PUBLICATION

Making the Grade - SEC Finalizes Revision to Regulation A Offering, Including New Tier 2 Offerings for up to $50 Million [Ober|Kaler]

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A periodic bulletin keeping small businesses informed about current developments in securities law and related matters.

As we have noted in prior Bulletins, pursuant to Section 5 of the Securities Act of 1933 (Securities Act) and state securities laws, any offer and sale of a security must be registered with the Securities and Exchange Commission (SEC) and any applicable state securities regulators, or exempt from such registration. Currently, SEC rules under Regulation A of the Securities Act provide an exemption from registration for offerings by certain issuers of up to $5 million, including $1.5 million on behalf of selling securityholders, in any 12-month period. This exemption requires the preparation of an offering statement on Form 1-A that must be filed with and qualified by the SEC (or qualified automatically 20 days after the delaying amendment is removed) and is subject to staff review and comment. The offering circular included in the offering statement, which is similar to a prospectus included in a registered offering, must be distributed to potential investors in the Regulation A offering. Securities sold in Regulation A offerings are not restricted securities and may be freely resold, except by affiliates of the issuer where the issuer has not had income from continuing operations in at least one of its last two fiscal years.

On March 25, 2015, the SEC adopted amendments to Regulation A that it proposed in 2013. The amendments adopt two tiers of offerings – Tier 1 for offerings of up to $20 million and Tier 2 for offerings of up to $50 million, in any 12-month period. The amendments are substantially similar to the proposed amendments with, notably, an increase in the Tier 1 offering amount from $5 million to $20 million. But, in general, offerings under Tier 1 of amended Regulation A will be substantially similar to the current Regulation A provisions. The most important distinctions between Tier 1 and Tier 2 are that (i) Tier 2 offerings will not be subject to registration or qualification under state securities laws, (ii) non-accredited investors in a Tier 2 offering will be subject to limits on how much they can invest, and (iii) issuers that conduct a Tier 2 offering will become subject to ongoing SEC reporting requirements, though such requirements will be significantly less onerous than those to which SEC reporting companies are subject. As under current Regulation A, both Tier 1 and Tier 2 offerings will be unregistered public offerings with no restrictions on the nature of offerees or investors and will allow for general solicitation and advertising (provided that in Tier 1 offerings any state law restrictions in this regard are complied with). In addition, securities sold under Tier 1 will continue to count towards the stockholders of record threshold for registration and reporting under the Securities Exchange Act of 1934 (Exchange Act), but securities sold under Tier 2 will not count towards the threshold if the issuer (i) engages a registered transfer agent, (ii) remains subject to and current in its annual and semi-annual reporting obligations, and (iii) has a public float (market value of securities held by non-affiliates) below $75 million.

As proposed, Tier 2 offerings will be preempted from the registration requirements of state securities laws. Therefore, compliance with the registration provisions of state securities laws under Regulation A will be required only in a Tier 1 offering, to the extent an exemption from registration is not available in the applicable state(s). Most states are now participating in a new streamlined coordinated review program for Regulation A offerings through the North American Securities Administrators Association that may make Tier 1 Regulation A offerings more feasible than Regulation A offerings have been in the past.

The amendments will be effective 60 days after publication of the adopting release with respect to the amendment in the *Federal Register*. We discuss below certain other provisions of the amendments.

General; Issuer Eligibility; Investment Limits

As proposed, Regulation A offerings remain limited to U.S. and Canadian companies not subject to the reporting requirements of the Exchange Act. Companies currently prohibited from using Regulation A, including companies registered or required to be registered under the Investment Company Act of 1940, companies with no business plan or whose only business plan is to merge with or acquire unidentified companies (blank check companies) and issuers of fractional undivided interests in oil or gas rights or similar interests in other mineral rights, will remain ineligible.

Companies with, or that have certain insiders and offering participants with, certain criminal convictions or that are subject to certain bars or orders will be disqualified from conducting Regulation A offerings; these provisions are generally consistent with the "bad actor" disqualification provisions applicable to Rule 506 offerings under Regulation D of the Securities Act, which we have discussed in prior Bulletins.

In addition, issuers that (i) have not filed all required ongoing reports triggered by a prior Tier 2 offering during the two years preceding the filing of the offering statement or (ii) are or have been subject to an SEC order denying, suspending or revoking the registration of a class of securities for failure to comply with the provisions of the Exchange Act or the rules and regulations thereunder within five years before filing the offering statement, will be ineligible to conduct a Regulation A offering. Further, consistent with current Regulation A offerings are limited to equity securities, debt securities and debt securities convertible into equity securities; in addition, as proposed, under the amendments asset-backed securities may not be sold via a Regulation A offering.

Finally, non-accredited investors (as defined in Rule 501 of Regulation D under the Securities Act) may not purchase in a Tier 2 offering more than 10% of the greater of their (i) annual income or net worth (natural persons) or (ii) annual revenue or net assets as fiscal year-end (entities). Issuers must inform investors of this limitation but may rely on a representation from an investor as to compliance with the limit.

Sales by all selling stockholders are limited to 30% of the aggregate offering price (i.e. no more than $6.0 million for Tier 1 and $15 million for Tier 2) in an issuer's first Regulation A offering or any subsequent Regulation A offerings during the first year following its first Regulation A offering. Following the first year of an issuer's first Regulation A offering, this limit applies solely to sales by selling securityholders that are affiliates of the issuer. The limitation on sales by affiliates of issuers without income from operations, however, has been removed in the Regulation A amendments.

Offering Statement

Under the amended rules, Regulation A offering statements must be filed electronically through the SEC's EDGAR filing system instead of in paper as is done under current Regulation A. Similar to the process for emerging growth companies filing a Form S-1 registration statement for an initial public offering, the amended rules provide an option for non-public review of draft offering statements for issuers that have not previously sold securities under Regulation A or a Securities Act registration statement.

As proposed, the general structure of the Form 1-A offering statement will remain the same, with Part I focusing on basic information about the issuer and the offering, summary financial statement information, and whether the issuer qualifies to use Regulation A (with boxes to check and drop-down menus similar to Form

D), Part II consisting of the offering circular that is provided to potential investors (narrative disclosure), and Part III, exhibits and signatures. The information in Part I will be considerably expanded, however, to provide the SEC and market participants with more information about the Regulation A market as it develops. In Part II, as proposed, the "Model A" question and answer option for the offering circular disclosure has been eliminated. The "Model B" option intended to be a scaled version of the Form S-1 disclosure requirements has been updated to be similar (although not identical) to what smaller reporting companies provide in a Form S-1 registration statement, including information about the issuer, its business and the offering (including use of proceeds and plan of distribution), material risks, management's discussion and analysis of financial condition and results of operations (MD&A), liquidity and capital resources, information about executive officers and directors, executive compensation, beneficial ownership information, related party transactions and a description of the securities offered. The alternate option to provide disclosure required by Part I of Form S-1 remains. The SEC also added the option to follow the requirements of Part I of Form S-11 for REITs and similar issuers.

The financial statements required for Tier 1 offering will remain largely the same, except balance sheets for the last two fiscal years, instead of the most recent year only, will be required, consistent with the proposed rules. U.S. issuers must prepare their financial statements included in a Regulation A offering circular in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP), while Canadian issuers may use either GAAP or International Financial Reporting Standards (IFRS). The amendments also permit issuers to delay the implementation of new accounting standards to the extent such standards provide for delayed implementation by non-SEC reporting companies, provided they give notice of such choice when they first file their offering statement and that such issuers must apply such delay to all such accounting standards. Consistent with current Form 1-A and the proposed amendments, financial statements for issuers conducting a Tier 1 offering, other than with respect to pro forma financial statements and financial statements of acquired businesses, will follow the form and content requirements set out in part F/S of Form 1-A instead of Regulation S-X, and such issuers will only be required to provide audited financial statements if they had been previously prepared by an independent auditor in accordance with U.S. Generally Accepted Auditing Standards (U.S. GAAS) or Public Company Accounting Oversight Board (PCAOB) auditing standards. Issuers conducting a Tier 2 offering will be required to provide financial statements prepared generally in accordance with Article 8 of Regulation S-X applicable to smaller reporting companies and audited in compliance with either U.S. GAAS or PCAOB standards by an auditor that is independent under and otherwise complies with Article 2 of Regulation S-X, though the auditor need not be PCAOB-registered. Financial statements filed on Form 1-A will not need to be filed in extensible business reporting language (XBRL).

As proposed, the SEC adopted an "access equals delivery" model for final Regulation A offering circulars consistent with Rule 172 under the Securities Act for registered offerings, whereby issuers (and participating broker-dealers) may satisfy their delivery obligations for the final offering circular via filing on EDGAR and delivering a notice to that effect to purchasers. This assumes, of course, that a preliminary offering circular has been delivered, and there must be disclosure in the preliminary offering circular (which, in the case of an issuer not already subject to Tier 2 reporting requirements, must be provided at least 48 hours before sale) that the obligation to deliver a final offering circular may be satisfied electronically.

The amendments also modernize the rules for permissible continuous or delayed offerings (but not at-the-market "shelf" offerings) under Regulation A, most notably by specifying the types of such offerings that will now be permitted and allowing some changes to the offering circular, pricing information (assuming a price range is included in the qualified offering statement) and information with respect to the underwriting syndicate, to be included via a supplement to the offering circular instead of an amendment that must be qualified by the SEC.

Finally, as proposed, issuers can no longer have an offering statement become qualified automatically by filing an amendment that removes the delaying amendment; qualification will require the issuance of a "notice of qualification" by the SEC's Division of Corporation Finance pursuant to delegated authority.

Solicitation

Currently, Regulation A permits issuers to communicate with potential investors, with no limits on the types of investors (i.e. they need not be qualified institutional buyers or accredited investors), to gauge investor interest prior to filing the offering statement, commonly known as "testing the waters." Under the amended rules, as proposed, issuers will be able to continue using test the waters communications with all potential investors before, as well as after, filing an offering statement. Solicitations after the public filing of the offering statement must be accompanied by the current preliminary offering circular or a notice informing potential investors where it can be obtained, and, in most cases, issuers must update and redistribute such materials if the preliminary offering circular or other soliciting material becomes materially inaccurate or inadequate. Such other soliciting materials must be filed with the SEC and include certain prescribed legends or disclaimers.

Ongoing Reporting

Currently, issuers that conduct a Regulation A offering must file a Form 2-A with the SEC every six months to report sales under the offering, with a final filing due within 30 days after the end of the offering. As proposed, the amendments rescind Form 2-A. Instead, issuers conducting a Tier 1 offering will be required to provide information about the amount of securities qualified and sold, as well as the price, fees and net proceeds, in the Regulation A offering just once, on a new Form 1-Z exit report, not later than 30 days after termination or completion of the offering. Issuers conducting a Tier 2 offering will be required to report the same information on Form 1-Z or, depending on when the offering is terminated, in their annual report on Form 1-K, and will be subject to ongoing reporting requirements including: (i) annual reports on new Form 1-K, which will include the same information required in a Regulation A offering circular except for the offering-specific information; (ii) semiannual reports on new Form 1-SA (consisting primarily of financial statements and an MD&A); (iii) current reports on new Form 1-U to report certain enumerated events (including among others "fundamental changes," bankruptcy or receivership, non-reliance on previously issued financial statements, audit report or interim review, changes in control, departure of certain executive officers and unregistered sales of 10% or more of outstanding equity securities); and (iv) in certain circumstances depending on the financial statements included in the Form 1-A and the timing until the next annual or semiannual report, special financial reports on new Forms 1-K and 1-SA to close the gaps in such financial reporting. All such filings will be made through the SEC's EDGAR system.

Issuers may suspend such ongoing reporting (other than in the fiscal year their Form 1-A offering statement is qualified and assuming they have filed an annual report for that fiscal year) using Form 1-Z if the securities of each class to which the offering statement relates is held of record by less than 300 persons (1,200 persons for banks and bank holding companies), offers and sales under the offering statement are not ongoing, and they have complied with their ongoing reporting obligations. In addition, Regulation A reporting obligations will be automatically suspended if the issuer becomes subject to the Exchange Act's periodic reporting obligations.

Other

Securities sold in a Regulation A offering remain eligible to be freely resold by nonaffiliates of the issuer. Affiliates will remain subject to the provisions of Rule 144 other than the holding period requirement. The adopting release specifically provides that the ongoing reporting required of Tier 2 companies will satisfy the "current public information" requirements of Rule 144 for only part of each year, making affiliate resales more

difficult than for affiliates of SEC reporting companies; Tier 2 issuers, however, have the option to file quarterly financial information on Form 1-U, which would make them compliant with the Rule 144 requirement year-round.

With the increased amount of $50 million and pre-emption of state registration for a capital raise in Tier 2, and the increase to $20 million and the streamlined state review process for Tier 1 offerings, we believe that Regulation A now offers a viable alternative for companies that want to raise capital without becoming full-blown SEC reporting companies. The ongoing reporting requirements for Tier 2 offerings are much less onerous than those for SEC reporting companies under the Exchange Act, and the regular availability of such information may increase the liquidity and market value for the securities of Tier 2 companies. Further, the ongoing reporting requirements of Tier 2 will also, under the amended rules, satisfy the informational requirements needed for a company's securities to be quoted on the Over-the-Counter Bulletin Board (though Exchange Act registration and reporting is still required to have securities listed on a national securities exchange), further increasing the attractiveness of Regulation A as a capital raising option.

The final release for the Regulation A amendments is available at www.sec.gov/rules/final/2015/33-9741.pdf.