential investors, including retail investors, prior to the filing of the offering statement. Any TTW materials used in the process must be filed with the SEC no later than the time of their first use. Like securities sold in registered public offerings, Regulation A securities are not deemed “restricted securities” and are freely tradable in secondary markets. However, Regulation A offerings are not exempt from state securities law requirements, and companies conducting Regulation A offerings are subject to the registration and qualification requirements of various state jurisdictions.

The SEC promulgated Regulation A primarily to provide a simple and relatively inexpensive method for smaller companies to raise a limited amount of capital without undergoing the more costly and time-consuming registration process for typical public offerings. However, Regulation A has rarely been used in recent years.

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From 2009 to 2012, only 19 qualified Regulation A offerings were completed, raising a total of approximately $73 million. In contrast, approximately 27,500 offerings of up to $5 million based on Regulation D were completed during the same period, for a total offering amount of approximately $25 billion. A report from the U.S. Government Accountability Office to Congress indicated that the principal reasons for this lack of usage include the relatively low maximum offering amount and the burden of the multistate securities compliance requirement. In response to this trend, Congress made several attempts in the past to reform Regulation A to better align the cost of offering with the benefits of financing, and these efforts culminated in Title IV of the JOBS Act. Specifically, section 401 of the JOBS Act amended section 3(b) of the Securities Act, under which the SEC is directed to implement rules updating Regulation A that will, among other things,

- increase the aggregate offering amount to $50 million within 12 months;
- require issuers to file audit financial statements with the SEC annually;
- provide electronic filing of the offering statement; and
- require disqualification provisions similar to the “bad actor” prohibitions under Regulation D.

Regulation A+: Summary of Proposed Rules

The proposed rules would create two tiers of offerings of Regulation A–eligible securities:

- Tier 1 for offerings up to $5 million, including $1.5 million of securities sold by selling shareholders, in any 12-month period. This tier essentially preserves the existing Regulation A framework.
- Tier 2 for offerings up to $50 million, including $15 million of securities sold by selling stockholders, in any 12-month period.

Companies may choose to proceed under Tier 1 or Tier 2 for any offering up to $5 million, although the additional disclosure and procedural requirements are applicable for any Tier 2 offerings.

Eligible securities for Regulation A offerings are limited to equity securities, debt securities, and securities convertible into or exchangeable into equity interests, including any guarantees of such securities. Asset-back securities are excluded.

Basic Requirements

Eligible Issuers

Currently, Regulation A exemption is available only to U.S. and Canadian companies that are not subject to the reporting obligations of sections 13 or 15(d) of the Securities and Exchange Act of 1934, as amended (Exchange Act). Ineligible issuers include blank-check companies; companies registered under the Investment Company Act of 1940, amended; and issuers of fractional interests in oil, gas, or other similar mineral rights. As proposed, Regulation A+ would retain the eligible issuer requirements under existing Regulation A and add the following two new categories of ineligible issuers: (i) companies that have not filed with the SEC the ongoing reports required under the proposed Regulation A+ and (ii) companies that are or have been subject to an SEC order in the past five years revoking or suspending the registration of their securities pursuant to section 12(j) of the Exchange Act. The proposed rules would also retain, but revise, the existing “bad actor” disqualifications to substantially conform to the “bad actor” disqualification provisions under Rule 506(d) promulgated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Regulation A+ Offering Process

The proposed rules seek to update and modernize the existing Regulation A offering process, certain elements of which are drawn from the prevailing practice for registered offerings. As proposed, companies would be required

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to file offering statements electronically with the SEC on EDGAR instead of in paper form. As with the existing Regulation A framework, the offering statement must be qualified prior to any sales. Currently, an offering statement may be qualified automatically within 20 calendar days of filing in the absence of SEC action. The proposed rules would eliminate this option and require the offering statement be qualified only by order of the SEC. This would ensure that the SEC has an opportunity to review and comment on the offering statement prior to any sales. In addition, a preliminary offering circular must be delivered to prospective purchasers at least 48 hours prior to a sale. In cases where a preliminary offering circular is used, a final offering circular must be delivered within two business days after the sale. This delivery requirement may be satisfied under an "access equal to delivery" model by filing the final offering circular on EDGAR.

Confidential Submission

The proposed rules would also permit nonpublic submission of offering statements to the SEC via EDGAR. This is similar to the confidential submission of draft registration statements provided under Title I of the JOBS Act for "emerging growth companies," but Regulation A nonpublic submissions are not afforded the statutorily mandated protections of confidentiality. All nonpublic submissions of the offering statement, including amendments, must be filed publicly no less than 21 calendar days prior to qualification.

"Test the Water" Communications

The proposed rules would provide additional flexibility for conducting TTW communications in Regulation A offerings. Currently, Regulation A prohibits the use of any TTW solicitation materials after the initial filing of the offering statement. As proposed, companies would be permitted to use TTW materials before and after the offering statement is filed. In addition, any TTW materials would only need to be filed as an exhibit when the offering statement is submitted confidentially or filed publicly but would no longer be required to be submitted at or before the time of their first use as is currently required. The proposed rules do not change the type of investors that can be solicited; therefore, companies may continue to conduct TTW communications with retail investors.

Offering Statements: Form and Content

The existing Form 1-A consists of three parts: Part I (Notification), Part II (Offering Circular), and Part III (Exhibits). The proposed rules would retain the basic three-part structure of Form 1-A but would revise various disclosure requirements, most notably the changes in Part II, the offering circular. Currently, companies have the following three options in preparing the offering circular: Model A, which utilizes a question-and-answer format; Model B, which is a scaled-down version of the narrative disclosure standards of Form S-1; and the format called for by Part I of Form S-1. The proposed rules would eliminate Model A and make certain changes to the Model B disclosures.

In general, the proposed content of the offering circular would update the disclosure requirements in some respects to more closely align with the smaller reporting company disclosure requirements for registered offerings while retaining certain scaled elements exclusive to Model B. These changes include more detailed instructions on management discussion and analysis (MD&A) disclosures as well as a description of business for a period of three years (as opposed to the five-year requirement under the current form). Additionally, as with registered offerings by smaller reporting companies, companies would be required to disclose beneficial ownership of their voting securities, as opposed to record ownership of voting and nonvoting securities under the current form.

Continuous and Delayed Offering

The current Regulation A permits continuous and delayed offering but requires companies to file a postqualification amendment for any revision or update to a qualified offering statement, and this amendment is subject to further SEC review and requalification, which may be time consuming and costly. The proposed rules would relax this requirement by adopting a new procedure modeled after Rules 415 and 424(b) of the Securities Act for continuous and delayed offerings, which is similar to the "shelf" registration statement process. For example, companies would no longer be required to file a postqualification amendment for any change of

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information in the offering statement. Instead, the information may be updated annually in the financial statements filed with the SEC, and a postqualification amendment would only be required to reflect certain “fundamental changes” after qualification. The offering circulars would be permitted to omit certain information with respect to offerings analogous to the provisions for registered offerings under Rule 430A. The SEC also proposed to allow the use of offering circular supplements for final pricing information where the offering statement is qualified on the basis of a bona fide price range estimate.

Additional Requirements for Tier 2 Offerings

To address the concerns of investor protection as a result of the more flexible and expansive offering process, the SEC proposed to impose additional requirements for Tier 2 offerings, including those described below.

Audited Financial Statements

Unlike the existing Regulation A requirements, the proposed rules would require companies to include in the offering circular two years of audited financial statements that generally follow the requirements for smaller reporting companies under Article 8 of Regulation S-X. The financial statements must be audited in accordance with standards established by the Public Accounting Oversight Board (PCAOB), but the auditors need not be registered with the PCAOB.

Investment Limitation

The current Regulation A does not restrict the amount of securities that an investor may purchase. The proposed rules, however, would limit the amount of securities an investor may purchase in a Tier 2 offering to no more than 10% of the greater of the investor’s annual income and net worth. Annual income and net worth would be calculated based on the “accredited investor” definition under Rule 501 of Regulation D. The proposed rules would require companies to inform investors of the 10% limitation but permit companies to rely on the representation of the investor as to such limitation in the sale. Recognizing the potential burden of conducting investor due diligence, the SEC did not propose to require companies to verify an investor’s annual income and net worth and instead solicited comments on whether it would be reasonable to require companies to do so.

Ongoing Reporting Requirements

Currently, Regulation A only requires the filing of a short Form 2-A to report Regulation A sales after the termination or completion of the offering. The proposed rules would rescind Form 2-A and replace it with Form 1-Z, which is an exit report to be filed after the termination of a qualified Regulation A offering to provide information about sales in the offering and to update certain company information. The Form 1-Z filing requirement is applicable to both Tier 1 and Tier 2 offerings, but companies conducting Tier 2 offerings may provide the information in their annual report on Form 1-K as discussed below.

More importantly, the proposed rules would require companies conducting Tier 2 offerings to provide ongoing disclosures following the completion of the offering, which are similar to, but less extensive than, the periodic reporting requirements under the Exchange Act. These requirements include filing the following:

- Annual Report on Form 1-K, which would include disclosures on business operations for the prior three fiscal years; two years of audited financial statements and related MD&A disclosures; related party transactions; identities of executive officers and directors; and executive compensation information.
- Semiannual Report on Form 1-SA, which is similar to the quarterly report on Form 10-Q and would primarily consist of financial statements and related MD&A disclosures.
- Current Report on Form 1-U, which is modeled after the current report on Form 8-K and must be filed within four business days of the occurrence of specified events. Of the 26 relevant reportable events in a Form 8-K, 11 were proposed to be included in Form 1-U.

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- Special Financial Report on Form 1-K or Form 1-SA, which would provide certain information to investors covering the period between the date of the financial statement included in the offering statement and the due date of the first periodic report after qualification of the offering statement.

The forms and content of these ongoing reports largely follow the informational requirements in the offering statement on Form 1-A, and all such reports must be filed electronically via EDGAR.

Relationship with State Securities Laws

As discussed above, a primary factor contributing to the underuse of the current Regulation A regime is the burden of compliance with multistate blue-sky laws. Accordingly, the SEC proposes to exempt Tier 2 offerings from state securities law requirements. This state preemption is achieved by amending the definition of “qualified purchaser” in section 18(b)(3) of the Securities Act to include all offerees in Regulation A offerings and all purchasers of Tier 2 offerings. This would result in a difference in treatment between Tier 1 and Tier 2 offerings as Tier 1 purchases would not be preempted. The SEC reasoned that preemption for Tier 2 offerings is justified because the additional requirements would provide further investor protection.

The proposed rules also recognize that advocates of state regulation may have a different view on this issue. Specifically, the North American Securities Administrators Association (NASAA) recently proposed a coordinated review program for Regulation A offerings among states, which, if implemented, could potentially reduce state law disclosure and compliance obligations of Regulation A issuers. Under the NASAA proposal, a single state will be appointed as the “lead” examiner to review and provide comment on the Regulation A offering statement, thereby reducing the costs associated with multistate compliance. However, the SEC pointed out that a number of open questions remain about the NASAA coordinated review program, including the level of state participation and the extent to which the proposal will be adopted by the states. The SEC is soliciting comments on whether the proposed rules on preemption should be modified in light of the NASAA program.

Scope of Exemption: Other Items

Integration

The proposed rules generally preserve the existing safe harbor from integration and provide additional guidance on potential integration conducted concurrently with a Regulation A offering. In the proposal, the SEC stated that Regulation A offerings should not be integrated with other exempt offerings, such as a Regulation D offering, if each offering complies with the requirements of the exemption. In addition, the proposed rules would amend the existing Regulation A to provide that, if a company decides to abandon a Regulation A offering and switch to a registered offering, any offers made under Regulation A would not be integrated with the registered offering unless the company engaged in solicitation of persons other than qualified institutional buyers (QIBs) and institutional accredited investors in TTW communications.

Liability under Section 12(a)(2)

Consistent with the current Regulation A, the proposed rules would impose civil liability under section 12(a)(2) of the Securities Act for any offer or sale by means of an offering circular or an oral communication that contains a material misleading statement or a material misstatement of fact. In addition, the antifraud liability provisions under section 10(b) of the Exchange Act are applicable to Regulation A offerings.

Treatment under Section 12(g) of Exchange Act

Section 12(g) of the Exchange Act requires a private company to register its securities under the Exchange Act, thus becoming an Exchange Act reporting company, if its total assets exceed $10 million and if it (i) has 2,000 record holders of its equity securities or (ii) 500 persons who are not accredited investors. Title IV of the JOBS Act did not address how Regulation A issuers should be treated under section 12(g), including whether they should

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be exempt from the requirements. In the proposed rules, the SEC noted the importance of ensuring more expansive disclosures and compliance obligations under the Exchange Act if a Regulation A issuer crosses the record holder threshold, and it is soliciting comments on whether Regulation A issuers should be exempt from the section 12(g) requirements.

Impact of Regulation A+

Whether Regulation A+ can achieve its stated goal of increasing access to capital by small companies depends, in large part, on how companies perceive and balance the benefits and costs of the new offering method as compared to other available forms of financing, particularly the traditional Regulation D offerings and initial public offerings (IPOs) registered under the Securities Act.

Regulation A+ provides certain benefits that are not available in Regulation D offerings. Companies conducting Regulation A offerings can engage in general solicitation and sell securities to a wider field of investors, including nonaccredited investors, whereas Regulation D offerings typically are limited to a smaller pool of accredited purchasers. It may also be advantageous for certain types of investors to acquire freely tradable securities under Regulation A, which may facilitate the development of a more active trading market for otherwise illiquid securities. On the other hand, Regulation A+ imposes costs that companies do not incur in Regulation D offerings, including the preparation and filing of the offering statement, delays in the SEC review process, audited financial statement requirements, and ongoing reporting obligations. For early-stage start-ups whose securities have limited liquidity, these costs may prove to be too onerous relative to the benefits for Regulation A+ to become viable. In addition, venture capital and private equity firms may continue to prefer the well-established Regulation D investment because it provides more certainty and control over the governance of their portfolio companies, while they may view the advantage of holding unrestricted securities as marginal if no meaningful secondary markets exist.

Regulation A+ also offers a streamlined and less expensive method to conduct public offerings than fully registered IPOs, which may provide an attractive option for late-stage private companies considering an IPO with a size of $50 million or less. If these companies can meet the financial, corporate governance, and other initial listing criteria of national securities exchanges (e.g., NASDAQ or the New York Stock Exchange), Regulation A+ may provide a more cost-effective alternative to “go public” and become an Exchange Act reporting company after the completion of the Regulation A offering. However, a company seeking to list its shares on a national securities exchange must file a registration statement on Form 10 that requires more extensive disclosures unless the company is conducting a traditional registered IPO, in which case it may file a much shorter Form 8-A. Unfortunately the proposed rules did not address whether Regulation A issuers would be permitted to file Form 8-A, and the SEC is soliciting comments on whether they should be allowed to do so. As a practical matter, most smaller companies do not have the resources or the capabilities to embark on a fully registered IPO, and they are unlikely to satisfy the initial listing qualifications of national securities exchanges. For these companies, Regulation A+ may still turn out to be a valuable option—if not a springboard to an eventual IPO—because it will allow them to raise capital in the public markets and potentially improve the liquidity and trading of their securities.

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