

PUBLICATION

Regulation A+: A Capital-Rising Method that is Ready for Franchising

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In a prior article published in *Franchising Today*, we addressed the intersection of franchises and crowdfunding, a method of business financing which was made legal through rulemaking on the part of the Securities and Exchange Commission (SEC) as part of the Jumpstart Our Business Startups Act of 2012 (the JOBS Act). This article will focus on another provision in the JOBS Act, often called Regulation A+ (Reg A+). The provision is called Reg A+ because it is an expansion of an older, under-used securities selling procedure called Regulation A.

Reg A+ allows companies to raise up to \$50 million per year from the public. As the SEC designed Reg A+ to provide necessary capital to developing businesses, such as growing franchise concepts, Reg A+ generally translates into a method that is much cheaper than conducting a traditional initial public offering (or IPO) of securities. With the assistance of expert counsel, a Reg A+ offering is potentially not much more expensive than an equity crowdfunding offering. Also, unlike a crowdfunding offering, a Reg A+ offering need not be conducted through a third party platform, and instead, can be generally solicited directly to the public by the franchisor or franchisee.

Preparing to Use Reg A+

Franchisors are already subject to rigorous disclosure requirements under the Franchise Rule promulgated by the Federal Trade Commission and certain other state franchise laws. Much of the disclosure required to be included in a Reg A+ offering circular is already encompassed in a franchise disclosure document (FDD), so franchisors have already prepared much of the disclosure required to be filed with the SEC. From the franchisee side, the information in the franchisor's FDD provides some of the information necessary to meet Reg A+'s disclosure standards, or at least provides the basis for developing the necessary information to satisfy Reg A+'s requirements.

Does this mean that a franchisor can slap a new cover page sheet on its current FDD and be ready to file its Reg A+ offering circular with the SEC? No, but with a modest amount of effort on the parts of the franchisor, counsel and in certain cases, the franchisor's auditors, to describe the corporate governance documents and equity attributes not otherwise covered in the FDD, a franchisor can quickly be compliant with Reg A+'s offering circular requirements, allowing the franchisor to file the offering circular with the SEC to launch its securities offering.

Although the disclosures required in a Reg A+ offering circular (and SEC Form 1-A, which is the form filed with the SEC along with the offering circular) and FDDs are quite similar, franchisors and franchisees new to SEC reporting should be prepared to spend additional resources on securities law compliance. However, the costs of such securities law compliance are likely much smaller for a franchisor or franchisee, as compared to an issuer not engaged in franchising. By leveraging its compliance resource allocation for simultaneous franchising and securities law compliance, a franchisor or franchisee can "kill two birds with one stone." The obligation to file Form 8-K and the obligation to amend the FDD for material changes are likely consequences of the same significant event. An audit is an audit, and the skills and reporting for one area are not dissimilar to the other, such that an audit conducted for franchising purposes can just as easily be used for securities law compliance.

To help franchisors and franchisees understand the landscape of SEC compliance, a short discussion of the legal nuts and bolts of Reg A+ follows.

Legal Nuts and Bolts

Reg A+ is divided into two tiers. Tier 1 allows a company to raise up to \$20 million, but does not pre-empt state level (or "blue sky") registration requirements. For this reason, it is unlikely that many issuers will utilize Tier 1, as the cost and time burden of effectively conducting separate securities offerings in each state of the union is likely to be economically and temporally inefficient.

Tier 2 of Reg A+ allows a company to raise up to \$50 million per year and the offering is exempt from state blue sky registration and qualifications. However, Tier 2 issuers must provide two years of audited financials, whereas the financials included in Tier 1 issuers' offering circulars need not be audited. The other key difference between the tiers of Reg A+ is that Tier 2 issuers must file semi-annual reports and material event reports with the SEC until the offering is terminated, while Tier 1 issuers are only required to file reports upon the commencement of an offering, termination of the offering or when a material change to the offering has occurred. The securities issued under both Tiers 1 and 2 are unrestricted and freely transferable, meaning that the issuer's securities are available for immediate secondary trading and can be listed on Nasdaq or the New York Stock Exchange (NYSE), or quoted on the OTC Markets Group Inc.'s marketplaces such as the OTCQX and Pink Sheets. The audit requirement is consistent with the FTC's approach to start up franchisor audit requirements in Item 21 of the FDD. However, many registration states require the opening day balance sheet of a franchisor to be audited as a condition to obtain registration.

To assist in creating liquidity for non-insider shareholders, secondary sales by issuer affiliates (such as officers and directors of the issuer) during the first year after the commencement of an issuer's initial Reg A+ offering cannot account for more than 30 percent of the total dollar amount of securities offered for sale in the offering.

Franchisees as the Franchisor's Stockholders

How often does a franchisee ask whether he or she can invest in the franchisor? Reg A+ offers franchisors the opportunity to consider paired or paperclip offerings, where the prospective franchisee is also offered the opportunity to invest in the franchisor's equity. Existing franchisees that are successful and committed to the success of the franchise concept may offer another pool of potential investors in a franchisor's Reg A+ offering. Communication vehicles between a franchisor and its franchisees also offer the opportunity to promote the offering to a group of potential investors without the need for any general solicitation.

If such franchisees are accredited investors, there is no dollar amount limit to the number of securities franchisor can sell, up to the \$50 million limit under Reg A+, Tier 2. Broadly, in the United States, to be considered an accredited investor, one must have a net worth of at least \$1 million, excluding the value of one's primary residence, or have income at least \$200,000 each year for the last two years (or \$300,000 combined income if married).

For Reg A+ issuers that do not list their securities on Nasdaq or the NYSE under Reg A+, Tier 2 (investments by individual, un-accredited investors cannot exceed either: (a) ten percent of the investor's annual income; or (b) ten percent of the investor's net worth, whichever is the greater number. Tier 1 offerings do not have such limitations, beyond the \$20 million cap imposed on Tier 1 offerings, For entities investing in Tier 2 offerings, investments must not exceed the new Regulation A+ limitation of either: (a) ten percent of the investor's annual revenue at the last fiscal year-end; or (b) ten percent of the investor's net worth at fiscal year-end, whichever is the greater amount.

Conclusion

Using Reg A+ to raise money from franchisees is just one example of the utility of Reg A+ for franchisors. Franchisees may also use Reg A+ to finance improvements to their existing locations, purchases of new locations or even purchases of real estate upon which to build new locations. The financing possibilities are legion when harnessing the ability to raise money by soliciting the general public for investment. Best of all, Reg A+ offerings in the franchising context are particularly attractive as administrative efficiency opportunities can be exploited to minimize legal costs and the economic burden of compliance already inherent in franchising, thereby maximizing franchise revenues.